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UNIT TRUST CORPORATION

ADVISORY SERVICES DEPARTMENT

Newsletter

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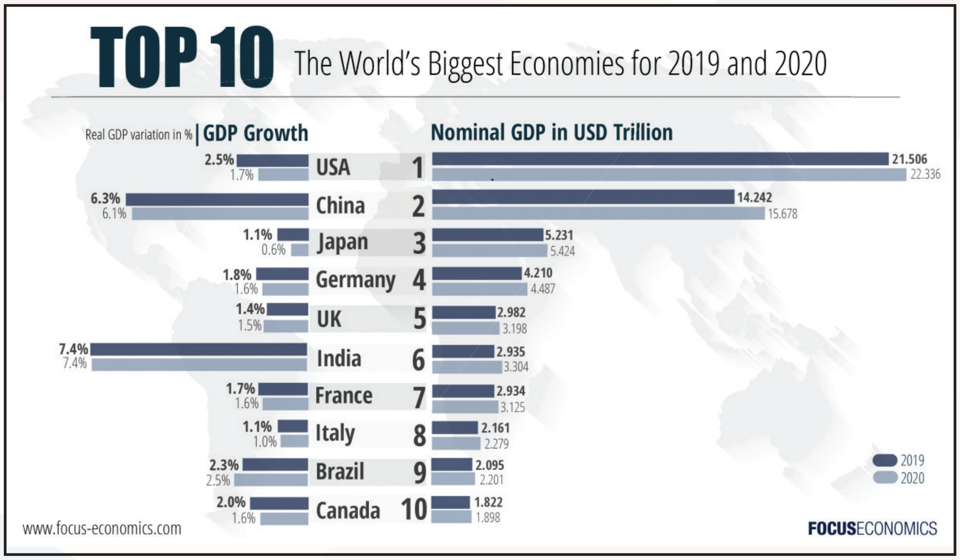
THE TRADE WAR BETWEEN THE U.S. AND CHINA

The United States and China, the world's two largest economies, have been locked in a trade war for over a year where they have been imposing tariffs on billions of dollars' worth of each other's goods. This however has the potential to tip the global economy into a recession and lead to a sharp decline in world stocks.



The U.S. economy has been the biggest economy since the late 19th century and represents about 20% of total global output. It's nominal GDP is forecasted to exceed USD 21 trillion in 2019. It is dominated by services-oriented companies in sectors such as technology, financial services, healthcare and retail. Large U.S. corporations also play a major role on the global stage, with more than a fifth of companies on the Fortune Global 500 coming from the United States. The U.S. economy is projected to grow 2.5% in 2019 and 1.7% in 2020.

On the other hand, the Chinese economy is still considered an emerging market economy, even though it experienced astonishing growth in the last few decades which catapulted the country to become the world's second largest economy. It has a nominal GDP of $14.17 trillion, and according to the International Monetary Fund (IMF), it's expected to grow by 6.3% in 2019 and 6.1% in 2020.

Since the global economy is interconnected, it is nearly impossible to target only one country or one industry without affecting another, which may even include allies. The U.S. placing tariffs on China, the world's largest manufacturing hub, will likely have ripple effects on many other countries, products, and companies that rely on this global supply chain.

The IMF has warned that the US China trade war has caused "self-inflicted" damage that has already made global growth "sluggish and precarious" and could create further financial vulnerabilities by depressing both consumer and business sentiment. In its latest *World Economic Outlook*, the IMF projections show 2019 GDP growth at 3.0%, down from the July forecast of 3.2%, mainly as a result of the increasing fallout from global trade friction.

U.S. Trade Deficit

For many years, China has sold more to the U.S. than vice versa, resulting in a trade deficit which has been growing larger. In 2018, the U.S. trade deficit with China was $419 billion resulting from the U.S. exporting $120 billion to China compared to imports of $540 billion from China.

