8 April 2019

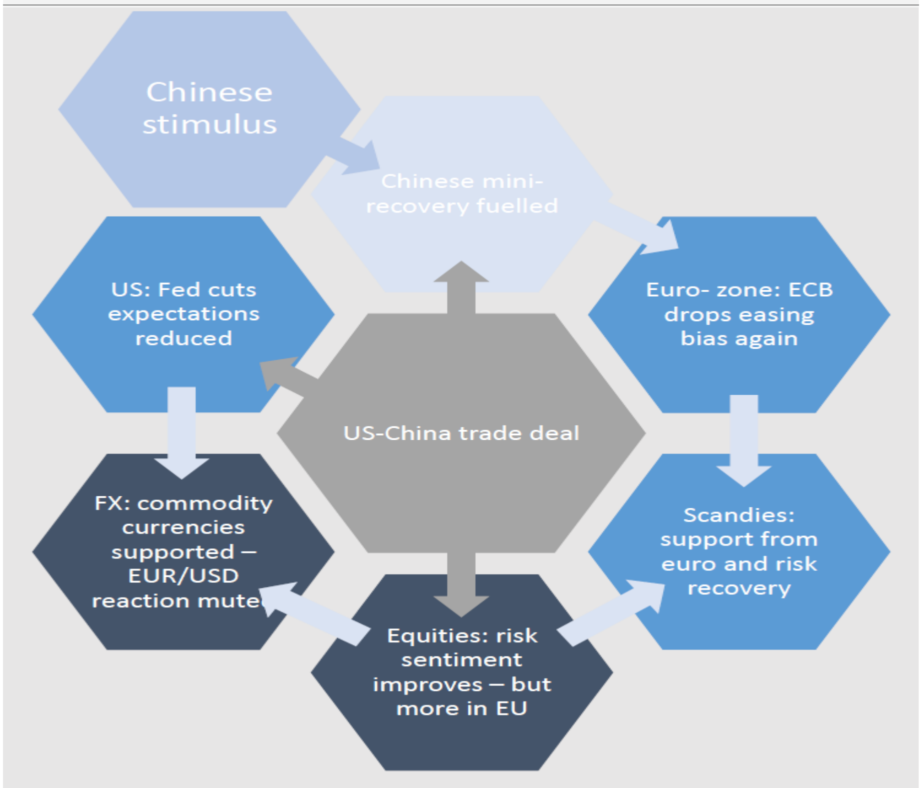
Global Research

What a US-China trade deal would bring to the markets

- **In our view, a US-China trade deal is likely in H2 – and we expect it to be extensive.**
- **We look for a deal, among other things, largely to roll back tariffs. Meanwhile, we see a 15% risk Donald Trump will attack the car industry in a next step.**
- **A trade deal would support a recovery in China and emerging markets and stabilise eurozone growth at a time when past monetary easing also starts to support.**
- **In equities, a trade deal is largely priced in, leaving risks largely balanced, if not slightly on the downside, given the negative 'reality gap' at present.**
- **In FX markets, we would expect a trade deal to support commodity currencies versus notably JPY; EUR/USD support in 3-6M but muted to negative initial reaction.**

The cyclical peak in the global economy in early 2018 notably coincided with the US's introduction of tariffs on China. Needless to say, trade-policy uncertainty has risen markedly since President Trump took office but to what extent has the dispute affected global growth over the past year? What would a US-China trade deal contain if/when it arrives and what are the economic and financial implications? We try to answer these questions below and provide a simplified overview of our expectations in Chart 1.

Chart 1: Trade deal: China recovery to fuel euro and risk sentiment



Source: Danske Bank.

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An extensive deal could be on the way

Trade war part I: impact on global economy so far?

Despite expectations of a trade deal rising markedly since New Year, trade-policy uncertainty remains elevated (Chart 2). Our two preferred leading indicators for global trade, the CPB world trade monitor and the RWI/ISL container index, show that growth in global trade volumes indeed slowed last year and both indices hover around zero annual growth currently (Chart 3). We do advise caution in using these figures, as they are possibly elevated by stockpiling ahead of the escalation of trade, i.e. inventory build leads to more, not less, trade in the short run. This may be the reason why both indicators dropped sharply around New Year, when the tariffs were set to come into force.

