THE WATCH

15 October 2019

U.S.-China mini-deal: trade policy volatility is here to stay

- The so-called "mini-deal" between the U.S. and China is not a game-changer for the global economy. The U.S. average tariff could reach around 8.5% by year-end (taking into account a 10% tariff on EU car imports and the 15 December round of tariffs on Chinese goods). We remain in our intermediate "Trade Feud" scenario; policy volatility is the new norm in trade negotiations, and it goes beyond tariffs (ban lists of companies).
- We are far from a comprehensive agreement. The hardest part of negotiations still lies ahead: the two parties are switching to "Phase two", which should deal with market access, IP protection, China's industrial subsidies, U.S. sanctions on Huawei and Chinese surveillance firms. We are unlikely to see a comprehensive deal before the 2020 U.S. election.
- We give 55% probability to the scenario of the U.S. turning its trade policy focus to Europe on 17 November. In the case of a 10% tariff on car imports, aggregate export losses for the EU would be EUR4bn per year, and GDP growth would be hit by an annual -0.1pp.

The U.S.-China mini-deal is not a game-changer for the global economy. We expect no comprehensive deal before the U.S. election

On October 11, the White house announced a "deal" with China, although the Chinese official press did not used the words "deal" or "agreement". The details will be finalized over the next month and ideally Presidents Trump and Xi would sign the agreement in Chile mid-November at the APEC Summit. However, this agreement is only "Phase one" of the negotiations: During a White House meeting with Liu He, China's Vice Premier, President Trump said "It's such a big deal that doing it in sections, in phases, is really better. . So you'll either have two phases or three phases."

Figure 1 – What the two sides are said to have agreed on (subject to change in the next four weeks)

On the U.S. side...	On the Chinese side...
Suspending the hike from 25% to 30% tariffs on USD250bn of Chinese imports initially planned for 15 October. However, the 15 December tariffs are still in the pipeline, which means they could depend on the "Phase two" negotiations.	USD40-50bn of annual purchases of U.S. agriculture and changes in agriculture policy Currency transparency (guidelines on how the renminbi is managed) Opening market access for U.S. financial services firms

Sources: Various, Allianz Research

Hence, we are far from a comprehensive agreement, and the hardest part of the negotiations still lies ahead. The two parties are now switching to "Phase two", which should deal with market access, IP

protection, China's industrial subsidies, U.S. sanctions on Huawei and Chinese surveillance firms. We are unlikely to see a comprehensive deal in 2020. We reiterate our belief that a softening in China's stance on such core issues is unlikely. China would rather play the long game as it is not bound by elections. That being said, China has started to import more from the U.S. (+1.6% y/y in August 2019, see Figure 2).

Figure 2 – Bilateral trade between the US and China, y/y

Sources: National sources, Allianz Research

The mini trade deal between the U.S. and China is yet another illustration of the continued volatility over policy announcements on both the U.S. and China's sides, with indications of a temporary Trade Détente following this summer's escalation. This is something we pointed out in our September Global Macroeconomic Update. We continue to believe this policy volatility is the new norm in trade negotiations.

The Trade Détente is not a game-changer for the global economy: As of 15 October, the U.S. average tariff dropped -0.7pp compared to our previous estimate since USD250bn of Chinese imports remains taxed at 25%, not 30%. Hence, by year-end, the U.S. average tariff should reach 8.3% (instead of 9%), from around 7.5% today, taking to account the 15 December tariff implementation. The 50% tariffs on steel imports from Turkey (likely on 21 October) would have a negligible effect on the U.S. average tariff.

Figure 3 - U.S. tariffs on China's imports

Tranche	Value	Current tariff	Product groups	Change as of October 15	Potential future change
List 1 + 2 + 3	Around USD250bn	25% (respectively since 6 July 2018, 23 August 2018 and 10 May 2019 for 1, 2 and 3)	Industrial machinery, capital goods, electrical equipment, furniture, electronics, autos, leather goods	No hike to 30%. Unchanged	-
List 4A	Around USD300bn	15% since 1 September	Apparel, footwear, electronics, TVs/monitor screens	-	Could be hiked to 25% (not baseline)
List 4B		15% on 15 December	Cell phones, computers, toys, electronics	-	Could be delayed after Christmas. Could be hiked to 25% later (not baseline)

Sources: Various, Allianz Research

The tariff volatility is here to stay, notably during the impeachment inquiry. Although the mini trade deal provided relief to financial markets, it will not improve global economic growth, which would continue to slow down to +2.4% in 2020, the lowest level since 2009. We remain in our "Trade Feud" scenario and we believe the impeachment inquiry in the U.S. will create further noise and switch President Trump's attention to other regions (similar to the recent conflict with Turkey). The U.S. economy is likely to continue in its slowdown phase before a

negative quarter of growth in Q1 2020. The Fed should pursue its monetary policy easing cycle: We expect one more rate cut by year-end and three more in 2020. As a reminder, in our monitoring framework, the switch from "Trade Feud" to a full-fledged "Trade War" happens at the 12% U.S. average tariff threshold. To switch to a full-fledged trade war (not our baseline scenario) we would need two out of the three following events: (i) Mexico tariffs hiked to 25% on all imports (USD370bn); (ii) 25% tariffs on all cars imported into the U.S. (USD200bn) and (iii) a tariff hike from 15% to 25% on list 4 (A and B) of U.S. imports from China (USD300bn). We expect a correction in the European equity markets, which will comfort the ECB in cutting the deposit rate in Q1 2020 and increasing the QE size (from the current EUR20bn per month to EUR30bn).

