LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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U.S.-CHINA TRADE DEAL, ONE WEEK LATER

John Lynch *Chief Investment Strategist, LPL Financial*
Barry Gilbert, PhD, CFA *Asset Allocation Strategist, LPL Financial*

KEY TAKEAWAYS

Conflicting messages from government officials led investors to question initial trade-deal optimism.

Progress is likely on some easier issues, but negotiations will be challenging around areas related to intellectual property.

Expect headline volatility to persist over the next few months as both sides jockey for position.

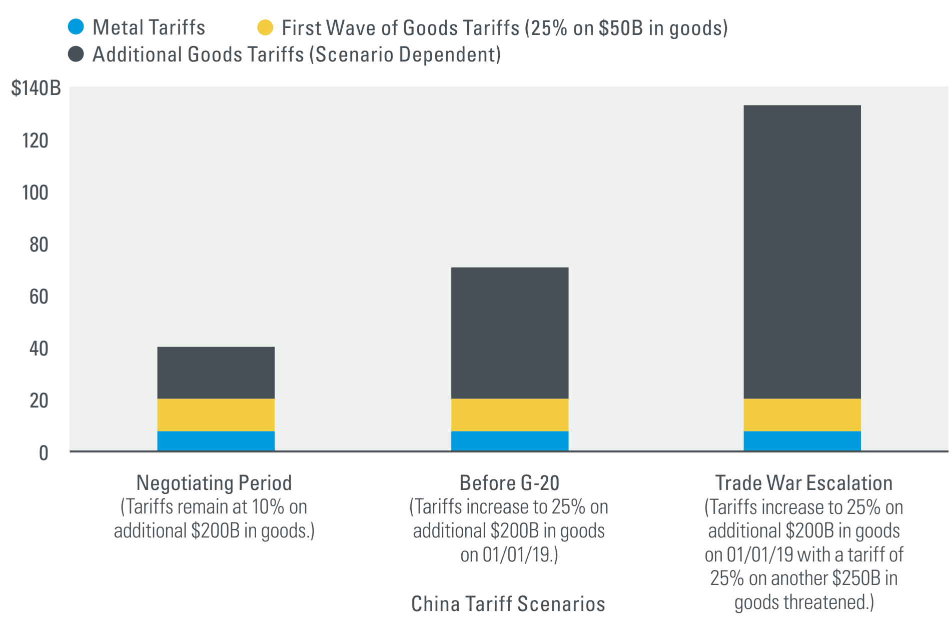
The 90-day negotiating period may turn out to be more of a progress report than a final deadline.

While the broad outline of a negotiating period was a positive takeaway from the trade agreement between Presidents Donald Trump and Xi Jinping at the G-20 summit, details remain elusive. Headlines following the meeting signaled a meaningful cooling of tensions as the Trump administration put a hold on further tariff increases during the negotiating period, and both sides raised their commitment to making progress on key issues. However, conflicting details contained in official statements and administration comments from both sides reminded markets of the potential challenges to finding common ground. Both sides continued to express optimism that a deal can be reached, and we remain optimistic as well; however, a number of tricky hurdles remain, and negotiations, even if successful, are likely to go through rough patches as both sides push for the best possible deal.

AGREEMENT UNCERTAINTY

What was agreed on? That depends on which side you ask [Figure 1]. In their post-meeting statements, both parties included the point that the United States

1 G-20 DEAL SUSPENDS ADDITIONAL THREATENED TARIFFS DURING NEGOTIATING PERIOD



Source: LPL Research, Bloomberg 12/10/18

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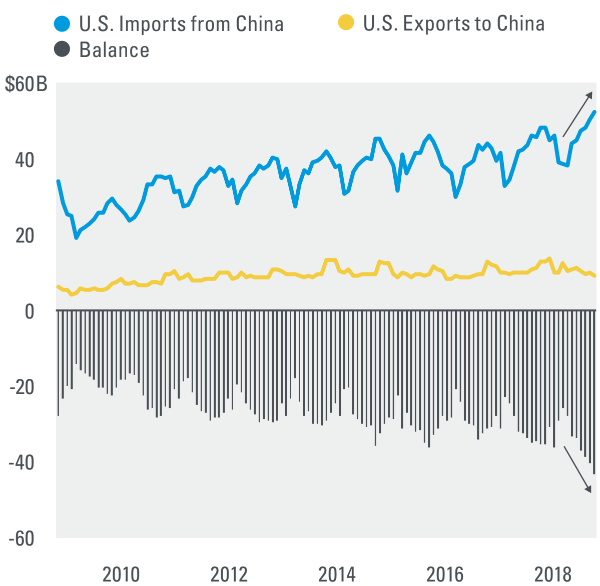
will suspend planned increases of tariff rates from 10% to 25%, which had been slated to take effect on roughly $200 billion of Chinese imports at the start of 2019, and that 25% tariffs threatened on another $250 billion of goods—which would signal the trade skirmish could be turning into a trade war—were off the table, at least temporarily. According to the Trump administration, the tariff hike from 10% to 25% will still take place if a deal is not reached within 90 days from the time of the meeting, or around March 1, 2019. Beyond that, the statements left investors with more questions than answers, and officials have yet to provide sufficient clarity on some of the key discrepancies, including:

- China aims to speed up the negotiating process to work toward removing all new tariffs. The U.S. made no mention of removing current tariffs.
- The U.S. indicated China will negotiate immediately on forced technology transfer, intellectual property (IP) protection, non-tariff barriers, and cybertheft. China made no reference to any of those issues.
- The U.S. statement said China will immediately begin purchasing "very substantial" amounts of agricultural, energy, industrial, and farm products. China simply stated that it will import more U.S. goods, and U.S. officials have been hesitant to attach a figure to the claim.
- Some variation of all three points will likely be part of the process, but the range of possibilities remains quite wide.

2 U.S. MERCHANDISE TRADE DEFICIT WITH CHINA HAS BEEN INCREASING



Source: LPL Research, Bloomberg 12/10/18

LOW HURDLES, HIGH HURDLES

The United States' merchandise trade deficit with China has actually increased since the first round of tariffs were implemented in March [Figure 2], but it's important to note that the growth came as many U.S. firms have been frontloading supplies ahead of each round of tariffs. So while this trend may continue in the near term, it will not be sustained should tariffs remain in place or increase. And while headlines indicate U.S. firms are paying record amounts of import taxes due to new tariffs, it's important to bear in mind that trade represents a surprisingly small portion of the U.S. economy and that the fiscal tailwinds from this year's tax cuts and government spending boost should more than offset any tariff headwinds in the coming year, even if President Trump sees fit to increase levies should negotiations fall short of expectations.

CONCLUSION

The G-20 summit, which was the first face-to-face meeting between Presidents Trump and Xi since trade tensions escalated, demonstrated the two sides' commitment to working toward a resolution and was an important step on the path to a formal trade deal. And though the path is long and 90 days is by no means a significant amount of time to reach the end of it, if meaningful progress has been made, an extension is likely. In the near term, we expect "low hurdle" issues like increasing U.S. agricultural and energy imports and removing existing tariffs on U.S. auto imports will be addressed. However, compromises that would require structural changes on China's part, such as its handling of technology transfer, IP protection, and cybertheft, are "high hurdles" that are unlikely to be resolved in a matter of months.

We are nonetheless encouraged by the renewed negotiations and expect a deal will be forthcoming, although it may take place in stages. In the meantime, headline volatility will likely persist as both sides jockey for position. ■