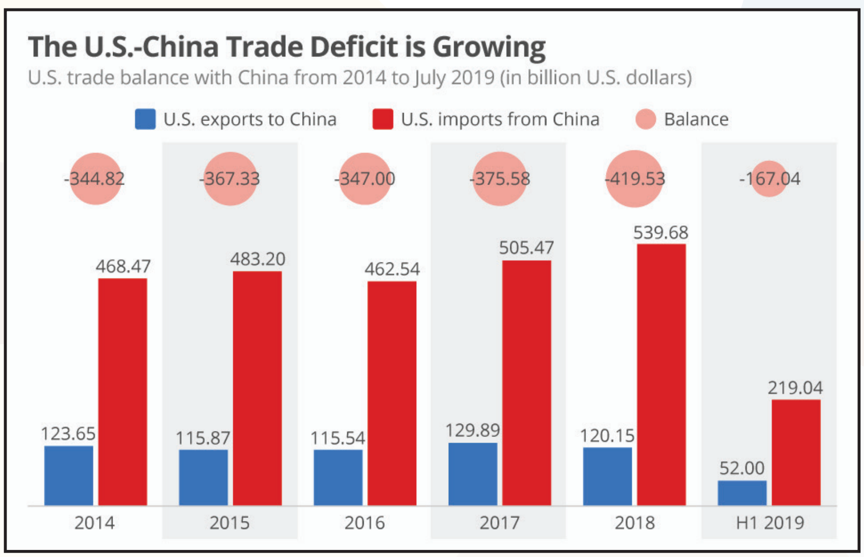
The biggest categories of U.S. imports from China were computers and accessories, cell phones, and apparel and footwear. However, a significant portion of these imports are from U.S. manufacturers that send raw materials to China for low-cost assembly and are considered imports when they are shipped back to the U.S.

Conversely, China's biggest imports from America were commercial aircraft, soybeans, and autos. In 2018, China canceled its soybean imports after President Trump started a trade war. He imposed tariffs on Chinese steel exports and other goods.

Source: The Balance

Since 2014, the U.S. trade deficit with China has increased. It was $345 billion in 2014, rose approximately 22% to $419 billion in 2018. The chart below shows exports, imports, and the trade balance from 2014 to June 2019.

U.S. Trade Balance with China (in billion U.S. dollars)



Source: United States Census Bureau, statista

Causes of the Trade Deficit

China produces goods at lower costs compared to other countries. If the U.S. implemented trade protectionism, "Made in America" goods would be more expensive and most U.S. consumers would rather pay as little as possible for computers, electronics, and clothing, which would likely have little impact on the trade deficit.

So how is China able to keep prices so low? Economists agree that China's competitive pricing is due to:

- A lower standard of living, which allows companies to pay lower wages to workers.
  China is not only the world's largest economy but also has the biggest population with approximately 1.4 billion residents. As a result, there is a large work force that can be cheaply employed in the production sector. One of the key objectives of the Chinese government is to raise the standard of living.
- An exchange rate that is partially fixed to the dollar.
  China sets the value of its currency, the yuan, to equal the value of a basket of currencies that includes the dollar. However, China does not have a floating exchange rate that is determined by market forces but a managed float system where the exchange rate fluctuates from day to day. Yet when the dollar loses value, China buys dollars through U.S. Treasury securities to support it. The true value of the yuan is difficult to ascertain but experts agree that the currency is substantially undervalued. By keeping the yuan at artificially low levels, China makes its exports more competitive in the global marketplace.

