PICTET WEALTH MANAGEMENT
ASSET ALLOCATION & MACRO RESEARCH
19 December 2018

US-CHINA 2019 OUTLOOK - TRUST BUT VERIFY

TENTATIVE DEAL POSSIBLE BY MARCH, BUT TENSION WILL LIKELY FLARE UP AGAIN

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SUMMARY

- Following the Trump-Xi dinner on 1 December, there are signs of goodwill on both sides, leaving the impression that a 'mini deal' is possible before the 1 March 2019 deadline set by the US. This could push back the threat of *additional* tariffs in the very near term.
- But we think the devil will be in the details, and particularly in the implementation details. Some sort of hiccup is likely to take place once we enter this phase, in our view.
- Long-term thorny issues, such China's economic (and technological) rise are unlikely to find an easy resolution – and there is perhaps not enough time to squeeze in these before the March deadline. These structural concerns could come back and haunt any 'truce'. Both countries are fundamentally on a different wavelength. Geopolitical frictions could also reverberate on the economics.
- President Trump has to tread carefully between the need to avoid inflicting too much harm on the US economy, while 'saving face' before his core voting base on a crucial 2016 campaign promise. Trade topics could help provide distraction from Democrats' likely deeper inquisition into Trump's 'dossiers'.
- As a result, we continue to think that in 2019, further tariffs are more likely than a removal of current tariffs. In other words, trade tensions are likely to continue to pollute economic visibility.

2019 could be another year of back and forth on trade tensions

The US-China trade tensions are likely to remain a major economic driver in 2019. But the outlook on this front remains fundamentally uncertain. Not helping matters are the lack of clarity around President Trump's priorities on trade policy, including with regard to China, his notoriously volatile personality and mood, as well as his constant Tweeting – which short circuits his own administration's line of command.

Another salient feature going into 2019 is that Trump will now have a divided Congress after the Democrats regained a majority in the House in the November 2018 midterms. While constitutionally trade falls under the remit of Congress, Congress has extensively delegated its powers to the US president in recent decades. Statutes dating back from the Cold War in the 1960s and the 1970s, give Trump a lot of leeway to act unilaterally.

In other words, trade is an area, like foreign policy, where Trump does not really need the approval of Congress – apart from when it comes to signing new trade agreements (like with Mexico and Canada, and potentially with the European Union in 2019-2020). Congress could still decide to 'take back control' of trade matters, but Democrats are most likely to leave that with Trump, which would be an implicit acknowledgement of his practices.

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The key here is that Trump has managed to put trade, as well as the question of China's economic and geopolitical rise, at front and centre of the US political scene. Even more importantly, Democrats have increasingly embraced Trump's more aggressive tactics (say, compared to predecessors Obama and Bush), and a consensus seems to have emerged that now is the right time to confront China's trade practices.

In addition, these calls are echoed by others on the geopolitical and military side to "contain" China's economic and technological rise.

John Bolton, Trump's National Security Adviser, recently outlined a US strategy that while aimed at Africa, really highlighted the need to contain China's role there – words that echoed a similar line of thinking by Vice President Mike Pence a few weeks prior.

2018 finishes with a thaw in the US-China trade relationship

After a year of tension (see *Box 2* for a recap), in the wake of the Trump-Xi dinner on 1 December 2018 in Buenos Aires, relations between the two leaders have thawed – even though US tariffs on Chinese imports remain in place, at least that rate is not set to rise on 1 January, as initially threatened.

Among the 'good news' since that dinner, China has accepted to lower the tariff rate on US automobiles, which it had jacked up from 15% to 40% in retaliation to initial tariffs from the US.

China also resumed the purchase of US soybeans, which was interrupted in July after the first US tariffs were placed on Chinese merchandise. It was also announced that a large state owned oil company would resume imports of US crude oil.

Meanwhile, a cycle of meetings has been scheduled, and China's Vice Premier Liu He spoke with his US counterparts to prepare the ground for a visit to Washington DC in January 2019, even though no firm date is in the agenda yet.

There has been some concern that the arrest of the Huawei's CFO over alleged violations on business with US-sanctioned countries, might hamper the truce, but the US administration has made clear that the arrest was mostly driven by the Department of Justice, i.e., unrelated to the talks on trade (the US administration was reportedly not aware of the arrest when they had the dinner in Buenos Aires). Trump even mentioned the possibility of himself intervening to ensure the arrest does not pollute trade talks.

