US-China tensions could be the biggest risk to US stocks this year

Weekly Market Compass: A massive policy response has helped bolster stocks against the economic impact of COVID-19, but another tariff war could threaten markets

May 18, 2020 | Kristina Hooper, Chief Global Market Strategist

In the last several weeks, stocks have exhibited weakness and higher volatility. I am convinced that rising US-China tensions are behind this, and that the potential for a reignition of the US-China tariff war could be the single biggest risk to the US stock market this year.

Semiconductor shipments become a flash point

Last week, the US Commerce Department announced it was amending an export rule in order to "strategically target Huawei's acquisition of semiconductors that are the direct product of certain US software and technology."[1] In other words, the Trump administration is essentially blocking the shipment of semiconductors to Chinese tech company Huawei Technologies. US companies would need a special license approved by the Commerce Department in order to continue to sell semiconductors to Huawei. The Commerce Department's rule has a 120-day grace period and impacts not only US chipmakers but a number of other semiconductor manufacturers around the world, including Taiwan Semiconductor.

This is very significant and is likely to slow Huawei's 5G plans. It also has broader implications for technology going forward. This includes the possibility that China could retaliate for the Huawei restrictions by placing US companies on an "unreliable entity list." A variety of US companies could be impacted should this come to pass, including Apple and Boeing, which could see purchases of its airplanes by China suspended.

Other tensions rise to the surface

But that's only one flash point among many recent ones in Sino-US tensions. Last week, US Secretary of State Mike Pompeo accused China of attempting to steal US intellectual property and data related to COVID-19 research. He was highly critical of China, and his comments followed a joint statement from the Federal Bureau of Investigation and the Department of Homeland Security warning about threats to coronavirus-related research from China-related entities. The Chinese Embassy in Washington condemned the allegations as "lies."

Another flash point relates to investment in China. President Donald Trump recently made the decision to halt the investment of federal retirement funds in China. While this is not as dramatic as it sounds, it does signal that the US-China friction is occurring on a variety of different fronts. To be clear, the US is not withdrawing any money from Chinese stocks – it is merely halting a planned change to one investment option in the federal retirement plan. That means that approximately $6.05 billion would have been allocated to Chinese stocks but now will not.[2] The US said it may sanction Chinese companies, which was the rationale it gave for preventing the federal retirement plan from offering investment in China. Since then, President Trump has suggested he would be examining Chinese companies listed on US stock exchanges that do not follow US accounting rules, presumably to de-list them.

Another flash point is military in nature. The US has also shared its view that China has taken advantage of America's preoccupation with battling COVID-19 in order to become more aggressive militarily in southeast Asia. The US has sent naval ships to the South China Sea in recent weeks in order to ensure "freedom of navigation" and push back on what it views as China's aggressiveness. Last week, the US Pacific Fleet Commander stated that China "must end its pattern of bullying Southeast Asians out of offshore oil, gas and fisheries."[3]

Another flash point – one that seems to rattle markets most – is trade. Last week, President Trump threatened to shut down the US' entire trade relationship with China, saying the US would save $500 billion if he "cut off the whole relationship" with China.[4] He also added that he is no longer speaking with President Xi Jinping. As we saw in late 2018 and 2019, tariffs had a negative impact on the economy – but an even greater negative impact on the stock market.

Behind-the-scenes talks may find a way forward

It's clear that the US is in a difficult position. With the November election looming, the Trump administration is in the midst of a delicate balancing act: It's blaming China for the pandemic's spread (a popular position among the president's voter base), but it's also trying to avoid more economic headwinds in the midst of the massive drop in economic activity and rise in unemployment – and of course it also wants to avoid stock market weakness.

I believe there is a distinct possibility that the US may levy some tariffs against China in order to extract reparations and retribution for the pandemic – which would likely be met with trade penalties from China. However, I think it is more likely that this scenario can be avoided.

Quietly, in the midst of all the higher-profile Sino-US tensions, Chinese Vice Premier Liu He, US Trade Representative Robert Lighthizer, and US Treasury Secretary Steven Mnuchin have had far more amicable relations. The Chinese Ministry of Commerce released a statement saying that the parties pledged to create favorable conditions for implementation of the US-China trade deal arrived at earlier this year, and to cooperate on both the economy and public health. Lighthizer's office reiterated that sentiment, explaining that "good progress is being made" on "creating the governmental infrastructures necessary to make the agreement a success."[5] He reassured that, "in spite of the current global health emergency, both countries fully expect to meet their obligations under the agreement in a timely manner."[5]

Conclusion

While lockdowns (and how to end them) continue to dominate the economic conversation, it seems to me that the stock market has largely shrugged off the damage created by the pandemic-related cessation of economic activity. But that's because of the massive policy response, particularly monetary policy. I don't believe it would be as easy for stocks to shrug off a reignition in the US-China tariff war, especially in the midst of this pandemic. That's why I'll continue to watch this issue carefully for signs of progress or deterioration.

Source

[1]Source: 1 Source: US Commerce Department press release, May 15, 2020

[2]Sources: MSCI, Thrift Savings Plan, and Invesco calculations. Based on the Thrift Savings Plan's international asset allocation as of Dec 31, 2019, and MSCI index exposures to China as of April 30, 2020. The Thrift Savings Plan (TSP) is a retirement savings and investment plan for Federal employees and members of the uniformed services, including the Ready Reserve.

[3]Source: The Wall Street Journal, "U.S. Warships Support Malaysia Against China Pressure in South China Sea," May 13, 2020

[4]Source: Fox Business, "Trump on China: 'We could cut off the whole relationship,'" May 14, 2020

[5]Source: Office of the United States Trade Representative press release, May 7, 2020

Important information

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