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The Next Chapter in the U.S.-China Trade War

At the G-20 meeting in Osaka, Japan, President Trump and President Xi reached an agreement to restart trade negotiations between the two countries. As part of the deal, the United States apparently committed to not impose tariffs on the remaining $300 billion of imports from China and agreed to soften some restrictions on Huawei's purchases of U.S. technologies. China, in turn, promised to hike its purchases of U.S. agricultural goods. While some of these details still need to be worked out, the important point is that the two sides are talking again and, for the time being, the trade war is not on an escalating trajectory. This outcome was broadly in line with market expectations for the meeting.

The deeper question is how much closer are we to a final resolution? The stakes are high. The amplified tensions between the world's two largest economies have dragged heavily on global growth and financial markets over the past year. And if anything, the most recent flare-up put more distance between the two sides than earlier this year.

Our baseline continues to be that both Presidents have compelling incentives to find some resolution to the conflict. Trump needs a strong economy and a rising stock market leading up to the presidential election in November 2020. Xi has the dual of objectives of hitting his 6.0-6.5% growth target and avoiding further accumulation of debt and leverage in the economy. An escalation of the trade war, or even a continuation through early next year, would be inconsistent with these objectives.

Nevertheless, as we have seen in an earlier chapter of the trade war, confrontations between major powers sometimes cascade in unexpected ways, even to the participants themselves. Thus, investors should continue to monitor the negotiations as well as the evolving incentives that the two Presidents face, and be prepared for the possibility of further surprises.

That said, with the benefit of hindsight over the past few months, we continue to believe that the four principles we laid out in our January paper provide a useful framework for thinking about President Trump's potential actions going forward.[1] In articulating these points, we don't claim any special insight into the President's psychology; rather, we are summarizing his observed behavior and our take on his incentives.

- **The trade war is about more than just trade.** It is also about technology transfer, intellectual property rights, investment, currency policies, and how any agreement should be enforced. The Trump Administration believes that, ultimately, the trade war epitomizes broader "strategic competition" between the two countries.
- **President Trump will be slow to give up the negotiating leverage that tariffs provide.** President Trump sees international relations through the lens of zero-sum negotiations. Tariffs are "beautiful" because the size of the U.S. market provides leverage with international partners.
- **A rising stock market is the one thing he likes better than tariffs.** President Trump has cited the stock market as a gauge of his effectiveness. Although the S&P 500 Index recently set new record highs, concerns about the trade war remain given the disruptions to supply chains and pricing that tariffs create.
- **Trump wants the trade war to be wrapped up by early next year.** Tariffs bring winners and losers. But some of the losers will inevitably be Trump supporters. In 2016, he was able to cobble together a coalition that brought a narrow victory. As November 2020 approaches, he can't afford to lose any of these supporters. And he has now clearly proven that he's "tough on China."

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[1] *See "The Outlook for the Trade War: Assessing President Trump's Next Move," January 2019.*

The first two points shed light on why the trade war has been so fraught—the objectives are broad, and President Trump is using tariffs as a tool to reform the entire U.S.-China relationship. The last two points provide some insight as to why Trump continues to return to the negotiating table and, ultimately, why we expect some resolution well before the 2020 election (that said, if his campaign is successful, U.S. tariff policies in 2021 and 2022 could be much less restrained).

For President Xi, the overriding incentives are economic. He has promised to double Chinese GDP by 2020 and must achieve his announced growth target to meet that goal. Further, he has emphasized that mounting levels of debt and leverage in the economy pose a medium risk that potentially jeopardizes his legacy. The trade war runs counter to these objectives.

However, as highlighted by the recent breakdown in negotiations, President Xi also must manage political pressures. An eventual deal cannot be seen as China capitulating to U.S. demands. Chinese leaders have emphasized that an eventual deal must include the U.S. removal of existing tariffs and that U.S. demands for increased purchases of its goods should be grounded in economic reality.

Accordingly, the negotiators will face significant challenges as the talks resume. The two sides must work to reestablish trust. They must sort through a range of complex issues stretching from trade to technology transfer to enforcement of the agreement. They must determine what will happen to the U.S. and Chinese tariffs already in place and whether any parts of the agreement will be incorporated into domestic law.

In addition to all of this, U.S. sanctions against Huawei pose a further complication. In taking action against Huawei, the U.S. cited national security concerns, but the sanctions were seen in China as unfairly targeting one of its national champions. Judging by the firestorm of protest in the Chinese media, the frustration regarding Huawei was even deeper and more visceral than on tariffs. President Trump's willingness to soften these measures in Osaka was undoubtedly well received in Beijing, although it remains to be seen how far the U.S. is prepared to go. The key question is how deep are the national security concerns that were cited in the sanctions? So far, President Trump has seemed comfortable using the Huawei sanctions as a bargaining chip in the trade negotiations.

Given this discussion, we offer four scenarios as to how the trade talks might proceed over the next year. These scenarios seek to provide some idea of where the negotiations might land.

Scenario	Probability
Smooth progress. The two sides hunker down over the next six months and hammer out a compromise agreement. The U.S. doesn't get everything on its wish list, but still sees an agreement as an important step forward. Accordingly, U.S. tariffs on Chinese goods are rolled back, and the U.S. government works with the Chinese authorities to resolve concerns regarding Huawei.	40%
Rocky progress. The negotiations continue, but in fits and starts. Periods of progress are punctuated by periods of acrimony. Along the way, President Trump imposes 10% tariffs on the remaining $300 billion of U.S. imports from China. Ultimately, the two sides reach an agreement similar to that sketched out in the previous scenario, but the deal is not finalized until the spring of 2020.	35%
Trade tensions continue to bubble. As in the previous scenario, the negotiations proceed in fits and starts, and President Trump imposes the 10% tariffs. Further, he offers only symbolic relief to Huawei and takes new steps to constrain Chinese investment in the United States, for example. The trade talks are ultimately unsuccessful, but both sides are careful to prevent the tensions from escalating into a full-blown trade war. In November 2020, Trump counters voter complaints about tariffs by citing a need to be "tough on China."	20%
The negotiations collapse and a full-blown trade war ensues. The differences between the two sides prove too wide to be negotiated away. President Trump imposes a full 25% tariff on the remaining $300 billion of imports, fully enforces the sanctions on Huawei, and takes other confrontational actions against Chinese firms. The Chinese authorities complain bitterly and implement countermeasures. They threaten, but do not move forward with, a ban on rare-earth minerals. Firms in the two countries actively seek to reduce their exposures to the other. China policy becomes a central issue in the U.S. presidential election.	5%

Source: PGIM Fixed Income as of July 1, 2019

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of July 2019

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