A wide-ranging trade deal: tariff hikes to be rolled back

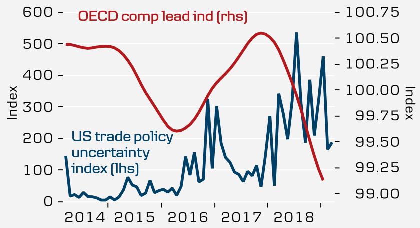
Following months of intense negotiations, the US and China have seemingly moved much closer to a deal. Based on reports from US officials, we expect a 'signing meeting' between US President Trump and Chinese President Xi Jinping to take place in the coming months - both April and June have been mentioned as viable options. We expect a fairly wide ranging trade deal to be landed, see Table 1. A deal should, among other things, roll back the majority of tariff hikes implemented during the trade war and could for some goods result in lower tariff rates than before the trade war started (#8). Further, US demands on China could include a Chinese commitment to buy more US goods (#1) and to avoid CNY weakening against the USD (#7), plus a range of agreements to protect US companies against Chinese competition (#2-6).

Table 1. What a US-China trade deal can be expected to cover

1.	**Chinese purchases of US goods for amount around USD100 bn per year.** Within agriculture, energy and some manufacturing products
2.	**Ban on forced technology transfer** when going into joint ventures with Chinese companies
3.	**Strengthening of protection of intellectual property rights in China**
4.	**Further opening up of investments** for foreign companies in more areas. Faster opening up in car sector.
5.	**Elimination of non-tariff barriers.** Equal treatment of foreign companies vs. Chinese companies (competitive neutrality) in areas such as getting regulatory approvals and public procurement.
6.	**Adjustments to Chinese industrial policy** (Made in China 2025 strategy, less subsidies)
7.	**Currency agreement** with Chinese commitment to avoid weakening of CNY vs. USD
8.	**Reduction in tariffs.** A roll-back of tariff levels to pre-trade war levels on most goods. China possibly moving tariffs lower on some items (cars has been mentioned)
9.	**Enforcement mechanism to ensure agreement is upheld.** Some reports suggest monthly, quarterly and bi-annual meetings on different levels of government.
10.	**Truce on prosecution on Chinese tech companies?** It is unclear if China wants this as part of a trade deal. Currently Huawei CFO is prosecuted by the US and chipmaker Fujian Jinhua is facing an export ban from US.

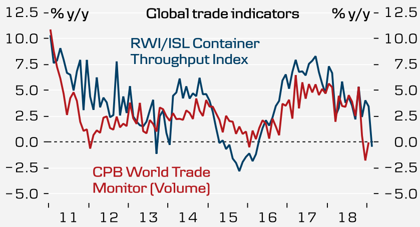
Source: Danske Bank

Chart 2: Trade-policy uncertainty elevated – and likely a key factor behind turn in global cycle in 2018



Source: Macrobond Financial, Danske Bank

Chart 3: Global trade indicators hint that activity has been impaired



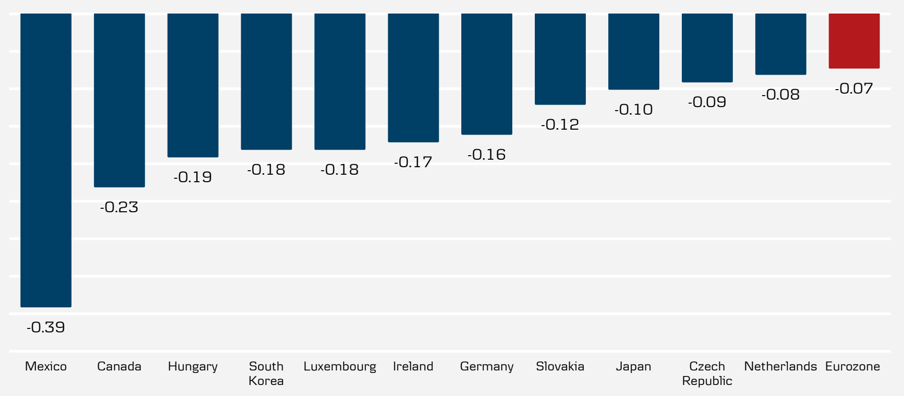
Source: Macrobond Financial, Danske Bank

Trade war part II: could the EU be Trump's next victim?

Even if the US and China settle their trade dispute as outlined above, the US may not be done fighting trade wars. Attention could turn to US car imports, which could be slapped with a 25% tariff on 'national security' grounds. Trump has to decide on this before 18 May. Tariffs on imported cars would be a pertinent issue for the EU, as euro-area car exports to the US amount to 0.4% of GDP. We think this is unlikely to take effect, though, and assume a mere 15% probability for this scenario. However, we believe the US is likely to use this threat as a bargaining chip to pressure the EU to broaden the scope of the negotiations of a trade deal to include agricultural products. A recent *study* by the EU Commission on the economic impact of eliminating EU-US industrial tariffs found significant gains for both sides, boosting EU exports of industrial goods to the US by 8% and US exports to the EU by 9% by 2033. Hence, the incentive to find a solution for both sides is apparent, not least because the EU has made it clear that any new tariffs would make any deal void.

