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US-China trade war escalates

Recent developments

Last week, on 10 July, the US Government announced plans to implement tariffs of 10% on a further $200 billion of China's exports to the US. This follows the anticipated commencement of 25% tariffs on around $50 billion of China's imports to the US on 6 July (and the expected matching response by China). The extent of the move was widely unexpected by analysts and the market. While further tariffs had been threatened by the Trump Administration, only a list of potential targets was expected to be released.

Instead, last week's announcement went materially further, with the US commencing the legal process to impose these new tariffs. Moreover, the US took steps to expedite the process, announcing the new tariffs would be a 'supplement' to the existing Section 301 intellectual property case. This allows the US to implement these tariffs before the end of September this year, against market consensus that any new tariffs would be subject to the usual 360-day window for negotiation and implementation.

Macro-economic and market impacts

The impact of the initial $50 billion trade stoush on the global outlook, and the US and China economies, is widely seen as inconsequential. Impacts on growth centre on just 0.1 percentage point for both the US and China economies. Were this to be the likely peak of the trade impost, as has been expected, it would present little headwind for risk markets to continue to grind higher.

However, last week's escalation by the US has materially increased the expected economic costs, as well as the potential for markets to react negatively. As World Trade Organisation Director-General Roberto Azevedo recently commented, the "continued escalation (in new trade-restrictive measures) poses a serious threat to growth and recovery in all countries".

UBS has modelled the impact of moving to the next stage of the US-China trade dispute, being the US implementation of tariffs on a further $200 billion of US imports, together with full-retaliation from China, including non-tariff barriers and potential imposts on US corporate activity in China (given China only imports around $150 billion of goods from the US). UBS estimates this could:

- cause global growth to slow to 3½% from its current robust 4% pace;
- see a correction in US and European equity markets in the order of 10%; and
- underpin a renewed rally in global bond yields, as global growth and central bank policy expectations are revised lower.

Were the escalation of the trade dispute to transition to a full trade war, including the US implementing tariffs on all China imports with proportional responses from China, the impacts could be even more significant.

We continue to watch developments

We are not there yet. While narrow, the path to some de-escalation of this trade dispute exists. Much will depend on the public hearings on the proposed tariffs in the US, slated for 20-23 August, as well as China's response to them. Markets are speculating, rightly or wrongly, that China's retaliation will be less than proportional (in part due to its more limited imports from the US). This increases the possibility of 'de-escalating negotiations' before this next larger round of tariffs is implemented by the end of September.

The substantial economic harm that could flow from a full trade war also increases the likelihood of a settlement. Negotiations between the two governments had progressed, and there is a reasonable chance, given the stakes at hand, that these negotiations can recommence. For now, we continue to monitor what is a highly fluid situation. Key will be the extent to which President Trump is prepared to trade US economic growth for rising popularity, ahead of the November mid-term elections in the US.

Asset allocation remains key

Unanticipated risk-off events, such as the current escalation in the US-China trade dispute, remind us to remain vigilant in ensuring our strategic asset allocation is appropriate. As we noted in our recent *Core Offerings*, the economic and asset cycle is maturing, reflecting our current tactical overweight to cash and liquidity, and our recent decision to increase our allocation to alternative assets. The risk of an unexpected weakening in global trade and production is also embodied in our recent decision to remain neutral on emerging markets, further underweighting domestic equities, a key beneficiary of positive global risk sentiment, while increasing our exposure to unhedged offshore equity markets, such as the US. Given the very recent increase in uncertainty and risks to the growth outlook, ensuring an appropriate strategic allocation to fixed income assets, in particular government bonds (as opposed to hybrids and corporate credit) is important to providing some protection of total returns should a further escalation of the trade war ensue.

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