7 August 2019

US-China Trade

Three trade war scenarios – 'no deal' now our baseline

- US-China trade relations have clearly deteriorated and our baseline scenario is now that the two countries will not reach a deal this side of the 2020 election. In this scenario, we see two possible paths. One is no deal but a status quo without much further escalation (35% probability). The other is an all-out economic war in which we see a significant escalation of the trade war (25% probability).

- We also still envision a scenario (40% probability) in which Donald Trump scales back his demands on China to reach a deal in 2020, in which China buys significant amounts of agricultural products. Trump's big headache with respect to the 2020 election is the substantial pain the trade war is inflicting on US farmers. These are decisive voters in key swing states, where his showing in the polls is currently weak.

- Overall, we see a clear increase in downside risks to growth over the coming year. The main restraint on Trump's economic attacks on China is the potential damage to US markets and the economy resulting from Chinese retaliation.

US-China relations reached a new low point this week, with the US designation of China as a 'currency manipulator'. This followed a sharp move in USD/CNY above 7 as the expected tariff increase on 1 September triggered selling pressure on CNY.

For now at least it seems that both the US and China have thrown in the towel in terms of reaching a trade deal. The gap between them is simply too big to be bridged and the relationship between them on all fronts has eliminated the trust in each other on both sides. Trade talks in Shanghai last week showed no movement on either side of the table. The recent development has left significant uncertainty over where this trade war is heading. When faced with high uncertainty, we believe working with scenarios is normally a good idea. Below we sketch out three potential scenarios for where we could go from here (one can imagine many more but for clarification we stick to three).

Scenario 1 (35%): no deal but not all-out economic war

Generally, we now see a 60% probability that we will not see a deal this side of the election. In this case, we see two possible scenarios. One is a path where the deadlock continues and the rhetoric is still very tough but the status quo is broadly in place with only limited further escalation. US export controls on Huawei stay in place but the US does not increase tariffs on Chinese goods further.

What would be the rationale for such a scenario? First, Trump may reach the conclusion that it is not possible to do a trade deal at all because China is simply not moving enough. China's demand for a total roll-back of tariffs without being willing to write part of the deal into its laws may be too much for him to swallow. China may also simply not want to make a deal. It may have reached the conclusion that it is better off by aiming to weaken Trump's electoral base, hoping to negotiate with a Democratic President on the other side of the election.

Global economy set to move into recession in the event of a full-blown trade war scenario

Source: Macrobond Financial, Census Bureau

Both US and China manufacturing feel the pain already
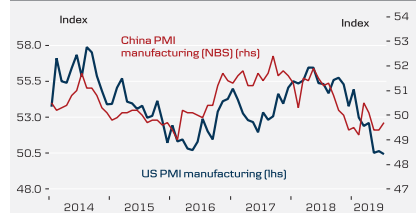
Source: Macrobond Financial, Census Bureau

US exports have taken a bigger hit than Chinese exports due to the halting of agriculture purchases from China

Source: Macrobond Financial, Census Bureau

Chief Analyst
Allan von Mehren
+45 45 12 80 55
alvo@danskebank.dk

Important disclosures and certifications are contained from page 5 of this report.

https://research.danskebank.com

The US confrontation on all fronts, including Hong Kong, Taiwan, Xinjiang, South China Sea and The Belt and Road Initiative, may have led China to conclude that it should not give Trump anything that could help him to get re-elected. While the Democrats will also take a tough stance and are more likely to build a broad alliance to put pressure China, this is unlikely to be more challenging than what it faces with the current administration. China may also fear that Trump could reinstate tariffs after the election.

Then what could be the force that stops the trade war from escalating further if no deal is on the table? If the US economy keeps weakening and markets stay weak, it might restrain how much further Trump tightens the screws on China. Retaliation and rising fears of recession could weaken the US economy and stock markets too much for Trump still to sit on a strong economy and markets when he heads into the 2020 election. Given how strong the economy is, most political analysts agree that his approval ratings should be much better under normal circumstances. Hence, he cannot afford to lose this platform of a strong economy when facing voters.

In contrast, we believe China is unlikely to escalate on its own, as it has been very consistent in not shooting first, mainly returning fire when it is being shot at.

Scenario 2 (25%): no deal and all-out economic war

Another possible outcome in a no-deal scenario is one where Trump decides to escalate further. He might believe that he will gain the most among voters by switching to a strategy of being as tough on China as possible, or that by going 'all in' and putting China under significant pressure it will cave in and give the concessions he wants (which it does not). This could result in an all-out economic war that entails a significant broadening of export controls, an increase in tariffs from 10% to 25% on USD300bn of Chinese exports and possibly sanctions on Chinese financial entities restricting their access to USD and US assets. It could also entail a currency war in which Trump uses the Treasury Department's Exchange Stability Fund to weaken the USD against the CNY.