Trade policy volatility is not limited to tariffs. The U.S. recently added eight new Chinese electronics companies to its business-ban list. However, should the U.S. expand this list in a new round of trade restrictions, the impact will be felt by big companies (e.g., Lenovo). As China remains the U.S.'s first market, this could in turn affect U.S. companies. In that case, the impact on semiconductor supply chains will also be disruptive beyond China (Taiwan, South Korea and Germany will also be hit).

Figure 4 – US multinational companies' exposure to China in the electronics sector

Company	2018 sales ($m)	% sales in China (2018)	China's rank	Business model	Key segment	Estimated market share in key segment
Qualcomm	22,732	66.6%	1	Fabless	Mobile microprocessors	50%
Micron	30,391	57.1%	1	Integrated	DRAM	24%
Broadcom	20,862	49.4%	1	Fabless	Mobile Wifi	30%
Texas Instruments	15,784	44.3%	1	Integrated	Analog IC	18%
AMD	6,475	38.9%	1	Fabless	Discrete GPU	30%
Applied Materials	17,253	29.6%	1	Equipment	Semiconductor Equipment	25%
Xilinx	3,059	27.8%	1	Fabless	FPGA	60%
KLA	4,569	26.6%	1	Equipment	Metrology / Inspection Equipment	70%
Intel	70,848	26.6%	1	Integrated	Server CPU	90%
LAM Research	9,654	22.4%	2	Equipment	Semiconductor Equipment	21%
Microchip Technology Inc	5,350	22.0%	2	Integrated	Microcontrollers	15%
Apple	265,595	19.6%	3	Products	Smartphones	15%
NVIDIA	11,716	19.5%	2	Fabless	Discrete GPU	70%
Analog Devices	6,201	19.5%	3	Integrated	Analog IC	9%

We give 55% probability to the U.S. turning its trade policy focus to Europe on 17 November

The decision of imposing U.S. tariffs on car imports (currently taxed at 3% from the EU) is expected to come on 17 November. President Trump has criticized ECB policy on several occasions and put Germany on the list of "currency manipulators". There is also a delicate balance with France, which has recently imposed a GAFA tax. Hence, we expect President Trump to announce on 17 November that the U.S. aims to implement a 10% tariff (from a range of 10%-25%) on imported European cars (EUR48bn from the EU out of the EUR260bn of total imported cars by the U.S.) in the absence of noticeable progress on the U.S.-Europe trade deal.

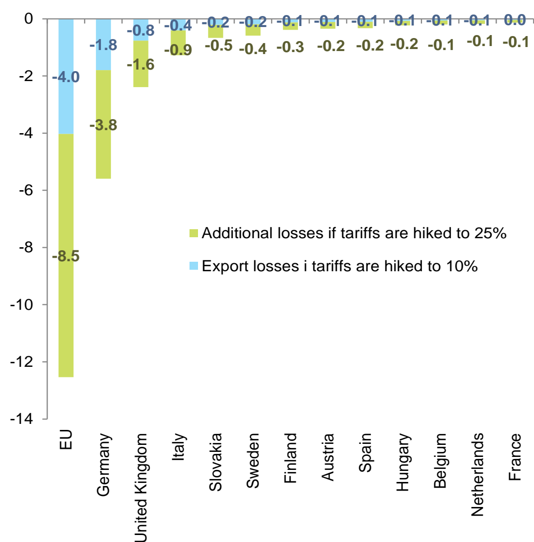
What could be the impact?

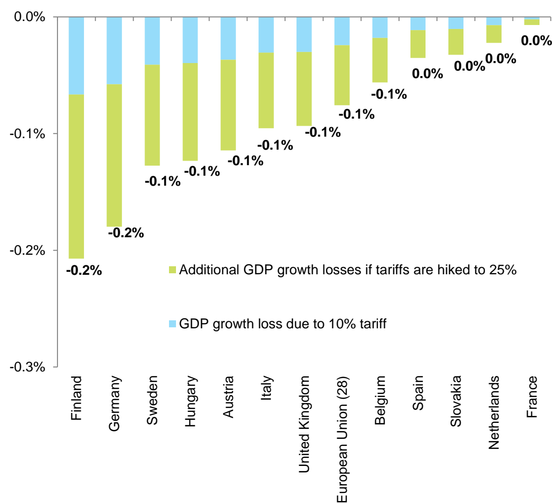
- **EU growth would be hit by -0.1pp (for 10% U.S. import tariffs).** Germany would be hit the hardest in terms of export losses and given the weakness of its automotive sector, we expect the recession in the industrial sector to continue in early 2020. Hence, a technical recession could easily materialize even if it is not our central scenario. In terms of GDP growth, Finland, Germany and Sweden would be the most exposed.
  - If the U.S. were to impose 10% tariffs on its EU car imports in November:
    - Aggregate export losses for the EU would be EUR4bn per year.
    - The increase in the U.S. average tariff will be very limited (+0.2pp), which is still far from a "Trade War" situation (average US import tariff above 12%.[1])
  - If tariffs are further hiked to 25%:
    - The total export loss for the EU would be EUR12.5bn per year.
    - Germany would be hit by more than -0.3pp of real GDP growth per year, pushing it closer to a full-blown recession.
    - The U.S. average tariff would go up by +0.5pp.

[1] **Cf. page 4** https://www.eulerhermes.com/content/dam/onemarketing/euh/eulerhermes_com/erd/publications/pdf/20190919TheView-Liberal-cycleCOMPRESSED.pdf

We expect a correction in the European equity markets, which will comfort the ECB in cutting further the deposit rate (-10bps in March and -10bps in September) **and increasing the QE size in April** (from the current EUR20bn per months to EUR30bn).

Figure 4 - Expected annual export losses by country from higher U.S. import tariffs on cars (EURbn and pp of real GDP growth)





Sources: ITC, WTO, Allianz Research

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