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CIO Viewpoint

The Art of Trade War

Investment Solutions

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Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Last week, the US and China signed a "phase one" trade agreement halting their escalating rounds of retaliatory tariffs. Investors welcomed the deal that helps to cap the economic uncertainty that has disrupted global trade flows since early 2018. Longer term, the truce is a symbol of a new era that has thrown globalisation into question.

Under the terms of the 15 January agreement, China will buy industrial machinery, oil, gas and coal, agricultural commodities and services including financial services and insurance worth a total of USD 200 billion from the US for two years through 2021. The text anticipates that the increases will then continue through 2025. The agreement also calls for mutual intellectual property protections, increased market opening to foreign firms and a dispute resolution procedure.

"Nobody has ever seen anything like it," said President Donald Trump at the signing. "This is the biggest deal there is anywhere in the world, by far." That would understate the scale, for example, of the European Union's single market, the bloc's trade agreement with Japan in 2018 and the World Trade Organisation's creation in 1995. With the accession of China and Russia, the WTO's 151 members cover more than 96.7% of global Gross Domestic Product.

China has also committed to refraining from competitive currency devaluation and increasing the transparency of its exchange rate system. In return, the US has also dropped its largely symbolic "currency manipulator" label. Since the dispute started, dollar-yuan has risen sharply, offsetting some of the negative tariff impact. China's trade balance with the US and current account have fallen below the levels needed to justify the US label.

The People's Bank of China has kept the yuan's exchange rate between 2% and 4% lower than this effective rate, putting the dollar-yuan around 2% lower than the current effective tariff implied rate. China last week reported GDP growth in 2019 of 6.1%, its lowest since 1990. However, monthly sentiment and activity data have recently shown signs of a cyclical trough. Any further signs of improvement in the Chinese economy would see the USDCNY rate decline, placing the yuan in line with the broader dollar index (see chart).

Key takeaways

- The US/China trade truce halts existing tariffs and commits China to US purchases, but leaves most duties in place for a 'phase two'
- The US dropped a 'currency manipulator' label from China
- The agreement leaves issues around state subsidies and telecoms security unresolved
- Emerging market currencies remain below our fair value estimates
- A further US/China dispute over the terms of the truce would hurt the global economy and signal a return to pre-multilateral trade era of 'might is right.'

Difficult issues ahead

The US/China tensions that erupted two years ago run far deeper. Some of the most difficult issues, including China's state subsidies and security around telecoms security, are not covered by this initial truce.

The deal also leaves two-thirds of the recent US tariffs on Chinese imports in place and more than half of China's tariffs on US goods. A "phase two" is not expected until after the US November presidential elections. In the meantime, the duty on Chinese shipments to the US remains on average more than 19%, six times higher than applied before the trade tensions, while US exports entering China will pay an average of 20.9%, or 2.5 times more than in 2017.

Weakening the WTO

Strategically speaking, while last week's deal marks a major step away from multilateralism, globalisation has been working in reverse for much of the past decade.

The US/China phase one deal calls for "increasing cooperation" at the WTO and mutual reminders of rights and obligations at the global trade body. Unfortunately, the consensus-driven WTO increasingly lacks the power to arbitrate effectively. Its own dispute mechanism is now foundering as the US is blocking new appointments to its panel of appeal judges. That threatens the WTO's ability to police global trade rules.

As the global economy continues to count the costs of the US-China dispute, we should not forget that the recent history of international trade negotiations was about simplifying business and delivering globalisation's development promises. Rounds of tit-for-tat tariffs have undermined trade flows as markets have sought new suppliers and routes. The US/China truce will have a "rather small" impact, the World Bank said, as it cut its trade forecast this month. A slower recovery in trade and other geopolitical tensions will limit trade growth to 1.9% this year, compared with 1.4% in 2019, its slowest pace since the financial crisis of 2008-09.

