Global risk radar

Global trade: Playing with the tipping point

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This publication series helps investors to identify and assess global financial market risks and their investment implications.

At a glance

- Tensions between US and China have recently escalated once more following President Trump's decision to increase tariffs on US imports from China.
- In our base case, we expect the latest round of tariffs to be implemented and estimate that this will take around 0.3ppt off US growth over the next 12 months. In our downside scenario, we see the risk of a US recession rising significantly as a result of additional US sanctions such as higher tariffs on sensitive goods from China or the imposition of duties on car imports.
- While we still believe that a US recession is not imminent, risks are clearly tilted to the downside. We have recently trimmed our equity exposure, leaving us underweight to stocks overall. Instead, with rates likely to stay lower for longer, we look for income-enhancing opportunities.


Source: iStock

Over the past weeks, the trade conflict between the US and China has unfolded in a series of announcements, countermeasures, bold statements, and reversals. After regretting not raising tariffs on Chinese goods further, US President Trump quickly switched to renewed optimism for a trade deal (see Fig. 1). Predicting the next moves in the US-China conflict has become challenging. Overall, we expect tensions will remain elevated and that currently proposed tariffs will be implemented. However, we don't rule out a worsening of the situation over the next six to 12 months.

Financial markets have been closely following the recent developments in the trade dispute. The VIX index – a proxy for market risk and investor sentiment – has jumped in August to levels last seen at the end of 2018. In the meantime, bond yields have fallen considerably and, for the first time since the financial crisis, the spread between 2- and 10-year Treasury yields has become negative, a development that has in the past anticipated recessions.

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Despite the rising risks, we still believe the US can avoid a recession in 2020. Nevertheless, we acknowledge that markets are increasingly being driven by trade news – even more than monetary policy. With high uncertainty over the outlook for the trade dispute, we prefer to limit our exposure to stock markets. In our tactical asset allocation, we are modestly underweight equities and favor carry strategies, which should benefit from central bank easing in a low-growth environment.

Tariff escalations intensify

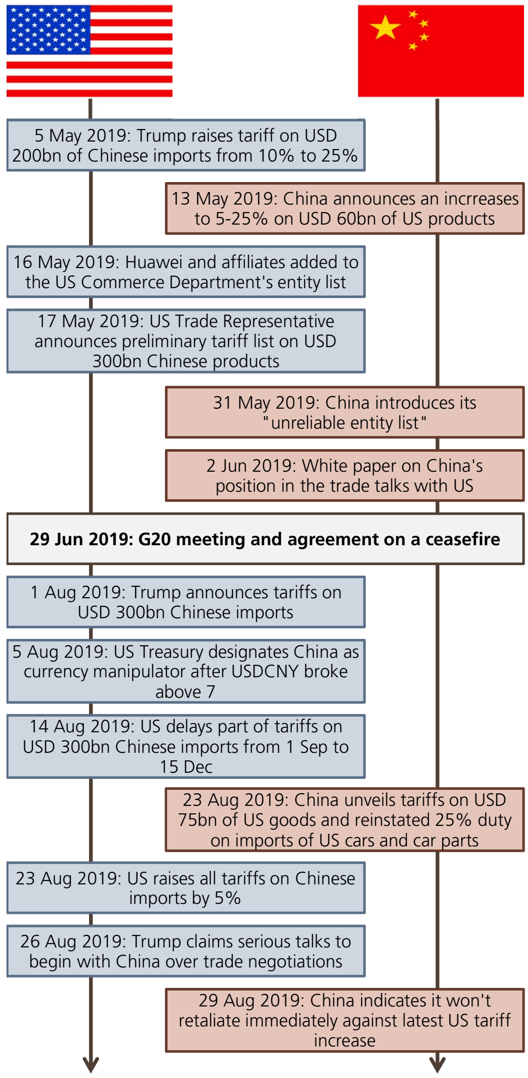
The temporary ceasefire resulting from the G20 summit ended in the first week of August, when President Trump decided to levy a 10% tariff on USD 300bn of Chinese goods. Since this announcement, the dispute has quickly alternated between softening and tit-for-tat moves (see Fig. 1).

The step up in the pace of retaliation and the US pledge to increase tariff above 25% rate – a level that many believed to be a ceiling in punitive levies – have marked a shift toward a higher level of escalation.

We believe that Beijing has also changed its stance on trade. Since the breakdown of negotiations in May, China has been even more reluctant to offer unilateral concessions and has embraced the idea that a resolution of the trade conflict would not mitigate the tensions with the US. In our view, the rivalry between the two nations has gone far beyond trade, extending to other fronts including technological leadership and geopolitical supremacy.

At present, we still believe that the negotiations scheduled for early September will take place. Both sides are poised to head back to the table, but the risk that the global economy has been irreversibly dented from the latest tariff escalation is very high.

