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Amundi ASSET MANAGEMENT

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Investment Talk:

US-China Trade: Continuing the Talks While Making the War

INVESTMENT TALKS

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- *In our opinion, we should dismiss the idea that talks could breakdown, albeit uncertainties remain. On one side, in order to reach an agreement China wants the U.S. to remove all extra tariffs, set targets for Chinese purchases of goods in line with real demand, and ensure that the text of the deal is "balanced" to ensure the "dignity" of both nations.*
- *Controversially, we are actually closer to a deal more than a few months ago, from the perspective that both sides have made concrete efforts at middle- and low-levels, with day and night works towards details and wording. In other words, we are entering the final stage but probably the most difficult part, as the remaining issues are critical and tough decisions.*
- *Higher tariffs will hurt everyone, Chinese exporters as well as US consumers. However, based on different degrees of policy interventions, the impact on global growth and trade should be contained to a certain extent, while we do not expect an outright recessionary scenario either in China or in the U.S. Unlike from what happened in 2018, the authorities in China are now better equipped to offset the external shock and local sentiment looks less fragile; on the other side the Federal Reserve stance is more accommodative than it was last year. The countries more integrated with China in the production chain will suffer the most, while exporting countries that compete with China can benefit from increasing their exports share to the U.S. and from production relocation of certain manufacturing sectors.*
- *The consensus is that the economy in China will hit the bottom in Q2 this year; we think it may take a little longer than expected, actually. However, in our opinion some sectors may offer better value than other in the A-share market, as domestic demand will well work as a buffer against the damage caused by the tariffs and we will continue to see strong investments from the central government. We are constructive on consumer non-cyclical and technology companies.*
- *Within the Asian region, increased tariffs will inevitably have a significant impact considering both its high correlation with the global trade and the economic role of China in the area. The countries most impacted by tariffs might be Korea, Hong Kong and Taiwan, whereas India should be the least affected among the region's countries. Across sectors, the automotive industry is the one in the weakest position together with the rest of the industrial sector.*

- *In our base case scenario, with the U.S. and China finally reaching a deal, global economy recovering in the second half of the year, and central banks remaining accommodative, we look for episodes of market volatility that may create attractive entry points in markets with compelling valuations. Nonetheless, challenges remain across the board and, at this juncture, we suggest to maintain a cautious stance. In particular, we believe that a potential escalation of trade tensions is not fully priced in markets yet and, as a consequence, it would impact the short-term sentiment and trigger a major selloff in risk assets. However, this is not our base case scenario at the moment.*

Where do we stand in terms of US/China talks?

After the US raised its tariffs on $200bn of Chinese products from 10% to 25%, China announced retaliation measures on $60bn of US goods that will be effective from 1st of June. We should now wait for the U.S. to add more pressures with its plan to begin the process of raising tariffs on all remaining imports from China (roughly $340 billion), whose details were announced to be released shortly. According to reports, the U.S. told China to seal the deal in one month before facing tariffs on all its exports.

"Recent works have been on details and wording, while several major issues remain."

We started to get a clearer picture about what happened in these last days by combining latest information from both China and US sides. Recent works have been focusing on details and wording, with majority of the document having been done. Several major issues still remain, which will be largely up to Trump and XI to make final decisions. In particular, Chinese Vice Premier Liu He revealed for the first time that in order to reach an agreement the U.S. must remove all extra tariffs since last year, set targets for Chinese purchases of goods in line with real demand (this last Liu's comment revealed that U.S. push for bigger Chinese purchases to level the trade imbalance than had originally been agreed at G20), and to ensure that the text of the deal is "balanced" to ensure the "equality", "dignity", and not to undermine Chinese "sovereignty". In other words, China felt that the deal would be too imbalanced with China to make almost all concessions while US makes little in return, which would be difficult to be accepted by locals.

Are they far or closer to reach a deal in your view?

As of today, there are limited hopes to reach an agreement in the very near term, given newly increased tariff and Chinese retaliation, coupled with tough stance from both sides. However, at least for now, it seems that neither sides wants a complete breakdown, reporting that negotiations will continue. While China looks still very keen to reach a deal, it looks that US will probably have to make certain concessions.