A mini deal is possible before the March deadline

The problem with the March deadline is it leaves insufficient time to address all of the issues impeding the US-China relationship. Furthermore, it is unclear what the US really wants by then, i.e. what the deliverables needed are, and how these deliverables have changed compared with previous iterations.

Indeed, the US has repeatedly submitted a 'wish list' to Chinese authorities. US demands were particularly explicit during the official US visit to Beijing in May 2018. We know the talks did not end well, resulting in the imposition of tariffs over the summer of 2018 and again in September. This is the backdrop for today's pursuit of truce. It is possible that

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May's 'wish list' will serve as a basis for a mini deal by March 2019, although we are still in the dark about what will be emphasised.

It looks like the deal will most likely include 'hard' and 'soft' commitments. The low hanging fruits are promises to buy more US goods, including soybeans and oil. China could also commit to improving its intellectual property framework and dial back additional tariffs beyond those on US autos. The US could pull back on the threat to block the export of chips, processors and other technologically advanced goods to China.

Implementation will be key as major challenges remain

It is possible that the US will ask for quarterly meetings to continue checking the implementation of the deal, if any, since there will likely be vague commitments that necessitate follow-up. This could be where significant problems emerge, in our view.

On the trade side, if the US insists on China raising imports from the US by USD 200bn by 2020, as it did in May, it could prove overly ambitious (total imports from China are roughly USD 130bn today). We already know quarterly targets to reach USD 200bn would not be met.

On the reform side, China – fundamentally worried about falling into the 'middle income trap' – is unlikely to ditch its intention to grow its technology sector. President Xi Jinping reiterated this sentiment in a speech marking the 40th anniversary of Deng Xiaoping's "Reform and Opening Up", in which he said "No one is in the position to dictate to the Chinese people what should and should not be done," according to Bloomberg News.

How the relationship is managed also matters. Trade hawk and US Trade Representative Robert Lighthizer is now in charge of talks, rather than Treasury Secretary Steven Mnuchin, who was much more amenable to the idea of a deal and tends to focus on the brighter side of the relationship. Mnuchin, for example, resists blaming China as a currency market "manipulator" (in opposition to one of Trump's crucial campaign mantras). By contrast, Lighthizer is a China hawk and could set much higher targets than Mnuchin, lowering the chances of a truce holding.

A last bout of pressure on trade talks is likely to come from the geopolitical hawks, who are increasingly impatient and keen to show China a stronger hand. As mentioned, Bolton was the latest to hint at a strategy for China containment, at least in Africa (however the US officially rejects the use of the word "containment" and that it is pursuing such strategy). Vice President Mike Pence sharply criticised China in a speech at the Hudson Institute – which made particularly big waves given the usual detached role of US vice presidents – and then at the ASEAN summit, where his attack was directed at China's 'One Belt One Road' global strategy.

In short, we fear that the implementation phase of any mini deal agreed by the March 2019 deadline could fall short of US demands. A particularly contentious issue, in our view, is around requests on both sides to roll back the tariffs applied in 2018. This could give way to a fundamental conflict in interests since the US sees low tariffs on a portion of Chinese imports as a way of keeping pressure on China in the medium term, particularly in order to continue addressing its economic policy around state-owned enterprises (SOEs) and its intellectual property framework. This could create tension in

