Global Economics & Markets Research
Email: GlobalEcoMktResearch@uobgroup.com
URL: www.uob.com.sg/research

Macro + FX Strategy

US-China: Conclusion Of Phase One Trade Deal Reduces Uncertainties Ahead

Thursday, 16 January 2020

Ho Woei Chen
Economist
Ho.WoeiChen@uobgroup.com

Peter Chia
Senior FX Strategist
Peter.ChiaCS@uobgroup.com

- The long-awaited US-China Phase One trade deal was finally signed on Wed (15Jan) by US President Trump and Chinese Vice Premier Liu He. The details of the trade deal are in line with the recent comments from US officials with regards to its scope and include more specifics on implementations and commitments by China. This is more comprehensive than we had expected and addresses previous concerns on the lack of enforceability of the agreement.
- Overall, the Phase One trade deal reduces the uncertainties for global trade but is unlikely to catalyze a strong rebound in growth, particularly for China, since the bulk of the US-China tariffs will remain in place. We are maintaining our growth forecast for 2020 GDP growth at 5.9% for now. The 4Q19 and full-year 2019 GDP data will be released tomorrow with consensus looking for a stabilisation in growth at 6.0% y/y in 4Q19 (UOB: 6.0%) and 2019 growth at 6.2% (UOB: 6.1%).
- Although US Vice-President Mike Pence said discussions have already begun for Phase Two agreement, President Trump had earlier indicated that it may not be concluded until after the US Presidential Election in Nov. Indeed, both parties are not expected to sign Phase Two of the agreement until they are satisfied with the progress of the current Phase One deal which covers China's commitment over two years for the scheduled increases in its imports from US.
- Despite renewed optimism in both trade relations and the Chinese economy, we are of the view that most of the positives are already in the price of the CNY. Nonetheless, if risk sentiment continues to stay strong and improve, it is likely our current end-year USD/CNY's target of 7.20 is at risk of a downgrade.

Long-Awaited Phase One Trade Deal Concluded

The long-awaited US-China Phase One trade deal was finally signed on Wed (15Jan) by US President Trump and Chinese Vice Premier Liu He. The details of the trade deal are in line with the recent comments from US officials with regards to its scope and include more specifics on implementations and commitments by China. This is more comprehensive than we had expected and addresses previous concerns on the lack of enforcibility of the agreement.

The agreement also laid out the committed increase in China's imports from US over the next two years. While there may be a risk of shortfall, this would not be immediately clear over the next few months of bilateral trade flows. As we highlight below, the targeted increase in China's agriculture imports from the US is viable given the room for substitution of its large agriculture purchases. In 2019, US accounted for less than 10% of China's annual agriculture imports.

Overall, the Phase One trade deal reduces the uncertainties for global trade but is unlikely to catalyze a strong rebound in growth, particularly for China, since the bulk of the US-China tariffs will remain in place. There was no further rollback in tariffs other than earlier announced halving of the tariff rate on US$120bn of Chinese goods exports to the US that was implemented at 15% on 1 September 2019. US will maintain its 25% additional tariff on US$250bn of Chinese goods while China imposes additional tariffs on around US$110bn of US goods.

Notwithstanding the recent improvements in China's Dec trade data and expected stabilisation in the US-China trade relations, we continue to expect China's economic growth to slow in 2020. We continue to expect China's economic growth to slow in 2020 due to the structural reforms and ongoing supply chain diversification. We are maintaining our growth forecast for

2020 GDP growth at 5.9% for now. The 4Q19 and full-year 2019 GDP data will be released tomorrow with consensus looking for a stabilisation in growth at 6.0% y/y in 4Q19 (UOB: 6.0%) and 2019 growth at 6.2% (UOB: 6.1%).

Key Components Of The Phase One Agreement

The 96-page trade agreement comprises of seven main chapters covering: 1) Intellectual property (IP); 2) Technology transfer; 3) Trade in food and agricultural products; 4) Financial services; 5) Macroeconomic policies and exchange rate matters and transparency; 6) Expanding trade; 7) Bilateral evaluation and dispute resolution. In particular, Chapter 7 sets out the implementation arrangements which includes the creation of the high-level Trade Framework Group to discuss the implementation of the agreement (led by USTR and a designated China Vice Premier) and a Bilateral Evaluation and Dispute Resolution Office for each party as well as the process for dispute resolution.