"We are actually closer to a deal more than a few months ago, but the talks are probably entering in their most difficult part."

Controversially, looking from a longer time horizon, we are actually closer to a deal more than a few months ago, from the perspective that both sides have made concrete efforts at middle- and low-levels of officials, with serious works done on details and wording. In other words, we are entering the final stage but probably the most difficult part, as the remaining issues are critical for tough decisions. China has been acting cautiously - although vowed retaliation, but measures have been delayed to announce, which seems to avoid further serious escalations and to leave room for further negotiations. Moreover, Trump's top economic adviser, Larry Kudlow, stated that U.S. representatives have been invited to Beijing for the next round of talks (although there's no a detailed plan yet) and also emphasized the possibility that presidents Trump and Jinping will have a cordial meeting at the June 28 G-20 meeting in Osaka. On the other side, there are also risks that US will keep firm in its stance and China is willing to take further pains, which could lead to tariffs on the rest of $300bn of Chinese products. In such a case, it would add huge pressures on both sides.

"Higher tariffs will hurt everyone, Chinese exporters as well as US consumers."

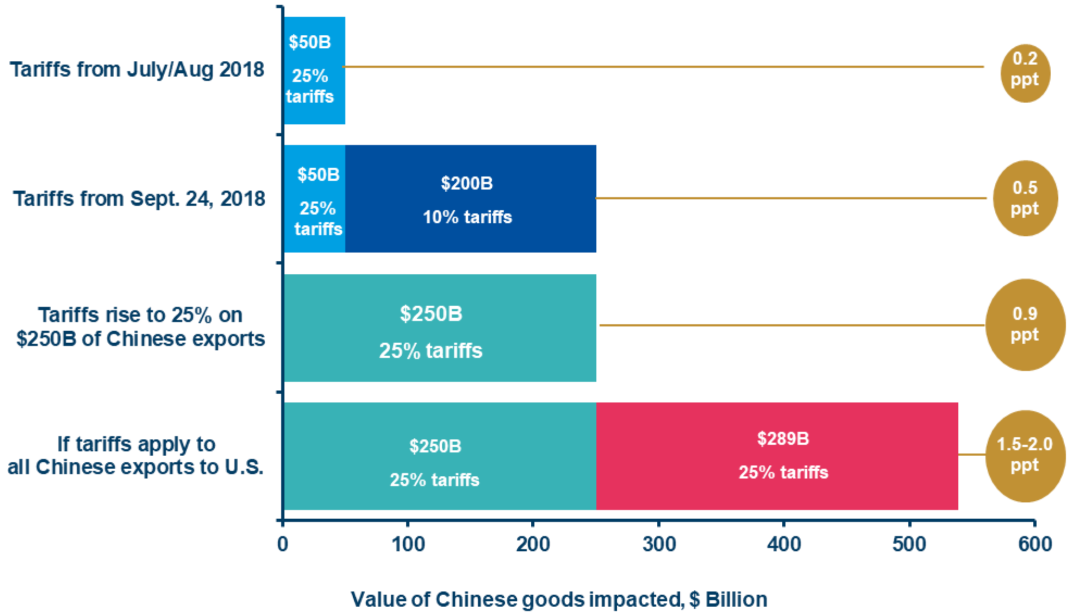
What is your assessment of the potential impact of new tariffs?

Overall, uncertainty has increased with regard to a risk that most of the investors and analysts thought had reduced and was on the way of some sort of solution. Higher tariffs will hurt everyone, Chinese exporters as well as US consumers. With a possible delay of one or two months, inflation in the U.S. will be impacted as more as a larger number of consumer goods is under the tariffs and as longer as the US companies will take to change their supply chain. The capacity of US corporates to absorb the increased costs will impact their bottom line. However, based on different degrees of policy interventions, the impact on global growth and trade should be contained to a certain extent, while we do not expect an outright recessionary scenario either in China or in the U.S. Unlike from what happened in 2018, the authorities in China are now better equipped to offset the external shock and local sentiment looks less fragile; on the other side the Federal Reserve stance is more accommodative than it was last year. A reassessment of the outlook will be necessary, should the tariffs on the remaining imported goods (roughly $300bn) occur.