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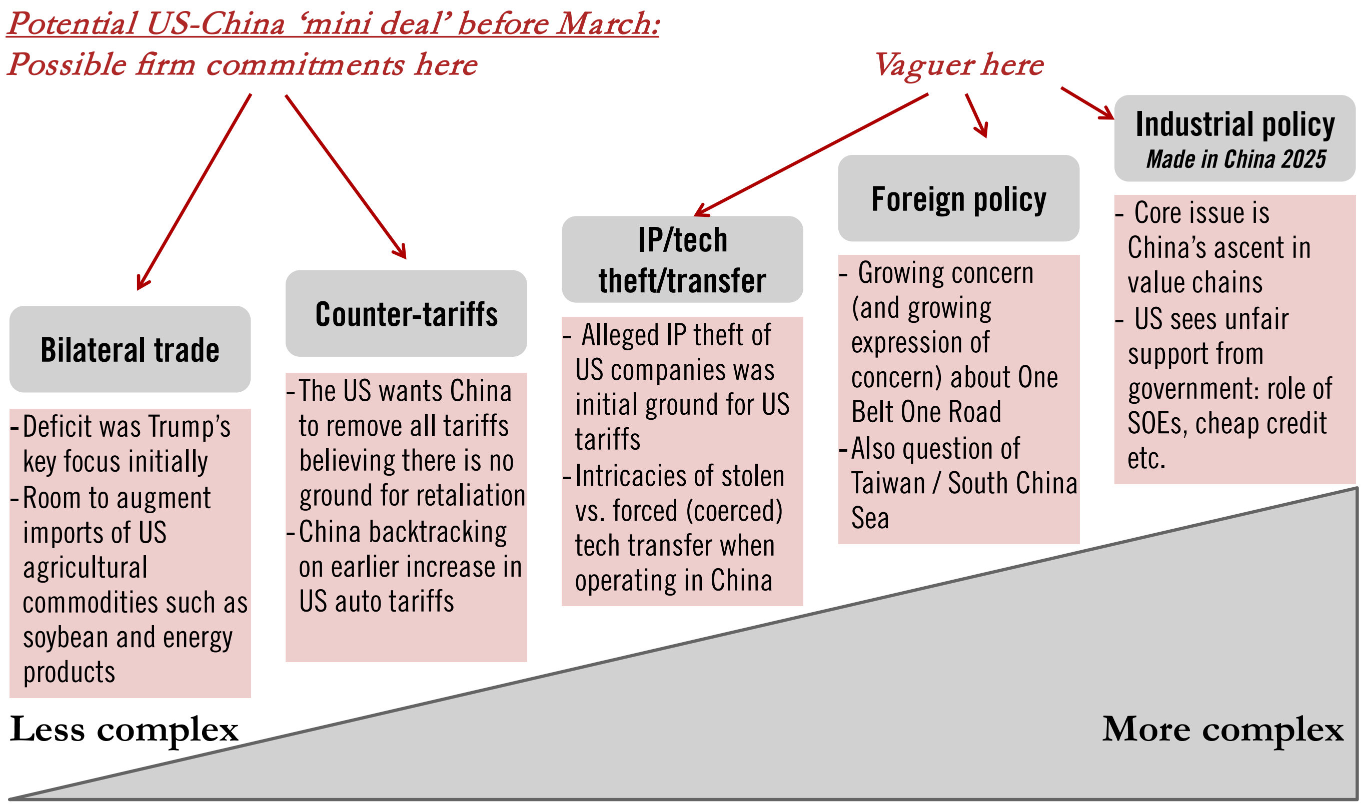
China. Ultimately, we see the US resorting to additional tariffs as a way of applying additional pressure on China.

CHART 1: ISSUES IN THE US-CHINA TRADE RELATIONSHIP, AND WHAT A 'MINI-DEAL' COULD LOOK LIKE



Source: Pictet WM - AA&MR

China's stance: Towards a more 'practical' approach

Since trade tensions between the US and China flared up in March, the Chinese government's stance seems to have changed considerably, from initial tough talking to a recent pragmatic approach to securing a trade agreement. In our view, the Chinese government is trying hard not to escalate the trade dispute to a full-fledged confrontation with the US, although a 'regime shift' probably has already occurred in the relationship between the two countries since Trump's election, with 2018's tariffs marking a watershed moment.

In the early stages of the trade dispute, the Chinese government had apparently misjudged the intention and underestimated the political will of the Trump administration.

It is not the first time over the past three decades that trade frictions between the two countries have arisen. However, in the past these tended to dissolve fairly quickly, by, for example, the Chinese government promising to buy more American products (such as aeroplanes and agricultural products) and/or addressing intellectual property concerns to some extent and/or talking market access.

This time, however, is different. First, the magnitude of the Trump administration's requests is unprecedented. For example, the request that China increase imports from the US by USD 200bn was considered simply impossible by the Chinese government.

Second, the scope of US requests, which goes well beyond the trade area and challenges China's economic model (such as China's industrial policy, subsidies to SOEs and the "Made in China 2025" plan), is likely far beyond the Chinese government's expectations.

Initially the Chinese government did not seem to realise the seriousness of such demands, assuming rather that they were being used as a bargaining tactic. Nor did it appreciate the political will of the Trump administration, given in the past, when such trade frictions arose, business lobby groups would quickly swing into action and put pressure on the White House to reach a quick resolution.

