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The Outlook for Escalating Trade Tensions

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Recognizing that uncertainties regarding U.S./China trade tensions have multiplied, our perspective on recent developments are based on the question of: "what do we actually know?"

- There's still a few weeks before the new tariffs begin to meaningfully bind given that goods currently being transported were exempted. This provides a window of opportunity for a deal, if the two sides are inclined to do so.

- China today announced its response to the U.S. tariff hikes. While we are still assessing the details, our initial assessment is that the response is "moderate." It falls short of full-scale, one-for-one retaliation, but is nevertheless meaningful and significant. The key question now is how does President Trump respond? Notably, before China's announcement, one of his tweets implied further U.S. retaliation, and at a minimum, his threats (e.g., tariffs on the remaining $300 billion of imports) may escalate. But China's less-than-proportional response likely provides the U.S. with some time to assess its next move. More broadly, another important question: is the perception that the Chinese economy is in a better place softening Chinese authorities' motivation to reach a deal?

- Actually imposing tariffs on the remaining $300 billion of imports from China could be politically more costly for President Trump. It would mean putting tariffs on cellphones, laptops, toys, etc.—goods that would hit consumers in the pocketbook and would be broadly felt. Of course, this doesn't mean he won't do it. But it would be more costly and controversial domestically and probably harder to sustain. That said, as noted below, the adverse effects on China would likely be greater still. And being "tough on China" could be a favorable message for him leading up to the 2020 election.

- Many folks seem to be expecting that a deal will be done over the next few weeks. If market sentiment on this point deteriorates further, we could see volatility and a further leg down over the next couple of weeks. In addition, heightened trade tensions are likely to put further downward pressures on the value of the renminbi, which in the absence of intervention by the authorities could become a further source of tension between the two sides. All this said, we continue to believe that President Trump wants to avoid a sustained and severe decline in the equity markets. He really likes tariffs, but he loves a rising equity market.

- We estimate that if the current set of tariffs (25% on $250 billion from China, plus the earlier steel and aluminum tariffs) remain in place, this would depress the level of U.S. GDP this year by roughly 0.33 of a percentage point and perhaps up to 0.40 of a percentage point if China substantively retaliates. That said, some estimates are materially higher. Given China's greater dependence on trade, we estimate that the effects on Chinese GDP would be roughly twice as large. Further, we find that the move from 10% to 25% on the $200 of imports will raise core inflation this year by a little less than 10 bps. If tariffs are hiked to 25% on the remaining $300 billion of imports from China, this would add a further 20+ bps. These estimates do not include the market impacts from the escalating tensions.

- We agree with China's Vice Premier Liu He on the point that the objectives for Chinese purchases of U.S. goods outlined in the trade agreement should reflect reasonable estimates of the trajectory of actual demand (for additional detail, see "Implications of a U.S.-China Trade Deal: Who Wins? Who Loses?").

So, How Do We See Things Proceeding From Here?

Our assessment is that, despite the recent escalation, both sides clearly still desire to reach a deal. China likely wants to avoid the necessity of providing more stimulus, thus further stoking debt and leverage, and President Trump wants a strong economy and a rising equity market to support his 2020 re-election bid (he's convincingly shown that he's tough on China).

Even so, it may be more difficult to move from the current stand-off back to constructive negotiations. One way to break the logjam is for some kind of personal intervention between Presidents Trump and Xi. Even a cordial phone call between the two, which could generate some mutually conciliatory language, would probably give the negotiations scope to get back on track. As such, our modal expectation is that the two sides reach an agreement over the next six weeks or so—with the G20 meeting in Japan at the end of June a particularly good opportunity. Even so, the risks now are clearly skewed toward longer and more contentious outcomes.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of May 13, 2019

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