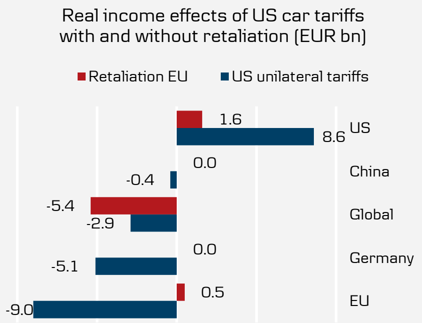
However, there is a real risk that Trump becomes impatient with the EU's sluggish negotiating tactics and adopts the same strategy of pressure it has used on China. This remains one of the biggest risks for the fragile euro-area economy near term in our view. The automotive sector is one of the largest manufacturing sectors in the EU, producing almost 19m passenger cars and light trucks in 2017. An *Ifo study* found that among EU countries, Germany would be the most strongly affected by far by potential new US tariffs on car imports, with car exports to the US falling by almost 50%, and German real GDP shrinking by about EUR5bn (or 0.16% of GDP) (Chart 4). That said, the total economic effect would depend on the retaliatory response from the EU (Chart 5). Notably, the EU has already prepared retaliatory measures totalling EUR20bn if Trump acts on his threat. Furthermore, many EU car manufacturers already have large production facilities in the US supplying the domestic market (Chart 6), which might also moderate the direct hit to euro-area exports. Needless to say, Japanese car makers are also at risk of tariffs; more on this below.

Chart 4. Impact of US tariffs on car imports (% of GDP)



Source: Ifo Institute

Chart 5. Economic effects depend on retaliatory response from the EU



Source: Ifo Institute

Chart 6. German car producers already have large US production facilities

Number of autos and vans sold in America, major brands, unit sales in 2017

Company	Made in the US	Sold in the US	Net Imports	Percentage of Imports compared to US sales
BMW[1]	371,000	354,110	-	-
Daimler (Mercedes-Benz)	332,964	375,311	42,347	11%
VW Group	140,417	625,068	484,651	78%
Fiat-Chrysler	1,150,000	2,070,000	920,000	44%
Ford	2,470,000	2,570,000	100,000	4%
General Motors	2,240,000	3,000,000	760,000	25%
Honda	1,210,000	1,640,000	430,000	26%
Hyundai-Kia	695,000	1,270,000	575,000	45%
Nissan	930,000	1,590,000	660,000	42%
Toyota	1,260,000	2,430,000	1,170,000	48%
Total	10,799,381	15,924,489	5,141,988	32%

1) Net exports from the US: 16,890; 2) Including the brands audi, Porsche and others; some figures have been rounded

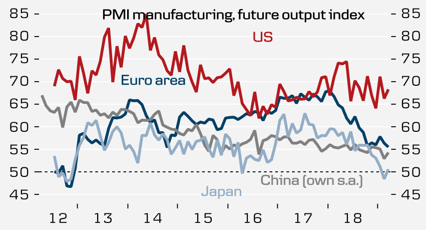
Source: Handelsblatt, Centre for Automotive Research

Global macro: trade deal → Chinese recovery → eurozone stabilisation

For the global economy, there is already some comfort to be found, as leading indicators increasingly warrant optimism regarding China. At this stage, what looks like a Chinese stabilisation is largely attributable to extensive monetary easing over the past year. A trade deal should reinforce this development, everything else being equal.

However, while trade woes explain part of the global manufacturing slowdown, they cannot account for all of it. Notably, divergent trends in the future output component of the PMI manufacturing indices (Chart 7) suggest that it is not just a common shock to global trade that has been driving the business cycle of late: policy tightening in China in 2017 and 2018, Brexit uncertainty and temporary factors such as bottlenecks in the European car sector following new emission test standards and political uncertainty more widely in the euro area are also likely to blame.

