Trump & Trade: What you need to know

1 May 2018

- The current level of trade tensions between the US and China is not just about trade deficits and/or tariffs; it's more forward-looking and also driven by the Trump administration's view that past pledges of fundamental change in China are yet to be fulfilled, as well as concerns over the "Made in China 2025" industrial plan.
- Although President Trump has clearly ramped up his aggressiveness on trade this year, especially with China, his trade policy decisions to date have been less aggressive than his rhetoric. This is reflected in our base-case scenario (60% probability) for the US/China intellectual property (IP) dispute. In our base case we expect both countries to impose 25% tariffs on about $50bn worth of imports from the other country, with a 20% probability of further escalation (and a 20% probability of an agreement being reached with lower tariffs).
- While not our base case, we believe the trade ideas for a trade war are long JPY/KRW or long AUD vs GBP vol. However, in Rates it would be short 3yr swap spreads, long 1y10y vs 1y2y rates vol, higher term premia and further upside for US inflation valuations relative to euro valuations. In Equities it would be sectors that have benefitted the most from globalisation that would suffer such as Japanese electronic parts and autos, with rare earth miners a potential outperformer.

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Production Complete: 2018-05-01 16:47 UTC

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“Even shooting wars end in negotiations”

Executive Summary

The current level of trade tensions between the US and China is not just about trade deficits and/or tariffs; it’s more forward-looking and also driven the Trump administration’s view that past pledges of fundamental change in China are yet to be fulfilled, as well as concerns over the “Made in China 2025” industrial plan.

Although President Trump has clearly ramped up his aggressiveness on trade this year, especially with China, his trade policy decisions to date have been less aggressive than his rhetoric. This is reflected in our base-case scenario (60% probability) for the US/China intellectual property (IP) dispute. In our base case, we expect both countries to impose 25% tariffs on about $50bn worth of imports from the other country, with a 20% probability of further escalation (and a 20% probability of an agreement being reached with lesser amounts of tariffs). In this piece we discuss what has been said by both sides so far, what is up for negotiation, and what economic, market and other policy tools both the US and China have in case there is an escalation of trade tensions.

While not our base case, we believe the trade ideas for a trade war in FX that would do well are long JPY/KRW or long AUD vs GBP vol. However, in Rates it would be short 3yr swap spreads, long 1y10y vs 1y2y rates vol, higher-term premia and further upside for US inflation valuations relative to euro valuations. While we deem a severe escalation and the tools available unlikely to be used, should they actually be applied, we note that the end game of a deal may still remain the same. As Wilbur Ross once said “even shooting wars end in negotiations.”

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- The US trade deficit is not just with China, but also the EU and Japan too
- The end-game: perceived costs now between now and the future
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What is going to happen on the 301 case?

In our opinion, the US 301 case against China’s intellectual property policies poses the biggest risk to significant tariff escalation. Despite heated rhetoric and the often-used phrase of “trade war” our base case (60% probability) is that the US/China dispute over IP could be settled this summer (with the aim of securing a ‘win’ before the mid-term elections). However, that doesn’t mean tariffs won’t be imposed. We expect the US and China to impose tariffs of about 25% tariffs on about $50bn worth of imports from the other country. This would outcome would represent, at least to some degree, a moderation current tensions. Overall, the amounts of these tariffs are very small relative to the overall volume of trade for the two countries—i.e., this would be well short of a disruptive “trade war.”

That seems like a big step down from current tensions; how did we reach that conclusion?

Although President Trump has clearly ramped up his aggressiveness on trade this year, especially with China, to date ***his rhetoric on trade has been far more aggressive than his final actions*** (see Figures 2 and 3). Forces likely restraining President Trump include the negative consequences of a sharp escalation in trade protectionism, especially before the mid-term elections. Based on our observations, he would be

concerned with negative market reactions, the negative implications to the economy (and especially those in areas that voted for him), and public opinion (which has been lukewarm on tariffs, although based on polls[1], his base appears more supportive).

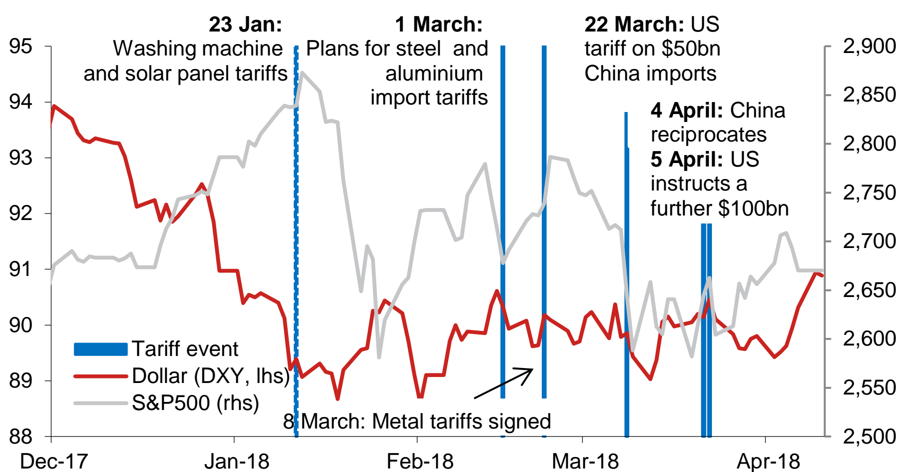
Trump's trade rhetoric/action dichotomy makes predicting his actions on trade policy difficult. Several of Trump's key trade advisors are very hawkish on China. Recently prospects for completing a relatively benign renegotiation of NAFTA have gone up. But this shift probably has few implications for the US-China dispute. The US trade deficit with Mexico is much smaller than the trade deficit with China, and Canada is a key export market for the US (also, when including services, the US has a trade surplus with Canada). Other areas of friction between the US and China include alleged misuse of intellectual property (IP) in China and the expanding trade deficit under Trump's watch. For these reasons, we should not dismiss the risk of further US-China tensions before the more market friendly end-game.

What are the economic and market implications of the base-case scenario?
For the base-case scenario (25% tariffs on $50bn of imports), we think the economic effects for both countries would be minor. However, during the negotiation period, business confidence could soften as a result, not just from the final actions that are taken, but also because of the uncertainty around the final outcome. Reflecting this uncertainty, financial markets are likely to continue to face headline risk. As we have been monitoring in our Trade war tracker the historical pattern observed in previous trade tensions is that the USD tends to weaken against other reserve currencies such as the JPY and EUR.

The USD has been trading in a sideward range for the past few months during these trade tensions and US rates markets' correlation to tariff news has been relatively low. The implied equity vol term structure is slightly upward sloping but essentially flat until year-end, suggesting that market participants expect equity vol to remain elevated over concerns of a potential broader correction due to a deepening trade war and/or a sharper tech stock correction (see Broader markets can't shake tariff blues). Although the USD has recently broken higher, we believe it's been rallying for "bad" reasons. FX markets could be signalling that the risk environment has turned to geopolitical concerns (with many event risks for the next few weeks it could continue).

That said, our view remains that investors should position for a medium-term downtrend in the USD, and if combining that with concerns of a trade war, *short USD/JPY is the core trade to hold.*

Fig. 1: US trade actions and market reactions



Source: Bloomberg, Nomura

What lies ahead for US/China trade relations?
There are several upcoming events on the US/China trade risk radar screen. On 15 May the USTR's Section 301 Committee is scheduled to hold a public hearing of testimonies from business groups and lobbyists, increasing the possibility of some dilution. While this

[1] For example, see an April 2-8 poll from the *New York Times*, https://www.nytimes.com/2018/04/17/business/economy/trade-midterm.html

should make headlines, any decision to impose tariffs will likely come after the 22 May due date for submission of post-hearing rebuttal comments.

Further, it has been announced that a high-level US delegation will go to Beijing in an attempt to lower trade tensions and reach an agreement. While we do not expect the US or China to back down from their initial tariff threats, we do not expect there to be any escalation either. However, there is a risk that this meeting could signal a deterioration in relations, increasing the likelihood of further escalations. It is also possible that the meetings could generate an agreement, although given the lack of detailed preparation that seems highly unlikely. Going forward, please see our Event Risk Radar for updates (link).

That's all for the short term. Our end-game base case is outlined above; how we arrived to that conclusion relies on some assumptions that may be tested in the course of the next few months. Thus, in the following pages, we provide further details on how we reached our view and at the end provide the tail risk trades that should perform if tensions do end up escalating.

A series of "trades that work in a trade war" on the back of our findings can be found at the end of this report.

