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Matthews Asia

Matthews Asia Perspective

Our Views on the U.S.-China Trade Dispute

Trade concerns are weighing on investor sentiment, which impacts stock prices, but the underlying fundamentals for China remains strong. Call it a trade tiff, dispute, spat or squabble, but we believe the tariffs imposed so far by President Trump do not (yet) rise to the level of a trade war. In this note, four members of the Matthews Asia investment team explain why the new trade taxes may have a small impact on the Chinese economy and investment environment.

Andy Rothman, Investment Strategist

The tariffs announced by President Trump—and the Chinese response—are troubling but do not constitute a trade war because the macroeconomic impact is likely to be insignificant.

Trump said the U.S. will collect a 25% tax on US$50 billion of imports from China. That amount, however, is equal to only 10% of the value of all Chinese imports last year. Moreover, Chinese exports to the U.S. accounted for only 19% of total Chinese exports, so the new tax will be levied against only about 2% of all Chinese exports.[1]

It is also important to recognize that the Chinese economy is no longer export-driven. Net exports (the value of a country's exports minus the value of its imports) account for only 2% of China's GDP, down from a peak of 9% in 2007.[2] In contrast, domestic consumption now accounts for the majority of China's economic growth and more than half of its GDP.

We have also considered the impact on China's economy of the reciprocal taxes Beijing will levy on US$50 billion of its imports from the U.S. Based on our estimates of the price elasticity of both Chinese exports and imports, we expect the current trade dispute to reduce China's GDP growth rate by about 0.1%. That would have reduced the 1Q18 GDP growth rate of 6.8% to 6.7%, for example, a modest slowdown that would not influence how we think about investing in China.

I am in Beijing now, and last week a senior Chinese government economist told me that authorities have reached the same conclusion about the impact on the country's economy.

On a micro level, I believe much of the impact of Trump's import taxes will not be borne by Chinese companies; about two-thirds of the 25 largest exporting companies based in China are foreign-owned. Moreover, one-third of the value-add from all Chinese exports actually accrues to firms from other countries, including U.S. partners such as Japan, South Korea, Taiwan and Germany, as well as to U.S. companies.

Finally, we acknowledge that disputes can turn into wars.

The Chinese government's tariff response mirrored the Trump taxes and Beijing has called for restraint and negotiations. There are reasons to hope that Trump will not respond with another round of tariffs, which probably would lead to another response from Beijing. Trump can claim that the tariffs delivered on his campaign pledge to get tough on China, and then move on to negotiations over issues that really matter to U.S. companies, such as better protection of intellectual property and market access in China.

The president may also want to show restraint because Chinese retaliation is designed to inflict pain on Trump supporters, such as soybean farmers, which could help Democrats take control of the House in November.

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Most importantly, an angry Xi Jinping probably could scuttle a denuclearization deal between Trump and Kim Jong Un.

Still, Trump may think a trade war with China is easy to win and decide to escalate. If that happens, my view is that the damage to the Chinese economy and investment environment will be much less than many expect, because the U.S. accounts for a small share of total Chinese exports and because China is no longer an export-driven economy. An economy driven by Chinese companies selling goods and services to Chinese consumers should be well-insulated from the impact of a trade war with the U.S.

Andrew Mattock, Portfolio Manager, Matthews China Strategy

Trade conflicts between China and the U.S. have been an overhang for Chinese equity markets thus far in 2018. Market observers worry that trade disputes could severely impact business environments in China. We are confident that our portfolio holdings for the Matthews China Strategy remain largely unaffected by the trade dispute as we continue to focus on China's domestic consumption and expanding middle class.

If these trade conflicts escalate into a full-fledged trade war, however, the impact on global businesses and consumers would need to be re-evaluated. A trade war would not be purely a China problem. To a large degree, the effects could be felt more abroad than in China. China is part of a global manufacturing supply chain that produces jobs worldwide.

Further, China's monetary policies remain largely independent. The country no longer relies on trade as a source of growth and has ways to spur domestic consumption and demand. While China is not shielded completely from external forces, we believe it will be able to weather most of the negative implications of global politics. Still, a full-blown trade war would be detrimental not only to both parties but also to the global economy.

Sherwood Zhang, Portfolio Manager, Matthews China Dividend Strategy

While near-term market conditions could remain volatile, we believe China already has transformed its economy into one led by consumption growth rather than export-driven growth. Our Matthews China Dividend Strategy is focused on Chinese firms selling goods and services to Chinese consumers, not on exports to the U.S. We expect the trade dispute, therefore, to have an insignificant impact on the bottom line of our holdings. The impact to consumer wealth is relatively small, but consumer sentiment is a factor, as it may damper consumption, but this should be a short-term factor.

As portfolio managers, we have long been positioning for the growth in consumer-related industries, including financials, health care and consumer staples. In terms of our China Dividend Strategy, we believe it is prudent to increase the portfolio's defensiveness by increasing our weight of high dividend-yielding stocks with stable underlying cash flow to balance the portfolio's exposure to dividend growth names. Any sell-off would increase the attractiveness of companies that can sustain and grow their earnings and dividends in this environment. We continue to seek these types of compelling opportunities.

Tiffany Hsiao, Portfolio Manager, Matthews China Small Companies Strategy

U.S.-China trade tensions should, in our view, have little impact on China's smaller companies given their domestic focus. Our China Small Companies Strategy seeks innovative and capital-efficient small companies that are relatively insulated from macroeconomic uncertainties. As long-term investors, we look for secular growth opportunities that we believe may be relatively immune to tariffs and trade issues. A way to approach this is through an investment framework that focuses on the needs and wants of the domestic Chinese consumer. China's consumers will continue to look for ways to improve their quality of life and will seek out brands that cater to their tastes and aspirations.

Another way to identify long-term growth opportunities is by considering some of China's strategic priorities for fostering home-grown industries. For example, China has articulated plans to foster its own domestic semiconductor industry for reasons of national security and continued economic growth. The absence of a domestic supply chain and manufacturers for semiconductors has long been a weak spot for China. Accordingly, China is taking aggressive steps to build its own semiconductor ecosystem, a long-term economic development goal that is likely to continue with or without a trade war. Another example of strategic priorities is China's decision to fast-track the development of cancer treatment drugs within its dynamic biotech sector to help reduce national medical costs. A trade war may accelerate some of these domestic, internal priorities for China.

Our portfolio tends to have a consistent overweight allocation in the consumer and health care sectors, as well as selective businesses within the industrials and information technology sectors. In addition, the Strategy generally is structurally underweight in companies with cyclical business models and capital intensive sectors such as real estate. We will continue to seek companies with sustainable, quality earnings streams, strong cash flows and good balance sheets that can weather uncertain economic conditions.

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