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In a nutshell

- Tariffs are taxes: the higher and longer tariffs last the more harm we expect to come
- Intellectual property protection and other China reforms require legislation
- The summer of tariffs: both the United States and China are expected to turn up the tariff heat
- Taking tactical action: we changed our signal so we expect that the next 5% plus S&P 500 move will be down, we reduce the EM allocation

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Americas CIO View

The summer of tariffs: the heat is going up, seek shade

Tariffs are taxes: the higher and longer tariffs last the more harm we expect to come

We expect the U.S. – China trade conflict to de-escalate in coming months, but this is unlikely in the coming days or few weeks. We expect China's delegation to return home without a deal, with both sides raising tariffs, and the earliest window for an accord being pushed out to the G20 meeting in Osaka, Japan at the end of June.

Before delving into the latest details of this intensifying trade spat, we keep in mind that tariffs are taxes and we get less of what's taxed. Tariffs tax trade and thus can smother an important source of productivity, that being the efficient allocation and specialization of labor at a global level. This makes higher and long lasting tariffs more damaging to gross domestic product (GDP) and profit growth than the mere shift in funds from producers and consumers to the government. Yet using tariffs tactically, and ultimately temporarily, to push China for more intellectual property protection and free market reforms could lead to an even more productive trade relationship by helping to shift trade from goods to higher value services and intangibles. It is this potentially positive result that kept us constructive, albeit a bit tense, while watching these risky tactics be employed since last summer. But now we are entering a period where progress must be made soon to prevent economic harm, diplomatic resentment, and the possibility of tariffs becoming entrenched.

Intellectual property protection and other China reforms require legislation

The U.S. is adamant about wanting better intellectual property protection and enforcement from China.¹ Proper protection requires legislation. Protections for technology and even medicines, which can easily stir political controversy in any country. Legislation takes time to craft and build a consensus for and simply may not come in one package anytime soon, but instead incrementally over time. Other U.S. asks include more liberalization and opening of China's financial system to foreign banks, reducing state owned enterprise subsidies, simpler rules and legal structures to facilitate foreign direct investment, currency stability, etc. These are things that China wants for itself too, but President Xi cannot just decree such changes overnight. Even if he did such things take time to implement without risking instability. That said, more speed is needed from China and more patience from the US to de-escalate.

¹<https://de.reuters.com/article/uk-usa-trade-china-idUKKCN1PX1ZS>
All articles are available on <https://go.dws.com/cio-view-articles>

The summer of tariffs: both the United States and China are expected to turn up the tariff heat

We expect the 10% tariffs just raised to 25% to stay in effect at least through June. The United States now puts a 25% tariff on 250 billion U.S. dollars (USD) of imports from China, which is nearly half of all imports from China. We expect China to retaliate quickly with details soon coming. The United States would need to make section 301² preparations to raise tariffs on remaining China imports. This would take at least a couple of months to implement and we still see this as unlikely. We are convinced that China will not turn to currency devaluation in response. We expect Renminbi support (USD/CNY) at about 7.0. China will employ further stimulative measures to mitigate weaker exports, these measures with the recent encouraging signs of soft landing³ keep 6% China GDP growth likely for 2019. The U.S. economy should be fine, but this conflict should weigh on manufacturing activity. There is more sensitivity at the S&P 500 to these tariffs than U.S. GDP. We estimate 3 to 5 USD of S&P 500 earnings-per-share (EPS) risk, vs. our standing 2019 estimate of 169 USD, should these tariffs go beyond June. As we noted in the past, we consider the Industrial, Material, and Energy sectors, as well as the Auto and Semiconductor industries most at risk to trade conflict.

Taking tactical action: we changed our signal so we expect that the next 5% plus S&P 500 move will be down, we reduce the EM allocation

By next week, we think it will be evident that it will take longer to reach an accord and that tariffs will be significantly higher while waiting. The cost and operational uncertainty that this will bring to companies is likely to cause the S&P 500 to fall to near 2725. But given the demonstrated resilience of the U.S. economy and profits over the past couple of quarters and low interest rates, we do not think the S&P 500 declines into a 10% plus correction. We think investors save further reactions until after the G20. We reduce our total equity allocation from 60% to 58% and raise our allocation to Treasuries. We cut emerging market (EM) equity exposure from 9% to 7%. While China is sensitive to exports, China's listed companies are more domestically driven. We expect their profits and also the CNY to demonstrate encouraging resilience to this second-quarter shock.

Appendix: performance over the past 5 years (12-month periods)

	04/14 - 04/15	04/15 - 04/16	04/16 - 04/17	04/17 - 04/18	04/18 - 04/19
S&P 500	10.7%	-1.0%	15.4%	11.1%	11.2%

Past performance is not indicative of future returns.

Sources: Bloomberg Finance L.P., DWS Investment Management Americas Inc. as of 5/10/19

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²Section 301 allows the President to take all appropriate action to get removal of any policy that violates an international trade agreement or burdens U.S. commerce.

³A soft landing is when an economy's rate of growth slows in a controlled fashion without major disruptive effects on employment, external balances etc.

Glossary

Correlation

Correlation is a measure of how closely two variables move together over time.

Devaluation

Devaluation is the forced reduction of the value of a currency against other currencies.

Earnings per share (EPS)

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Emerging markets (EM)

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

G20

The **Group of 20** are the largest industrialized and emerging economies in the world.

Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Renminbi (RMB)

Renminbi (RMB) is the currency of the People's Republic of China.

S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasuries

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

U.S. dollar (USD)

The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

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