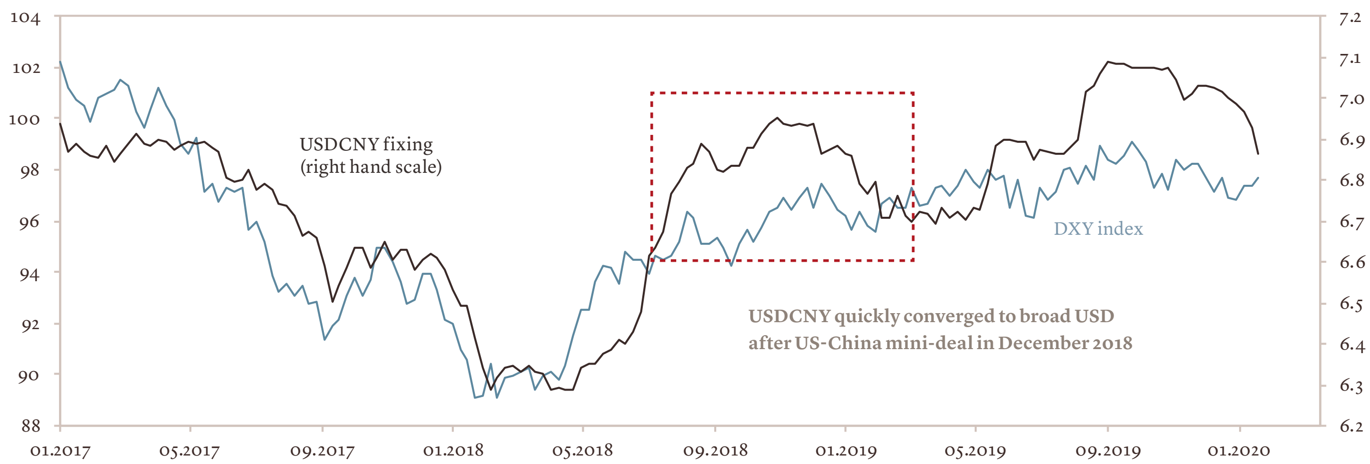
Carry & currency upside

In this environment of persistent uncertainty and in a search for yield, we continue to favour carry strategies with positions in global high yield and emerging market debt. Even after accounting for the structural decline in emerging economies' fundamentals, emerging market currencies remain below our fair value estimates, which suggests more upside in 2020. We maintain a more optimistic view of the Chinese yuan and forecast 6.80 for the end of 2020, even as the prospects of cutting the tariffs recede. A stronger currency grip by China's authorities on the currency, thanks to the agreement, and a cyclical improvement in growth, would both help.

Any failure to satisfy last week's provisions could see either the US or China resort to dispute measures, including another rise in tariffs. That would hurt the global economy, yuan and cloud any emerging asset recovery.

In the context of a weaker WTO and wider multilateral environment, the geopolitics of trade risk returning us to an earlier era of 'might makes right'.

USDCNY should lower as trade uncertainties decline



Sources: Bloomberg, Lombard Odier calculations

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SWITZERLAND

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Bank Lombard Odier & Co Ltd[1]
Rue de la Corraterie 11 · 1204 Genève · Suisse
geneva@lombardodier.com
Lombard Odier Asset Management (Switzerland) SA
Avenue des Morgines 6 · 1213 Petit-Lancy · Suisse
Support-Client-LOIM@lombardodier.com
Management Company regulated by the FINMA.

FRIBOURG
Banque Lombard Odier & Cie SA · Bureau de Fribourg[1]
Rue de la Banque 3 · 1700 Fribourg · Suisse
fribourg@lombardodier.com

LAUSANNE
Bank Lombard Odier & Co Ltd[1]
Place St-François 11 · 1003 Lausanne · Suisse
lausanne@lombardodier.com

VEVEY
Banque Lombard Odier & Cie SA · Agence de Vevey[1]
Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse
vevey@lombardodier.com

ZURICH
Bank Lombard Odier & Co Ltd[1]
Utoschloss · Utoquai 29-31 · 8008 Zürich · Schweiz
zurich@lombardodier.com

EUROPE

BRUSSELS
Lombard Odier (Europe) S.A. Luxembourg · Belgium branch[2]
Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
brussels@lombardodier.com
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Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom · london@lombardodier.com
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LUXEMBOURG
Lombard Odier (Europe) S.A.
291, route d'Arlon · 1150 · Luxembourg · Luxembourg
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291, route d'Arlon · 1150 · Luxembourg · Luxembourg
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Lombard Odier Gestión (España) S.G.I.I.C, S.A.U.
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MILAN
Lombard Odier (Europe) S.A. · Succursale in Italia[2]
Via Santa Margherita 6 · 20121 Milano · Italia
milano-cp@lombardodier.com
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Bank Lombard Odier & Co Ltd · Representative Office Moscow
Letnikovskaya st.2, bld.1 · 115114 Moscow · Russian Federation · moscow@lombardodier.com
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Lombard Odier (Europe) S.A. · Succursale en France[2]
8, rue Royale · 75008 Paris · France. RCS PARIS B 803 905 157 · paris@lombardodier.com
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JOHANNESBURG
South Africa Representative Office · Bank Lombard Odier & Co Ltd
140 West Street · Sandton · Johannesburg 2196 · South Africa
johannesburg@lombardodier.com
Authorised financial services provider Registration number 48505.

MONTEVIDEO
Lombard Odier (Uruguay) SA
Luis Alberto de Herrera · Torre 2 · Oficina 2305
11300 Montevideo · Uruguay
montevideo@lombardodier.com
Supervised by Banco Central del Uruguay.

NASSAU
Lombard Odier & Cie (Bahamas) Limited
Goodman's Bay Corporate Centre · West Bay Street · P.O. Box N-4938 · Nassau · Bahamas · nassau@lombardodier.com
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9 Raffles Place · Republic Plaza #46-02 · Singapore 048619 · singapore@lombardodier.com
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Lombard Odier Trust (Japan) Limited
Izumi Garden Tower 41F · 1-6-1 Roppongi, Minato-ku · Tokyo 106-6041 · Japan · tokyo@lombardodier.com
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