The History of US-Sino trade relations

After two decades of a US trade embargo, President Nixon made a landmark visit to China and signed the Shanghai Communique in 1972. This began the work that led to the normalization of diplomatic relations between the People's Republic of China and the United States. In 1980, the first special economic zones opened in China giving preferential treatment to foreign investors. China also returned to the World Bank and IMF in that year. In 1984, President Reagan signed an agreement to eliminate dual taxation and ban tax-evasion, however, the relationship wasn't all in one direction. US sanctions were applied in 1989 after the Tiananmen Square tragedy and the first intellectual property rights disputes broke out in 1994. However it was not until 2001 when China joined the WTO that China's trade surplus with the US widened sharply, rising from $24bn in 2000 to $420bn in 2017. Although US-Sino trade interdependency has climbed to record-highs, it's the trade balance, adherence to the spirit of WTO principles, and IP disputes that appear to be at the centre of the current tensions.

The US frustrations of past dialogues with China

Since China acceded to the WTO in December 2001 there have been five US-China "Strategic Economic Dialogues." These detailed and broad ranging discussions were generally not contentious, but they generated only limited changes in economic policy. President Trump's first visit to China was met with a lot of fanfare. Deals were announced, promises were made and market sentiment ran high, but that was six months ago and still we are witnessing increased trade tensions. The official USTR website states that these bilateral efforts have largely been unsuccessful and US trade council director Peter Navarro (the author of the book "Death by China," link) recently framed China's reaction to US demands as *"the Great Wall of Denial"* (link). The annual USTR report to Congress on China's WTO compliance explains that in November 2017 when Trump visited Beijing, the US made it clear that it had no further interest in bilateral discussions of the past. Instead, the US requested that China make fundamental changes to its trade regime.

For trade, Trump's bark seems worse than his bite so far

Considering all the above, a pretty dismal picture can be painted with regard to the direction this is heading. However, on trade policy the Trump Administration's rhetoric has been more severe than their actual policy. Figure 2 highlights a few key examples.

In addition, for the 301 China IP investigations, the initial salvo surprised to the downside in two dimensions. First, the damage estimates of $50bn/year were lower than other estimates that have been produced (link). Second, up until the announcement, it was unclear if there would be $50bn in tariffs or if tariffs would be applied to $50bn worth of goods imports. In the end, it was announced that 25% tariffs would be proposed on about $50bn worth of goods imports, implying potential tariffs of $12.5bn.

Fig. 2: Trump's trade policy barks…

1. **Trump's campaign rhetoric** of labelling China a currency manipulator, withdrawing from TPP, and imposing large tariffs on China's products.
2. **NAFTA:** Throughout 2017, Trump repeatedly threatened to withdraw from NAFTA. Further, USTR Lighthizer initially pushed a number of very controversial changes to NAFTA including new content rules and a sunset clause to NAFTA.
3. **Steel and aluminium tariffs:** On 1 March, Trump announced blanket tariffs on steel (25%) and aluminium (10%).

Source: Bloomberg, Nomura

Fig. 3: …seem worse than his bites

1. The Trump administration did withdraw from TPP, but *did not label China a currency manipulator* and has imposed relatively modest tariffs so far on steel, aluminium, and solar panels.
2. The Trump administration has been pushing to get the NAFTA renegotiations finalized and has *softened its demands*. It has been reported that withdrawal from NAFTA is being considered (link), but as a tool to pressure Congress to quickly agree to the renegotiated NAFTA.
3. For steel and aluminium, *significant exemptions were granted* after the initial announcement. NAFTA exemptions announced 8 March, and wider exemptions announced on 22 March. All told, 63% of steel and aluminium tariffs were exempted through at least 1 June.

Source: Bloomberg, Nomura

Fig. 4: The Trump Circle of Trade Influence

Source: Nomura. Ross (link), Navarro (link), Lighthizer (link), Kudlow (link), Hassett (link), Mnuchin (link 1 and 2).

But that was the first year; now Trump is surrounded by trade hawks

In Figure 4 we split the main trade advisors to President Trump between trade hawks and doves based on their public comments. This exercise demonstrates that while the doves seem optimistic that something positive will come from the trade talks, they also appear: 1) confident that there would only be a small impact to the US economy if the tariffs were to go ahead; 2) expect it to take time and 3) believe embarking upon trade tariffs to be the lesser of the two evils than maintaining the status quo. Meanwhile, based on our observations, the hawks seem to believe that the end game should be a much larger change to the status of trade than has been offered by China thus far.

Larry Kudlow's view of US import tariffs

In early March before he became part of the Trump administration, Larry Kudlow in his capacity as a CNBC commentator wrote an op-ed entitled "Mr. President, tariffs are really tax hikes." Within it he pointed out where the US historically raised tariffs, e.g., the protectionist moves during the Great Depression in the 1930s, Richard Nixon's 10% import surcharge and stagflation experience of the 1970s; Ronald Reagan's anti-dumping provisions against Japanese steel and George W. Bush's steel tariffs in the 00s. He argued that these tariffs have "almost never worked as intended and almost always deliver an unhappy ending." It's partly why we have put him on the "dove" side of our trade hawk/dove scale (see Figure 4).

Recent events demonstrate how announcing measures can quickly lead to retaliation

The bad news is that both sides were already at the negotiation table and making progress before the latest rounds of tariffs were announced. The good news is that the larger tariffs have yet to come into force, leaving some room for negotiation.

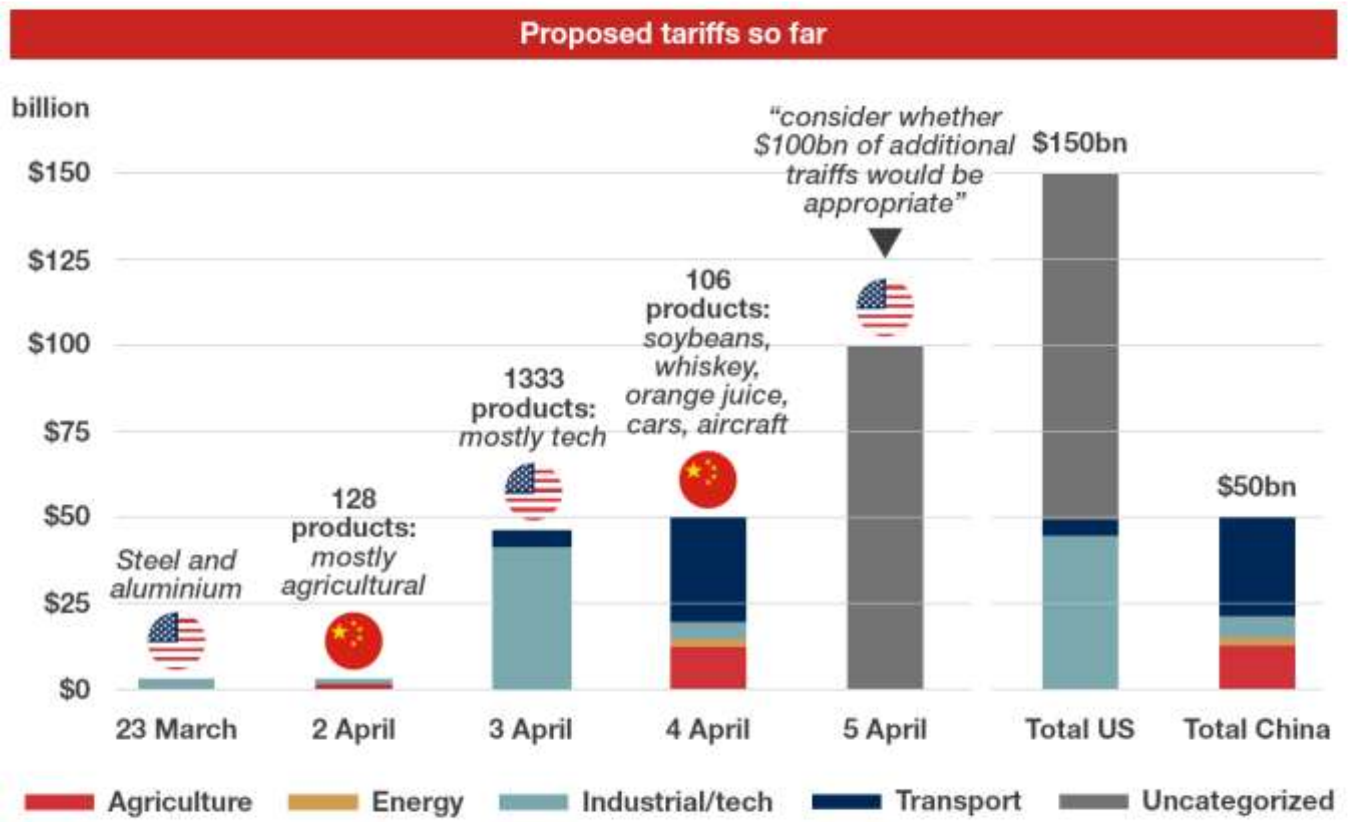
- **23 March:** The US imposes new tariffs on steel and aluminium (worth ~$3bn).
- **2 April:** China retaliates with 128 categories of products (worth ~$3bn).
- **3 April:** The US announces $50bn of Chinese products that could face 25% tariffs as soon as June.
- **4 April:** China announces $50bn of tariffs for possible retaliation.
- **5 April:** President Trump instructs the US trade representative to "consider whether an additional $100bn of additional tariffs would be appropriate."
- **10 April:** President Xi Jinping lays out plans to make the economy more open (link).
- **11 April:** PBoC Governor Yi Gang offered a timeline of financial sector liberalisation (link).
- **16 April:** US companies banned from selling to China's ZTE (link).
- **17 April:** China introduces 179% tariff/deposit value on US sorghum (link) but also scraps limits on foreign ownership of automotive ventures (link).