However, the Trump administration is obviously no traditional US administration (it is itself probably marking a 'regime shift' for US politics), and the presence of the China hawks in the White House is probably at its highest in the last three decades – to name but a few: Commerce Secretary Wilbur Ross, Economic advisor Peter Navarro (the author of '*Death by China*') and Trade Representative Robert Lighthizer. A considerable anti-China sentiment was also sparked by the then advisor Steve Bannon, whose influence remains significant even after his White House departure.

As a result, the Chinese government's initial stance towards the tariff threat was quite tough. On the one hand, it promised to retaliate against any tariffs on Chinese goods with the same scale and intensity. On the other hand, its negotiation strategy was focused mainly on increasing purchases of US products, while making few concessions on other US requests.

However, the quick escalation of tensions, combined with the sharp deceleration of the Chinese economy since Q2-2018, has prompted the Chinese government to reflect on its policy. It has gradually shifted to a more 'practical' approach.

First, in July, when the US threatened 10% tariffs on USD 200bn of Chinese imports, the Chinese government abandoned its earlier commitment of retaliation by equal scale and intensity. Rather, China imposed tariffs only on USD 60bn worth of US goods, with an average tariff rate of about 7% – although in theory it could impose tariffs on all remaining US imports, which are roughly USD 100bn.

Second, after the Trump-Xi dinner there is no longer outright denial of US accusations of China's "technology theft" and "cyber intrusion" in the official Chinese media (although there was no admission either). Instead, the government has taken a more pragmatic approach by agreeing to start negotiations on these issues and at the same time, quickly strengthened regulation to protect intellectual property.

Third, as a friendly gesture, the Chinese government has agreed to lower the tariff on US automobiles and start purchasing US agricultural products before any formal agreement is reached between the two countries.

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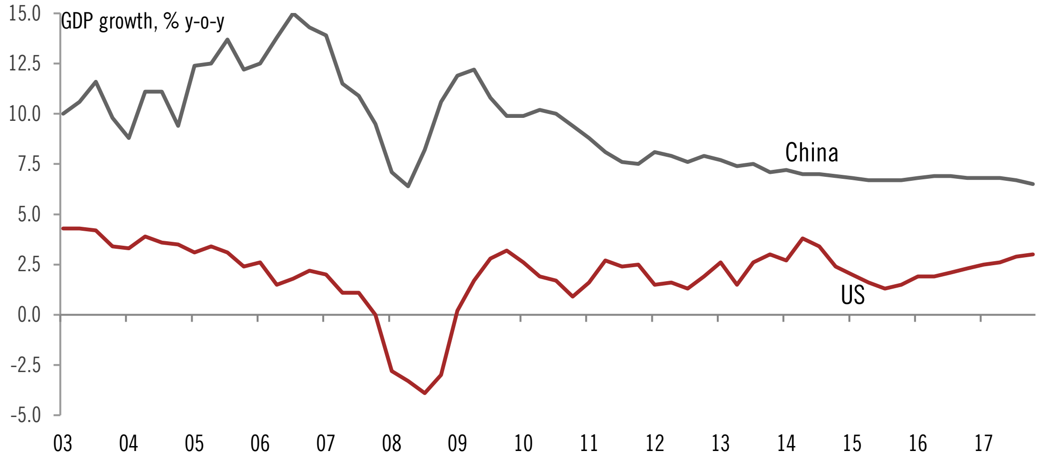
Finally, there are unconfirmed rumours that the Chinese government is willing to make some changes to the "Made in China 2025" plan, although we believe it's highly unlikely that the Chinese government would completely abandon such a plan.

CHART 2: THE GAP BETWEEN CHINA'S AND US' GDP GROWTH HAS NARROWED IN RECENT QUARTERS



Source: PWM-AA&MR, Bloomberg

BOX 1: US-CHINA TENSION REVERBERATES THROUGHOUT THE WORLD TRADE ORGANIZATION

The Geneva-based World Trade Organization (WTO) is feeling the heat of US-China tensions particularly. President Trump's coming to power has been followed by a much more assertive tone towards the WTO, as criticism has poured in. According to the US, the WTO is ill-equipped to deal with China's growing role in global trade, while its trade dispute settlement is biased against US interests.

Our participation in a WTO-organised conference in December offered a reminder of the most pressing US concerns. The US was represented there by Dennis Shea, an appointee of President Donald Trump who was previously the Vice Chairman of the US-China Economic and Security Review Commission (established by US Congress in 2000).