"A reassessment of the global outlook will be necessary, should the tariffs on the remaining imported goods occur."

Considering the wide spectrum of goods involved (about 6,000 products), we reiterate the view that there may be different channels of reaction to such decision. The countries more integrated with China in the production chain will suffer the most, while exporting countries that compete with China can benefit from increasing their exports share to the U.S. and from production relocation of certain manufacturing sectors. Vietnam and Mexico are among the countries that may benefit, with some caveats always related to the U.S. foreign policy. Vietnam could be included among the currency manipulators list (if that list will be enlarged and some parameters further narrowed), while Mexico is still waiting for the USMCA ratification by the Congress.

Tariff impact on the Chinese economy



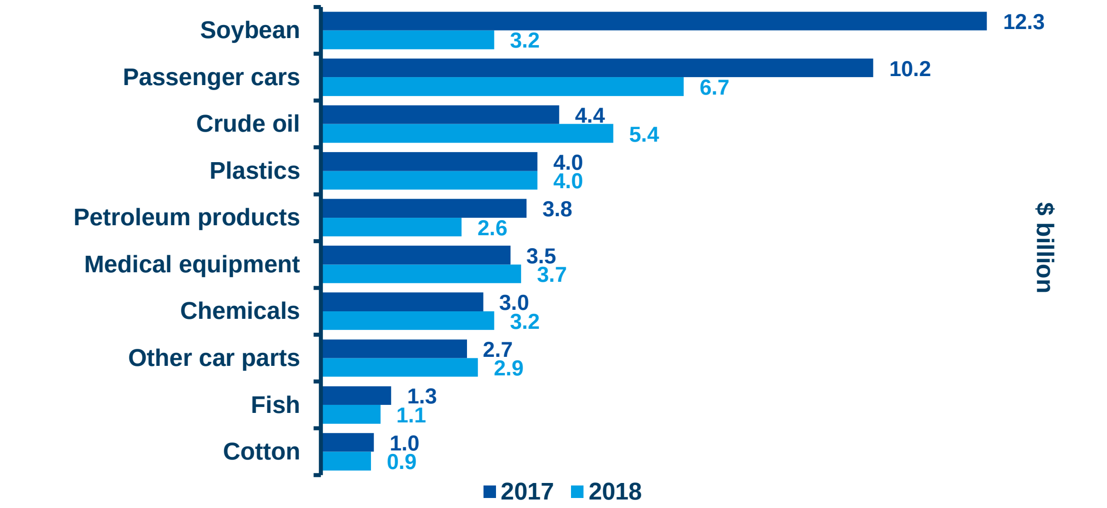
Source: Bloomberg, U.S. International Trade Commission, Amundi. Data as of 10 May 2019. Note: bubbles show cumulative impact on annual growth

"Our base case scenario is still of a moderate slowdown for China through policy interventions."

Has the recent imposition of increased tariffs changed our base case on China?

We continue to believe that China is on the right path to manage economic slowdown through policy interventions. In particular, China is in the middle of a comprehensive transition to a more balanced and sustainable economy, with policymakers fully engaged in a difficult and delicate balancing exercise of maneuvering deleveraging, preventing a disruptive slowdown (6% represents a sort of threshold level for the market), correcting the misallocation of capital, and intervening with the right stimulus. The transition of climbing the value chain and moving away from an investment- and export-led growth model to a focus on domestic sectors and consumption (though still very much in progress), if successful, should finally result in the economy becoming more resilient and less exposed to cyclical swings.

Top 10 items in U.S. exports to China facing tariff hike



Source: U.S. Census Bureau, Amundi. Data as of 10 May 2019. Note: Agricultural tariffs were imposed in Jul. 2018, most other in Sep. 2018.

"Increased tariffs can have a heavy impact on the Asian region, especially in the auto sector. Watch out for the Asian currencies."

Which countries and sectors are most at risk in the Asian region and what could be the next issues for investors to watch, if any?