Future dates to consider

- **15 May:** The USTR's Section 301 Committee is scheduled for a public hearing of testimonies from business groups and lobbyists, increasing the possibility of some dilution of the tariffs.
- **22 May:** Deadline for rebuttal comments to the Section 301 Committee, further tariff measures from the USTR may follow.
- **1 June:** US exemptions for certain countries such as the EU on steel tariffs potentially come to an end (see Event Risk Radar).

So far the Trump administration has side-stepped many consumer goods on its list of tariffs, but could struggle to avoid doing so in any further escalation as already the $150bn of potential tariffs cover nearly 30% of US imports from China in 2017 (Census Bureau). China's options for meeting further US tariffs with more of its own is more limited, as raising tariffs to match the potential $150bn from the US would represent more than what China imported from the US in 2017. But as one Chinese official put it "it's only polite to reciprocate" (link) so if tariffs do escalate we examine the other options below.

Fig. 5: Timeline of US/China tariff escalation



Source: Nomura, USTR, The Financial Times, Bloomberg, Reuters,

The focus of US-Sino negotiations

Potential common ground in trade talks

- **Continued liberalisation of China's financial markets**. China has taken many small steps over the years to liberalise its economy, and has opened some but not all of its key sectors (i.e., telecoms, the internet, education, media, cars and pharmaceuticals) to full foreign acquisition. It's been a source of contention in US-China discussions since China's WTO entry in 2001 (link). In November of last year, vice-minister of finance Zhu Guangyao announced that foreign firms would be able to take majority stakes in securities, fund management and futures companies and announced in early April that it will be done "within a few months" (link). President Trump rejected the offer at the time as insufficient (link). It's unclear how he came to that conclusion but critics argued that the foreign ownership cap was only lifted for non-listed securities firms, which are much smaller (link). This has been a problem in and of itself, as when it comes to trade talks, it often takes time to go from rhetoric to action. In the meantime, US officials have pointed out that China is only allowing foreign-majority control in sectors dominated by large domestic companies.

- **China's auto sector:** President Trump has outlined his demands for lower auto tariffs and a loosening of the 50% foreign ownership limit in China's auto sector. Xi Jinping's 10 April speech at the Bo'ao Forum announced a lowering of import tariffs for autos and some other imports, but no specific timeline was provided. His four-point plan consisted mostly of previously announced initiatives. Since then, China has conceded and lifted ownership rules that limit foreign investment in Chinese car makers in full by 2022, starting with makers of electric and plug-in hybrid vehicles by end-2018, commercial vehicle makers in 2020 and the wider car industry by 2022. Whether that will be quick enough remains to be seen in these negotiations, but we think this is a good start.

- **A potential deal:** The deal in question is what China and the US can agree to in the next couple of months. US Treasury Secretary Mnuchin has highlighted the possibility of this quite recently (link). For China to agree, however, it will likely need to be framed as a "win-win" and it remains highly uncertain how we

would reach that point, given that the Trump administration appears to view trade as a zero sum game, according to public comments. However, there seems to be enough common interest, when considering the costs of trade barriers are deadweight, to make the case for a desirable outcome for both sides. In some respect, both sides seem inclined to make progress on a managed economic relationship.

A fully fledged free trade agreement (FTA) is not usually done quickly nor is it what we're expecting. That would be very unlikely, given the Trump administration's stance. To put this into perspective, the average length of a free trade negotiation for the US is 18 months and 45 from launch date to implementation (link). If we have misjudged, it's important to consider that trade agreements have different levels of "free trade." For NAFTA, it took between 1994 and 2008 for tariffs to be reduced between the US and Mexico (link) with some tariffs still in effect (link). China's FTA with Switzerland saw some tariffs eliminated from day one, but the majority of FTAs could take 5 to 10 or even up to 15 years to be reduced (link). The point being that free trade agreements do not necessarily lead to all tariffs being neither removed nor done quickly even after the agreement.

The contentious issues

The US Trade Policy Agenda is broad and the list of countries and issues at hand can be found in Chapter 1 (link). When it comes to the Section 301 investigations into China (link) there are many parts under consideration but below are some key aspects in the public domain on which the Trump administration may focus in talks.

- **Intellectual property (IP) theft and non-tariff barriers –**China has announced to re-organize the Bureau of Intellectual Protection this year (link), improving law enforcement and raising the cost of committing IP violations. Already some IP law experts argue enforcement has been improving in recent years (link) but the USTR in its Section 301 report stands by its conclusions that not enough has been done (link). China argues that the Section 301 probe is not an objective assessment of the improvements in China's IP protections (link). Thus it has become a key source of contention in these negotiations, which has spanned many years. Estimates of IP theft from the Commission on the Theft of American Intellectual Property puts that number between $225bn and up to $600bn per year (link). Chinese officials have pointed out that China is paying more for foreign IP and has reinforced the country's laws (link).
- **The goods deficit** – If China were to reduce high tariffs on US imports, it would be a quick win for the US administration. The US still enjoys a large lead over China in high-end manufactures or technology but faces high tariff and non-tariff measures. The main issue for the US when raising tariffs against Chinese goods is that the 1980s world defined by bilateral trade in finished goods is no longer applicable. Globalisation has led to a system of supply chains where the tariffs against China would hit intermediate goods into the US and the end result is that it will likely make US finished goods (that rely on Chinese intermediary goods) more expensive and less competitive. Since 1996, 75.5% of imports from China to the US were subject to duties at an average rate of 7.2%; that has now fallen to 41.3% of imports at an average duty of 6.5% (as of 2017), but raising tariffs could put an end to that trend (link and link).
- **Made in China 2025** – In the conclusion of the USTR's investigation into China trade practices "Made in China" was mentioned 114 times; this has been a large focus for the Trump administration. Since its announcement as policy, foreign firms have made it clear that this is likely to block US companies' access to the electric car and robotics industries in China. The goal of Made in China 2025 is to comprehensively upgrade Chinese industry, making it more efficient and integrated so that it can occupy the highest parts of global production chains and thus avoid the "middle income trap." The plan identifies the goal of raising domestic content of core components and basic materials to 40% by 2020 and 70% by 2025. It's these unofficial targets/guidelines that captures the most criticism of the plan (see Made in China 2025 and The impact of US trade protectionism, centring on China and link).

- **Subsidies to state-owned enterprises (SOE)** – SOEs are not just in China; they exist in most countries with prime examples being the post office, trains, energy or mining companies. In 2013 the OECD found that SOEs represented 6% of World GDP (link). In China the OECD estimates put SOEs at ~20% of China's total employment and 30-40% of total GDP (link). The US continues to argue that Chinese SOEs receive subsidies that unfairly benefit Chinese exporters (even though the WTO ruled against the US accusation in 2014). But SOEs have been declining in their overall influence in China's trade for quite some time now at just 16.4% of total Chinese merchandise trade (USITC staff paper). However, the USITC staff paper explains that SOEs remain prominent in certain sectors that China has considered strategically important, that affect global market conditions.
- **US export restrictions on hi-tech products to China.** US export controls are designed to *"protect national security interests and promote foreign policy objectives"* (link). It's been a part of the discussion between the US and China in previous talks (link). While it would be a measure that if removed would reduce the trade deficit with China slightly it would not be enough to make it a likely move the US would agree to due to security concerns.

The Trade Tension Tail Risks

China's options in an escalation

After the latest round of trade tariffs announced by the US, China stated that it was prepared to adopt comprehensive countermeasures to the actions taken by the US, some of which could help de-escalate tensions but the majority would serve only to raise them (see China: Impact of US tariffs).

1. **Increase imports from the US** – A headline-catching option to win over US trade representatives, particularly in high-tech areas, although this is likely to do little to change the big picture of Sino-US trade relations if the argument is over China's industrial policy and IP. The US will also likely to have to offer China something positive in return as has been the case at previous economic dialogues that the USTR has cast doubt on.
2. **File a complaint to the WTO** – A lengthy process, but a dispute settlement that can work with other WTO members to defend itself. It took three years before China's rare earth elements had their export restrictions lifted. As was widely reported, China indicated that it views the US measures as a violation of WTO rules and has launched a request for consultation at the WTO (link).
3. **Drag negotiations on until US softens**. Imply enough reform to keep negotiations moving with the aim that the US will eventually be lobbied enough by corporates affected by trade tensions to soften its stance.
4. **Limits on US companies and services in China** – Regulators may withhold licences or alter business conditions to hamper US/foreign business activity. It need not be widely publicized or formerly announced as this would relate to individual firms and cases but the retaliation would likely have a lower political impact if kept out of the public domain. In this scenario, several US firms could see their local join-venture partners reneging on agreements or authorities using minor regulatory reasons to halt production as a negotiation tool.
5. **Limit Chinese tourism to the US** – More than half of the US service surplus to China comes from travel and education ($32bn, see US: Trade War Risks). When South Korea deployed the US THAAD missile defence system, China included an unofficial order to travel agencies to halt tour groups to South Korea. The ban, introduced in March 2017, was partly lifted in November of last year but re-introduced in December. Tourism numbers had fallen 60% versus the same period last year at an estimated cost to South Korea of $6.5bn.

