



# Market Note



7 November 2018

## A moderation in Sino-US trade relations expected after US mid-term election results

On 6 November (US Time), the United States held mid-term elections. Various media reported that the Democrats won a majority of seats in the House of Representatives, while the Republicans maintained their majority in the US Senate<sup>1</sup>. In this market note, Ronald Chan, Chief Investment Officer, Equities, Asia (Ex-Japan), gives his views on how the results of the US mid-term elections will affect the trajectory of US-China trade relations and Asian markets moving forward.

### Mid-term results diminish US focus on China, removes market uncertainty

According to Ronald Chan, his base case scenario for US mid-term elections was a split Congress, which was confirmed by various media on 7 November (Asia Time)<sup>1</sup>: a Democratic-led House of Representatives and Republican-led Senate. The main short-term impact of the elections, Chan believes, is that the US administration's pre-election focus on China is likely to be more structured and pragmatic and that both sides will be able to follow a clear set of requirements.

Indeed, US-China relations and tariffs arguably occupied a top spot of the administration's agenda over the summer and early fall campaign season. However, the election's results should herald a shift to focus more on domestic issues and potential political gridlock for three reasons: The Democrats now have power to pass or block legislation, the political focus in the US will shift to the 2020 presidential election, and the US economy will face increasing challenges.

Regarding the latter point, Chan believes that the US economy, while currently strong, will begin to marginally decelerate along with global economic growth heading into 2019. The dollar will start to gradually turn over as a result. This development should be a positive for Emerging Markets (EM) and particularly Emerging Asia where a stronger US dollar has hurt equity returns year-to-date<sup>2</sup>.

Overall, Chan believes mid-term election results should have a moderating impact on the US-China trade relationship. Up to this point, the Trump administration has determined the direction of US-China trade policy. The introduction of Democratic Party leadership, which possesses a different style of governance and opinions, will interject diversity and structure into how US-China trade relations should be run.

Finally, the mid-term elections should help remove some market uncertainty, as the US does not have many tariff-based policy moves left. The US has already placed US\$250 billion of tariffs on Chinese goods, while China has responded with US\$110 billion in tariffs on US goods<sup>3</sup>. The US only has one tranche of tariffs left, estimated at roughly US\$257 billion<sup>4</sup>, to place before tariffs have been exhausted. Chan believes the market already recognises the full extent of the economic punitive measures, and with

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<sup>1</sup> CNN, CNBC, Bloomberg, Reuters, 7 November 2018.

<sup>2</sup> FactSet, as of 31 October 2018. MSCI Emerging Market Index and MSCI Asia Pacific ex-Japan Index, total returns in US dollars.

<sup>3</sup> Reuters, 30 October 2018.

<sup>4</sup> Bloomberg, 30 October 2018, "U.S. Plans More China Tariffs If Trump-Xi Meeting Fails, Sources Say."

greater clarity on the political side, recent trading based on uncertainty and lacklustre sentiment should gradually find a direction.

### **Chinese policy represents a potential upside, opportunity to upgrade**

On the Chinese side, Chan believes that China still has the policy tools to deal with continued trade friction. Although some recent economic data, such as third-quarter GDP print, show a marginal weakening of economic growth<sup>5</sup>, high-frequency data points remain strong and the Chinese government has strategically waited until the US mid-term elections concluded to fully respond. Thus, initial policy to mitigate the impact of US tariffs has focused on targeted efforts to support the economy such as personal tax cuts, monetary liquidity injections, and regulatory relief for businesses. More aggressive policy tools such as fiscal stimulus have been withheld until there was greater clarity on the political situation in Washington D.C. These stronger policy responses represent a potential upside for the Chinese economy and domestic equity markets.

Overall, Chan thinks that China will continue to adopt reforms to strengthen the economy and increase its competitiveness over the long-term. On 5 November, President Xi's announcement that China will cut import tariffs further and broaden market access is symbolic of this policy direction<sup>6</sup>. The Chinese government will also promulgate policies and assist businesses pursuing innovation, upgrading the nation's manufacturing base as firms move up the production value-added chain. Finally, Chan believes China will build its economy through accelerating regional integration initiatives. US-China trade tension has catalysed regional-based initiatives such as the Regional Comprehensive Economic Partnership (RCEP). Continued trade tension between the US-China will likely strengthen regionalism in Asia moving forward.

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<sup>5</sup> Reuters, 19 October 2018: "China third quarter GDP growth slows to 6.5 percent year-on-year, missing forecast"

<sup>6</sup> Bloomberg, 5 November 2018, "Xi Says China to Cut Import Taxes Further, Import \$30 Trillion."

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