How the Trade War Escalated

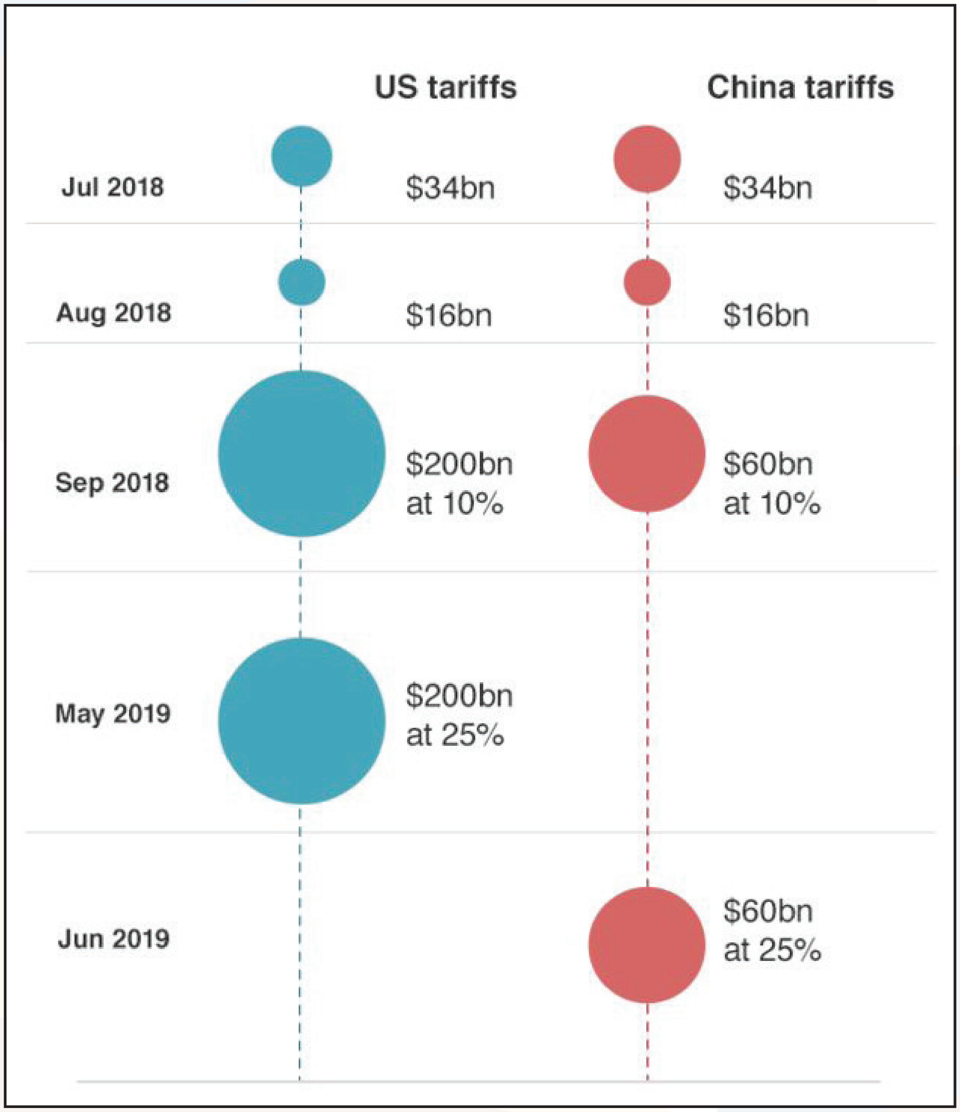
U.S. President Donald Trump has long accused China of unfair trading practices and intellectual property theft. Additionally, in China, there is a perception that the U.S. is trying to curb its rise.

In February 2018, the U.S. first imposed 30% tariffs on solar panels and washing machines, which prompted China to issue a complaint to the World Trade Organisation. Then in March 2018, the U.S. imposed steel and aluminium tariffs across the board (which included on China). The Chinese government then responded with tariffs on 128 U.S. products such as wine, fruit, and pork.

However, the trade war began in earnest in July 2018 when the U.S. levied its first round of punitive tariffs, triggered by an investigation under Section 301 of the Trade Act into Chinese trade and intellectual property practices.

China quickly matched the U.S.'s duties on US$34 billion in Chinese products. Then in August 2018, the U.S. imposed tariffs on another US$16 billion which was again matched by China. This was followed by an additional US$200 billion in September to which China responded by targeting US$60 billion in goods from the U.S.