   Although we believe i*t would serve to worsen the US deficit*, President Trump is reportedly also considering measures to restrict the number of Chinese students at US colleges and universities (link).

6. **A currency devaluation** – A measure that has consequences. Overall, we do not believe deliberate RMB depreciation will be a good option for China if trade protectionism worsens (see China: Impact of US tariffs). We think China will attempt to keep the RMB relatively stable, given the negative externalities. It's likely any benefits to the external sector from pursuing a weaker RMB would be more than offset by the negative local impact from accelerated capital flight, liquidity tightening and possible increased credit stress, driven by the domestic private sector scrambling for foreign currency assets and reducing foreign currency liabilities (see RMB: Deliberate policy to weaken currency is unlikely).

   This would not just impact trade with the US either, and thus could have the unexpected outcome of convincing key US allies to reach an agreement to bring a case to the WTO. It might also serve to diminish and delay China's optimism of firmly establishing the RMB as an international reserve currency

7. **Stop buying**, **or worse**, **selling of UST holdings** – This threat could trigger a sharp spike in the overall level of UST rates and severely dent the market's confidence in the US dollar as a reserve currency. However, this is widely regarded as a non-credible threat given the costs it would inflict on China, the potential tightening of global financial conditions and a lower USD/CNH.

   China has diversified its holdings before and if it were to follow this option it would likely be done slowly to not cause too much disruption. Further, with overall money market rates offering a viable alternative for USD (versus holding FX reserves in securities form), one natural step would be to buy less at the UST auctions and let bonds mature and keep the proceeds as bank deposits.

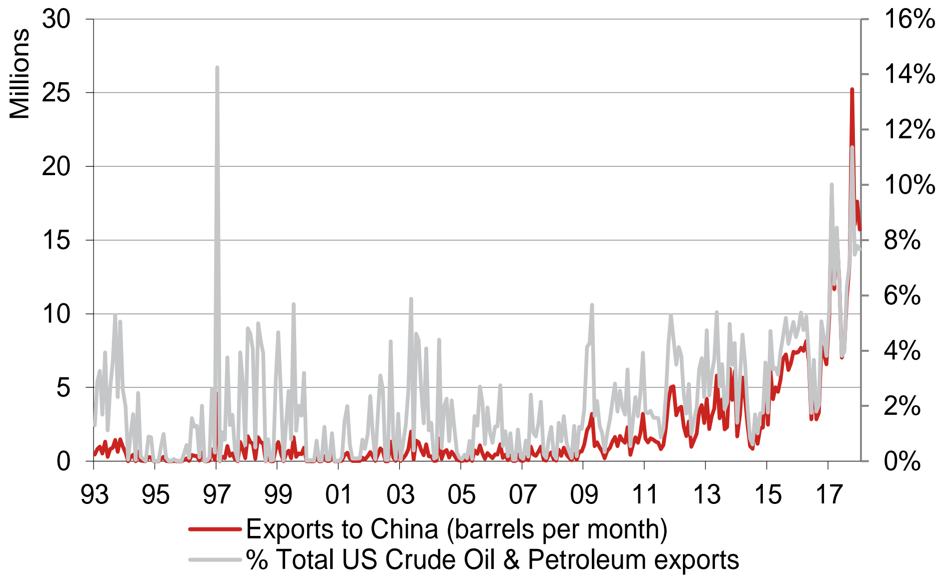
   However, in an unlikely scenario where China announced its intention publicly and then executed a large sell-order quickly (e.g., $100bn USTs at the open of trading), the US has some measures in place to help support bond markets.

   The Federal Reserve could intervene and dampen an indiscriminate malicious UST selling via buying equal or greater amounts in an open market operation. In a worst-case scenario, the US could enlist the help of its key allies' global central banks to defend the USD, but again this is beyond what we would expect as a reasonable option at first, but those options remain. One extreme, and again unlikely scenario, to stem the flow of selling in an escalation would be the US freezing China's UST holdings held by US custodians (although some of this could be mitigated if UST holdings are warehoused overseas – see link).

   These are just a few very dire outcomes if China used USTs as an economic weapon. A scenario that is unlikely, in our opinion, but if were to happen we would anticipate an unleashing of volatility and tighter spreads.

8. **Counter-tariffs on US oil** – US net exports to China are significant at roughly 453,000 bbl/d (ranging between 7-10% of total exports) at around $8.41bn last year in value (EIA) and has been a large growth market for US producers. Cutting oil imports from the US is an option for escalation but continuing to increase imports would also be a tool for de-escalation. By China agreeing to increase purchases of US oil further, it could be an offer to reduce the trade deficit that the US would welcome. However, it would only form a part of helping to reduce the deficit; US total oil exports to the world for 2017 amounted to just $117bn (EIA) and there is only so much oil supply that China can take.

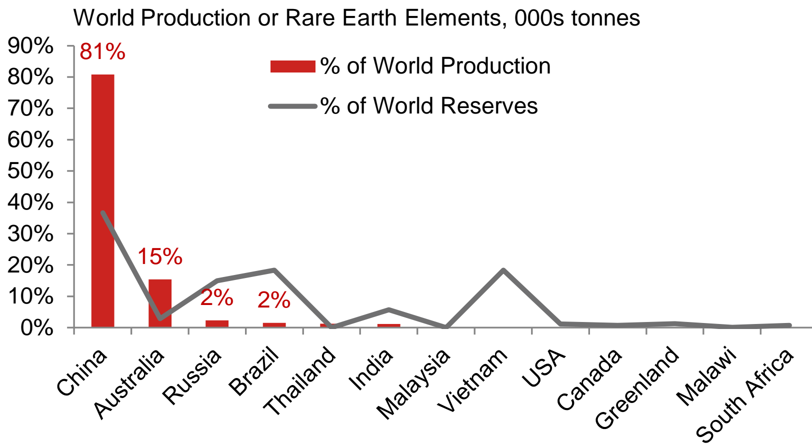
Fig. 6: US Oil and Petroleum exports to China



Source: EIA, Nomura

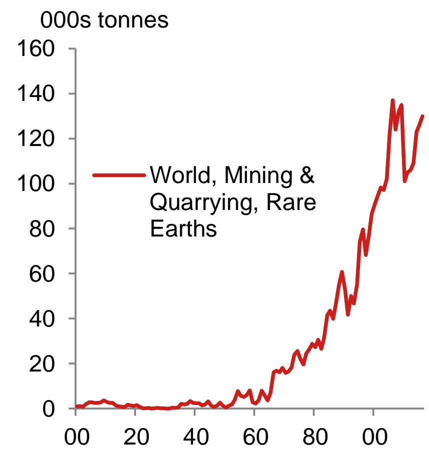
9. **Restrictions on Rare earth elements (REE)** – In 2012, the US, EU and Japan filed at the WTO a request for consultations with China over restrictions on exporting rare earth elements (China controls >80% of the world's production). It was a move that forced multi-national firms in the production of high tech products (e.g., smart phones, wind turbines or advanced military weapons) to relocate at least part of their operations to China. The export restrictions were lifted at end-2015 after the WTO case, but the experience showed how exposed the US is in the sector. The US is completely import-reliant after the closure of the Mountain Pass mine in 2015. For those who question China's willingness to use this as leverage, the brief 2010/11 trade war with Japan is a good example of when REE prices soared.

Fig. 7: Rare Earth Element production by country and reserves



Source: USGS

Fig. 8: Rare Earth elements on the rise



Source: USGS, Nomura

a. **In the long run**, **the US will aim to remove its import dependency:** President Trump issued an executive order in December classifying REE as essential to the economic and national security of the US and to end its reliance on foreign sources.