Chart 7. Divergence in PMI future output hints that other factors at play

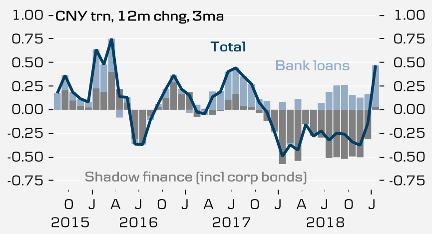


Source: Markit, Macrobond Financial, Danske Bank

China: stimulus + a trade deal = recovery

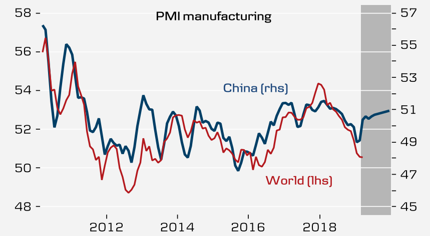
In our view, for China, a trade deal would lift a big cloud of uncertainty. In addition, the impact of past Chinese stimulus measures, as well as new measures to lift growth, would also underpin stronger economic activity. Not least of all, Chinese loan growth is on the rise, driven by bank loans rather than shadow finance this time around (Chart 8). With China increasingly acting as the epicentre of the global slowdown, we could expect a rebound to spread gradually and drive a moderate recovery in the world economy – not least in the euro area and emerging markets (more below). China has already showed the first signs of a bottom, as metal prices have increased, and in February, the PMI increased for the first time in a year, followed up by another rise in March (Chart 9). The direction is right and a trade deal would provide further support.

Chart 8. Chinese lending on the rise again – now driven by bank loans



Source: IHS Markit, Macrobond Financial

Chart 9. Chinese recovery should spill over to global rebound

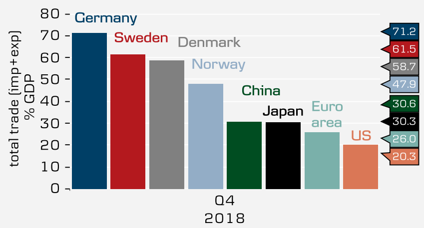


Source: Macrobond Financial, Danske Bank

US: companies have stockpiled due to trade fears

The US economy has fared better than the rest of the world for some time, partly because of Trump's expansionary fiscal policy and partly because the US economy is not a very open one: total trade (exports + imports) constitutes a mere 20% of GDP in the US compared with over 70% in Germany (the figure is much lower for the euro area as a whole though, see Chart 10). In our view, the impact of global trade uncertainty on the US has been limited. However, the US manufacturing sector is not immune to what is going on in the rest of the world, and both the PMI and ISM manufacturing indices have declined markedly, albeit from elevated levels (ISM).

Chart 10. Trade openness: Germany in front – US shielded

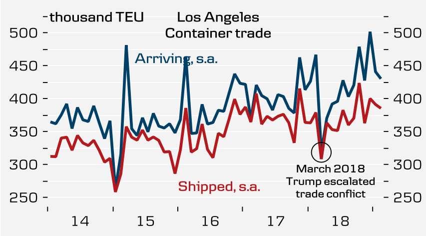


Source: Macrobond Financial, Danske Bank

Looking at US port traffic, we note that The Port of Los Angeles, one of the world's largest ports, saw a big increase in containers arriving from March 2018 (when the trade war with China escalated) onwards, probably because US companies started stockpiling goods as they feared higher tariffs (Chart 11). The gap between containers arriving and shipped increased during 2018, suggesting US activity has been impaired to at least some degree lately.

Overall, the trade war has not had a big impact on the US economy so far though, and hence we would not overestimate the positive impact of a deal. If the rebound in China is robust and spills over to Europe, it would also support the US manufacturing sector. A Chinese commitment to buy US goods would clearly also support activity in the short term. While we previously thought a trade deal and a rebound in the global economy would be sufficient for the Fed to continue its hiking cycle, Powell and co have changed their reaction function and unless we see higher inflation expectations, the Fed is likely on hold for a long time - including in the face of an extensive trade deal.

Chart 11. More containers arrived in Los Angeles after Trump started the trade conflict

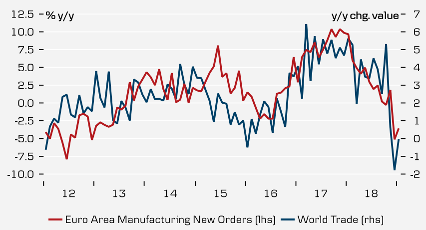


Source: The Port of Los Angeles, Macrobond Financial

Euro area: suffering significant collateral damage

Although Europe has avoided becoming a direct target of Trump's tariffs so far, the open euro area economy has not been left unscathed. Many European (especially German) companies are highly integrated in global value chains - and have subsidiaries and production facilities in China and the US - and have hence suffered significant collateral damage from the trade dispute. Euro area export growth slowed down markedly from 5.5% in 2017 to 3.0% in 2018, and manufacturing export orders tumbled, now standing at their lowest level since 2011. The Chinese slowdown during 2018 was an important headwind for external demand, but weaker intra-euro area trade was also to blame.

Chart 12. Manufacturing took a beating from weaker global trade activity...



