We assess the winners and losers of the US-China trade war, and the outlook from here.

What has happened so far?
Since March, 2018, when President Donald Trump imposed 25% tariffs on steel imports, US-China tensions and tariffs have escalated, and weaker trade has contributed to a global growth slowdown. Markets became increasingly concerned by the end of 2018. President Trump’s 1 August Tweet proposing additional tariffs on the remaining 300bn US dollars (USD) of Chinese imports broadsided markets. China’s response to let the yuan weaken below seven to the dollar spread further panic, with President Trump branding the country a “currency manipulator.” We now put the risk of a trade negotiation breakdown at 40%, up from 25% previously.

Winners and losers – the macro perspective
Our model shows key growth indicators slowing since 2018, with the US economy holding up relatively well, Europe suffering, and China deteriorating considerably (see chart 1). US and European employment has weakened. Inflation generally remains subdued, but central banks globally have moved to cushion the impact of slowing trade.

Chinese growth has slowed from 6.8% in the first quarter (Q1) of 2018 to 6.2% in Q2 2019, with fiscal, monetary and credit easing softening the blow. The shift of not just lower-level manufacturing, but tech and consumer goods companies from China to neighbours including Thailand and Malaysia has accelerated. We forecast Chinese growth will slow to 6.0% in 2020. Still, authorities can step up growth stabilisation measures; lower US rates will be a help. And China’s leaders can take a longer-term view, unlike President Trump, who faces re-election in 2020.

In the US, the impact has been more subdued, but a Chinese slowdown should eventually feed through into higher US inflation, and lower corporate profits and growth. Proposed new tariffs will be on consumer goods for which China has fewer competitors, making it harder for American buyers to switch. Tariffs are increasingly damaging US industrial, agricultural, energy and transport sectors, hitting Trump’s voter base hard. Farming leaders want a deal. Trucking and energy companies have registered double-digit falls in August alone. We see 2020 US growth slowing from 2.3% this year to 1.8% next.

In Europe, export-oriented economies (Italy and Germany) have been hit hard by weaker demand. In Asia, economies like India, Indonesia and the Philippines have held up relatively well. Vietnam, Korea and Taiwan have benefited from export substitution to the US, and in some cases the gradual redirection of investment as global supply chains shift. But even here, higher US exports have to a large extent been offset by lower exports of input materials to China, leaving little net gain. All three economies slowed in Q1 2019.

Key takeaways
• China has suffered most so far; the US also faces pain ahead
• Vietnam, South Korea and Taiwan have seen US exports rise, but little net benefit, given lower exports to China
• Gold has been the biggest trade war winner
• Emerging market equities have seen big losses; safe haven currencies big gains
• A full trade/currency war and globalisation reversal will benefit no one
• US actions have weakened the multi-lateral, rules-based global trade regime
• We favour a defensive tilt in portfolios.
Chart 1 – Lombard Odier World Economic Indicator

The US economy fairly resilient, while Europe suffers and China’s growth deteriorates considerably

Sources: Bloomberg, Lombard Odier calculations
Asset class focus – gold, equities, fixed income and currencies

The biggest trade war 'winner' so far has been gold, which has gained 14% since March 2018.

In equities, emerging markets (EM) have felt the biggest blows, with the MSCI EM index falling 16% since March 2018, led by China. Energy and materials sectors have suffered badly. But in the US, leading indexes remain near record highs. Europe has also proved comparatively resilient, aided in both cases by supportive central banks. We favour keeping portfolios well balanced between cyclicals and defensive stocks, and have rolled over our portfolio hedges (put options on major equity indices) into November 2019.

In fixed income, a flight to safety has cut developed market government yields sharply since 2018, and yield curves have flattened. The US 10-year Treasury yield hit a multi-year low on 1 August, on the heels of the first Federal Reserve (Fed) rate cut since 2008. The German sovereign yield curve has fallen fully into negative territory, and the stock of negative-yielding government debt globally now stands at USD15.6 trillion. EM credit spreads have widened in the past month, although hard currency EM corporate bonds – where we retain some overweight – have remained more resilient.

In currencies, traditional 'safe havens' (USD, Swiss franc and Japanese yen) have gained ground, while higher-beta, liquid and trade-exposed currencies have suffered (see chart 2). Since March 2018, the yuan (CNY) has depreciated by 10% against the dollar, but only just over 1% against the euro – somewhat belying claims of currency manipulation. While we still see the hurdle to a major CNY devaluation as high, we have downwardly revised our USDCNY forecasts to 7.05 by Q4 and 7.00 by Q1 2020. In portfolios, we maintain a USD downside bias, and have turned cautious on EM FX currencies.

Where to from here?

While tariffs can lead to individual 'winners', a full trade war, protectionism and a reversal of decades of globalisation would damage economies across the board, hitting emerging markets particularly hard. Global recession risks are rising. Over half of the countries in the global manufacturing Purchasing Managers Index are now in contraction territory.

Developed market central banks have little room to act in a downturn, unless they resort to more unconventional measures. Low rates spark fears of a fresh housing bubble in some markets (eg Denmark), and help the run-up in global debt, which is at a record high of 320% of GDP. With monetary policy running out of road, some countries may have little choice but to use currency adjustments.

Meanwhile, US actions have placed the multi-lateral, rules-based trade regime under threat. President Trump’s propensity to use tariffs and sanctions as policy tools are emboldening other actors. Threats of further US tariffs hang over Mexico, and the auto sector in Europe and Japan. Another trade war is brewing in Asia between Japan and South Korea. And thanks to a US veto on new appeals judges, the World Trade Organization’s dispute resolution mechanism has been significantly weakened.

While neither a full trade nor currency war is our core scenario, we highlight the need for caution. Government and central bank policy support is likely to have a positive but limited impact on growth. Trade remains the most important threat to the global economy, in our view. With this in mind, we favour a defensive tilt in portfolios, maintaining positions in gold and the yen, and seeking alternative sources of return and diversification in EM debt in hard currency, Swiss and European real estate and hedge funds.

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**Chart 2 – Spot currency performance since 22 March 2018**

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<td>TW USD</td>
<td>6.9%</td>
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<td>7.2%</td>
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<td>TW CHF</td>
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<tr>
<td>TW JPY</td>
<td>-2.9%</td>
<td>-5.5%</td>
<td>-4.6%</td>
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<td>-7.2%</td>
<td>-7.8%</td>
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Sources: Bloomberg

**Chart 3 – A currency manipulator?**

Sources: Bloomberg, Lombard Odier calculations
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