Dennis Shea took opposition against two aspects in particular. First, the Appellate Body (basically, the WTO's 'Supreme Court') has overstepped its boundaries in his view (it "moved away from what we negotiated" when establishing the WTO), its appeals process takes too long and it sets legal precedent when it should not. Put differently, Shea worries that the court judges are overstepping into the international negotiators' role – in other words that judges are getting too much power. The US has been blocking the appointment of new judges to the Appellate Body, pending reforms, which brings the Body to a slow death as judges gradually retire and are left un-replaced.

The second key focus is China, particularly over China's continuing to call itself a "developing country", which in the WTO's rulebook allows a differentiated treatment versus "developed economies" such as the US. This 'label' seems a particular irritant, as Shea challenged how China can still claim "developing economy" status when it is launching "a space programme and a lunar mission". China is not the only country to claim this status (the wealthy Singapore does as well, for instance), but Shea's belief is that this has to change now. Another irritation about China is its lack of transparency, including on its data on the various state subsidies to the domestic economy.

One panellist at the conference, and former WTO staffer, joked about whether his WTO pension would still be payed in coming years. This summed the feeling among participants up well, as doubts grow over the future of the WTO amid growing US-China tension.

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Trade tensions affect Chinese data

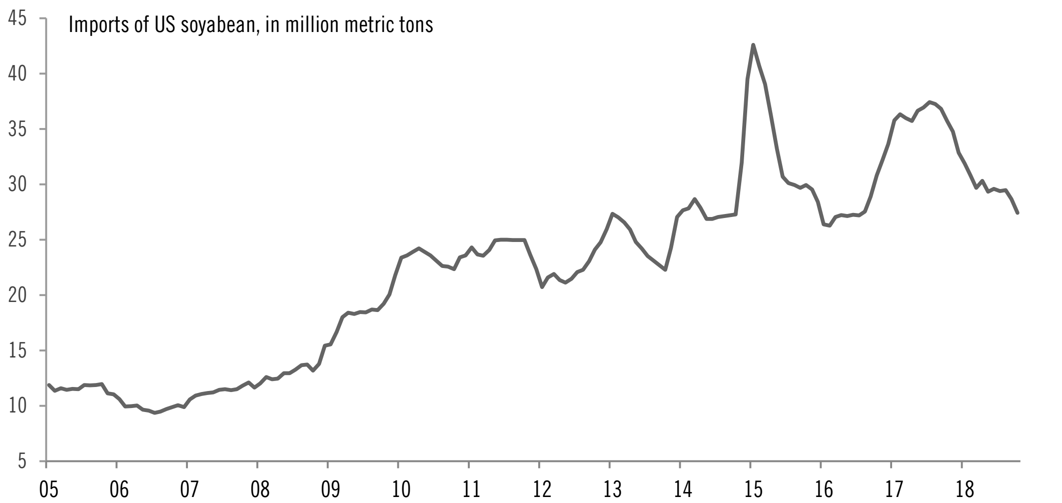
In our view, one of the major reasons behind the Chinese government's shift in stance is the sharp deceleration of the Chinese economy.

Since Q2 2018, economic data from China has indeed deteriorated significantly. The manufacturing purchasing manager index (PMI) started to decline in June, with the latest reading in November at 50, exactly on the expansion-contraction threshold. While a big part of the deceleration was domestically driven as the Chinese authorities embarked on a financial system deleveraging campaign, trade war concerns have likely also played a role. This is especially evident in the new export orders sub-index of the PMI survey, which was at 47 in November, the worst reading since November 2015.

Weakness is also evident in fixed-asset investment and consumption. Despite the government's policy easing, the improvement in infrastructure investment was still limited. For example, in the first 11 months of 2018, infrastructure investment grew by 3.7%, compared to 7.3% in the first half of the year. Growth in retail sales is also heading lower, coming in at 8.1% y-o-y in November, compared to 9.0% in June. Automobile sales are the main drag, with passenger car sales contracting by 13% in November, compared to 2.3% growth in June.

With the sharp decline in growth momentum, we think it is understandable that the Chinese government is turning more practical in trade negotiations and also more likely to show willingness to make concessions.

