ECONOMIC RESEARCH – THE WATCH

U.S.-China trade deal:

No biggie, but de-escalation confirmed

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GEORGES DIB
Economist
Georges.dib@eulerhermes.com

FRANÇOISE HUANG
Senior Economist
Francoise.huang@eulerhermes.com

EXECUTIVE SUMMARY

- The U.S. and China officially signed a "Phase 1" trade deal on 15 January: The U.S. will halve its 15% tariff on about USD120 billion of Chinese goods and suspend planned duties that were set to take effect last December. China should increase its imports from the U.S. by USD200 bn over the next two years and also agreed to greater intellectual property (IP) protection.
- There are three main takeaways from the deal: **(i) It is a short-term relief as it partly dissipates uncertainty and the average U.S. tariff drops 1pp to 7%; (ii) the agreed enforcement mechanism leaves room for policy volatility and does not entail any further tariff reduction this year.** While we see no further sizable escalation, we still expect that the U.S. average tariff could fluctuate this year; **(iii) don't expect phase 2 to be agreed this year**, as the issues remaining are more controversial.
- **U.S. trade policy volatility could impact Europe**: The digital tax, the European car sector, potential retaliation against Boeing subsidies and climate policy could become irritants, triggering (limited) U.S. retaliation.
- **What does this mean for markets?** As underlying tensions remain unsolved, equity investors will continue to be temperamental on trade news. Trade policy volatility could trigger mini episodes of flight to safety, but monetary policy will continue to be the main driver of global yields. We see the US10Y yield roaming below our fundamental fair value estimate (1.9%) before the 2020 elections.
- **What does this mean for companies?** All the purchases that China committed to are not equally feasable: While stepping up agricultural imports could be within China's reach and would be the priority, increasing energy and manufacturing imports could be more challenging. American farmers should benefit from additional Chinese purchases. Yet Brazilian, EU and Australian agrifood exports could be at risk of being susbtituted by imports from the U.S. Similarly for energy, where Russian and Saudi Arabian exports are at risk of being substituted, and manufacturing, where Japanese and EU exports are at risk. At a global level, although 2020 will see a modest improvement from 2019, trade growth will remain subdued.

The U.S.-China "Phase 1" trade deal was finally signed today in Washington. While the Chinese newspaper *The Global Times* noted that "factors that triggered the trade war have not disappeared," the deal has the merit of preventing trade tensions from significantly worsening. In that sense, the deal is a short-term relief from uncertainty for market participants and companies. In addition to the deal, de-escalation was confirmed by the U.S. lifting its designation of China as a currency manipulator. But Phase 1 is likely to be the only positive U.S.-China milestone in 2020: On 14 January, U.S. officials confirmed that existing tariffs are likely to stay in place until after the American presidential election, and that any move to reduce them will hinge on Beijing's compliance with the terms of the Phase 1 deal.

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<table>
<tr><th>What the deal covers</th><th>Specifics of the agreement</th><th>What this means for companies</th><th>What this means for markets</th></tr>
<tr><td>ENFORCEMENT MECHANISM</td><td>Complaints of one party will be brought to a U.S.-China working group and if officials can't resolve their dispute, a decision will be made at the ministerial level of what action to take. That action could include tariffs or other measures.

For instance, after 90 days of non-compliance with the terms of the deal, the U.S. would be able take action in the form of tariffs or other remedial measures.</td><td>**The agreement only partially dissipates trade uncertainty for companies.** If China does not comply with the USD200bn purchases, since President Trump has reduced tariffs on intermediate and capital goods, he has the leeway to increase them again to retaliate without penalizing U.S. consumers. In consequence, expect still subdued trade growth in 2020.</td><td rowspan="4">**As underlying tensions remain unsolved, equity investors will continue to be temperamental on trade news. Trade policy volatility could trigger mini episodes of flight to safety**, but monetary policy will continue to be the main driver of global yields. We see the US10Y yield roaming below our fundamental fair value estimate (1.9%) before the 2020 elections. 2021 would see the yield climb on the back of subdued but positive economic optimism and reanchored inflation expectations.</td></tr>
<tr><td>TARIFF REDUCTION (only on the U.S.' side)</td><td>> The U.S. committed to a reduction in tariffs from 15% to 7.5% on tranche 4a (USD120bn of imports).
> Tranche 4b (expected to be tariffed in December) is suspended (USD160bn).
> Tariffs on tranche 1+2+3 do not change (i.e. 25% on USD250bn).