Fig. 1: US-China trade dispute since May 2019



Source: UBS, as of 30 August 2019

Our scenarios

Base case (45% chance): Prolonged trade tensions

In our baseline scenario, we expect the latest round of tariffs to be implemented. We estimate that this will take around 0.3ppt off US growth over the next 12 months. We do not believe this will be enough to tip the economy into recession, but we cannot rule out the possibility that sentiment will turn down more than we forecast. We expect China's response to be measured (see Table 1), although we cannot exclude further US sanctions to the extent that the US economy is not irremediably impaired.

China's response is likely to include mild retaliation because in the end it continues to engage in talks and we think fundamentally seeks a deal. Under this scenario China's GDP growth suffers by attrition and could slow to 5.8%-6% next year. We see the CNY depreciating further, perhaps as far as 7.4 in the next 3-6 months.

Currently, we expect the US Federal Reserve to cut interest rates three more times in the next 12 months. A decision to ease monetary policy further could support Trump in his aggressive trade policy agenda and feed a fresh rounds of tariffs.

Table 1: Possible measured responses from China

· Moderately increasing tariffs on current US imports
· Curbing further US imports such as agricultural goods, aircraft, crude oil, Liquified Natural Gas (LNG)
· Discouraging travel to the US
· Allowing managed depreciation of the CNY potentially up to 7.4
· Releasing an "Unreliable Entity List" for US companies, similar to the US Entity List
· Curbing imports of US services, including tourism and education, IP products including movies and CDs, and professional services (e.g. legal, accounting, and financial services)

Source: UBS, as of 30 August 2019

In our view, the outlook for a deal before the US election remains weak. Nevertheless, we still believe that the US administration will try to avoid increasing the risk of a recession unnecessarily ahead of the US presidential election next year. This should ultimately dissuade the White House from significantly increasing tariffs on Chinese goods.

Downside scenario (35% chance): Escalation leading to a US recession

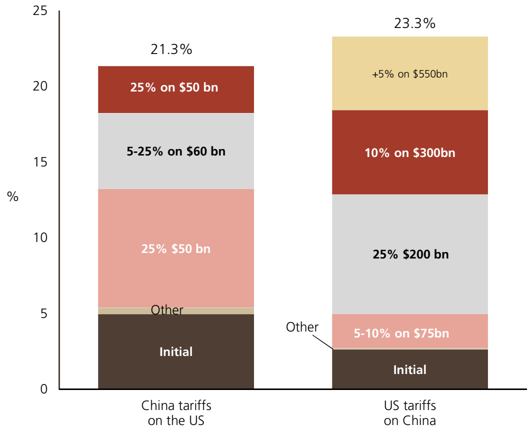
In our risk case, we see the chances of a US recession and a global economic downturn caused by trade sanctions rising dramatically. The recent escalation has already raised this probability, and so defining a line in the sand to call for an end of the current cycle is harder. However, we think 35%+ tariffs on most goods could be the danger zone, depending on policy offsets. In addition, there are lags where the impact of the latest round of tariffs may only be felt next year. Front-loading of purchases may create the illusion of continued economic strength. Secondary effects including higher uncertainty on business confidence and the full impact of supply chain shifts may also take time to show up. We prefer therefore to define actions on the trade front that would give us a fair confidence to call the end of the longest US expansion on record over our tactical investment horizon.

- **More tariffs:** In a situation where the US administration decides to increase the tariff rate on Chinese imports to a level that would irreparably hurt margins of US companies, lower earnings would quickly take a toll on employment. We believe that a step-up to 25%+ of the tariff rate on the consumer electronics (currently set at 15%) or an outright increase of the average tariff rate on China from the current 23.3% (see Fig. 2) to more than 35% would force companies to materially cut investment and ultimately jobs. *China's response would likely include yet greater tariffs on US agriculture and key services products such as banking, tourism and education, IP-entertainment/leisure products. On the policy side, support would step up to avoid GDP growth sinking too far below 5.5% with a combination of greater PBoC lending facilities, 200bp+ of general RRR cuts, more than 20bp of* medium-term lending facility (MLF) *interest rate cuts and CNY 4tn+ of local government bonds issued. CNY depreciation would accompany this and a move weaker than 7.5 may be unavoidable. A more serious breakdown of diplomatic relations could trigger US Treasury bond sales.*

- **Technology escalation:** So far, the US Department of Commerce has granted a temporary delay to an import ban against Chinese telecom giant Huawei. The US administration could decide to escalate on the tech front by immediately restricting US companies trading with Huawei or including more Chinese companies in the Entity List, perhaps extending into artificial intelligence (AI) and biotech, effectively blocking them from receiving US tech products. *China's response may mirror such a move and lengthen its own list of US companies on the Unreliable list, imposing on them a higher cost of doing business. In such a case China would have to live with much reduced access to US tech products, and this over time would depress China's growth trajectory, with 2020 growth perhaps 50bps slower than our base case of a 5.8%-6% range.*

Fig. 2: Bilateral tariffs have crossed the 20% level on both sides

Average tariff rate on imports (weights based on 2017 trade data)