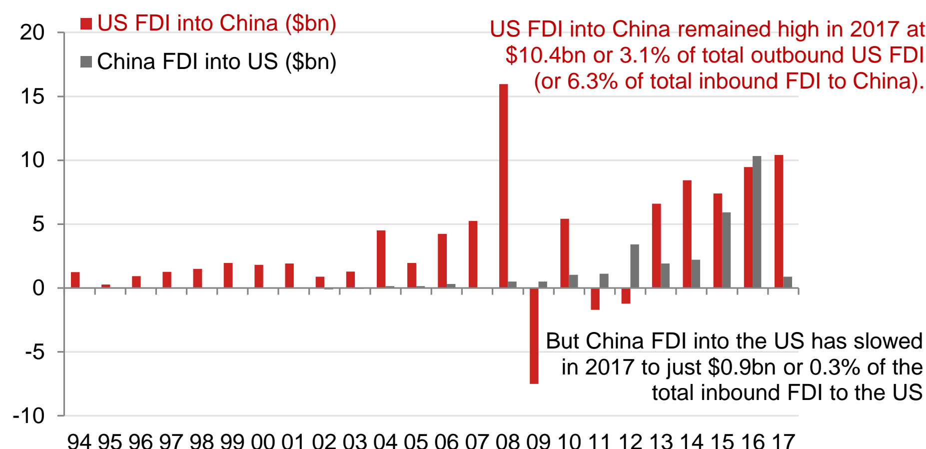
b. **REE prices are likely to remain elevated until then -** Prices of REE rapidly increased in 2017 partly due to China shuttering illegal producers and implementing tighter environmental policies as well as maintaining a production quota. Global demand is on the rise, with China widely expected to become a net importer of some rare earths by 2025/26.

The US options in an escalation

1. **Increase the scope of US tariffs further**. The US thus far has targeted Chinese tariffs in categories of goods that will not broadly hit consumers. Around 90% of the 1,333 products announced on 3 April were each worth less than $50mn in 2017 and only the tariffs on colour televisions' features in the top ten imports from China (link). Increasing the scope or the level of the tariffs (from 25%) are two ways in which to escalate things.
2. **Co-ordinate a response to China with allies in Europe and Asia**. This could be a more highly effective strategy, but by withdrawing the US from the TPP and with President Trump consistently arguing for bilateral talks over multilateral talks, it seems unlikely for the time being. A co-sponsored challenge at the WTO is likely, given Japan wants to join the US's complaint while the EU may be a third party (link) but this process may be slow moving and would not be the first challenge at the WTO in regards to IP theft (the first being brought in 2007 and decided upon in 2009).
3. **Declare China as a currency manipulator and/or weaken the US dollar:** If China was to be labelled a currency manipulator, legislation highlights that the US President, through the Secretary of the Treasury, would commence enhanced bilateral engagement. After one year, if the Secretary determines that the country has failed to adopt appropriate policies to correct its undervaluation and external surpluses, the President would take further action. The latest April FX report does not suggest that action on this front is imminent.

   As we have long argued, the easiest way for the US trade deficit to adjust is for the dollar to weaken. With Trump's fiscal expansion/ tax cuts, the case for this has strengthened. Like tariffs, a weaker dollar will likely encourage less consumption (relative to total output) as households' real purchasing power declines through higher import prices. Meanwhile, domestic production rises as exporters now find their exports more attractive overseas. Together, this would mean higher savings rates in the economy. Further, this is more likely to improve US growth than tariffs.
4. **Announce restrictions on Chinese acquisitions of US companies in strategic sectors.** Already there is legislation proposed in Congress that would broaden the remit of the Committee on Foreign investment in the US (CFIUS) that reviews transactions that could pose a national security threat. The game changer, in our opinion, would be that the legislation would give jurisdiction over outbound investment by US companies too and enjoys bi-partisan support. The latest block of the Qualcomm deal is a good example of Washington's hawkish stance. Roughly $8bn of transactions were blocked in 2017 according to Rhodium. That said, China's investment has cooled already due to its state council imposing restrictions on outbound foreign investment too (link). Even so, the US administration is considering invoking the International Emergency Economic Powers Act (IEEPA) to crack down on China's investment.

Fig. 9: FDI flows between the US and China



Source: BLS, Macrobond

5. **Increased restriction of US exports of sensitive products to China**, on US firms transferring technology to Chinese partners. We expect that this time hi-tech industries (e.g., IT, semiconductors and new energy) will be the focus, rather than heavy industries (e.g., steel) that have traditionally been the subject of such measures (see China: Trump fires on China's IP violation).

6. **Protect domestic US producers hurt by China tariffs.** To buffer the administration from a backlash in key Trump states, the President has already instructed his agricultural secretary to "implement a plan to protect our farmers and agricultural interests" from potential retaliation from China (link). This could also extend to the manufacturing sector, given the difficulty it would bring to the US supply chain with most of the tariffs against intermediate goods, but it would be more costly and difficult to set up and perhaps counter-intuitive if the aim was to encourage firms to bring the supply chain back to the US.

7. **Threaten to sanction state-owned enterprises** that dominate energy, telecoms and banking. Although China agreed to make SOEs operate according to free market principles when it joined the WTO, US representatives still contend that SOEs are being heavily subsidized by the banking system. After failing to win the case at the WTO in 2014, we think it is unlikely the US would again follow such a route. We have seen such measures used against small Chinese lenders in regards to North Korea sanctions but with SOEs as a declining share of Chinese exports it may have a limited effect. Sanctions against medium to large lenders were threatened in case China was to use a veto at the UN Security Council in regards to North Korea sanctions but not administered. If it's not on trade grounds, national security concerns will do. The recent example of the US Commerce department imposing a seven-year ban on China' second largest telecommunications equipment maker ZTE is a case in point. However, as widely reported, it did involve ZTE admitting to illegally shipping US technology to Iran and North Korea. To produce a blanket ban and argue that SOE's broadly pose a security risk may seem a stretch of the imagination but the tariffs proposed so far have been announced on such reasoning.

Quantifying the economic costs in a trade war

Nomura's economics team last year delved into the details of US-Sino trade negotiations via a game theorist's dynamic game to find a Nash equilibrium where no country can gain from a change of strategy. If the loss from a trade war turns out to be mutually disadvantageous enough, China could opt to move dovishly, while the US might be hawkish until the last minute and then accept a deal. That said, one problem with the game theory is that we often assume the actors are rational and that the payoffs are known. There is also more than just economic payoffs; politics also apply. If President Trump were to be perceived by his base as too soft on China, it could result in a loss of votes for the Republicans at the US mid-term elections and lower the probability of Trump being re-elected. If China were to be perceived as too soft, it could lead to a weakening in its regional image; potentially ceding economic and political influence to the US.

Consequently, we attempt to build on this theory, and summarise the findings of our Global Economics team but also look further into the political side of the trade talk payoff matrix and the potential for US/China trade retaliations.

Gauging the GDP and inflation costs in a trade war

- **China:** In an effort to estimate the order of magnitude a trade war would bring to China's economy, we consider two scenarios in which Chinese exporters' response to US import tariffs take two extremes (see China: Impact of US tariffs). In the first scenario, Chinese exporters cut prices and fully absorb the impact of the tariff hikes. In this scenario, our back-of-the-envelope calculations show that a 25% tariff on US imports from China totalling USD50bn would cause a 2.9% fall in China's total goods exports to the US (at USD433bn in 2017), and a *0.1 percentage point (pp) drop in nominal GDP growth* (at USD12.2trn in 2017).

  The second scenario involves the opposite reaction, and thus Chinese exporters refuse to take on the tariffs at all and provide the products at the

same price. Here, a $12.5bn tariff would see the US consumer absorbing on average a ~3% rise in the price of goods made in China. If we assume a price-demand elasticity of 0.5 for consumer goods, a rough estimate is that US demand for China's imports would fall by 3%, or USD6bn. This would mean a 1.4% decrease in China's exports to the US and a *0.05pp subtraction from China's nominal GDP growth*. A more practical (and likely) middle ground could see China's exporters adjust their export prices to try to maximise the result for themselves, with a more realistic estimate of the impact being a 1~3% decrease in exports and *0.05-0.1pp reduction in nominal GDP growth*.

- **US:** Last December, Nomura's US Economics team estimated that a 5% hike in across-the-board import tariffs *may add an extra ~0.1% to core inflation* in a "moderate" scenario (see US: Trump Considers Import Tariffs, 23 December 2016). The "aggressive" case, with 100% passthrough of tariff changes to import prices, generates a much larger effect, *boosting core inflation by about 0.6% at the peak and lowering GDP by 0.2%.* More recently, in reaction to the steel tariffs announced in March, Nomura's US Economics team found that the inflationary impact on consumer prices would be about 2.3bp. In contrast, a 10% across-the-board tariff on China's imports, including final consumer goods, would result in a one-time increase of 0.2pp on consumer prices (see US: Risk of Trade Disruptions Ahead and Economic Implications). With US exports to China in 2017 at only 0.7% of GDP or 5.6% of total exports, these may be figures small enough for President Trump to consider risking a trade war.
- **The ultimate costs may be higher than the headline trade figures.** If financial conditions were to tighten significantly or business confidence was to deteriorate, it could hurt both sides more than the tariffs alone. US supply chains could be severely disrupted if non-tariff barriers were to be created at an ultimate cost to the consumer.
- **But the US can potentially switch from low-cost China imports to low-cost rest of World imports.** The argument against the Trump administration taking on China in a trade dispute is the cost to the US economy and its consumers that have become very dependent on low-cost imports. The counter-argument from trade hawks is that China is not the only low-cost exporter and US importers could look elsewhere.

