Philequity Corner (June 25, 2018)
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Who wins the war?

After months of negotiations, trade tensions among different countries appear to be escalating into an all-out trade war (*Trade Wars*, March 26, 2018). Politicians, economists and investors are all watching to see who will be the winners and losers in a trade war and how the rest of the world will be affected.

Trump instigates trade brawl, China counters

After trying but failing to hammer a deal with China, Trump declared the imposition of 25% tariffs on $50b of Chinese exports to the US last June 15. In response, China announced retaliatory tariffs on $50b of US goods. Aside from imposing tariffs, China may also retaliate by reducing its purchases or holdings of US Treasuries. Moreover, the Chinese government may ask its citizens to boycott mainstream American brands that are doing well in China such as McDonald's, KFC, Starbucks and Apple.

A fight for tech dominance

In justifying the trade war, the Trump administration asserts that the Chinese government forced American companies operating in China to transfer technology and intellectual property to their Chinese counterparts. According to a report by the Trump government, China's allegedly illicit practices on intellectual property and technology have allowed it to become a global leader in technology while costing the US hundreds of billions of dollars. Thus, it appears that Trump is bent on derailing China's aspiration of attaining technological dominance in the future.

Strong US economy emboldens Trump

Investors, economists and political analysts are wondering why Trump has boldly instigated a trade war against China, Europe, Canada and other countries. We at Philequity believe that what emboldened Trump to initiate a trade war is the strong performance of the US economy in the past months. Estimates for annualized 2Q18 GDP growth range from 3% to 4.8%, with a mean estimate of ~4%. Meanwhile, US unemployment has reached an 18-year low amid rising but manageable inflation. These prompted the Fed to raise its benchmark rate for the second time this year and increase its 2018 rate hike guidance from three to four (*4, not 3* – June 18, 2018). The Fed's rosy assessment of the economy has given Trump the confidence that the US can win a full-scale trade war.

Preliminary scorecard

Based on recent market performance, it appears that the US is winning the early rounds. Since the tariff declaration on China last June 15, the Dow and S&P 500 both declined but fared better than the Shanghai Composite, which fell 4.4% in the past week.

Stock market performance: US vs. China

	Year-to-date	Jun 15 to Jun 22
Nasdaq	11.4%	-0.7%
Russell 2000	9.8%	0.1%
S&P 500	3.0%	-0.9%
Dow Jones	-0.6%	-2.0%
Shanghai Comp	-12.6%	-4.4%
Shenzen Comp	-15.9%	-5.6%

Source: Bloomberg

Despite the announcement of new tariffs by the US and China, both the Nasdaq and Russell 2000 touched new all-time highs last week before correcting last Friday. In contrast, the Shenzen Composite fell sharply last week because Chinese tech stocks are the most vulnerable to Trump's attacks.

US economy may withstand China's body blows

So far, it appears that the US economy may be able to withstand China's trade punches and body blows. The US has deep, liquid and sophisticated financial markets that can offer diversified exposure to different segments of the economy. In fact, there are certain sectors, such as tech and midcaps, which can thrive despite the prevalence of a trade war. The US possesses a strong domestic economy that has been buoyed by tax reform and deregulation. In contrast, there are concerns about the potential damage that will be dealt by Trump's trade war to China's export-driven economy.

Collateral damage

When two giants brawl in the street, innocent bystanders can get punched in the nose. In this case, emerging markets (EM) are collateral damage in the brewing global trade war. As seen in the table below, many EM countries are down for the year after falling sharply last week.

Stock market performance – EM Asia

	Year-to-date	Jun 15 to Jun 22
India	4.8%	0.2%
Pakistan	2.9%	-4.7%
Taiwan	2.4%	-1.7%
Vietnam	-0.1%	-3.3%
Hong Kong	-1.9%	-3.2%
Korea	-4.5%	-1.9%
Malaysia	-5.7%	-3.8%
Thailand	-6.8%	-4.1%
Indonesia	-8.4%	-2.9%
Philippines	-17.5%	-6.2%

Source: Bloomberg

Many countries, including the Philippines, provide 'intermediate goods' to China and are part of the value chain for Chinese products. Moreover, several Asian countries are vulnerable to a full-blown trade war due to their dependence on exports, widening current account deficits and weakening currencies. These countries are susceptible to capital flight as money flows away from EM Asia and back to the US.

Everybody loses in an all-out trade war

The US appears to be winning the early rounds of the trade war but actually, it is only losing less. As we show in the table above, collateral damage especially to emerging countries in Asia has so far been severe. The main risk is that ongoing trade tensions may evolve into an all-out trade war similar to the one that occurred in the 1930s. A trade war of that magnitude may usher in a sharp and protracted economic recession, akin to the Great Depression in the 1930s. So far, countries that are most vulnerable to a trade war have shown more pronounced weakness in their stock markets. While Trump may believe that the US can win the battle, the reality is everybody loses in a full-blown trade war.

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