Source: Macrobond Financial, Danske Bank

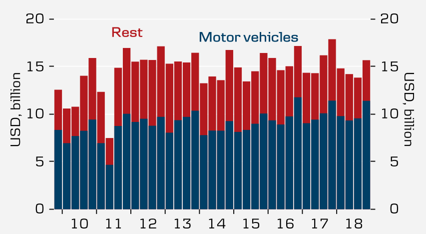
Given the close links between the euro area and the global cycle, and notably China (Chart 12), a deal-fuelled Chinese recovery should have important positive knock-on effects for the euro zone. That said, euro area export growth is unlikely to reach previous highs amid a tougher climate for global trade and ongoing economic challenges in key emerging market export markets such as Turkey and Russia. Hence, net exports are likely to continue exerting downward pressure on growth in 2019. Naturally, US tariffs targeting the EU (primarily cars) would reduce the European growth outlook; the Ifo institute estimates that car tariffs could reduce car exports by 50% (or 0.2% of GDP). We attach a relatively low probability to this at the current stage (see above), but it remains one of the most prominent downside risks to the euro area export outlook in the near term.

Besides actual trade figures, we also stress the importance of likely improving business and consumer confidence in the wake of a deal; confidence suffered marked setbacks in H2 last year. This is important for the ECB, which has become increasingly concerned about the negative impact of persistent political uncertainties. Thus, a trade deal is a building block for the ECB to drop its current easing bias further down the road.

Japan: car industry at risk as Trump's next target

For Japan, exports have been an important driver of growth in recent years and they will remain key given the limit to how much Japanese consumers will contribute. Thus, if the US maintains its focus on trade deficits post a deal with China, this poses a significant risk to Japanese exporters. Trump has criticised Japan's annual USD60bn trade surplus with the US (Chart 13), which is the third-largest behind China and Mexico – a criticism that goes back 30 years. In 1989, when Japan was the US's largest trading partner and shipped more than 2.5m cars across the Pacific, Trump said on Japan: '*They have systematically sucked the blood out of America. They have got away with murder…We have to tax the hell out of them*'.

Chart 13. Japan's trade surplus vs. US



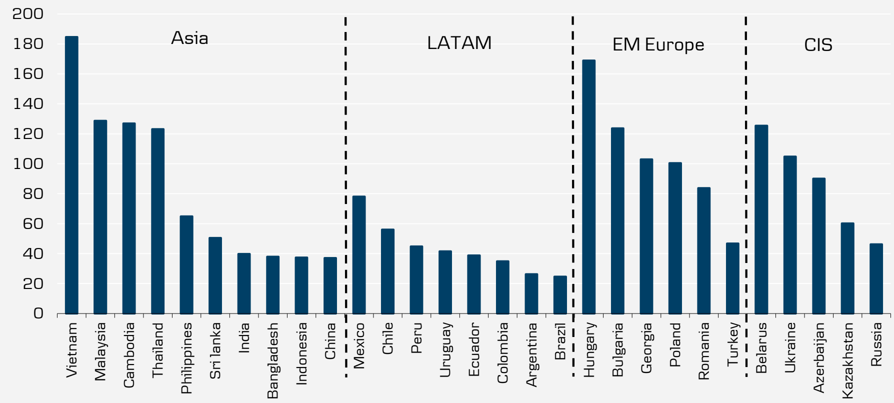
Source: Japanese Statistics Bureau, Macrobond Financial

Now, Trump holds the presidency and there is a real risk he will follow up on his old remarks. This could come in the form of a 2.5% tariff on Japanese cars, which the US has previously threatened to levy. A 25% tariff has also been mentioned, which would be a significant blow to Japan, as cars constitute the bulk of exports to the US and shipping of cars to the US makes up around 6% of Japan's total exports. Alternative routes to make the US happy include better market access for US cars and a Japanese promise to buy more soybeans and defence equipment from the US. Japanese PM Abe and Trump are likely to meet to discuss trade issues, among other things, in late April.

Emerging markets: Asia and CEE to benefit most from a trade deal

For emerging markets, a US-China trade deal should have positive repercussions for the highly trade-oriented block of countries. The trade wars arguably had a negative impact on many emerging market economies in 2018 amid a tighter monetary policy stance from major central banks. Asian economies in particular are highly exposed to the US and China alike and stand to benefit from a deal. However, Eastern European countries should also enjoy a deal given their large export sectors - although these could be vulnerable if the US threatens to impose tariffs on European car exports (see above). Some of the larger s such as India, Brazil and Russia are notably more closed economies and have thus not been affected to the same degree as their smaller more open counterparts (Chart 14).