Increased tariffs can have a significant impact on the Asia region considering both its high correlation with the global trade and the economic role of China in the area. The countries most impacted by tariffs might be Korea, Hong Kong and Taiwan, whereas India should be the least affected among the region's countries. Overall, the globalization trend has benefitted most of the Asian countries in the past 25 years and now they will inevitably feel the pain of the stalling of the trend. Across sectors, the automotive industry is the one in the weakest position together with the rest of the industrial sector.

The main Asian currencies vs US dollar are definitely a very relevant factor to monitor. The Hong Kong Dollar (HK$), the Chinese Yuan (RMB), and the Korean Won (KRW) have started to show signs of weakness recently and, as long as those currencies remain weak, the "risk-off" scenario for emerging markets equities will be on play.

How do you think it is worth positioning in the China's equity market?

Foreign investors started to lighten positions few weeks ago given the poor results expected in Q2, while local investors were less keen to close positions and take profits. In general terms, the consensus is that the economy in China will hit the bottom in Q2 this year; we think it may take a little longer than expected, actually.

"In our view, A-share stocks may offer better value as some sectors will continue to see supportive domestic demand and strong public investments."

In relative terms, we think that the A-share market is riskier than the H-share market at the moment, with the former attaching an expectation of a further 5% correction in the next three months. However, in our opinion, some sectors may offer better value than other in the A-share market, as domestic demand, well supported by an expansionary fiscal policy, will well work as a buffer against the damage caused by the tariffs. Furthermore, sectors like education, pharmaceutical, semiconductor, and information technology will continue to see strong investments from the central government with the aim to reduce the technology gap with the U.S. As far as our sector preference, we are more constructive consumer non-cyclical and technology companies, whereas we are less constructive on financial, communications consumer cyclical and energy industries.

Do you expect major movements of the Chinese yuan against US dollar?

For now, we expect the Chinese yuan (RMB) to move in the range of 6.7-7.0 per US dollar, but without breaching the resistance level of 7.0, perceived by the market as a dangerous threshold. We believe policymakers are prepared to intervene if necessary (capital control has been tightened since last year). Chinese policy stimulus is supportive for domestic sentiment, as well as a boost to portfolio inflows due to benchmark inclusion. In addition, the current account dynamics points towards more balance into the medium term and we don't see any sharp deterioration near term. If US/China talks shouldn't go relatively smoothly, with US starting to apply tariffs on the rest of $300bn of Chinese products, there could be a real chance that China could let RMB to breach the level of 7.0.

US dollar to China Renminbi (onshore)

Source: Bloomberg, Amundi. Data as of 13 May 2019.

"Our base case remains that a deal between the U.S. and China will likely be reached, nonetheless we suggest to maintain a cautious stance in case of a potential escalation of tensions ."

What would you expect the markets might do in light of recent events and potential trade developments?

The escalation of global trade tension is clearly negative for risk assets. However, it seems that markets are on hold so far, waiting for the results of the talks and seeing the continuation of the negotiations as a clue that both parties are still keen to reach an agreement.

So far, albeit talks seem to proceed with slow progress, our base case remains that a deal between the U.S. and China will finally be reached, at least as long as we continue to see some encouraging signals coming from both parties letting us be confident that negotiations can continue (Xi wrote a "beautiful letter" to Trump, who then said that US-China relations remain very strong and that he feel China talks will be successful). That said, the path to a final deal could be tougher and longer than it once expected.

We should now expect markets to enter a consolidation phase, while trying to get at what the next developments might be and whether global and earnings growth will surprise on the upside or downside. In our base case scenario, with global economy recovering in the second half of the year and central banks remaining accommodative, episodes of market volatility may create attractive entry points in markets with compelling valuations, such as the European and the emerging stock markets.

Nonetheless, challenges remain across the board and, at this juncture, we suggest to maintain a cautious stance. In particular, we believe that a potential escalation of trade tensions (U.S. applies tariffs on all the remaining Chinese imports, China announces further retaliation, and even a full breakdown in negotiations) is not fully priced in markets yet and, as a consequence, it would impact the short-term sentiment and trigger a major selloff in risk assets. It is clear that recent macroeconomic improvements would also be jeopardized, should the negotiations fail, leading us to reassess our current growth and earnings estimates. However, this is not our base case scenario at the moment.

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