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From a trade dispute to a trade war. And back?

4 min to read

The U.S.-China dispute weighs on our strategic outlook, even though its initial economic impact is small.

In April, the market hoped for a resolution. Instead, the U.S.-Chinese trade dispute has moved on, via various retaliations, to a new, higher level: a war rather than a battle. The United States has now made it clear that this conflict is not just about import tariffs and trade surpluses, but also about global technological supremacy. And as the crisis has ramped up, the recent words and deeds of both sides have made face-saving de-escalation more difficult. Chinese statements protesting about "interference in sovereignty" and an "attack on Chinese honor" show that Beijing sees an escalation of the dispute.[1] Meanwhile, further U.S. sanctions are unambiguous provocations.[2] We believe President Trump's interests also speak against a short-term solution: the president is now thought to have a better chance of re-election if the conflict continues to smolder and he takes a hard line against China. It now seems to be a cross-party and social consensus in the U.S. that the thumbscrews on China should not be loosened.

So, it cannot be ruled out that 2019 will go down in history as the year in which the U.S. and China fought with open eyes for global (technology) supremacy for the first time. An increasing number of politicians in Washington and Beijing would probably no longer contradict this view. But what do the capital markets think? At the end of May, despite some heavy selling in the last days, a few stock exchanges were still trading in reach of their record levels. Is this serenity mere wishful thinking? Or does it show that the political noise from the dispute might be far greater than its actual economic damage? World trade is vital but the decline the dispute provokes will initially have a much smaller impact on global gross domestic product (GDP)<javascript:void(0)>. Most flows of goods will only be diverted. And the Chinese and U.S. economies are relatively closed, with a foreign-trade contribution to GDP of only 20% and 13%, respectively, and so the impact, at least in the short term, on the world’s two largest economies is likely to be much less severe than might be imagined. In fact, the Washington/Beijing fight might leave the two boxers relatively unscathed while unfortunate bystanders, such as South Korea or Germany, with their much more open economies, take the hit. On the equity side, meanwhile, a few blows might well land on individual sectors and companies, as has already been seen in previous sell-offs. But at the macro level, even if we consider a long-term political solution increasingly unlikely, global growth should stay on its feet over the coming twelve months and, in fact, not be knocked down much at all.

It is not so much the direct effects of past and potential future sanctions that are worrying, however – it's the indirect effects. As they watch the worsening trade fight, consumers and businesses could take fright. Manufacturing data looks punch-drunk already: it has been coming in worse for months as a result of the trade dispute.

Consumers, however, still seem to be in good buying spirits for the time being. But that could change if tariff increases keep pushing prices up. Another indirect channel of trade woe is financing conditions. These could deteriorate due to higher risk premiums, which would also be reflected in weaker stock markets. But a market knock-out could actually have its benefits. After all, it's falling U.S. stock markets that have so far proved to be the most effective corrective to the U.S. President's more unorthodox plans. One could call it the Trump put.[3]

Our overall view of the economy remains optimistic. We have only become a bit more cautious and have reduced our global growth forecast for the current year by 0.1% to 3.4%. We expect the Federal Reserve to refrain from raising interest rates any further and inflation<javascript:void(0)>ary pressure to remain moderate. This would lead us back towards the ideal conditions for capital markets – the goldilocks<javascript:void(0)> scenario. We will, however, be far from ebullient, and not just because of the trade war. In Europe, Brexit<javascript:void(0)>, Italy and populism are big worries. Meanwhile, China once again needs to support its economy with stimulus programs, and the debt situation both in China and the U.S. corporate sector has not become more solid and crisis-resistant. We therefore see our relatively optimistic central forecast scenario as being more at risk than in the past. And in the coming months we expect nervous markets. We are therefore focusing on carry<javascript:void(0)>, the income component of investments, rather than on rising multiples.

For the individual asset classes, this means that we do not see any increase in government-bond yields in the U.S. and only slight increases in yields in Europe. The central banks have announced they are going to move at a cautious pace on interest rates. U.S. Treasuries therefore continue to offer a good risk-return profile. That is not true for European government bonds, given prevailing low or even negative rates, but they do offer protection should markets turn bad. We continue to like corporate bonds, but are very selective in the U.S. high-yield area. We also continue to see emerging-market<javascript:void(0)> bonds as positive, but the trade dispute could have a negative impact here in the short term. For the dollar, we expect a sideways trend over the next twelve months. For the yuan<javascript:void(0)>, on the other hand, a declining export surplus could lead to further weakening, but we assume that Beijing does not want to let the currency depreciate too much. Equities naturally benefit from an environment of lower interest rates, but we believe most indices have come close to fair levels since the spring rally. We now see some of the lowest potential gains for share prices since the financial crisis. Our regional preferences are for the U.S. and emerging markets.

Look at our forecasts</en-pt/insights/cio-view/cio-view-quarterly/q2-2019/our-forecasts-201905/> to see our 12-month outlook in numbers.

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DWS Investment GmbH as of 5/31/19
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1. See for example: https://www.scmp.com/news/china/diplomacy/article/3011832/arrogant-demands-us-invade-chinas-economic-sovereignty-state
2. Numerous sanctions against individual Chinese companies; expansion of U.S. representation in Taiwan
3. In memory of the so-called Greenspan put

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