Manulife Asset Management

Market Note

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Bilateral negotiations soothe escalating trade tensions

The recently concluded second-round of trade negotiations between the US and China point to progress. While the two sides did not reach a formal agreement, they released a joint statement and agreed to postpone the imposition of tariffs while negotiations continued.

The pause in escalating trade tensions suggest that the mutual interests that binds the world's two economies may be greater than the appetite for mutual damage. Further negotiations will likely help both sides realise this. In this note, Geoff Lewis, Senior Asia Strategist, believes the Chinese market's robust fundamentals and positive catalysts suggest that any further friction in the bilateral relationship should be viewed as a potential buying opportunity for investors.

Tariff war postponed, both sides willing to negotiate

Following a second round of talks last week between US and Chinese trade negotiators, it was announced that the implementation of import tariffs had been put on hold during trade negotiations. On 19 May, the US and China issued a joint statement, announcing that "China will significantly increase purchases of U.S. goods & services" and that "both sides agreed to encourage two-way investment and to strive to create a fair, level playing field for competition."[1]

Investors should welcome this development. True, it is only a first step – an agreement that on trade "jaw-jaw" is preferable to "war-war" between the world's two largest economies. But that surely reduces the risks of a serious rupture in US-China economic relations, even if the growing strategic competition between the two powers points to a cooler political relationship in the coming years. A decision for continued negotiations greatly reduces the chances of the two counties drifting into a needless confrontation over trade and marks a big change from the first round of trade talks in Beijing in early May which ended in discord and quarrelling between US team members.[2]

While the US has suspended its threat of raising tariffs on US$150 billion of imports of Chinese goods,[3] but President Trump could still impose the tariffs if the talks between the two countries fail to make progress, according to US Treasury Secretary Steven Mnuchin. Liu He, the Chinese vice premier in charge of Beijing's trade delegation to Washington, confirmed that China is holding off on tariffs for now.

Other US tariffs introduced earlier this year remain in effect; those on steel and aluminum would need to be reversed through a formal process. Similarly, China also has retaliatory tariffs on a number of U.S.

[1] Source: White House, "Joint Statement of the United States and China Regarding Trade Consultations", 19 May 2018.
[2] Source: Washington Post, "U.S. and China swap hard-line lists of demands at trade talks in Beijing", 4 May 2018.
[3] Note: The US negotiations were focused on proposed tariffs on US$150 billion of imported Chinese goods following an investigation of Chinese trade practices by the US Trade Representative. These tariffs never formally went into effect and have now been placed on hold.

exports formally in place. These were never more than minor irritants and could be removed once there is progress on the more substantive trade issues.

A Lesson for Investors: China's reality differs from media reports

For investors, a key lesson is that in China's case, the financial media's focus since the trade issue first broke in March has been almost exclusively on the negatives of trade tensions, policy uncertainty leading to potential disaster. Scare stories sell newspapers. China's improving corporate fundamentals over this period – which history suggests are the main determinant of Chinese companies' share prices over the medium to longer term – were ignored or downplayed.[4]

In addition to the trade war doomsday scenarios, other perennial issues, such as China's over-reliance on the use of credit to drive growth, the burden of inefficient State Owned Enterprises (SOE), the overheating residential property sector, and the risks of shadow banking are regurgitated in the financial media on a daily basis. Often such media reports contain little in the way of new information or insight.

Against this background of constant, negative noise, it is not surprising that many individual investors have until now been unwilling to take significant exposure to China in their portfolios. Now could be a very good time to invest in Chinese equities, for a number of key reasons that we mentioned in the May edition of Monthly Macro View.[5] These positive catalysts include the fact that economic data suggests there are few slowdown worries for the Chinese economy in the short term. China's Purchasing Manager Index (PMI) remains consistent with decent economic growth. Importantly, a more stable economic backdrop has allowed Chinese companies to perform well in terms of earnings, margins and return on equity (RoE).

Other positive catalysts for Chinese equities in the second half of 2018 are: MSCI A-share inclusion, higher QDII quotas and Stock Connect daily limits, and the expectation of more policy reforms at the CPC plenum meetings in October. In addition, Hong Kong's new, more flexible listing regime of allowing dual-share listings will make listings there by Mainland information technology stocks more attractive.

Further trade friction offers opportunities for investors

So what happens next? On trade relations, we believe that the US may be pushing at a half-open door, including in the more controversial areas like IP copyright and technology transfer. Beijing recognises that further opening the Chinese economy to foreign competition can help sustain high productivity growth, which is essential now that China's workforce has begun to slowly shrink. Moreover, many of China's new tech companies have intellectual property of their own which they are as eager to protect as their US peers. The media's representation of China as completely dependent on foreign technology is incorrect:

China is, after all, at the cutting edge of technology in many areas and ahead of the west in a few cases, such as e-commerce and online payment systems. The source of China's advances in IT lies more with

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[4] Note: We do not disagree with the view that China's equity markets are highly sensitive to policy and may be policy-driven to a greater extent than a typical developed stock market. This is partly to be expected, given the greater role of government in the economy.
[5] See Manulife Asset Management's Monthly Macro View, May 2018.

the leading Chinese universities and research institutes and the associated annual supply of highly qualified graduates than it ever has been with alleged cyber theft. Of course, the negotiations may last for some time. Both sides can be expected to leak information occasionally on progress (or lack of it) in key areas to gain leverage. Any bouts of investor nerves and market dips over trade concerns we would regard as potential buying opportunities, given the favorable fundamentals of Chinese equities.

With regard to the US-China bilateral trade balance – an item which seems to be of importance to President Trump, we doubt that China will commit to a hard target. The trade balance is after all the net result of the independent decisions of millions of US and Chinese consumers and businesses and therefore not amenable to tight control. But there are areas such as agriculture and energy where China could easily make efforts to increase imports from the US. We are optimistic that the US and China will eventually reach a trade agreement.