Chart 14. Asian and eastern European countries are more vulnerable to trade protectionism



Note: Here, we depict the Danske Bank World Trade Openness Index for selected emerging markets: a higher number indicates a greater vulnerability to trade wars. The index takes into account total foreign trade in % of GDP, export share to the US in % of GDP, and export % of GDP
Source: IMF, Danske Bank

Equities: a deal seems priced already

A trade deal between the US and China is crucial for the global equity market outlook, but 2019 has already been a remarkable ride for equity investors so far. We see three reasons for this. First, central banks have changed their guidance in a much more dovish direction. Second, 2018 ended on a weak note, with markets being very oversold. Finally, trade-deal expectations have increased markedly. The latter is crucial, as equity investors tend to 'buy the rumour, sell the fact' and vice versa when it comes to political events. In other words, a deal in itself is not a reason to buy stocks. That said, a very extensive deal should boost sentiment not least in emerging markets and Europe.

Risk of a 'reality check' has increased

The impressive equity performance year to date stands in strong contrast to the macro development, where especially, the manufacturing part has disappointed. Usually, there is a strong positive correlation between macro numbers and equity returns (Chart 15). The divergence we currently witness is, in our opinion, due the factors mentioned above and notably expectations building for a trade deal. That is, a deal is seemingly already priced. However, this has also opened up a gap between performance and fundamentals. Shortly after a deal is landed, we believe investors will start to look for the next driver for equities. With the existing gap between equities and fundamentals, there is a risk that a 'reality check' will put some pressure on performance.

Will capex pick up? Risk of an earnings recession this year

The devil often rests in the detail and, in this context, we think it will be key for equities how extensive the trade deal ends up being. The prospects for the manufacturing sector, and not least capex, are much more important than for the broader economy, and since the trade war escalated in Q2 last year, manufacturing has underperformed services and capex has deteriorated (Chart 16). This, in turn, implies that earnings growth will be much lower in 2019; we currently estimate 1-3% growth. Thus, unless we get a manufacturing acceleration and an increase in capex, there is high risk of an earnings recession in 2019. However, changes in industrial production and capex do not happen overnight and it is questionable whether investors will have the patience for macro numbers to improve. This leaves equity markets in a vulnerable position at present.

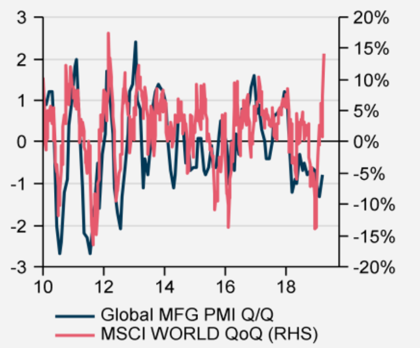
A tight race between regions

It would be straightforward to declare the US and China as the big winners in a trade deal. However, US equities are much less dependent on global trade than, for instance, European equities. That is also why we have seen European equities outperform US ones lately. US equities are currently trading at an unjustifiable high premium in our view and are not in for a significant earnings boost near term, and thus we recommend to underweight the US versus Europe. Our preferred region continues to be emerging markets, which we expect to benefit from a solution and to show the best macro momentum.

Further upside for equities is limited

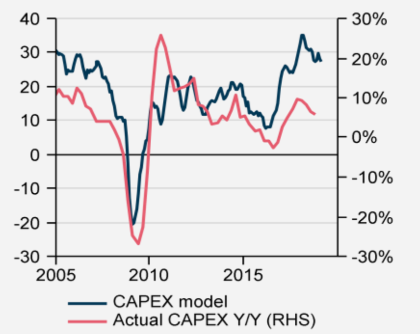
Eyeing an end to the trade war is positive for equities - especially if it initiates a wave of capex. However, it is likely much of this is already priced in, considering how equity markets have rallied alongside the rising probability of a trade deal, while the manufacturing outlook has largely weakened. While the long-term outlook still looks promising for equities, we see a much less potential short term.

Chart 15: Gap between equity performance and macro development



Source: Thomson Reuters

Chart 16: Capex growth slowing despite all late-cycle dynamics suggesting the opposite



Source: Thomson Reuters

FX: long commodity currencies vs JPY amid muted support to EUR/USD

In *FX Strategy FX ripple effects of global trade war* (16 July 2018), we presented a so-called 'global trade vulnerability scorecard' to guide the likely effects on the global FX market from an escalation of the trade dispute. This pointed to the most 'vulnerable' currencies being the commodity currencies, the Scandies and to a lesser extent the GBP and EUR, while the USD and especially the JPY were relatively shielded. 'Reversing signs' is a natural exercise in the face of a trade deal, but as is the case for equities (see above), FX markets have arguably already to some degree priced that a deal is coming. That said, the reaction in the FX market to a recent story in the *Financial Times* reveals that the FX market is alert to any signs of a closing of a trade deal and that it is not fully reflected in pricing at this point: a strong reaction was seen in notably AUD/JPY and NZD/JPY, but we also saw EUR/USD moving slightly higher. This could be a blueprint for how FX markets will respond to a trade deal (see also *FX Strategy – FX market blinked on trade headline*, 18 January).