These measures would be a very significant escalation that we believe would throw the global economy into a recession and not least hurt the Chinese economy. Even a significant policy stimulus globally would not be able to avoid a recession. The negative effects in this scenario are also the main argument against such a path, because it would also do significant damage to the US economy and markets. However, we cannot rule out Trump overestimating the strength of the US economy and choosing an election platform of 'teaching China a lesson' and proving that he is the toughest candidate on China.

Scenario 3 (40%): deal reached during 2020

The final scenario is one where things are deadlocked for a long period but Trump does not give up on making a deal with China. Although Trump reacted strongly this week by labelling China a 'currency manipulator', he has not yet taken further measures, such as keeping export controls on Huawei. His economic adviser Larry Kudlow smoothed things out a bit yesterday by saying the US still looked for trade talks with China in Washington in September and that Trump could be flexible on tariffs. It does not seem as though the White House has completely closed the door to a deal and, as such, we believe it shows that it still prefers a deal over no deal.

Trade war has increased US-China trade deficit to new record as China has stopped buying agricultural products
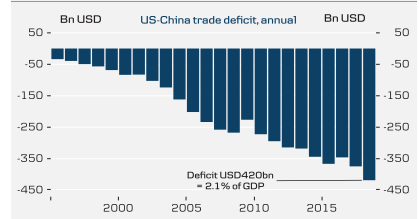
Source: Macrobond Financial, Census Bureau

If Trump's election polls don't look great moving into 2020, he might at some point decide to meet China halfway and go for a deal where, among other things, he gets big agricultural purchases from China and lower tariffs on cars. The current polls in some key swing states do not look very good. In the farm states Ohio and Wisconsin, his approval ratings have dropped quite a lot since the election in 2016. Michigan is also an important swing state, as it is the centre of the car industry. His ratings are also poor here. He won all of the above states in 2016 and he cannot afford to lose them in 2020. He needs more than 270 electoral votes to win the US election and he got 303 in 2016 because he managed to conquer most of the important swing states – some of these with a very tight margin. All else being equal, he would lose his majority if, for example, Ohio and Michigan flipped to the Democrats.

A deal also depends on whether China still wants to make a deal with Trump. This is not clear to us anymore.

Overview of US swing states – red shading show states Trump won in 2016, blue went to Hillary Clinton

State	% of votes in 2016 election			Trump net approval, % points (July-19)	Electoral Votes	
	Trump	Hillary	Net			
Florida	48,6	47,4	1,2	-1	29	
Pennsylvania	48,2	47,5	0,7	-8	20	
Ohio	51,3	43,2	8,1	-6	18	Farm state
Michigan	47,3	47,0	0,3	-11	16	Auto state
Georgia	50,4	45,3	5,1	2	16	
North Carolina	46,2	49,8	3,6	-1	15	
Virginia	44,4	49,8	-5,4	-4	13	
Arizona	48,1	44,6	3,5	-7	11	
Wisconsin	47,2	46,5	0,7	-14	10	Farm state
Minnesota	44,9	46,4	-1,5	-14	10	
Colorado	43,3	48,2	-4,9	-12	9	
Iowa	51,1	41,7	9,4	-11	6	Farm state
Nevada	45,5	47,9	-2,4	-11	6	
New Hampshire	46,5	46,8	-0,3	-17	4	
Maine	44,9	47,8	-2,9	-13	4	

Source: New York Times, Morningconsult.com, Danske Bank

Uncertainty rules

The only thing that seems certain currently is that the outlook is more blurred than ever. We have switched our baseline scenario to a no-deal outcome with a 60% probability, as we believe China increasingly prefers this scenario and it will be hard for Trump to make a soft deal given the pressure from Congress. However, should polls continue to look weak for Trump as we move further into the election campaign, he might blink and decide to make the deal anyway, as it could help him in some very important swing states.

Overall, though, we see the risks as having increased compared with our current global growth scenario of stabilisation in global growth in Q3 and a moderate recovery starting in Q4. In the worst case of a sharp escalation, we believe we would head for global recession. In the softer version of a no-deal scenario, we would be stuck with tariffs for a long time and a high level of uncertainty, which would keep the global economy hostage to the trade war. Growth stays subdued around current levels for longer and any recovery pushes well into 2020.

We intend to take a close look at our global growth forecasts in coming weeks.

https://research.danskebank.com

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Arne Lohmann Rasmussen, Chief Analyst.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

None.

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research report has been prepared by Danske Bank A/S. It is provided for informational purposes only and should not be considered investment advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

The research report has been prepared independently and solely on the basis of publicly available information that Danske Bank considers to be reliable. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and Danske Bank, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts responsible for the research report and reflect their judgement as of the date hereof. These opinions are subject to change and Danske Bank does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided herein.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom or the United States.

This research report is protected by copyright and is intended solely for the designated addressee. It may not be reproduced or distributed, in whole or in part, by any recipient for any purpose without Danske Bank's prior written consent.

https://research.danskebank.com

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/A, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Report completed: 8 August 2019, 16:38 CEST
Report first disseminated: 8 August 2019, 07:30 CEST