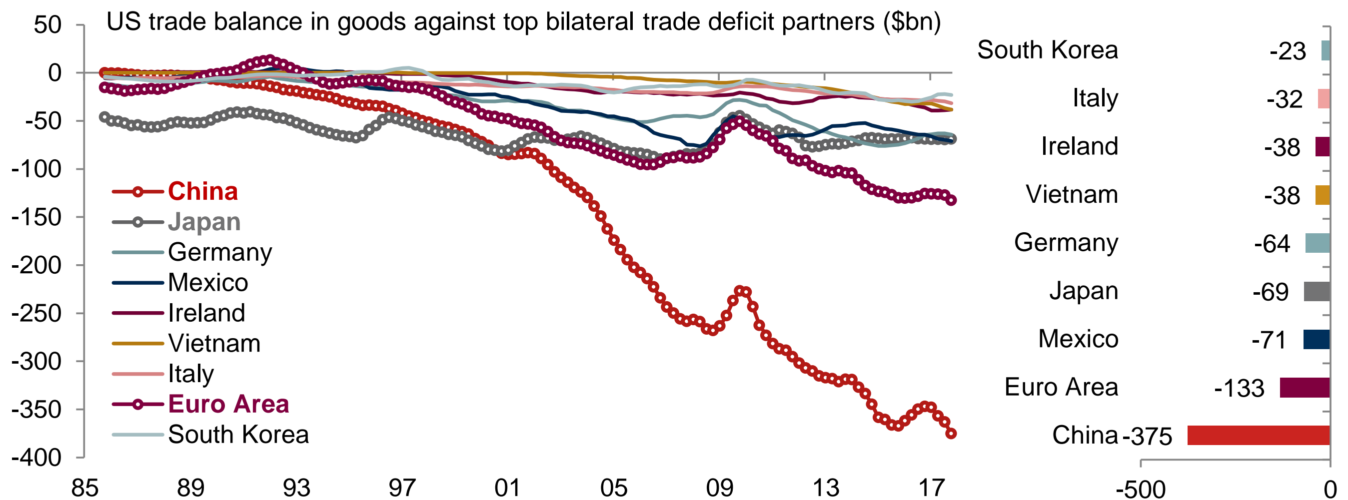
If the numbers don't suit, "alternative facts" may suffice
With the economics known, then the debate moves over to each side's perception of those numbers. A trade war would be big deal for both China and the US, perhaps more so than the Trump administration would concede, in our opinion, when taking into account the use of trade numbers (see US: Trade War Risks). We question whether President Trump takes into account that the US trade surplus with Hong Kong reduces the headline figure from $376bn to $302bn. We also question whether he is aware that the gross value added of China's exports is a measure that shows a much smaller trade deficit with the US at $152bn.

Even if there is an argument as to the true trade deficit, if the numbers don't suit, 'alternative facts' may have to suffice. In politics it's often all about optics, not statistics. That said the trade deficit is large, however one chooses to measure it.

Using polls to judge whether policy goes ahead might be a futile effort. The Republicans' tax bill was very unpopular but still passed. For what it's worth on trade 71% of voters agree that the US should take steps to reduce the trade deficit. While the majority of voters disagreed with steel and aluminium tariffs, Trump's base approved strongly across a variety of polling companies at 58-70% in favour (source: Quinnipiac), suggesting the administration was unlikely to be deterred by wider public sentiment.

The US trade deficit is not just with China, but also the EU and Japan too
This is not the end of trade negotiations; the US has yet to meaningfully turn its gaze on Europe and the upcoming steel tariff exemption roll-off on 1 June could bring further attention back to such tensions (see Event Risk Radar and Trade war tracker: Tit for tat). Talks on steel tariff exemptions rolling off at the end of the month between the US and the EU are yet to begin. Cecilia Malmstrom, the EU's trade commissioner, recently warned the EU will not enter talks until the threat of tariffs are dropped altogether (link).

Fig. 10: US trade balance vs main bilateral deficit partners (four quarter sum, $bn)



Source: Macrobond, Nomura

There was also the failure at the US-Japan summit to convince the Trump administration to re-join the TPP (see US-Japan summit: assessment). We think it is best to assume that there is still a risk of the US coming to Japan with specific demands, as suggested by President Trump's mention in the press conference of the US' "very big deficit" with Japan. He commented that tariffs would be "something we would discuss" if the two countries were unable to "come to an arrangement on a new deal." In particular, if the US were to demand that Japan export fewer autos to the US (see Lessons from past Japan-US negotiations), we think it makes sense to be wary of the considerable impact that this could have on Japan's real economy, as autos account for nearly 30% of Japan's exports to the US (link). The timing for the US-Japan trade talks is expected around mid-June (see Kick the can down the road).

The two countries agreed to create a new negotiation framework, where USTR Lighthizer and Japanese Economy Minister Motegi will lead the negotiations. This new framework could lead to FTA negotiations at some point. Japan may not gain exemption status from the US tariffs on steel and aluminium, which could be used as a tool to start the FTA discussions. At the same time, if the creation of a new framework successfully delays harsh discussions on trade for now, as the Pence-Aso dialogue did, we think the delays would be good for Japan's government. President Trump commented on the possibility of more military jet purchases by Japan, and fiscal stimulus by Japan may be a way to calm trade tensions between the two nations.

Trade war concerns have been putting downward pressure on yen-crosses via two channels, risk-off from the trade dispute between the US and any other nations (typically China) and concerns over the possibility of a trade war between the US and Japan. For now, concerns over the second channel will likely be weaker but may recur at some point (see Kick the can down the road).

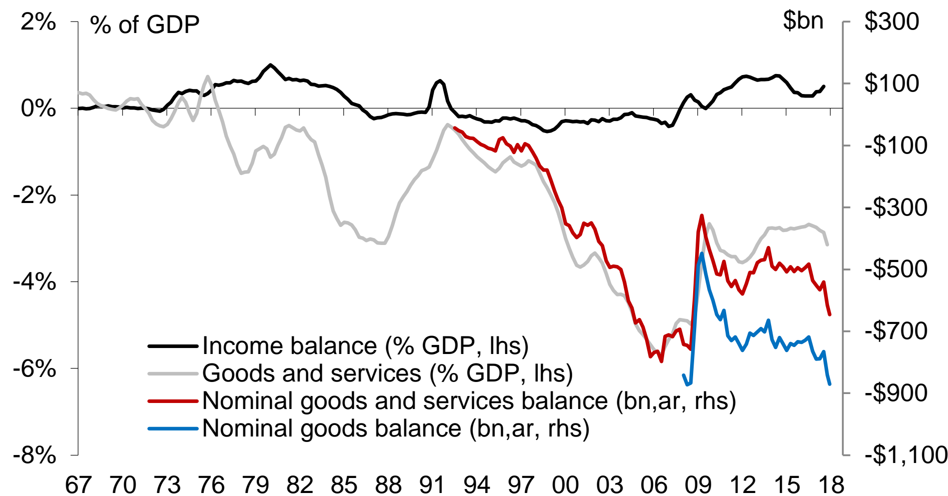
The end-game: perceived costs between now and the future

When discussing trade, we tend to focus on the current state of affairs and the costs involved when the status quo is disrupted. However, Peter Navarro's comment piece in the FT illustrates how the Trump administration is looking beyond the here and now. In which he considers the cost of not acting to lead to a further deterioration in the direction of bilateral trade, the potential cost to the US as a result of "Made in China 2025" but

also the security implications of intellectual property theft for the dominance of the US military.

Given the acceleration of the deteriorating US trade balance with China it may be that the short-term costs (what the market tends to focus on) may be outweighed by the long-term benefits of more balanced trade in their view. Or indeed the security angle brings more of the Trump administration doves in line with the hawks. While we can argue at length about whether such moves would be right or wrong, what matters more is understanding what camp the administration sits in and based on the rhetoric, it's the hawkish camp the administration looks to be focused on.

Fig. 11: The optics do not look favourable for the US trade numbers



Source: Bloomberg, Nomura. See Nomura trade war tracker.

The potential upside scenario of China making material market-opening concessions is what the US has in mind and UST Mnuchin's negotiations in Beijing could be the start of that. The downside scenarios for the US include: 1) China increases market protection on US/foreign firms or 2) China and US trade relations returns to the status quo.

Given the Trump administration would be likely to argue that the first scenario was not much different to the current state of affairs or "not life threatening" (see Wilbur Ross in Figure 4), we arrive at the conclusion that the US will likely follow the second scenario of a hawkish US, at least to begin with (see below) if discussions with China are slow in progress. While costs to the US are likely to be much larger than the trade statistics imply (link), the optics of the trade deficit are so dismal that leadership may simply not deem it so (see Sino-US trade optics bode poorly for China).

Using assumptions from the work our team did last year, it simplifies down to two choices for China of:

- **Scenario 1:** A choice for China between a very costly trade war or an acceptable punishment upon it from the US, e.g., opening domestic markets to competition.
- **Scenario 2:** Or when facing a demanding US with endless amounts of sanctions in sight, the cost is more than a trade war.

