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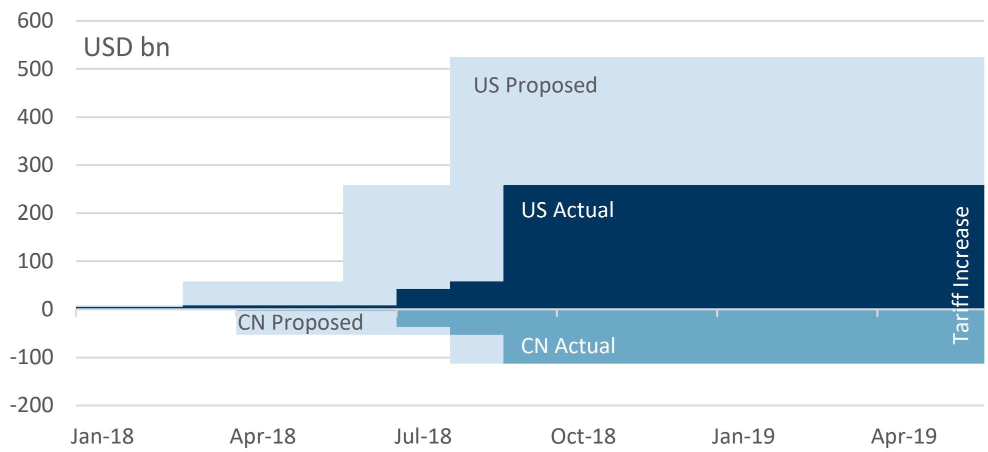
PERSPECTIVES, JUNE 2019

Ending the Trade Truce

Following weeks of positive messaging from both sides, the US and China appeared poised to reach a trade agreement before a sudden reversal left the trade outlook in question. Amidst competing narratives, we examine what we know.

The US followed through on threats to raise tariffs to 25% on $200B of Chinese goods from the 10% level that had been in place since September of last year. This initiated a rapid escalation as China announced comparable tariff increases across approximately $60B of US goods effective June 1st and the US responded by officially filing to raise blanket tariffs of 25% across the approximately $325B of remaining Chinese imports. The breakdown in late stage negotiations over a trade agreement reportedly occurred as China balked at including a formal requirement to change domestic laws and provide an enforcement mechanism around the central issue of intellectual property protection. Past attempts by prior administrations to negotiate with China on the issue have not proven successful and the current administration's unyielding approach, combined with rare signs of bipartisan support, indicate the potential for a protracted standoff. The sectors most likely to be impacted by the existing tariffs are Information Technology, Industrials, Consumer Discretionary, Health Care and Materials (Exhibit 1).

Exhibit 1: Tariff increases set to resume following collapse of the "trade truce"



Sources: Bloomberg, Office of the US Trade Representative

Looking ahead

Following the official filing of 25% tariffs spanning the approximate remaining $325B of Chinese imports, there will be a comment period and series of hearings conducted by the Office of the US Trade Representative before any concrete action is taken. The timeline may vary, but the process often takes six to eight weeks and provides a window for further negotiations. The next known major catalyst will be the G-20 summit in Japan from June 28-29 in which Xi and Trump will have the opportunity to meet and conduct further discussions. Currently, most estimates of the direct impact of the tariffs indicate a larger negative impact for China by as much as -0.5% from its current GDP growth rate of 6.4%. The impact to the US is expected to be smaller, at roughly a tenth of a percent, although concentrated on the consumer (Exhibit 2). However, the second order impacts to business sentiment and capital investment plans have the potential to be greater as both time and uncertainty grow. In the near term, the probability of renewed government support has increased within China with further reserve rate cuts, heightened infrastructure spending and currency devaluation all possible based on the actions taken in prior rounds of the trade conflict. From a US perspective, the added uncertainty has boosted the implied likelihood of a Fed rate cut late in the year and declining Treasury yields have cushioned the impact to corporate issuer financing costs. The negotiations themselves may have been an effort by China to create more time to bolster their economy, leading some analysts to question the sincerity of the negotiations in the first place. Ultimately, it may take an economic response to bring either party to a

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compromise, although more clarity on the status negotiations should come once both sides have had a chance to reassess their respective positions and meet again.

Exhibit 2: High level trade statistics, US and China

Trade with China 2018

$540B Imports	$120B Exports
21% of Imports	7% of Exports
3% of GDP	1% of GDP

May 10th	Tariffs on $200B of CN goods raised from 10% to 25%
June 1st	Tariffs on $60B of US goods raised up to 25%
June 28th	Trump and Xi meet at G-20
TBD	US threatening blanket tariffs of 25%

Sources: Bloomberg, US Census, Bureau of Economic Analysis, Office of the US Trade Representative

Market response

After initial bouts of volatility, markets have partially recovered awaiting more news from the approaching G-20 summit. Given the uncertainty and each country's stance, it seems possible that a resolution may prove difficult and drive headline risk and volatility through 2019. Opinions vary widely by source and primarily resort to estimates built on game theory and political analysis, but the potential exists for this risk to persist into the 2020 elections and requires close monitoring.

The trade negotiations have added an additional layer of complexity to a late cycle economy. Despite these difficult to dimension risks, the recent economic data has held up well, supported by an accommodative Fed. Volatility has reestablished its place in the near-term outlook and the situation is likely to remain fluid through the remainder of the year.