In summary, China will ramp up purchases of US goods and services by US$200bn over the next two years, using 2017 as the baseline. Agriculture purchases will increase by US$32bn over the two-year period, with steps to allow more market access for US products. Factoring in the increases, China's imports of US agricultural products is targeted to rise to a total of at least US$80bn over the next two years (from US$20bn in 2017 according to US Census Bureau data) and it will "strive to purchase an additional US$5bn of agricultural products annually". This is achievable if China substitutes its agriculture imports from other countries given that its total agriculture imports is worth more than US$130bn annually (see charts 2 & 3). The targeted increases in China's imports of US manufactured goods, energy products and services (IP charges, business travel and tourism) are also laid out in the agreement (see chart 1).

The agreement sets out undertakings by both parties on IP protection including the prevention and punishment for theft of trade secrets and confidential business information. "Within 30 working days after the date of entry into force of this Agreement, China will promulgate an Action Plan to strengthen intellectual property protection aimed at promoting its high-quality growth. This Action Plan shall include, but not be limited to, measures that China will take to implement its obligations under this Chapter and the date by which each measure will go into effect." The document also said that technology transfer or licensing of technology "must be based on market terms that are voluntary and reflect mutual agreement".

Under the agreement, China will remove barriers to help US banking institutions, insurers and other financial-services companies that are looking to expand in the Chinese market. China shall remove the foreign equity cap in the life, pension, and health insurance sectors and allow wholly US-owned insurance companies to participate in these sectors no later than 1 April 2020 and shall also eliminate foreign equity limits and allow wholly US-owned services suppliers to participate in the securities, fund management, and futures sectors.

On exchange rate matters, the parties commit to "refrain from competitive devaluations and not target exchange rates for competitive purposes, including through large-scale, persistent, one-sided intervention in exchange markets." China will also commit to a schedule of regular disclosures of data regarding its foreign-exchange holdings and forward positions according to IMF's template.

Phase Two May Take Longer To Materialize

US President Trump said all US additional tariffs on Chinese imports will be removed as soon as both countries completed the Phase Two of their trade agreement and does not plan to have a Phase Three. Phase Two is expected to address more thorny issues and is said to include services sectors other than financial services as well as cybersecurity issues.

Although US Vice-President Mike Pence said discussions have already begun, President Trump had earlier indicated that it may not be concluded until after the US Presidential Election in Nov. US Treasury Secretary Mnuchin even said that "phase two may be 2A, 2B, 2C." (i.e. we take that to mean long-drawn) Indeed, both parties are not expected to sign Phase Two of the agreement until they are satisfied with the progress of the current Phase One deal which covers China's commitment over two years for the scheduled increases in its imports from US.

With Phase One agreement in place, the risk of a re-escalation in trade tensions between US and China is now significantly lower. However, a complete deal could take longer to materialize especially since Phase Two is now touted as the final phase and will therefore attempt to cover all remaining issues.

FX Outlook: Most Of The Positives of Phase One Is Already In The Price Of CNY

The CNY has rallied strongly from about 7.03 /USD in mid-Dec when the Phase One trade was first announced to a 6-month high of 6.8669 /USD on Tuesday (14-Jan). Markets have recalibrated their previously too-negative expectations on the CNY as it appears that the most intense period of the 2-year trade conflict between US and China may be finally over. Furthermore, the domestic currency is also bolstered by recent stabilization of the Chinese economy. Manufacturing PMI returned back into expansion territory (at 50.2) across November-December. Exports rose by the most (7.6% y/y) since March in December while latest prints in industrial production and retail sales both came in above estimates.

Despite renewed optimism in both trade relations and the Chinese economy, we are of the view that most of the positives are already in the price of the CNY. Against the backdrop of an already extended rally in CNY for the past month, further gains from here need to be supported by a more sustainable rebound in China macroeconomic numbers. In our opinion, a V-shaped recovery of the Chinese economy remains unlikely, with China's GDP expected to moderate further to 5.9% this year. To that end, it is likely that recent gains in CNY would start to consolidate going forth. On the other hand, China's commitment not to devalue its currency or make persistent intervention in its currency market should also limit CNY weakness and volatility. Overall, if risk sentiment continues to stay strong and improve, it is likely our current end-year USD/CNY's target of 7.20 is at risk of a downgrade. The next review of our USD/CNY and other Asian FX forecasts is at the FX & Rates Monthly, scheduled to be published end-January or early February.

