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SPECTRE OF TRADE WARS RATTLES MARKETS

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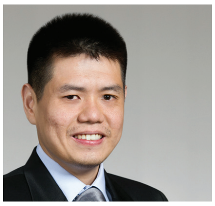

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The US administration's decision to slap trade tariffs on USD50bn worth of Chinese imports has rattled financial markets. The move to introduce tariffs should not come as a surprise given that one of President Trump's key campaign promises was to correct US' trade deficit, with China being a key perpetrator.

We have seen China's preliminary reaction; firstly, in our opinion the tariffs are aligned with the previous tariffs on steel and aluminum and secondly the petition to World Trade Organisation ("WTO") suggests restraint and consensus building.

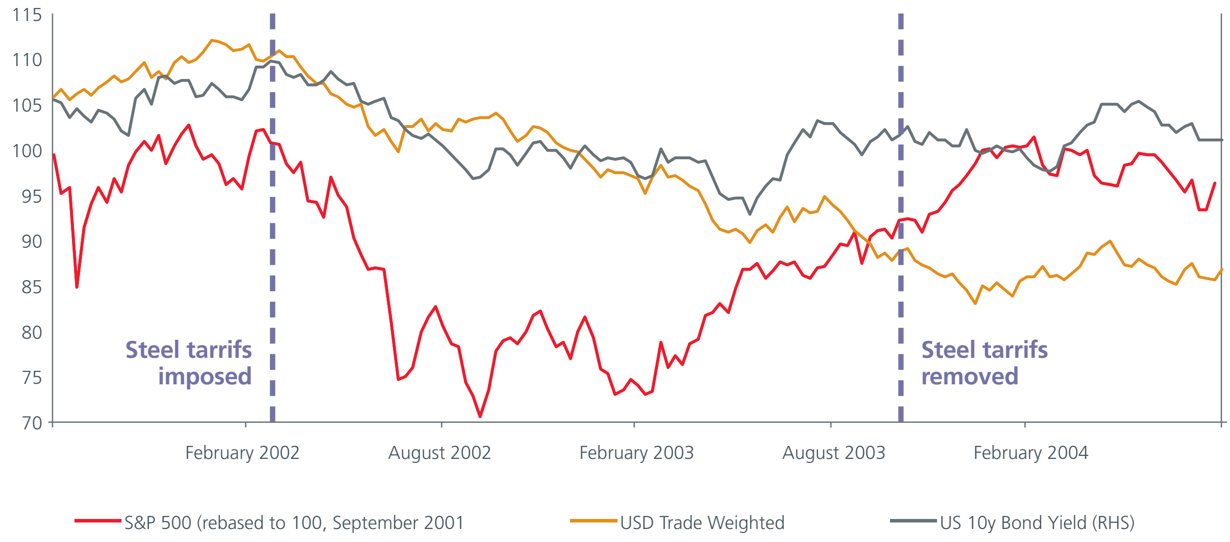
Thus far, investors have become nervous about possible escalation, triggering market volatility in the near-term. Longer-term, however, the wider implications of a "tit-for-tat" trade war and its knock on effect to the global value chain are legitimate concerns.

US TARIFF JUSTIFICATION

A 2011 report published by the US International Trade Commission argued that China uses a range of practices to force companies to transfer intellectual property ("IP") and that Chinese entities engage in theft (according to President Trump) of US trade secrets to become a leader in advanced manufacturing and artificial intelligence. The report also stated that if China matched US levels of IP protection, it would likely create 923,000 US jobs and increase US exports and affiliated sales to China by approximately USD107bn per year.

US businesses in China have long complained about being forced to hand over technology as the price of gaining access to the market. The US administration has also criticised the generous support given to Chinese state owned enterprises, arguing for the implementation of more market reforms, including the opening up of sectors of the economy to more foreign investment.

Fig.1: US equities and yields took a hit the last time steel tariffs were imposed[1]



POSSIBLE OUTCOMES FROM THE 301 FINDINGS

In Aug 2017, the US Trade Department - under President Trump's instructions - formally initiated an investigation on China under Section 301 of the Trade Act of 1974 to determine whether acts, policies, and practices of the Chinese government related to technology transfer, intellectual property, and innovation unfairly discriminated against or burdened US trade. The findings will likely be released in April and possibly activate:

1. Tariffs and quotas against a range of Chinese products in the high tech sector; the obvious targets include telecom, computer and other electronic equipment which account for approximately half of the bilateral deficit.
2. Restrictions on China's foreign investment in certain sectors of the US economy; Broadcom's blocked bid for Qualcomm is already one such example.
3. Restrictions on US visas granted to Chinese individuals, including student visas.

DIRECT AND INDIRECT IMPACT OF TARIFFS

The direct macroeconomic impact on China is likely to be modest initially as the proposed USD50bn is roughly 10% of US imports from China. A UBS research estimates that a 10% tariff on all Chinese exports will only shave 0.3-0.4 points off China's GDP growth; the caveat being the largest sector (telco equip/phones) has very little domestic value add as the factories assemble the parts for re-export. China also has a well-diversified export market and does substantial trade with Asia, Europe and Japan.

Within Asia, however, Korea and Taiwan (linked to China supply chain) will likely be negatively impacted by the US tariff move, while Malaysia and the Philippines (China competitors) may see a net benefit. Any trade war, however, will likely hit emerging markets ("EM") as its growth is closely linked to global trade volumes. A forceful application of protectionism would harm international trade volumes and impact overall EM economic growth, which has far outpaced developed market growth over the past 2 decades.

Fig.2: Changes in Average Tariff and Annual GDP Growth, 1990-2015[2]

The indirect impact is harder to quantify and ultimately could prove more influential. An actual trade war would also have a secondary impact on financial markets, undermine business and consumer confidence. US sectors sensitive to trade retaliation, such as agriculture and aircraft production, would likely be affected. The denial of access for US companies to key growth markets in China will pose another significant headwind. The impact of US economic growth is undeniably negative in such a scenario - it's merely a question of how much. From a US perspective, any counter tariffs from China will have minimal effect on exports. Many of the US high tech industries are already protected by policy directives; selected US companies are banned from exporting to China.

OUR TAKE

We do not expect an immediate implementation of the tariffs as US industry could be petitioned. The goal will be to sound tough on trade but minimise the impact on US consumer. Other announcements by President Trump have either been rolled back or watered down. The end game, from the US perspective, is designed to move negotiations and extract economic concessions from China at a faster pace, and ultimately reduce the US-China trade imbalance by USD100bn.

It is also unclear whether the Trump administration intends to move against China without first going to the WTO. It could argue that its concerns about China's IP policies and practices do not involve a WTO trade agreement and that the 1974 Trade Act empowers the US President to respond to a foreign country's unfair trade practices. Still, such unilateral approaches are not in US' favour; a significant trade war would destabilise global equity markets and impair the Trump administration's "market scorecard". We should note that depending on which goods China, Europe and Japan intend to raise import taxes, this may erode Trump's support base ahead of the US mid-term elections in November.

Risks of a full-blown trade war remain contained for now. Longer term the imposition of trade barriers and restricted information/people movement will increase friction, which could change the trajectory of global growth.

Sources: [1]Bloomberg and Eastspring Investments, 22 March 2018. [2]IMF, UNCTAD, WAO. Note: Data span 46 Advanced Economies and Emerging Market countries for which there are consistent annual data on average tariff rates for 1990-2015.