Scenario 1 seems the most likely and what the market appears to be pricing for. However, that is based on our assumption that the US views the cost of a trade war to be higher than a mild agreement on trade. Based on our observations, the Trump administration would seem to view China's opening concessions as not enough and the market may be too optimistic in what China may offer in future. In our game theory set up, it would remain the US' best interest to gain as many concessions from China as possible. As of now the Trump administration may argue it has yet to materially see them. If the theory holds in practice, at some point the market may have to price in a higher probability of scenario 2 along the way, even if we expect it is not the end game.

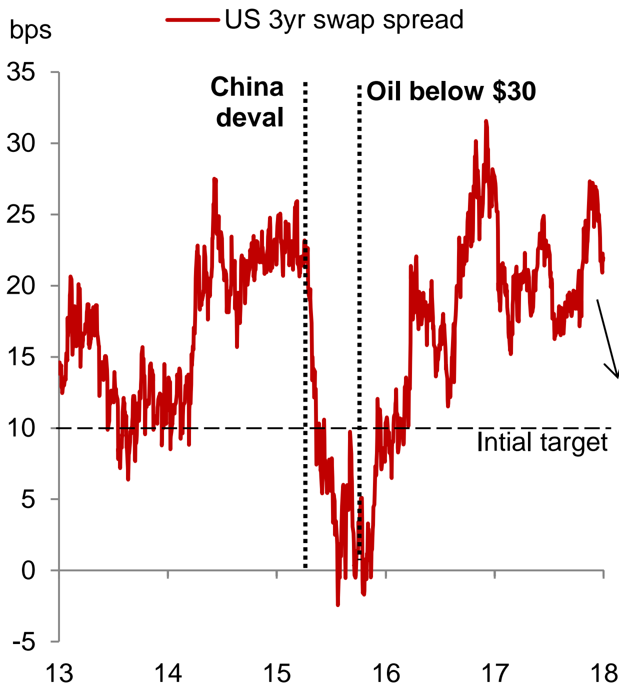
As Wilbur Ross said *"even shooting wars end in negotiations."*

Trade ideas for a trade war

To be clear, we do not expect a trade war that leads to high levels of escalation and retaliations. For our current set of FX, Rates or other trades that incorporate those views please refer to our research here. That said, **due diligence is always best** when assessing **large tail risks** such as further trade tensions. Below we look at a few trades that could potentially do well in the case of a deterioration in trade talks.

Rates: Short 3yr Swap Spreads and Long 1y10y/1y2y Vol switch

Fig. 12: Short 3yr swap spreads – A FX devaluation could amplify the risk of a lower LIBOR-OIS and weaker short-dated USTs



Source: Bloomberg, Nomura

Current level: 22, **1st Target** 10, **2nd target:** 0, **Stop:** 27

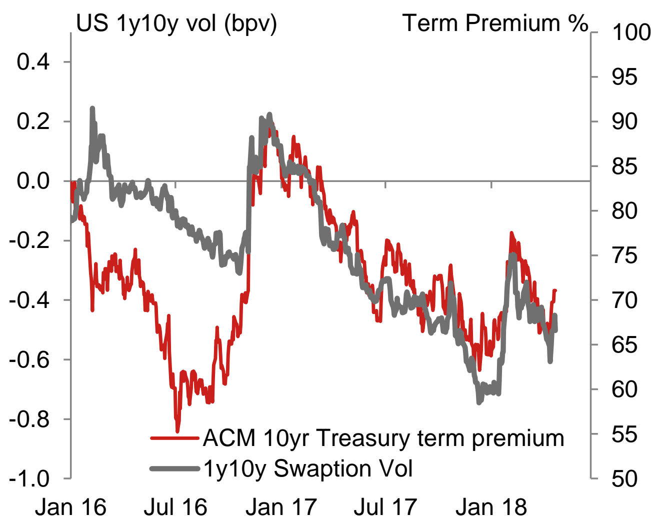
It's looking as if the 1Q18 widening of LIBOR vs other short-term rates was an overshoot. Banks are still full of liquidity and perhaps over-reached in their funding needs. We anticipate LIBOR will be backfilled by a higher Fed Funds rate and that spreads will tighten in the process. This should keep tightening pressure on all front-end related spreads.

Meanwhile, the US is embarking on one of the largest fiscal expansions in recent history funded by debt. The annual issuance of USTs will more than double what was issued in 2017 and sit around $1trn per year for the foreseeable future. This should also keep USTs cheaper vs swaps.

During the China 2015 currency devaluation and as oil went sub $30 a barrel, EMFX reserve managers worldwide had to shed UST paper in the process to defend currencies and/or tend to capital outflows. Given that foreign investors are critical to UST demand, with high debt needs ahead, the US Treasury needs steady buyers. Although we do not take the idle threats of retaliatory UST selling lightly, if one of the largest UST buyers steps away, swap spreads would tighten.

George Goncalves & Jason Wu

Fig. 13: Equity Vols are not cheap, long Rates Vol instead



Source: Bloomberg, Nomura

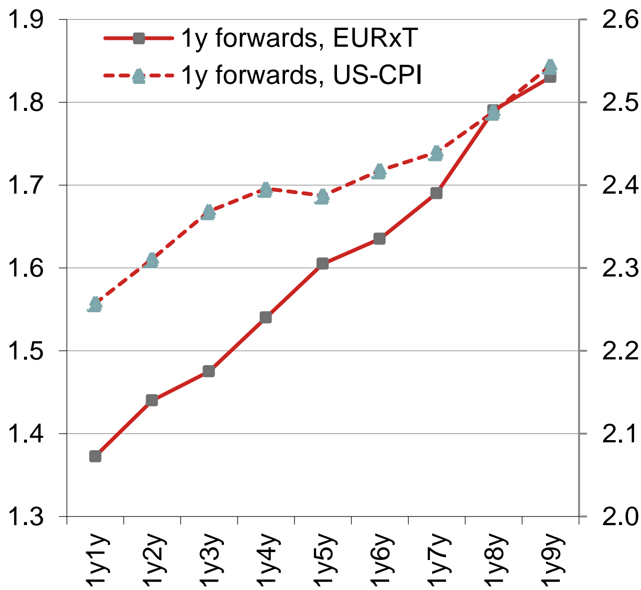
Long equity volatility in a risk-off environment is a clear choice, but equity volatility is already elevated while rates volatility is not. Long Rates vs Short Equity vols as a ratio is not a trade we would recommend either, as it would fall in a risk off but is already at near historically low levels.

Then there is the possibility of the market expecting further escalations which could involve UST sales that would lead to higher term premiums. Even if that's not the case, at these low levels of term premium the balance of risks are for a pick-up and it's hard not to see rates vol rising with it.

However, rather than being long 1y10y vol outright, we prefer to own it against a short in 1y2y vol as a vol switch, which also expresses our bearish view on intermediate left-side vol (see page 6 of Rates Weekly).

Michael Chang and Jordan Rochester

Fig. 14: Long US CPI-U 1-year in 4 years vs HICPxT 1-year in 9 years at 58bp, target 100bp



Source: Bloomberg, Nomura

In Inflation Insights - Inflation investing and global inflation issues we argued that if obstacles to trade increase further, the tactical focus for inflation investors should be the link between inflation valuation differentials and the exchange rate.

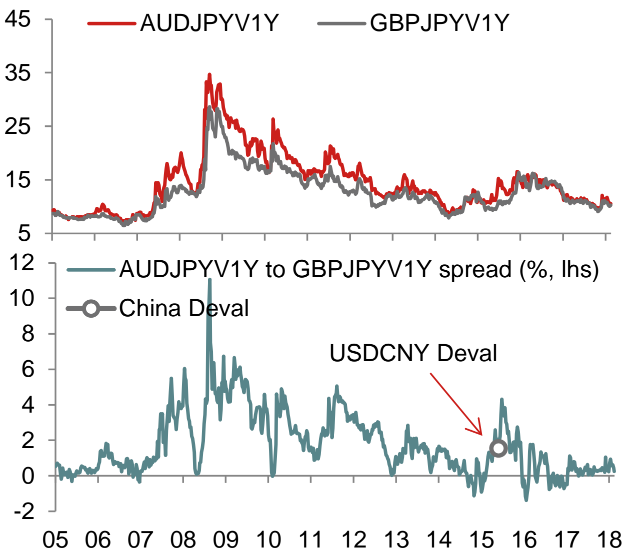
Obstacles to trade might generate large exchange rate moves that would not be related to economic fundamentals. Specifically, we would see further upside for US inflation valuations relative to euro valuations for instance.

The relative shape of the inflation swap curves suggests a long position on intermediate US maturities and a short position on longer euro maturities. Note that historical ranges would by definition not provide a good guide for the target of the trade.

