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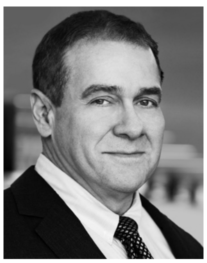
Global CIO Outlook
U.S.-China Trade War: The New Long March



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During the course of the last two years, we have consistently indicated that the course for the U.S. economy, along with risk assets and rates, was contingent on the impact of any unexpected exogenous events, most likely from overseas. Of all the exogenous events that could possibly derail our long-term economic and market outlook, a full-blown trade war with China is closest to being realized. Just a few weeks ago, Washington and Beijing appeared to be close to an agreement. The subsequent breakdown in talks and tit-for-tat tariff escalations have put the world's two largest economies on a collision course to a full-scale trade war. The United States has announced an increase in tariffs on $200 billion of consumer and other goods from 10 percent to 25 percent, with threats of further tariffs to come. China followed suit with its own schedule of increased tariffs on $60 billion of American-made products.

Given the limited historical precedent, it is difficult to predict if this face-off will continue long term or be resolved quickly. By all reports, neither the Chinese nor the Trump administration seem prepared to blink, but rather than rely on the press for insight, we decided to do some of our own digging. We recently talked to several China-based portfolio managers and a supply chain manager to learn more about the U.S.-China standoff. The main takeaway from our notes below: The Chinese are buckling up for a long ride.

- Beijing is preparing for a protracted standoff. The leadership has concluded that the intention of U.S. negotiators is not just to resolve trade imbalances but also prevent China from moving up the value chain, a key long-term objective for the Chinese.
- Tariffs on the remaining $300 billion of Chinese products would hurt China, but the United States would also feel the pain. Profit margins for consumer goods manufacturers average less than 5 percent. U.S. importers would either have to pay the tariffs, charge their customers more, or find suppliers elsewhere.
- The short-term impact on China could be smaller than previously expected. Factories that sold only to the United States have developed new markets over

the past year. Even if those factories stop exporting to the U.S., they will not go bankrupt immediately. It helps that the service sector is experiencing a labor shortage and could absorb some slack. For example, in China a delivery man sometimes makes more than an average office worker.

- Huawei will not be a part of any negotiations. Beijing thinks that Huawei is more of a political issue and would be targeted whether or not they make concessions on trade.
- The best policy response for the Chinese is to open up the domestic economy and have the state retreat from competitive sectors. Our sources see the tax cuts as an essential step in reducing the government's role in allocating resources, and that the pressure from the United States could ultimately force Beijing to seek a solution that makes the economy more productive.
- There has been a significant shift in the way that Beijing manages nationalist sentiment inside China. Until May the government had been trying to contain hawkish views on the U.S.-China relationship, but now they are just letting it grow. (See Chinese Trade War Fight Song Goes Viral.) Not only does this demonstrate that Beijing does not expect any short-term solution, because the negative sentiment will make it difficult for President Xi to make concessions, it also allows China to harden its diplomatic position given popular domestic sentiment.
- As for whether the Chinese are front-loading shipments to the United States to avoid pending tariffs, port data and local analysts indicate this has not yet happened. Shipments to the United States and shipping prices have dropped since the new tariffs were announced. The pending tariffs could cause some front loading, but it would be hard to beat the latest round of tariffs because they were imposed a few days after the announcement. Only products shipped before the new tariffs' effective date are exempt.

The consequences of a protracted trade war are manifold. The economic impact includes a drag on economic growth, import price inflation which will allow U.S. domestic and other foreign policy makers to raise prices, and the knock-on effects to other trading partners as the shuffle begins to find new sources and markets for different products. Researchers at the New York Fed have determined that the new round of tariffs on Chinese products will cost the typical American household an additional $831 per year. Trade barriers between the world's economic superpowers will slow global growth and put political pressure on all affected governments, stoking increasing nationalism and protectionism overseas while increasing inflation and reducing living standards at home.

The investment implications of a protracted trade war are still playing out. We have seen how sensitive markets have been to the trade news, with a strong risk-off bias resulting from adverse developments in the fourth quarter. While volatility will continue, there is no indication that the Chinese will attempt to liquidate their large holdings of U.S. Treasury securities. To do so would only drive down the value of the dollar, which would run counter to Beijing's desire for a weaker yuan. There is also no imminent change to monetary policy from the Federal Reserve as a result of trade saber-rattling, but if the financial markets begin to spiral out of control because of tariffs, then we could see a repeat of 1998, when the Fed eased as a result of the Asian financial crisis. With neither side apparently willing to step back from the brink, investors should be discounting a higher probability for a drawn-out fight.

At this point I have to pause and consider current facts and wonder why risk assets continue to hold up under the looming risk of a full-scale trade war. I am struck by the recent statement by Xi Jinping during his domestic tour to Jiangxi, a remote location where Deng Xiaoping began the Long March during the Chinese civil war with the Nationalist Party government.

"We are here at the starting point of the Long March to remember the time when the Red Army began its journey," Xi said in his speech. "We are now embarking on a new Long March, and we must start all over again." The Long March lasted for over one year while the armies of Mao Zedong regrouped and ultimately won the war.

The conclusions are obvious. Unless the current trajectory is quickly changed, the Chinese are digging in for a long fight. The cost to the United States will be high; the cost to the Chinese will be higher. The only question is who will endure and be the most innovative in this battle of wills.

As I have written before in "No One Wins a Trade War," the short-term costs are likely to outweigh the long-term benefits regardless of who "wins."

In the meantime, sovereign bond yields around the world are sending an ominous message, which investors in risk assets ignore at great peril. Their demise is near unless men succumb to the "better angels of our nature." Those words were Abraham Lincoln's appeal in March of 1861, warning of the looming Civil War. Lincoln's warnings fell on deaf ears, and today I fear that my recent warnings are receiving the same fate. In the words of Winston Churchill: "Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning." Let us take Churchill's words to heart.

The time has come. The war is at hand.