CHART 3: CHINA'S IMPORTS OF US SOYABEAN



Source: PWM-AA&MR, China General Customs Administration, Bloomberg

US business sentiment relatively resilient despite trade war news headlines

The surprise in the US this year has been the relative resilience of US business sentiment, despite the ongoing noise on the trade matters. The November manufacturing PMI was once again solid at 59.3, near the average over the past twelve months (59.2). However, recent signs of a dent to sentiment have emerged, although whether trade is the source of

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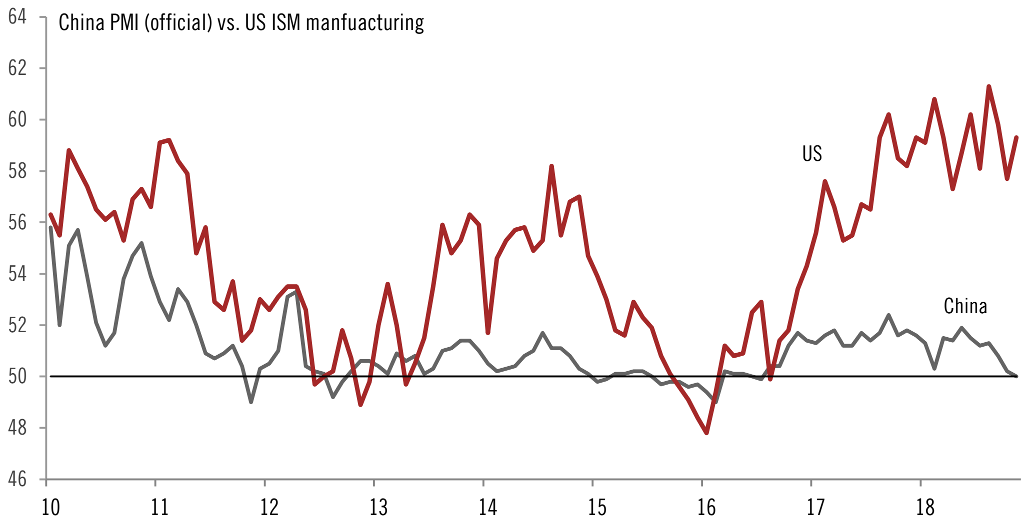
this erosion is difficult to ascertain. Indeed, there seems to be a triple whammy of a slowdown in European growth, falling oil prices affecting domestic energy related investment and a much weaker housing market (partly due to the rise in mortgage rates earlier this year).

While further oil price weakness could sap momentum (and remain the most important downside risk in the very near term, in our view), we remain relatively constructive about the US economy and still see near term recession risks as relatively limited. We see some potential upside surprise from private consumption, which seems particularly healthy at the start of the holiday shopping season (crucial statistics about December's trends will be available in January) and we think this could help partly offset the weaker momentum in housing. Even in housing, we think there are signs of a bottoming.

We remain watchful of financial market conditions however, as the recent US stock price weakness remains at risk of being self-validating by sapping consumer confidence (and therefore consumer spending) as well as business manager confidence. We will continue to watch the link between the financial world and the 'real economy' closely. Behavioural economics is key here as mere repeated talk of a recession, as well as poor headlines about the stock market, could start sapping confidence, and indeed lead into a slowdown.

CHART 4: COMPARISON OF BUSINESS SURVEYS (CHINA VS. US)



Source: PWM-AA&MR, Bloomberg

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CHART 5: US AND CHINESE STATEMENTS FOLLOWING TRUMP-XI DINNER ON 1 DECEMBER 2018

Issues	US statement	Chinese statement
Increase of tariffs	US will leave the tariffs on USD 200bn worth of Chinese imports at 10% for 90 days. The tariffs will be raised to 25% if an agreement is not reached by the end of this period.	Both parties agreed to hold off further increases in tariffs, but no mention of the 90-day deadline
Existing tariffs	No mention of any action regarding the existing tariffs	Both parties will work toward scrapping all tariffs introduced this year
Purchase of US goods	China will agree to purchase a not-yet finalised, but very substantial, amount of merchandise from the US and China has agreed to start purchasing agricultural products immediately	China will further open markets to, and increase imports from, the US. However, reaching a specific agreement on tariffs is the base and prerequisite for China to take the aforementioned positive measures. No mention of immediately starting purchases of US agricultural products
Intellectual property and cyber security issues	China has agreed to immediately begin negotiations on structural changes with respect to forced technology transfers, intellectual property protection, non-tariff barriers, cyber intrusions and cyber theft, services and agriculture	China will work to alleviate the relevant concerns in US-China economic and trade relations, but no mention of specific issues
Services & agriculture		
North Korea	Trump and Xi will strive to see a nuclear-free Korean Peninsula	Similar to the US statement
Taiwan	No mention of the Taiwan issue	Xi elaborated China's stance on Taiwan and the US agreed to stick to the "One-China" policy
Visits of both leaders	No mention of future exchange visits	Both leaders will visit each other at appropriate time
China students to the US	No mention of the student visa issue	The US welcomes Chinese students
Synthetic opioid Fentanyl	China has agreed to designate Fentanyl as a Controlled Substance	Similar to the US statement
Qualcomm-NXP deal	Xi is open to approving the deal	No mention of any such deal

