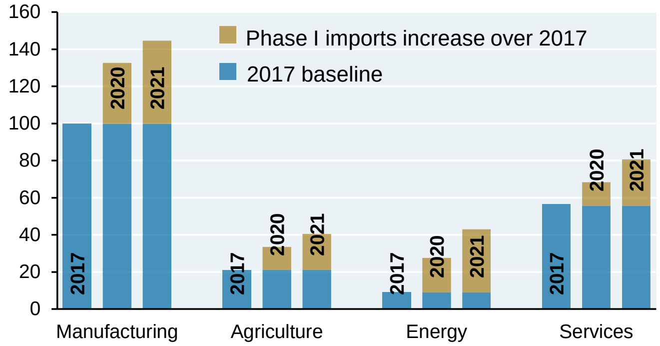
Rotten Tomatoes: Consensus reactions to the Phase I US-China deal are skeptical, but may be missing the broader point

China imports from the US, 2017 baseline and Phase I deal, US$ billions



Source: USTR, Suttle Economics. January 2020.

Key Phase I agreement terms in addition to China's commitment to increase US imports in 2020/2021:

- Increased Chinese penalties on IP infringement and trademark violations
- General language restricting forced technology transfer as a condition of market access
- Broad reductions of Chinese import restrictions on US agricultural goods
- Financial services liberalization (expansion of US underwriting, rating agencies, banking, electronic payments services, asset management, etc)
- Ban on competitive devaluations
- Some language on dispute resolution

Economists and analysts reacting to the deal have been pretty skeptical. I have aggregated representative responses below. I will give you my thoughts afterwards.

Economic skepticism

- Higher demand for certain US exports could, all things being equal, increase the price of US goods (either in nominal terms or via the US exchange rate) that will reduce the attractiveness of such goods to countries other than China, and increase the US demand for imports; both of which will probably result in no change to the US net trade deficit. In other words, US producers who supply China will benefit, while consumers and producers who supply non-Chinese markets will lose out[1]
- The deal entails an increase in US merchandise exports to China of $200 bn vs the 2017 baseline over the next 2 years. However, all that might happen is that US merchandise exports are simply diverted from third party countries to China, so that the US trade deficit is rearranged rather than reduced (the US would run a smaller trade deficit with China and a larger one with everyone else)[2]
- Much of the new purchases are derived via artificial demand rather than market forces. Once two years are up, China may diversify its imports. What would happen to US farmers who ramped up production on expectations of rising Chinese demand?[3]
- US firms and consumers have been the losers so far from the Trade War, absorbing 100% of tariff costs according to research from the Federal Reserve[4]; and most of these tariffs are staying in place
- The Trade War took a large bite out of global GDP and earnings growth by the end of 2019 (as discussed in our Outlook of January 1st), and the deal is not comprehensive enough to reverse all that negative momentum. The US economy was in good shape in the beginning of 2018, and by December 2019, growth rolled over, trucking employment was negative, farm bankruptcies were rising and the US experienced an earnings recession (i.e., two quarters of negative growth)

---

1 "*Phase 1 and Macro 101*", Michael Feroli, JP Morgan North America Economic Research, Jan 15, 2020

2 "*A Tough Ask on Trade*", Arthur Kroeber and Dan Wang, Gavekal Daily Research, Jan 16, 2020

3 Economist Intelligence Unit, Jan 2020

4 "*The Impact of the 2018 Trade War on US Prices and Welfare*", Amiti et al, Federal Reserve, Mar 2019