Chart 1: Breakdown Of The US$200bn Scheduled Increases In US Exports To China Over 2 Years

Source: USTR, UOB Global Economics & Markets Research

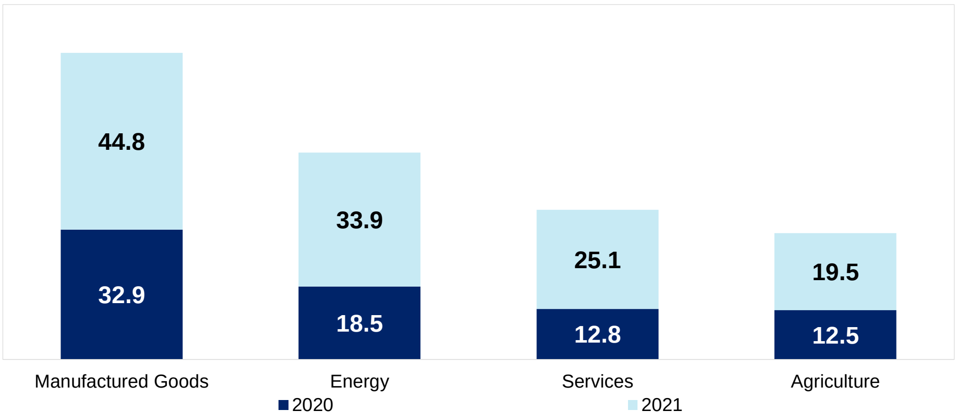


Chart 2: Exports Of Farm Products To China

Source: Macrobond, UOB Global Economics & Markets Research

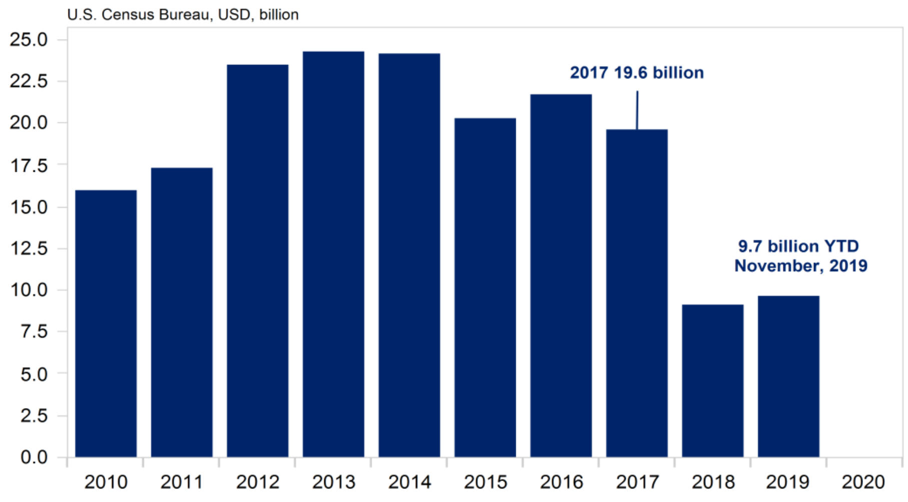


Chart 3: China - Value Of Farm Imports

Source: Macrobond, UOB Global Economics & Markets Research

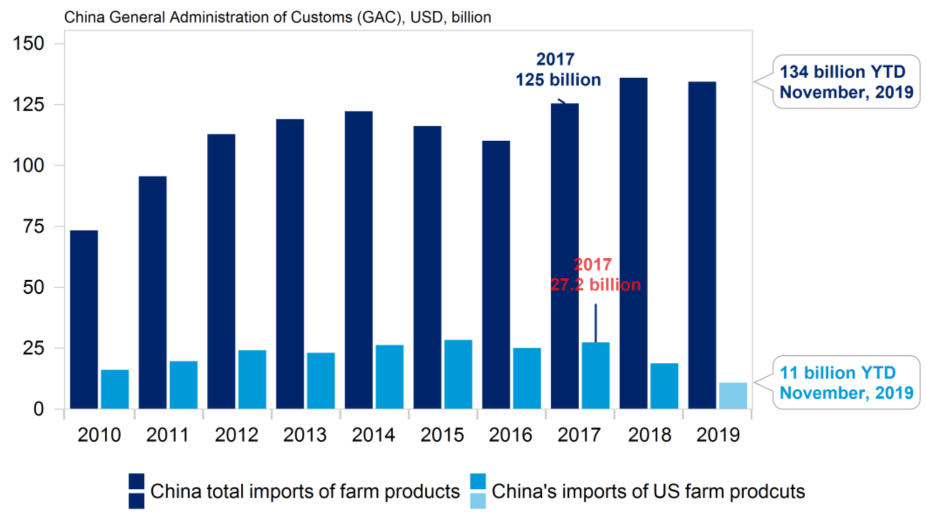
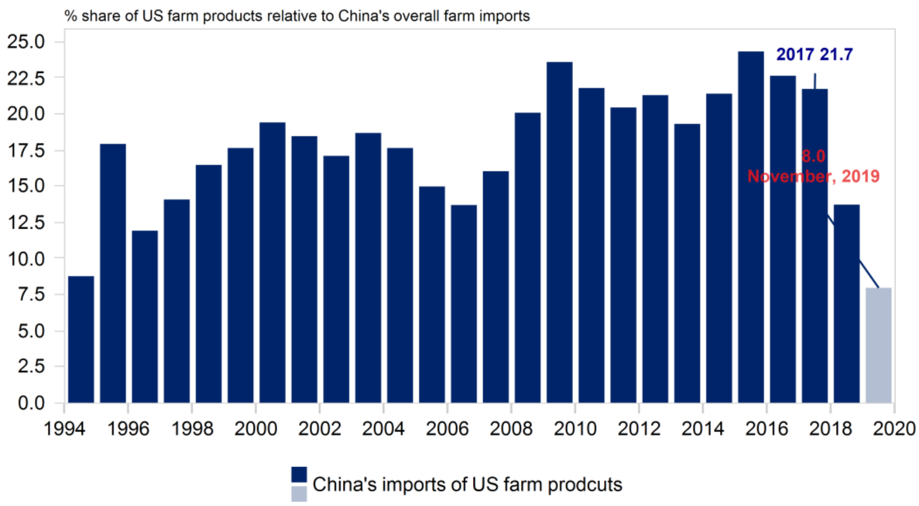


Chart 4: Share Of US Farm Products To China's Total Farm Imports

Source: Macrobond, UOB Global Economics & Markets Research



Please click on the following links to view the Phase One Trade Agreement and the Fact sheets:

1) https://ustr.gov/sites/default/files/files/agreements/phase%20one%20agreement/Economic_And_Trade_Agreement_Between_The_United_States_And_China_Text.pdf
2) https://ustr.gov/countries-regions/china-mongolia-taiwan/peoples-republic-china/phase-one-trade-agreement/fact-sheets
3) http://www.gov.cn/xinwen/2020-01/16/5469650/files/0637e57d99ea4f968454206af8782dd7.pdf

Disclaimer

This publication is strictly for informational purposes only and shall not be transmitted, disclosed, copied or relied upon by any person for whatever purpose, and is also not intended for distribution to, or use by, any person in any country where such distribution or use would be contrary to its laws or regulations. This publication is not an offer, recommendation, solicitation or advice to buy or sell any investment product/securities/instruments. Nothing in this publication constitutes accounting, legal, regulatory, tax, financial or other advice. Please consult your own professional advisors about the suitability of any investment product/securities/ instruments for your investment objectives, financial situation and particular needs.

The information contained in this publication is based on certain assumptions and analysis of publicly available information and reflects prevailing conditions as of the date of the publication. Any opinions, projections and other forward-looking statements regarding future events or performance of, including but not limited to, countries, markets or companies are not necessarily indicative of, and may differ from actual events or results. The views expressed within this publication are solely those of the author's and are independent of the actual trading positions of United Overseas Bank Limited, its subsidiaries, affiliates, directors, officers and employees ("UOB Group"). Views expressed reflect the author's judgment as at the date of this publication and are subject to change.

UOB Group may have positions or other interests in, and may effect transactions in the securities/instruments mentioned in the publication. UOB Group may have also issued other reports, publications or documents expressing views which are different from those stated in this publication. Although every reasonable care has been taken to ensure the accuracy, completeness and objectivity of the information contained in this publication, UOB Group makes no representation or warranty, whether express or implied, as to its accuracy, completeness and objectivity and accept no responsibility or liability relating to any losses or damages howsoever suffered by any person arising from any reliance on the views expressed or information in this publication.