U.S. officials confirmed that existing U.S. tariffs are likely to stay in place until after the American presidential election, and that any move to reduce them will hinge on Beijing's compliance with the terms of the Phase 1 deal.</td><td>**The average U.S. tariff would drop to 7%** (from around 8% had the December tariffs been implemented).

Hence most existing U.S. tariffs would remain (USD370bn of U.S. imports from China affected): roughly USD250bn taxed at 25% (unchanged) and USD120bn that will be subject to a 7.5% duty. We would still be in our intermediate scenario of a trade feud (the threshold is >6%), which is still our baseline for 2020.</td></tr>
<tr><td>ADDITIONAL IMPORT PURCHASES (only on China's side)</td><td>> Chinese agricultural purchases from America would rise by USD32bn over two years from a baseline of USD24bn in 2017. So they would reach USD40bn in both 2020 and 2021
> USD80 billion worth of U.S. manufactured goods over the two year period, including aircraft, autos and car parts, agricultural machinery and medical devices
> USD50bn of energy purchases
> USD35bn of services purchases

But if the deal states that China must purchase set amounts of U.S. products, it would be what is called "managed trade" and would likely violate WTO rules.</td><td>**U.S. farmers should emerge as winners.** But they would be even more vulnerable to a breakdown in talks as their export market share to China rises. **Other agrifood exporters to China could lose from a potential substitution effect.** As China will import more from the U.S., it would probably not be able to maitain the same levels of agrifood imports from other trade parters such as Brazil, the EU, Australia and Thailand, the three largest partners (see Figure 1).

It will be difficult to step up oil imports from the U.S. without substitution, given the effort needed to be made (see Figure 2)</td></tr>
<tr><td>INTELLECTUAL PROPERTY PROTECTION and the end of forced tech transfers</td><td>> China has agreed to end its long-standing practice of forcing or pressuring foreign companies to transfer their technology to Chinese companies as a condition for obtaining market access, administrative approvals or receiving advantages from the government.
> China has also committed to provide transparency, fairness and due process in administrative proceedings, and to have technology transfer and licensing take place on market terms</td><td>**China appeared to have minimized "structural" concessions:** In their press conference, the Chinese insisted that their commitments ("structural reforms and other changes to its economic and trade regime in the areas of intellectual property, technology transfer, agriculture, financial services, and currency and foreign exchange") were in line with their broader economic strategy of opening up, and would help improve the business environment. Many of the reforms apparently linked to the deal are ones that China has already started implementing in recent years.</td></tr>
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Overall, this reinforces our intermediate scenario of a continued "Trade Feud" until the 2020 U.S. presidential election and beyond. This entails:

- No sizable US-China escalation before the 2020 election for two main reasons: (i) the next tranche of U.S. tariffs on China would cover more consumer goods than previous tranches and hence harm the U.S. consumer on election year; (ii) 86% of goods in the latest category to tariff are imported from China which reduces the possibility of substitution for U.S. companies.
- Still high U.S. tariffs, hovering around 7% vs. 3.5% before Trump's inauguration, and subdued trade growth (+1.8% in 2020 after +1.2% in 2019, and a modest acceleration to +2.5% in 2021) due to uncertainty and tariffs.

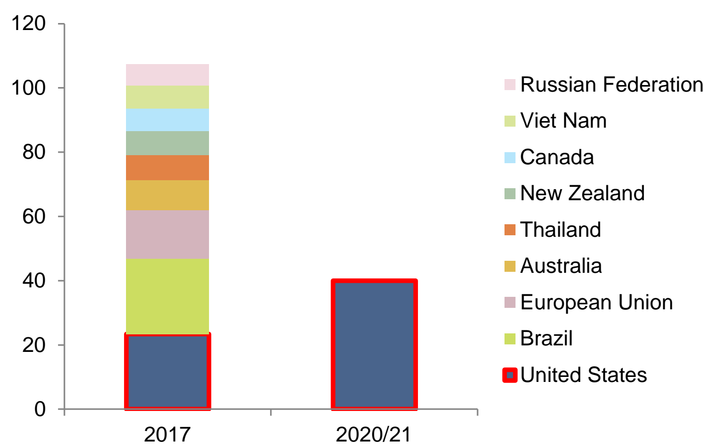
Moreover, while we see no significant escalation, U.S. trade policy volatility could impact Europe: The digital tax, the European car sector, potential retaliation against Boeing subsidies and climate policy could become irritants, triggering (limited) U.S. retaliation.