And the winners are: the commodity currencies...

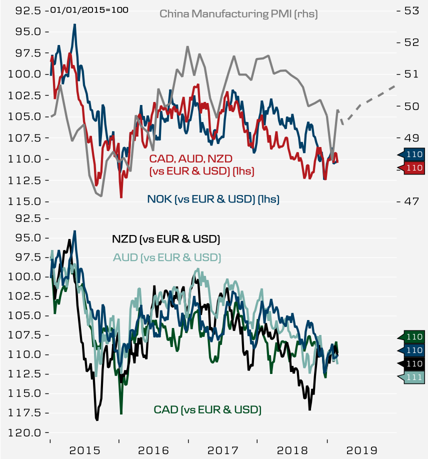
We have previously emphasised the remarkably synchronised moves between G10 commodity currencies (AUD, NZD, CAD, NOK) and the Chinese industrial cycle (Chart 17) in recent years. This close relationship is particularly noteworthy given the rather different domestic stories between Canada, New Zealand, Australia and Norway and suggests a strong key common denominator for the four currencies: China. The connection stems in part from the large Chinese consumption of energy and metals, but also from a sheer risk-appetite channel. G10 'high yielders' find guidance in the fact that China to an increasing extent leads the global industrial cycle. We expect a China trade deal to support commodity currencies such as the AUD, NZD, CAD and NOK.

...as well as the Scandies

Given that both Sweden and Norway are small, open economies that heavily depend on global trade, a US-China deal would clearly be positive for both Sweden and Norway. Further, we expect the positive impact to be amplified by the risk channel and therefore expect both EUR/NOK and EUR/SEK to move lower on a deal. Moreover, NOK/SEK and global growth/inflation expectations have seen a clear co-movement in recent years (Chart 18). Indeed, the NOK exhibits a relatively higher sensitivity to the global industrial cycle via the oil price than the SEK does, and a trade deal should, via this channel, support a higher NOK/SEK. In addition, given the substantial differences in inflation dynamics between Norway and Sweden, we think the near-term repricing potential of monetary policy remains the largest in Norway in light of a strong domestic outlook in Norway, where domestic factors continue to surprise to the topside relative to Norges Bank's forecasts (Chart 19).

We note, though, that a very specific weak spot in the euro area has been manufacturing, which in turn has been a strong headwind for the more industry-heavy Swedish economy. While inflation dynamics, in our view, remain too weak for a 2019 Riksbank rate hike, a rebound in Swedish manufacturing on a sharper China rebound could bolster the Riksbank's expectations for eventual higher underlying inflation and hence, also a steeper short-end of the SEK curve. This could in turn support the krona.

Chart 17: Commodity FX trading remarkably synchronised with turning points coinciding with China cycle

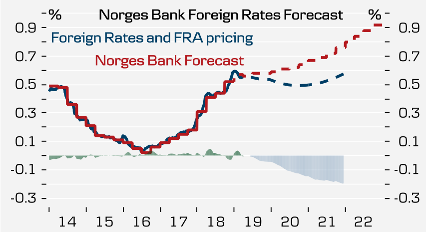


Source: Bloomberg, Macrobond Financial, Danske Bank

Chart 18: Positive relation between NOK/SEK and global inflation expectations

Source: Bloomberg, Macrobond Financial, Danske Bank

Chart 19: Higher foreign yields improves the repricing potential for Norges Bank in particular



Source: Bloomberg, Macrobond Financial, Danske Bank

JPY: likely to be the biggest loser among the majors

The JPY stood out as a main beneficiary of the escalation of the global trade war due to Japan's economy being relatively less open and Japan being a net commodity-importing country. Exports and the manufacturing sector in particular have struggled with declining demand over the past year, as China is Japan's largest trading partner, but domestic demand has remained relatively strong on the back of a historically tight labour market. The JPY is likely to be one of the biggest losers in FX markets following a trade deal – also because it could be next on the list of US tariff targets (see above).