Source: PWM - AA&MR, the White House, Xinhua News Agency

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BOX 2: RECAP OF THIS YEAR'S ESCALATING TRADE TENSION

2018 has seen a particularly sharp escalation in trade tensions between the US and China. While Donald Trump campaigned with strong rhetoric against China in 2016, repeatedly threatening to put tariffs on Chinese imports and criticising China's currency policy, some of his threats were actioned in 2018.

In March 2018, the US Trade Representative released a report estimating that China's intellectual-property practices harmed US companies by "at least USD 50 billion" per year following an investigation using Section 301 of the Trade Act of 1974 – a particularly wide-ranging statute, influenced by the Cold War backdrop and giving broad powers to act against foreign trade policies and practices that are "unreasonable or discriminatory" (a somewhat vague phrasing).

This was the legal basis for a 25% tariff on USD 50bn of Chinese imports applied over the summer and an additional 10% tariff on USD 200bn of imports from September 2018. The US also blamed China's retaliation to these initial tariffs in continuing to increase the tariff net. Total merchandise imports from China represented USD 505bn in 2017, meaning roughly half of all imports from China are covered by this year's fresh tariffs.

A mini truce between the two countries was agreed on 1 December, at a dinner during the G20 summit in Buenos Aires, which basically froze the threat of further tariffs, including the rate increase from 10% to 25% in January 2019 that was threatened by the US. The US pushed this threat out to 2 March 2019, wanting a trade deal by then.

Donald Trump's administration also put tariffs on global imports of steel and aluminium in March 2018, from which a limited number of countries were exempted (namely South Korea, Argentina, Australia and Brazil). The tariff rate was 25% on steel and 10% on aluminium. Imports from China were also caught in that tariff net. While the US has repeatedly blamed China for overcapacity in steel production, the tariffs in fact mostly hit US neighbours (and close allies) including Canada and Mexico, as well as the European Union. The formal legal basis for these tariffs was the fluid concept of "national security" (Section 232 of the Trade Expansion Act of 1962, another statute inherited from the Cold War). National security was also threatened to be used to limit imports of cars from Europe but this threat is still in limbo as of now.

Another front has been opened on tech exports, as well as sensitive investment into the US tech sector. Congress passed a law broadening and reinforcing the role of the Committee on Foreign Investment in the United States (CFIUS) – an interagency panel (chaired by the US Secretary of the Treasury) that can block company acquisitions on national security grounds. Officially, it does not target China per se, but unofficially, it is mainly aimed at it.

Meanwhile, confirming that the US-China trade tensions also circle around a power struggle on pioneering advanced telecommunications networks (including 5G networks), the US put an export ban of US technology (including US chips) to a major Chinese telecommunication network company. But a settlement with the company was found and the ban was subsequently lifted. Some members of Congress want to override the decision and keep the ban. There is ongoing anxiety among some members of Congress who would like to get more granular on US-China trade specifics, particularly on US tech exports to China.

