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US-China Escalating Trade Tension Threatens Global Economic Recovery

Tit-for-tat

FBM KLCI: 1,846.81 points

2018 Year-end Target: 1,900 points

Donald Trump signed an executive memorandum (related to so-called Section 301 Investigation) that would potentially result in punitive tariffs on (up to) USD60 billion of Chinese products imported into the US. We then witnessed a negative knee-jerk reaction in global equity markets after US President. Promptly, China promised to hit back but with rather modest USD3 billion proposed tariffs on US imports.

In our Strategy report titled "US Tariff Measures" dated 28 March 2018 (Part 1 and Part 2), we remarked that "The reaction from China was arguably more of a face saving measure and tacitly signals its unwillingness to flare up the situation."

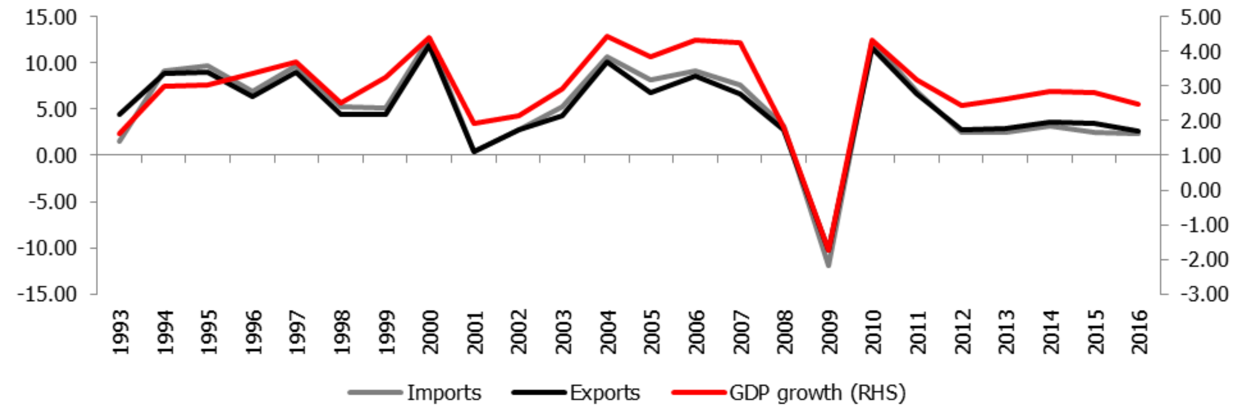
Reciprocal tariffs USD50 billion of US goods. China unveiled the plan to impose reciprocal tariff worth USD50 billion of US goods. Tit-for-tat responses matched the scale of the proposed US tariffs announced earlier. The timing of the implementation however will depend on when the US will apply its own. The escalating tension between the two biggest economies will cast a doubt about the near term outlook of global trade.

The threat of trade war at this juncture remains elevated. President Trump is a long standing sceptic of free trade. US withdrawal of long negotiated TPPA in January 2017 was one of his first anti-free trade move of many we seen so far. With the resignation of Gary Cohn in early March signalled that White House is in the full control protectionist. With host of tariffs announcements seen in the past weeks, the threat to global trading system is indeed real this time around. A full blown trade war will be disastrous.

Trade war - many possibilities, devastating outcomes. Trade war in 1930s was a distance past. But the lessons learnt remain relevant across time. The risk of tit-for-tat escalation will impede global trade and drain transnational investment. This will eventually create negative spill-over effects to the affecting countries but also trickle down to other parts of the world as well.

Slowdown in global economic performances. International exports and imports for the past few years reflect a slowdown in the global economy. Exports and imports in 2016 grew however at a softer pace by 2.7% and 2.4% respectively partially buoyed by easing economic activity globally. In 1Q17, trade indicators such as exports orders increased, signalling stronger trade growth for the year. Trade has high potential to reinforce global economic growth if the movement of goods and services across borders remains clear. However, the presence of uncertainties such as Trump's protectionism moves weigh on the outcomes.