Christophe Duval-Kieffer

FX: G10 vol correlations to tear apart and long JPY/KRW as a trade tension hedge

Fig. 15: G10 correlations to break apart? Long AUDJPY Short GBPJPY One year Vol Swaps



Source: Bloomberg, Nomura

2017 was the year of a goldilocks environment with a highly synchronised upswing in growth. This has seen FX vol spreads continue to tighten across the G10 especially with rates spreads so low.

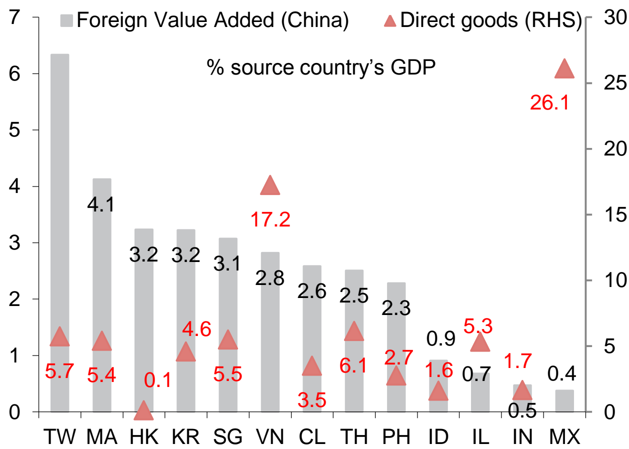
But when China decided to devalue its currency in 2015 the one-year spread between 1yr AUDJPY and GBPJPY implied volatility jumped from ~2 to 4 vols.

It was due to 1) the market pricing Australia to be more affected by the CNY devaluation than the UK and 2) AUD being more correlated to risk than GBP.

While don't expect a CNY devaluation, the trade would naturally benefit from it. The trade could falter if the continued low vol environment continues but would perform if AUD started expressing more of a risk premium. Something it could do if the RBA starts to hike by the end of this year as we expect.

Jordan Rochester

Fig. 16: Hedge against trade war – long JPY/KRW through call spread



Source: Bloomberg, Nomura

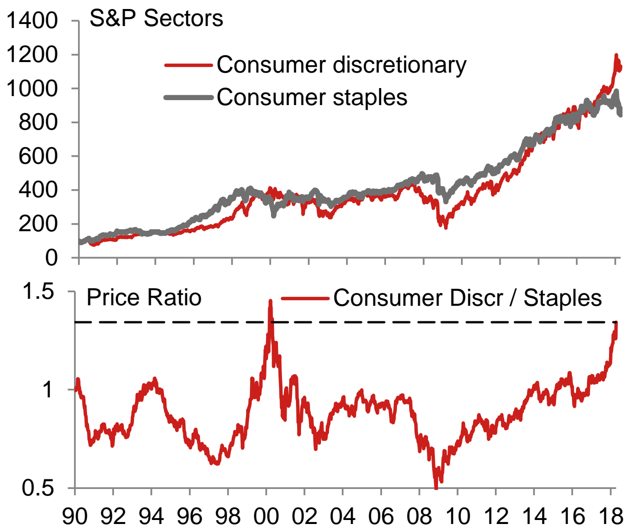
In the tail event of a severe escalation in Sino-US trade tension, we believe Northeast Asia FX, SGD and MYR would be the most negatively affected given their significant trade and financial linkages to China. This is more striking when we take into account indirect exposure ultimate export exposure of countries to the US, via China.

In particular, we think KRW could underperform significantly given its large dependence on electronics/semi-conductor exports. Locally, substantially local portfolio outflows (primarily KPNS) should also add to pressure on KRW. Further, there is a non-negligible risk that the Chinese might be less cooperative with the US on Korean peninsula issue. We maintain our long 2M JPY/KRW call spread (entry: 23 March) as a tail risk hedge.

Craig Chan and Wee Choon Teo

Equities: Short consumer discretionary vs long consumer staples, Relative value Topix trades and Rare earth supply tensions.

Fig. 17: Consumer staples stop underperforming Consumer discretionary?



Source: Bloomberg, Nomura. Note: Discretionary

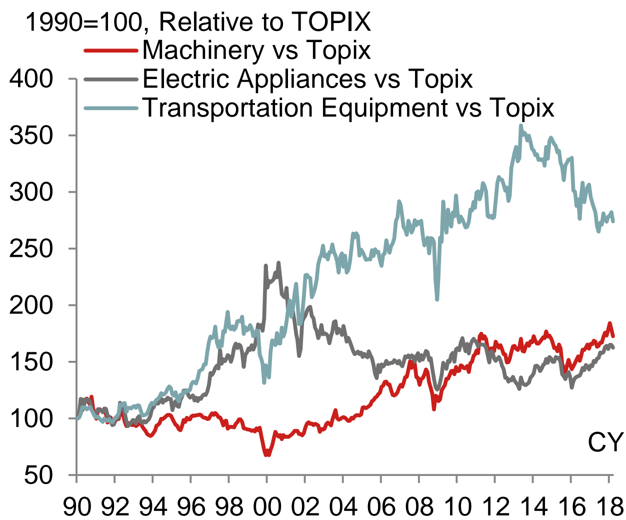
With several of the FAANGs in the Consumer discretionary sub-sector of the S&P500 it's no surprise to see the recent divergence of the two with the price ratio reaching dot-com bubble highs.

We wrote on this broader topic in The bubble you didn't know about could be bursting without you knowing and found that trade wars, populism and income inequality can be looked at in isolation, but together they all point to a reaction against the growth of fluid intangible intensive industries such as the data/platform companies that dominate discretionary.

But it's also the sector that has benefitted the most from the wave of globalisation in supply chains and could suffer more than staples typically do in a downturn as we saw post dot-com and 2007-08.

Jordan Rochester

Fig. 18: Topix relative value trades in trade war scenarios



Scenario 1: If China increases tariffs on high tech product imports from US. This may be positive for Japanese electronic parts and SPEs as China will still rely on non-US countries for growing value added manufactures.

Scenario 2: If US imposes further tariffs on Semi-conductors or smartphones from China, Japanese electronic parts and SPEs and machinery would suffer

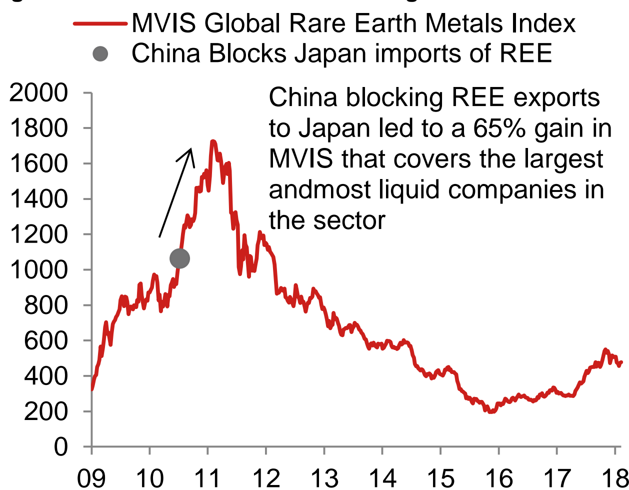
Both scenarios would likely see NKY suffer as Japan is still viewed as a high beta market for the global economy. Where in an extremely unlikely scenario where global trade does start to decline this would materially hurt marine transport.

Scenario 3: The US starts to target Japan. While talk of an FTA remains, the US has yet to grant Japan an exemption to the steel and aluminium tariffs. Suggesting that the Trump administration could suggest raising tariffs elsewhere in order to try and push negotiations along. Japanese Autos would suffer.

Hisao Matsuura

Source: Bloomberg, Nomura

Fig. 19: A less mainstream trade – Long the Rare Earth metal sector in anticipation of trade retaliations



As mentioned in the sections above on possible China retaliations in a trade war, the brief 2010/11 "trade war" with Japan is a good example of when rare earth metals soared.

It was sparked by Japan's detention of a Chinese fishing trawler captain; the Chinese government then blocked REE exports to Japan used in products like hybrid cars, wind turbines and guided missiles.

It's not just a trade that does well with trade tensions, as technology continues to develop the usage of REE are even more widespread, so much so that China is expected to become a net importer by 2025 (link) even though it controls over 80% of the world's production.

Jordan Rochester

Source: Bloomberg, Nomura

Nomura Research on China-US Relations and trade

US: Trade War Risks - 9 April 2018

A tit-for-tat week of Sino-US trade conflict - 4 April 2018

China: New tariff on US imports becomes effective, 2 April 2018

China: Impact of US tariffs, 23 March 2018

China: No one wins in a trade war, 9 March 2018

Sino-US trade optics bode poorly for China, 19 February 2018

China/US trade: Possible market reactions to more aggressive US remedies, 23 January 2018

China: Trump fires on China's IP violation, 18 January 2018

A new historical starting point for China-US relations?, 9 November 2017

China: US probe of intellectual property practices may ratchet up tensions, 15 August 2017

A possible inflection point in US-Sino trade relations, 20 July 2017

Appendix A-1

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