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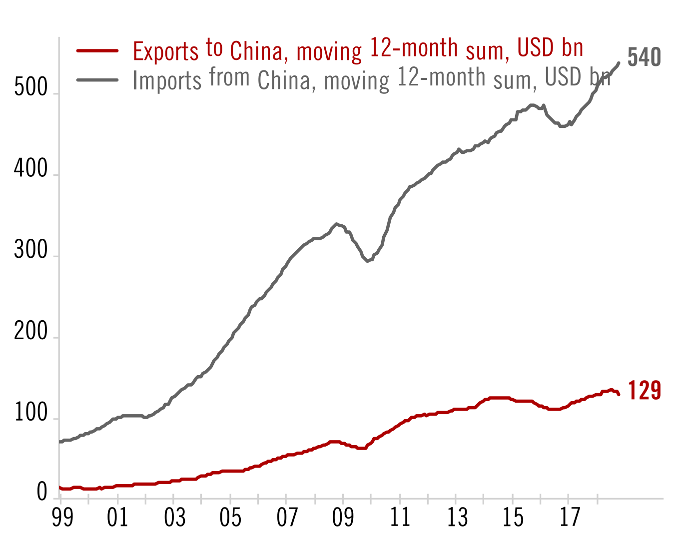
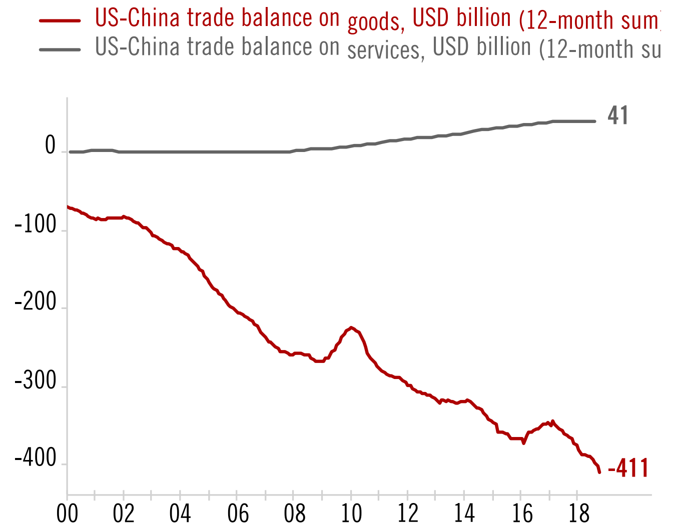
Appendix – Selected charts: US-China relationship

US TRADE WITH CHINA: IMPORTS AND EXPORTS, GOODS, USD BILLIONS



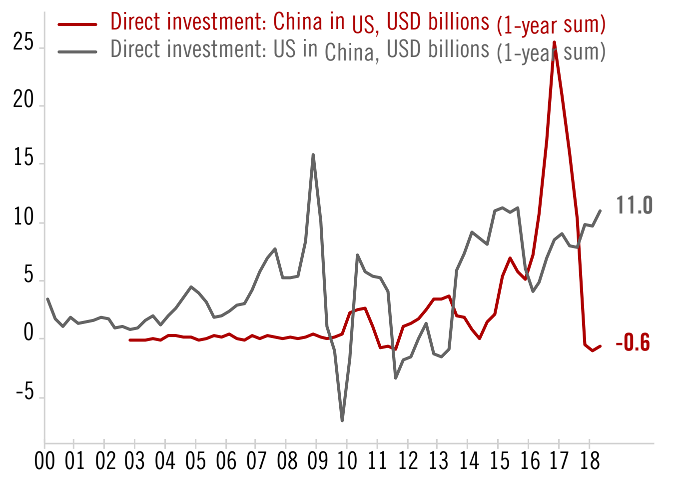
Source: PWM - AA&MR, Factset

US-CHINA TRADE BALANCE, IN GOODS AND SERVICES, USD BILLIONS



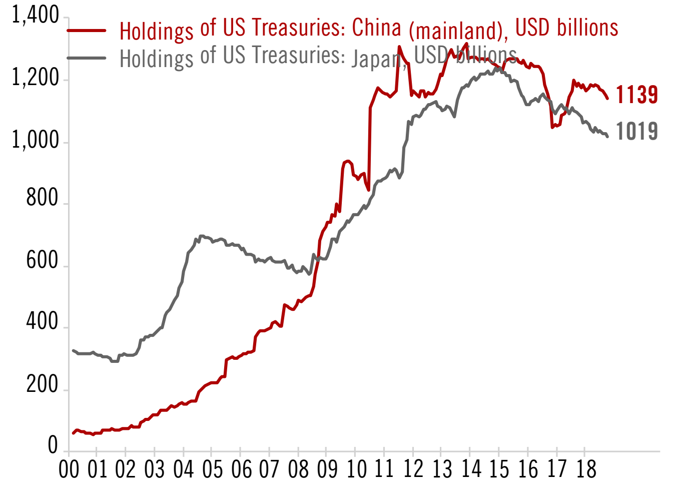
Source: PWM - AA&MR, Factset

US-CHINA DIRECT INVESTMENT FLOWS, USD BILLIONS



Source: PWM - AA&MR, Factset

HOLDINGS OF US TREASURIES CHINA VS. JAPAN, USD BILLIONS



Source: PWM - AA&MR, Factset

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