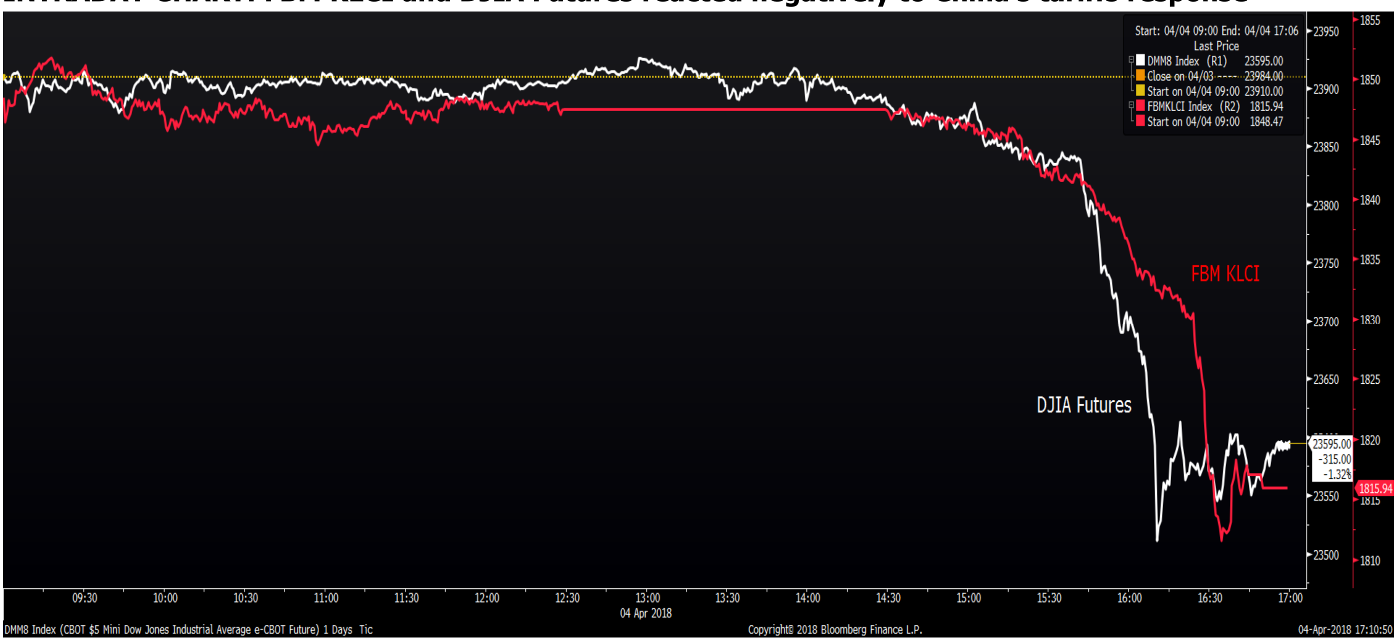
Chart 1: Global Growth: Imports & Exports vs GDP (YoY%)



Protectionism threat remains as global downside risks. As mentioned in our previous thematic report, Trump's administration is expected to impose tariff hike on steel and aluminium industries. As promised by Trump, "Make America Great Again" campaign is to attract US-based companies to relocate to the US and providing more jobs to the local Americans. Therefore, we foresee further protectionism moves to be made by the US government in order to 'protect' its economy. On the other hand, such moves would spur market uncertainties, drop in business confidence, affect commodity prices and to the extent could drag down global growth in the medium term.

Market reacted negatively to the surprise tit-for-tat move by China due to concerns of a possible trade war between the world's two largest economies. US stock futures and Asian equity markets tumbled as soon as the announcement was released by the Ministry of Commerce in Beijing. Locally, the FBM KLCI ended the day lower by -34.84 points to close at 1,815.94, the lowest level since 6 February this year. However, in spite of the negative market reaction, the amount of tariffs involved is minute in comparison to the quantum of trades between the affected countries. For example, China's exports to the US totaled more than USD500 billion last year and it is estimated that the recently announced tariffs may add levies by less than USD15 billion.

INTRADAY CHART: FBM KLCI and DJIA Futures reacted negatively to China's tariffs response



Source: Bloomberg, MIDFR

Possible counter retaliation by the US. Having said the above, the main worry is that China's tit-for-tat response results in a counter retaliation by the US. As highlighted in our previous Strategy report, it is worthy to again recall that as President Trump signed the memorandum on trade actions, he stated, "This is the first of many". On that score, we reckon a counter retaliation would almost certainly result in a full-blown trade war. History taught us that trade wars invariably led to net negative outcomes to all parties.

Maintain FBM KLCI year-end target at 1,900 points. At this juncture, we are nonetheless still hoping that cooler heads prevail. Hence we maintain our FBM KLCI 2018 year-end target at 1,900 points.

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STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >+10% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >+10% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -10% and +10% over the next 12 months.
SELL	Total return is expected to be <-10% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >-10% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.