Source, Deutsche Bank, UBS, as of 30 August 2019

- **Auto tariffs:** A final decision on the US investigation into auto imports is expected by mid-November. The US administration has, so far, refrained from levying duties on auto imports. Despite large consensus against these tariffs from the US Congress and business community, Trump has recently indicated that auto tariffs remain a possibility. We believe that a 25% tariff an all US auto and auto component imports would harm major auto exporters such as Germany and Japan while also hurting the US auto industry, and could make the global economy stumble. *While the US and Japan may soon sign a new trade agreement that would avert US sanctions against Japanese cars, trade talks with the EU have yet to start officially after the European Commission formalized the trade negotiating directives in April. In the meantime, the EU finalized a list of US goods that would be hit with retaliatory tariffs, should President Trump follow through on his threat.*

- **Other sanctions:** Recently, US president Trump ordered "American companies to immediately start looking for an alternative to China", threatening to invoke the US International Emergency Economic Powers Act (IEEPA). Such a move would impair US investment in China and make it difficult to do business with Chinese entities. In such case, US firms would be heavily encouraged to relocate and bear the costs of shifting their supply chain.

Upside scenario (20% chance): De-escalation before the US election

In our de-escalation scenario, we expect a significant improvement in US-China trade relations before the US election next year. There are already signs that some of President Trump's core supporters in the 2016 election are losing patience with the trade war, most notably farmers. The President can also ill afford a sharp slowdown in economic growth going into the election. If risks for a second term re-election should increase, Trump could decide to step-back from his aggressive negotiating tactic with China and try to reach a preliminary deal to please markets and promote his image of great deal-maker.

Although China indicated its preference for rolling back tariffs instead of escalating further, we believe Beijing will only accept an agreement, if Washington would ease restrictions against Huawei and other Chinese tech companies. Given the growing bipartisan consensus in the US to limit the Chinese technological ascent, we assign a low probability that such scenario could materialize.

Table 2: Summary of new CIO scenarios for US-China trade

Scenario	Probability (6m view)	Likely path	GDP impact relative to baseline (12m)	Fed response	US recession risk (2020)	Expected market performance (6m)
De-escalation before the US election	20%	✓ Some roll-out of currently pledged or already implemented tariffs High-level talks resume, giving room for further de-escalation	US: +25bps China: +10 to +20bps	-25-50bps	20%	Global equities: 0% to 10% EURUSD: ≤ 1.12 USDCNY: 6.8-7.0 Gold: $1,400/oz. Oil: $65-$75/bbl.
Prolonged trade tensions	45%	US and China latest tariff pledges come into effect as announced Uncertainty continues, further tariffs up to 35% and non-tariff escalation is possible	US: Baseline (1.75%) China: Baseline (5.8-6%)	-75-100bps	30%	Global equities: -5% to 0% EURUSD: 1.13-1.18 USDCNY: 7.0-7.4 Gold: $1,550-$1,650/oz. Oil: $55-$70/bbl.
Escalation leading to a US recession	35%	✗ 35%+ tariffs on all Chinese goods, and /or auto tariffs, technology escalation High probability of a global economic downturn	US: -100bps China: -30 to -50 bps	>-100bps	≥50%	Global equities: -15% to -20% EURUSD: 1.18 USDCNY: 7.4-7.6 Gold: $1,700/oz. Oil: $40-$50/bbl.

* Impact on official headline GDP growth in China, including offsetting effects of countercyclical policy measures by Chinese authorities.
Source: UBS, as of 30 August 2019

Investment conclusions

We recently adjusted our portfolio recommendation to reflect rising risk that the trade conflict could cause more damage to an already weak global economy. While we removed our overweight to equities versus bonds, we have not positioned for a strong equity sell-off, as central banks are in easing mode and fiscal stimulus is also on the horizon. We continue to take risk on income-enhancing strategies, which benefit from central easing as global growth slows.

In our upside scenario, risk assets would appreciate and safe bond yields rise. However, the extent of a risk-on rally would primarily depend on the degree of de-escalation and the amount of central bank policy easing. For global equities we would expect return between 0% and 10% while the USDCNY could potentially dip back below 7.

Our downside scenario would significantly increase the risk of a recession in the US next year. Ultimately, this would put markets from a late cycle stage to end of cycle territory with more severe repercussion for risk asset classes. We would expect global equities to experience a drawdown of 15-20%, with sector exposed to the trade conflict (e.g. industrials or materials) suffering more than defensive sectors such as consumer staples and health care – two sectors which we also like in our base case scenario. Safe-haven currencies such as the Swiss franc and the Japanese yen would appreciate alongside gold, which would likely exceed our target of USD 1,600 oz in six months. The USDCNY could reach 7.6, but a dovish enough Fed would prevent further upside in our view.

For more details on the investment implications of "end-of-cycle scenario" please refer to our report "Cycle scenarios: How can investors position?" from 19 August.

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