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DWS

INTO THE TRENCHES?

There are growing signs that the current trade dispute could be the beginning of something worse.

IN A NUTSHELL

- Trade talks between China and the U.S. stumbled last week.
- A compromise might still be possible.
- But unless a deal can be struck quickly in the coming weeks, markets will need to prepare themselves for an extended period of economic trench warfare.

Over the past year or so, we have repeatedly described recent U.S. trade policy as "fundamentally misguided and frighteningly uninformed" (e.g. CIO Perspectives: Too early to panic as of 8/1/18). "So what?" we and others in financial markets have been asking for almost as long. As anyone who has ever bought a used car will know, one side being ill-informed can be quite helpful in getting to a quick, if not necessarily particularly satisfactory, deal.

In the case of trade talks between China and the U.S., there was certainly the potential for such a bargain. China would agree to buy more U.S. goods and services. Unlike the market economies of other countries, the Chinese state can still dictate to a large extent where goods are sourced, however damaging that might be to global economic efficiency. Simultaneously, China would make some policy changes, some of them purely cosmetic, but some of them bringing forward quite fundamental adjustments that make sense for the country anyways. Making intellectual property rights easier to enforce looked like one such example. U.S. President Donald Trump, meanwhile, would declare victory and enter the 2020 presidential election campaign with a win under his belt.

Such a benign scenario is still possible. But the probability of it materializing is probably receding by the day. Unless a deal can be struck quickly in the coming weeks, markets will need to prepare themselves for an extended period of economic trench warfare. And large listed U.S. companies in particular could well find themselves in the line of fire.

This reflects some worrying political trends in both the U.S. and China in recent months. In Washington in particular, there appears to be limited understanding of the incentives Beijing has to strike a deal – and how these are changing. This increases the scope for miscalculations, with potentially far reaching consequences.

The U.S. political economy around trade has shifted dramatically over the past three years, and probably continues to do so with every quarter that passes. 2020 is shaping up as a contest of who can be harsher on China between Mr. Trump and whoever Democrats end up nominating. Given that dynamic, delays increase the threshold any deal will need to pass to satisfy China hawks. Worryingly, even a growing number of traditionally China-friendly U.S. business leaders appear to be thinking that a short period of tariffs causing pain is a prize worth paying, if it results in long-term policy changes in China.[1]

So, what can China do to stop this dynamic? Up until now, its strategy appears to have been to wait, strategically inflict pain, delay and hope U.S. pressure eventually goes away. As "The Economist" noted its retaliatory measures so far already came with quite a high cost at home: "China's choice of tariffs seems designed to deter escalation at any cost. Only regimes with no voters to satisfy can run that risk. The lesson is clear: if you start a trade war, fight a democracy, not an autocracy." [2]

1 As Gillian Tett recently noted in the Financial Times, "even if the current war of words with China ends with a "deal", almost nobody thinks that the bigger fight will be off. Far from it: the Milken event heard endless predictions that China and America are heading for years of conflict due to fundamental strategic rivalries. This might seem obvious. But these words were not being tossed around five years ago; back then, executive chatter was all about global supply chains." See: https://www.ft.com/content/5a47e5f2-71b5-11e9-bf5c-6eeb837566c5

2 https://www.economist.com/graphic-detail/2019/04/27/why-you-should-never-start-a-trade-war-with-an-autocracy

Well, that hasn't worked and events of the past week appear to have changed that Beijing calculus. Given China's history during the past two centuries, its leadership is understandably reluctant to be seen to make "concessions" to Western powers under duress – let alone to simply allow a foreign power to dictate Chinese laws. And the mere fact that Washington would publicly make such demands reeks of national humiliation.

Instead it must now be tempting for Beijing to change tack. For one thing, China does have a much longer time horizon. Unlike Trump, President Xi and whoever else has influence these days in the Politburo over trade does not need to be overly concerned about what might happen in 2019 or 2020. Short-term economic and political pain might well be worth it – if it promises gains in 10 or 15 years, or conversely, if the alternative is much worse.

Of course, that is the mirror image of what some in the U.S. are hoping. And it is also precisely the sort of aggressive posturing in the hope of securing concessions that is often at the heart of escalating conflicts between states. The nature of trade wars (like actual wars) is that they foster nationalist sentiment and jingoism. The first shots are fired in the hope of quick victories. And before you know it, both sides are stuck in the trenches, with no obvious and politically feasible way out. That point, we fear, could rapidly be approaching. In the coming days and weeks. We will watch carefully for signs that the Trump administration is starting to understand the gravity and urgency of the situation – while preparing contingency plans and analyses in case that it does not. In the meantime, we would simply point out that the downside risks to U.S. equities for now outweigh the potential upside.

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