Focus on purchases:

Agrifood

Stepping up agricultural imports could be within China's reach and would be the priority, as many trade barriers have been dropped by China. It will not be straightforward for U.S. importers nor for U.S. farmers: soy prices for instance have fallen compared to 2017 and hence reaching the USD32bn additional import target requires an even greater effort in volume, in a context of swine flu (and therefore part of the demand for soy is at half-mast). Hence China making such effort could create losers in Brazil, the EU, Australia (see figure 1), the other main exporters of agrifood to China.

Figure 1: Chinese imports in agrifood and projections under the Phase 1 deal (USD bn)

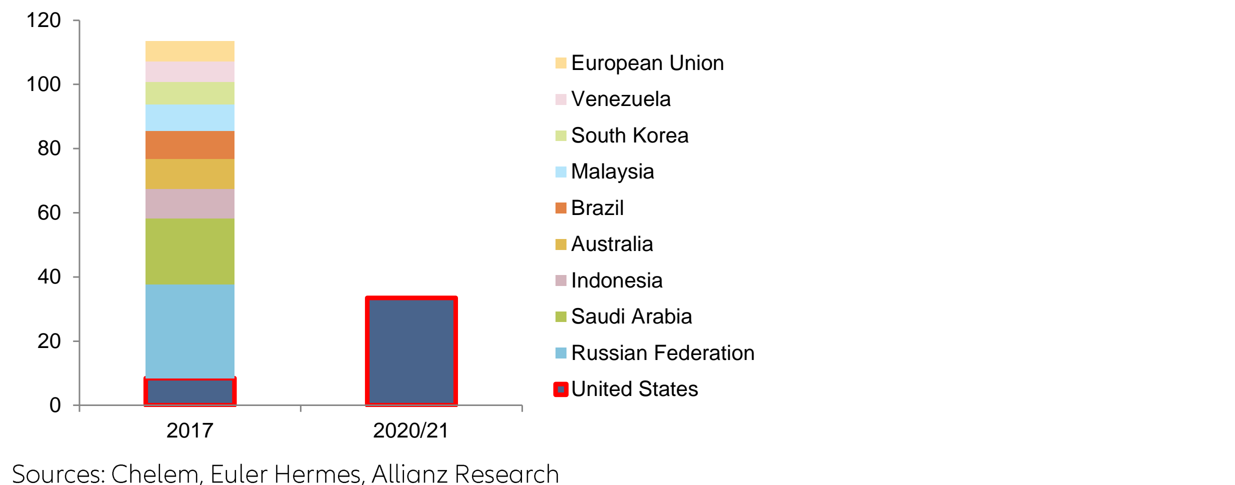


Sources: Chelem, Euler Hermes, Allianz Research

Energy

For energy, looking at the 2017 baseline (see figure 2) shows that the effort on energy imports will be even more sizable to reach the targets. While China has a long term plan to increase the use of natural gas in its energy mix, Russian and Saudi Arabian exports are still at risk of being substituted

Figure 2: Chinese imports in energy and projections under the Phase 1 deal (USD bn)



Sources: Chelem, Euler Hermes, Allianz Research

Manufacturing:
The planed boost in manufactured imports includes autos, auto parts, aircraft, agricultural machinery, medical devices and semiconductors. However, it appears that the Phase 1 deal does not address non-tariff barriers that have prevented more U.S. manufacturing exports from entering China, such as procurement rules, product standards and subsidies to Chinese state-owned firms. Moreover, we should take into account consumer preferences, for instance the fact that usually the Chinese prefer German (and Japanese) auto brands. Finally, the higher the product's technology content (e.g. semi-conductors) the lower the substitutability.

What's next?

- There is no deadline for the beginning of Phase 2 talks, while the elements left to negotiate are far thornier: As of now, the U.S. says future talks will also focus on digital trade, data localization, cross-border data flows and cyber intrusions. Phase 2 could also focus on China's industrial policy, a highly controversial matter.
- The positive news is that China came under greater international pressure to reduce industrial subsidies after the U.S., Europe and Japan agreed to push for stronger World Trade Organization rules against market-distorting government aid in a joint statement after a trilateral meeting. It seems the collaborative option is back on the table rather than bilateral escalation.

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