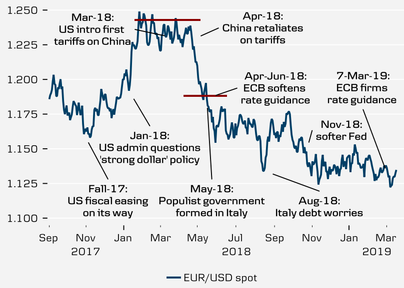
EUR/USD: trade deal to provide support... down the road

Looking back at the past year's price action in EUR/USD, it is tempting to conclude that the war on tariffs in spring 2018 was a key factor in taking EUR/USD down from close to 1.25 (h 20). We stress, however, that trade tensions came at a time when other unrelated factors also weighed: (1) the Chinese cycle was already faltering following the crackdown on shadow banking during 2017, and (2) the Italian election led to a fiscal-expansion plan laid out in May that reintroduced a debt risk premium on the euro.

That said, we do ascribe a significant part of the drop towards the 1.16 level in April-May last year directly or indirectly to the trade war. Channels for this were, in our view: (1) the positive terms-of-trade effect that the USD enjoyed from the introduction of tariffs, (2) the negative effects on the euro zone from its relatively large exposure to China commodity prices and trade openness more broadly and (3) the ECB softened its rhetoric in Q2 and introduced time-dependent rate guidance in June 2018. On the whole, a rough estimate is that around five big figures of the drop in EUR/USD, i.e. the move from 1.24 to 1.19 was down to factors directly or indirectly linked to the trade war and China. Does this mean EUR/USD could be in for a level shift higher if/when a trade deal arrives? Not necessarily.

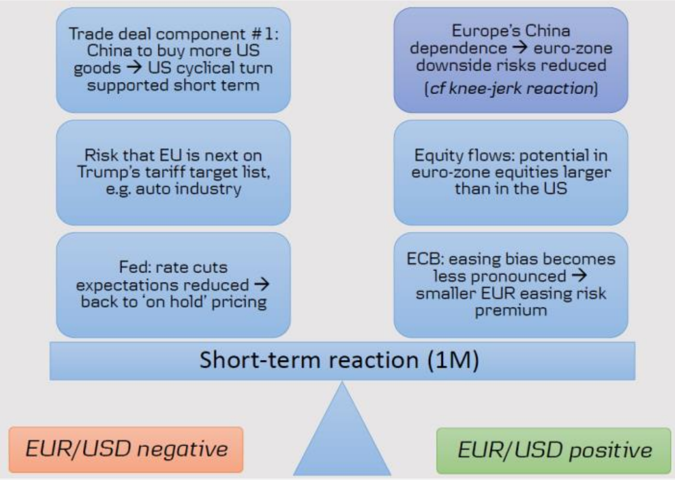
On announcement of a deal, we expect the market to initially send EUR/USD higher. The knee-jerk reaction is likely to be dominated by a brightening China outlook, reduced euro zone downside risks, and a reduced scope for ECB easing; further, the potential for euro equity inflows is also a short-term positive (Chart 21). However, we doubt that a trade deal would cause EUR/USD to break out of the recent range around 1.13. On a 3M horizon, the direction for EUR/USD will depend on the deal details, i.e. how much US goods would China buy, and would Trump go after the EU next with, e.g., auto tariffs? The potential for the Fed to sound more upbeat and disappoint current dovish pricing and the still-high carry on short EUR/USD positions also weigh in to provide a rather muted positive outlook for EUR/USD short term. Further out, we continue to see EUR/USD in a muted recovery towards 1.17 in 12M as the EUR-positive factors dominate and the risk of new ECB easing fades (Chart 22).

Chart 20: EUR/USD trade events and more



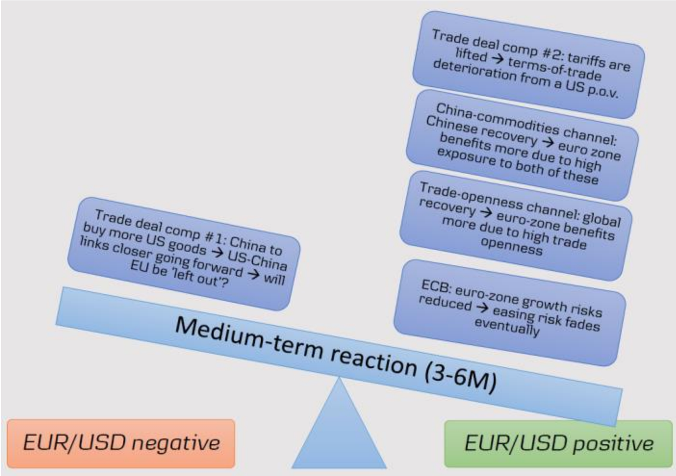
Source: Bloomberg, Macrobond Financial, Danske Bank

Chart 21: Short term: trade deal → EUR/USD slightly higher



Source: Danske Bank

Chart 22: Medium term: trade deal → EUR/USD supported



Source: Danske Bank

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