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Strategy

Trump's trade crusade: good or bad for world economy?

This week saw an escalation in the tit-for-tat trade war between the US and China. First, on Monday, the Trump administration announced 10% tariffs on USD200bn worth of imports from China, taking the total imports from China hit by new tariffs to USD250bn, or roughly half of the total US imports from China. Chinese authorities responded relatively swiftly, announcing 5-10% of tariffs on USD60bn of imports from the US from 24 September. Clearly, a negative development for the sake of the world economy, as it increases uncertainty for companies and risks hurting global trade if these trade restrictions are made permanent.

However, the market reaction this week was very interesting. Instead of falling off the cliff, risk sentiment actually improved. For a start, the market was probably relieved that the new US tariffs were 'only' 10% and not 25% as Trump had signalled. And the Chinese response were also fairly moderate. This reversed some of the sell-off that EM currencies faced in the early summer when trade tensions escalated. On another note, despite threatening to decline the US's invitation for further trade negotiations by the end of week if Trump proceeded with the new tariffs, the Chinese have still not called off these negotiations. Overall, this suggests that some caution is being exercised on both sides to not provoke the other side too much.

Our main scenario is for a deal in the trade dispute between China and US, but it will take a while to get there...

Source: Danske Bank

Key points

- The tit-for-tat trade dispute between the US and China escalated this week.
- However, the market reaction was positive, as the actions were not as bad as expected.
- Indeed, both countries pushed for lower trade barriers (with other countries).
- While it will be a long and difficult path, we think a deal will be reached eventually.
- This may actually leave the world economy better off than before the whole trade dispute started.

About half of US imports from China have been hit by new tariffs

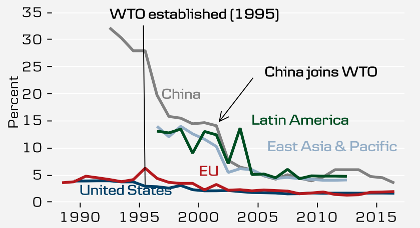
Source: US Census Bureau, Macrobond Financial

Chief Analyst
Jakob Ekholdt Christensen
+45 4512 8530
jakc@danskebank.dk

Furthermore, this week there were also pledges to reduce trade barriers towards other countries from both China and the US. While the US hit China with new tariffs, the Trump administration signalled a desire to push for bilateral trade agreements with Canada, Europe and Japan. Similarly, on Wednesday, China's premier Li Keqiang said China plans to cut tariffs on imports from the majority of its trading partners next month (see *Bloomberg*). It is an interesting development, as China cut tariffs in July on a range of consumer goods. Both moves, if put into effect, would be good for the global economy.

Finding a solution between China and US appears to be the biggest obstacle at this stage. We remain sceptical that a deal can be found before the US mid-term elections and think that genuine discussions will first start when the pain is felt on both sides. Along the way, there is a risk that the two sides might fail to reach a solution, and that the new higher trade tariffs become the 'new normal' or the conflict even escalates. However, we think that both sides will ultimately have a strong interest in finding an agreement. If such a deal includes scrapping the tariffs that have been put in place over the past months and moreover leads China to open up to more foreign investment and foreign trade (by actually lowering the average tariffs by more than before the trade dispute started), then the global economy may actually be better off. However, the road is likely to be long (lasting well into 2019) and is paved with uncertainty and market volatility.

Average tariffs still higher in developing world, including China



Source: World Bank World Development indicators, Macrobond Financial, Danske Bank

Financial views

Asset class	Main factors
Equities	
Positive on 3-12 month horizon.	Fundamentals still support equities on a 3-12M horizon. However, despite strong earnings, higher risk premium is expected in the short run, among other things due to trade tensions
Bond market	
German/Scandi yields – stable for now, higher in 12M	Strong forward guidance from the ECB. Core inflation remains muted. Range trading for Bunds for the rest of 2018. Still higher in 2018.
EUR 2Y10Y steeper, USD 2Y10Y flatter	The ECB keeps a tight leash on the short end of the curve but 10Y higher as US has an impact. EUR 2Y10Y mainly steeper in 2019.
US-euro spread – short-end to widen further	The spread in the short-end is set to widen further as the Fed continues to hike.
Peripheral spreads – tightening (Italy special case)	ECB forward guidance, better fundamentals, an improved political picture (ex. Italy) and rating upgrades to lead to renewed tightening after recent widening. Italy remains a special case. But BTP yields are already very high.
FX & commodities	
EUR/USD – lower for longer… but not forever	In a range around 1.15 in 0-3M as USD carry and political risks weigh but supported longer term by valuation and ECB 'normalisation'.
EUR/GBP – gradually lower over the medium term	Brexit uncertainty dominates now but GBP should strengthen on 6-12M on Brexit clarification and Bank of England rate hikes.
USD/JPY – higher eventually	US yields decisive near term with political uncertainty as a significant downside risk. Longer term higher on Fed-Bank of Japan divergence.
EUR/SEK – downside in warm-up to first hike	Lower as first hike form Riksbank looms by year end - but it could be one-and-done which should limit SEK strength thereafter.
EUR/NOK – set to move lower but near-term headwinds	Positive on NOK on valuation, relative growth, positioning, terms of trade, global outlook and Norges Bank initiating a hiking cycle.
Oil price – downside risk rest of year	OPEC increasing output and escalation of trade war has increased near-term downside risks.

Source: Danske Bank

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