Timeline of Imposed Tariffs



September 2019 – December 2019

The US and China have threatened to impose new tariffs and increase existing ones

Source: BBC Research

How Consumers Are Affected

The trade tension between the U.S. and China does not seem to be dissipating anytime soon and it can have real-life consequences for you and your finances which include your savings and investments, debts as well as purchasing power.

- Consumer spending

  Initial tariffs on imports from China may not directly affect consumers as they were placed on industrial material and supplies that are not usual items on shopping lists. However, the 10% tariffs announced in July 2019 will cause prices to increase on a significant number of items – from smartphones to toys and even shoes and furniture. A variety of studies suggest the tariffs will cost U.S. households up to $1,000 a year and U.S. financial economist for Oxford Economics stated that the larger price tags could compel people to cut back on spending or make it tougher for them to pay their bills.

- Stock Markets

  The stock markets have also been impacted, which can be seen by the increased volatility. The events and any escalations in the trade wars have caused investors to panic, which in turn caused the major U.S. stock indices to fall. In September, the markets slid as investors reacted to reports which indicated that Chinese officials had cancelled plans to return to China during preliminary discussions to lay the groundwork for more formal negotiations in October. Experts have indicated that they expect the turbulence to continue until the United States and China resolve their differences.

- Interest rates

  In July, the Federal Reserve lowered its benchmark interest rate and reported growing trade tensions as one of the main risks to the economy. The Federal Reserve has stated that the move was "not the beginning of a long series of rate cuts" but any further deterioration in the relationship between U.S. and China could influence future decisions.

  Lower rates are a mixed bag for consumers. On the one hand, mortgages and auto loans become more affordable, but people would also earn less interest on their savings.

- Economic activity

  A prolonged trade war could have negative impacts on the overall economy. Businesses may choose to deter investing or even hiring until the waters have settled. This could lead to slower job growth which would in turn affect consumer spending – the biggest driver of the U.S. economy. Despite this, experts think that the U.S. has enough domestic resilience to prevent a sharp downturn or a recession.

Investment Checklist

As an investor, you may be concerned about the U.S.-China Trade War and its impact on your portfolio. However, there are numerous economic indicators that can and do impact your returns. You do not need to have a degree in economics but a basic understanding of how the following economic measurements can influence investment returns is vital as an investor.

1. **Gross Domestic Product (GDP)**
   GDP is commonly referred to as the general gauge of the economic health of a country. Any significant change in GDP – up or down – usually has a substantial effect on the direction of the stock market. For example, when an economy is growing, businesses are generally expected to report higher earnings and growth which will propel investors towards equities. Conversely, lower GDP measurements can have the opposite effect on stock prices as businesses begin to suffer.

2. **Unemployment Rate**
   Like GDP, the rate of employment is a measure of the development and the strength of the economy. Essentially, more employed persons equate to higher economic output, retail sales, savings and corporate profits. As a result, the stock market generally reacts positively to good employment reports and negatively for poor reports.

3. **The Consumer Price/Produce Price Indexes**
   The Consumer Price Index (CPI) measures the average change in price of consumer goods and the Produce Price Index (PPI) tracks the average price of over 10,000 commodities that companies will use to transform into finished goods. These are both measures of inflation. High CPI numbers can translate into consumers not having any leftover money for discretional purchases, while higher PPI numbers could prevent a firm from expanding or hiring more workers, as the cost of producing goods increases. These can both impact corporate profits and in turn, cause the stock market to rise or fall.

4. **Retail Sales**
   Measures of consumer confidence and actual retail sales data is important. Any period which shows prolonged declines in retail spending – especially around seasonal highs, like Christmas – can be a trigger for a downturn in the economy as tax receipts to the government would decrease. Companies may also record lower profits and may have to take measures to reduce expenses, which include the number of employees.

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