What's standing in the way of a US-China trade deal?

Tariff rollbacks, agriculture purchases have remained topics of debate

Nov 11, 2019 | Kristina Hooper, Chief Global Market Strategist

In the last two months, I have had the pleasure of meeting with clients in a variety of different countries in Europe and Asia, as well as the US. There is one issue that all of these clients are interested in: the US-China trade conflict.

The last several weeks have seen sentiment grow increasingly positive around US-China trade relations in general and, specifically, a US-China trade deal (albeit just "Phase 1"). The most positive news of all came on Nov. 7, with reports that a Phase 1 deal had basically been finalized and that it would include the rollback of some tariffs. China's Ministry of Commerce spokesman Gao Feng announced that day, "In the past two weeks, top negotiators had serious, constructive discussions and agreed to remove the additional tariffs in phases as progress is made on the agreement."[1]

US President Donald Trump contradicted that assertion on Friday morning, explaining that he has not agreed to roll back tariffs on China. However, markets barely flinched. There has continued to be an assumption on the part of markets that Phase 1 of the trade deal is a fait accompli. Hence, the rise in US Treasury yields, the drop in gold, and the rise in equity prices. Japanese stocks have been doing particularly well in recent months.

However, as I have said before, I am not confident that even Phase 1 of the trade deal is guaranteed to happen. That's because I think there is a good chance that China will condition the signing of Phase 1 on a rollback of some tariffs – something I believe will be difficult for the US to agree to. After all, Phase 1 doesn't tackle the hard-core issues that are a major part of the US-China trade conflict, such as intellectual property rights and access to markets, so it doesn't behoove the US to make any significant concessions in the first phase.

Agriculture remains an issue

But never say never: The US is very desirous that China re-start its agricultural purchases, so it might just cave in. And although China was expected to already begin buying more agriculture from the US, it seems that those purchases have not yet begun, likely due in part to a major drop in the number of pigs in China, given a culling of the herd due to swine fever. (Last week's report from China's General Administration of Customs showed that China imported 6.18 million tons of soybeans in October, which is the lowest level since March and is down 24.6% from 8.20 million tons in September.)[2] Having said that, buying agriculture is one of the biggest bargaining chips that China has. US farmers have been hurting, and the Trump administration has been eager to alleviate their suffering, especially as the 2020 election nears. If China is not getting tariff relief in Phase 1, then it may not find it worthwhile to increase agriculture purchases from the US going forward.

And China has the luxury of waiting, as its economic data appears to be stabilizing. The Caixin China Composite PMI Index for October clocked in at 52.0, slightly up from 51.9 in September.[3] And while China has continued to sustain damage from the trade war, it appears to be moderating. China's exports in October fell 0.9% from a year earlier, which was less than expected – and far better than its decline of 3.2% in September. While exports to the US dropped 11.3% from January to October, exports to the European Union rose 5.1%.[4] And exports to Southeast Asian countries rose significantly, suggesting a back door through which exports are being sent to the US.

But perhaps the most compelling data supporting the fundamental strength of the Chinese economy can be found in Singles Day purchases. Singles Day is the 24-hour shopping extravaganza in Asia pioneered by Alibaba more than a decade ago. Early reports from this year's Singles Day (Nov. 11) indicate a strong consumer willing and eager to spend. According to the South China Morning Post, Chinese consumers collectively spent 268.4 billion yuan (US$38.4 billion) on Singles' Day. This set a new record, up from approximately $30.8 billion in 2018.[5]

This data suggests that, while the Chinese economy remains under pressure, it may easily tolerate the situation and may not be forced into any concessions that it is not fully comfortable with.

Market implications

However, the possibility that a Phase 1 deal falls through has market implications. In my view, failure to secure such a deal would be likely to send risk assets such as stocks downward. In such a scenario, Treasury yields would likely go down and gold would likely go up. While my base case remains that a Phase 1 deal comes to fruition, the risks are increasing – especially the risk that it could be delayed. I must stress that investors should prepare for – but not be frightened by – the possibility that a Phase 1 deal does not come to fruition or is delayed significantly. I believe any kind of resulting sell-off would be relatively muted and short-lived because of the cushion being created under risk assets by central bank accommodation. And any resulting sell-off could represent a buying opportunity for investors with longer time horizons.

Source

[1]Source: Bloomberg News, "U.S. Says Phase-One China Deal Would Include Tariff Rollback," Nov. 7, 2019
[2]Source: CNBC, "China October soybean imports fall 10.7% from year earlier- customs," Nov. 7, 2019
[3]Source: IHS Markit, Caixin, Nov. 5, 2019
[3]Source: South China Morning Post, Nov. 8, 2019
[3]Source: South China Morning Post, Nov. 11, 2019