Investment Note

27 March 2018

Overall impact on China bonds from US trade tariff is manageable

US-China trade tensions have intensified triggered by US President Donald Trump's plan to impose a 25% tariff on up to US$60 billion of Chinese imported goods. Hours after the announcement, China prepared tariffs of US$3 billion on US imported goods.

In this investment note, Paula Chan, Senior Portfolio Manager (Fixed Income), assesses the potential economic impact of tariffs on China and the Chinese bond market. On a Pan-Asian bond level, Endre Pedersen, Chief Investment Officer (Fixed Income, Asia ex-Japan), cautions investors that the market cannot fully price in events such as escalating trade friction – being nimble in volatile markets is the key.

Potential impact on China manageable

According to Paula Chan, Senior Portfolio Manager (Fixed Income), from an economics perspective, a trade war is a "lose-lose" scenario for both the US and China. However, at this nascent stage of development (based on initial US and China announcements on tariffs), the overall impact on China is manageable.

Assuming the up to US$60 billion tariff is referring to the tariff base, the estimated impact to China's economy is around 0.1% of its annual GDP,[1] which Chan believes is insignificant. Morever, China's foreign direct investment in Asia and the "One Belt, One Road" initiative may potentially help reduce the negative economic impact from any potential trade war. China's robust foreign reserves (US$3.1 trillion), high reserve-requirement-ratio (RRR at 17%)[2] and high real interest rate (2.4% after inflation)[3] also provide China with enough ammunition to buffer any external economic shock.

Currently, it is widely believed that China will not use its renminbi currency nor sell its US Treasury holdings as tools of retaliation. We are now entering into a timeframe for negotiation between the two countries; most believe the US and China may come to an agreement.

Our China bond positioning

Our onshore China bond strategy is positioned for the Chinese government's deleveraging policies and de-risking of the financial sector, which Chan believes is more influential for the asset class than trade policies.

[1] UBS Global Research, as of 23 March 2018.
[2] RRR is the amount of cash as a percentage of deposits that banks must reserve at the central bank. The current rate for major banks was set at 17% after the last general RRR cut in March 2016. Source for foreign reserves: National Bureau Statistics of China, 28 February 2018.
[3] Bloomberg, as of January 31, 2018.

The market's reaction to the tariff announcement has been measured. The renminbi is holding up relatively well and slightly outperforming some Asian currencies since last Thursday, which partly reflects China's strong fundamentals. Onshore Chinese government bond yields are slightly lower, while, at time of writing, credit spreads of Chinese corporate bonds have widened due to investor sentiment (and not fundamentals). Nevertheless, the Chinese corporate bond market is well-diversified, and we believe sectors such as financials and selective state-owned-enterprises (e.g. utilities) will not be directly impacted by the trade policies.

Markets have not fully priced in a potential trade war

In January 2018 at the Manulife Asset Management Regional Investment Conference, Endre Pedersen, Chief Investment Officer, Fixed Income (Asia ex-Japan), highlighted **"Rising geopolitical and protectionism risk"** as one of the top five macro themes for Asian bonds this year. Thus, the rising trade conflict between the US and China does not come as a great surprise.

Pedersen believes markets cannot fully price in complex events such as a potential trade war. Many unknowns still exist: whether it will actually occur, which policies and retaliatory policies will be adopted across the region (form); and how it will affect economic activity and markets (magnitude). Depending on how the situation evolves (e.g. whether US protectionism is extended to the wider region and China's full response), this could possibly amplify market volatility.

For positioning, we currently favour higher-yield Asian bond markets. With both issuance and idiosyncratic risks rising, security selection is the key consideration in Pan-Asian bond markets. For currencies, we favour the US dollar and currencies of domestically-oriented economies, such as Indonesia and India, as they may outperform once investor sentiment stabilises and fundamentals rise in importance. We believe currencies of regional export-led economies, such as South Korea and Taiwan, may suffer the most from rising trade tensions.

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