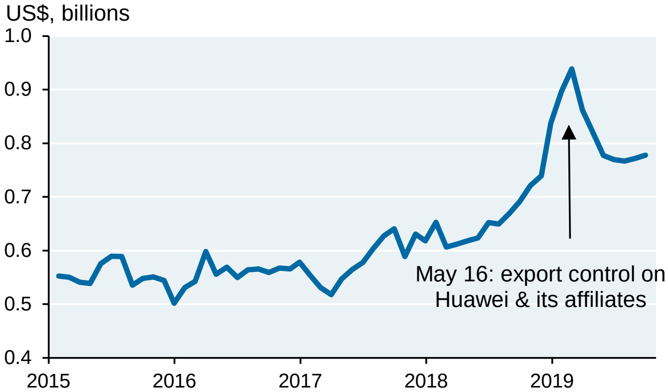
Policy skepticism

- How can China import more US manufactured goods at the same time that the US is imposing greater sanctions on Huawei, which is a large customer of US technology firms? In addition to direct sanctions on Huawei, the US is also considering new rules that would bar third party countries from selling US chips to Huawei if the designs originally came from US firms, or if chips were supplied by US companies
- Won't problems at Boeing be *another* obstacle for the China manufactured goods target, given their recent decision to switch from Boeing to Airbus?
- How good could the deal have been if existing tariffs mostly stayed in place?
- China has made promises before regarding intellectual property protection which never satisfied the US, so why should now be any different?
- The deal includes the phrase "according to market conditions" with respect to Chinese imports of US agricultural goods, which could mean different things to different people
- Shifting the burden of proof to the accused on intellectual property cases and moving them to criminal rather than civil courts could help, but legal system changes in China are very slow, and China's legal system is not known for its openness, transparency or fairness (see our Holiday piece of 2019)
- Phase Two talks won't yield any results since it covers China's domestic subsidies/loans which they will be reluctant to reduce

Skepticism about Chinese compliance, US reaction to non-compliance, and other things

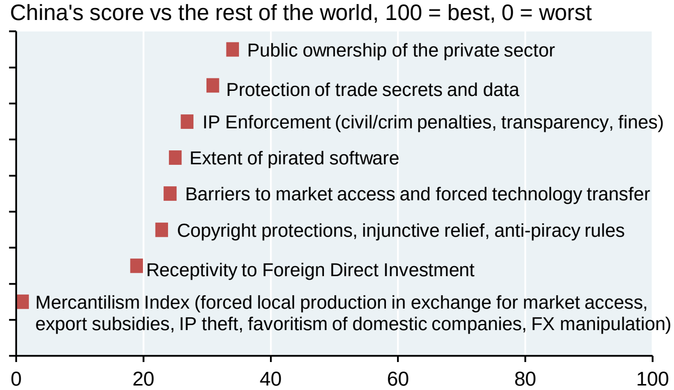
- There's too much room for China to continue to tilt the playing field in favor of its domestic enterprises, since it can absorb and re-engineer US technology without forced transfers
- The US could restart the trade war if China does not meet its import targets by 2021, or if the US decides that China is abrogating other terms of the agreement
- How did the US decide which US sub-industries would qualify for inclusion in the categories included in the Chinese import commitments? Only 40% of US 4-digit product codes were included, raising concerns about corruption and influence in an administration that is accused of wallowing in it
- The deal was timed to drown out impeachment hearings, and Trump used the signing session as an opportunity to opine on, among other things, Lindsay Graham's golf game and the Max 737 issue. As reported in Bloomberg, he also asked our Asset Management CEO to thank him for the firm's earnings

US semiconductor exports to China
US$, billions



Source: US Census Bureau. November 2019.

Points of dispute in the US-China trade war
China's score vs the rest of the world, 100 = best, 0 = worst



Sources: OECD, BSA, GIPC, ITIF, Fraser Institute, JPMAM. 2019.

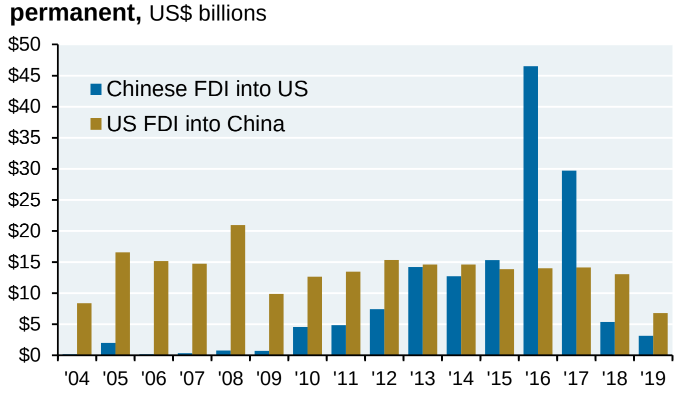
My reaction

Well, I suppose that one alternative was for the US to continue to do nothing, which has entailed:

- Unchecked Chinese mercantilism combined with China having the least receptive inward foreign direct investment regime other than Saudi Arabia
- More and more rounds of "China-US Strategic Economic Dialogue" talks that Bush and Obama administrations held repeatedly since 2006 and which basically accomplished nothing
- $250-$600 billion of annual losses to the US economy from counterfeit goods, pirated software and theft of trade secrets (US 2017 IP Commission Report)
- The continued hollowing out of US manufacturing communities resulting from US trade with China. Evidence includes the connection between rising Chinese exports and declining US manufacturing jobs[5], and the negative impact from Chinese competition on US workers *without* a college degree, compared to a much smaller impact on US workers *with* a college degree[6]
- China's intense and growing espionage activities against the US, which include cyberattacks against US government databases and companies, using venture-capital investment to acquire sensitive technology and targeting universities/research institutions[7]
- I'm not overly concerned about the impact on US consumers; they have received an *enormous* windfall over the last 15 years from Chinese trade (see box below). A redistribution from consumers back to US manufacturing workers, if it happened, would reverse a small part of this distortion

Like many divorces, unwinding the status quo was always going to hurt and was never going to be easy. China showed no intention of responding to US concerns until the tariff war started, so I think it's unreasonable to believe that any serious renegotiation of trade and investment could ever have been achieved with no economic losses on either side. I don't know if the deal will lead to fairer trade, but from a US perspective, at least it moves in that direction. It also tries to codify acceptable rules of engagement for the largest participants in the global economy, and for these reasons it deserves some credit, particularly given the complete lack of progress in prior Republican and Democratic administrations.

Decline in bilateral foreign direct investment may be permanent, US$ billions



Source: Rhodium Group. 2019 data is YTD through Q2.

The US consumer windfall from Chinese trade

- From 2000 to 2007, a one percentage point increase in Chinese imports in a given industry led to a three percentage point fall in that industry's CPI
- Increased Chinese imports generated benefits to US consumers through lower prices equal to $101,250 per lost manufacturing job, or a cumulative 1.97% fall in the aggregate US CPI between 2000 and 2007

Source: "*What are the Price Effects of Trade?*", Bureau of Labor Statistics and London School of Economics, July 2018

---

[5] "The 'aha' moment was when we traced through the industries in which China had surging exports to the local addresses of their US competitors and saw the **powerful correspondence between where China had surged and where US manufacturing employment had collapsed**." David Autor, MIT.

[6] "*Cheap imports and the loss of US manufacturing jobs*", Cooke, Kemeny and Rigby, Center for Economic Studies (Census Bureau), January 2016

[7] "*China's Spies are on the Offensive*", Atlantic Monthly, August 2019

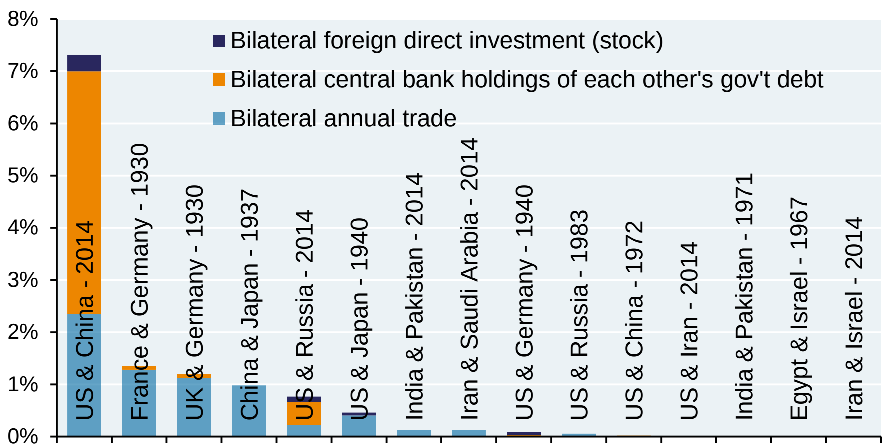
Maybe the US missed an opportunity to create a united front with Europe when negotiating with China given similar concerns about IP protection and technology transfer. There's also risk of re-escalation, bilateral foreign direct investment may never recover given ongoing tensions around national security on both sides, and the US might have the same overall trade deficit in 2 years for the reasons outlined on the first page. **Even so, worst-case trade war outcomes look like they are off the table, the Chinese purchase commitments are substantial indications of a willingness to compromise even if they're not reached in full, and some capital spending plans will now be restarted, which is what equity markets are responding positively to.**

At least Graham Allison's conflict theory seems more remote, for now. Allison's book "*Destined for War: Can America and China Escape the Thucydides Trap?*" found 16 cases over the last 500 years in which a major nation's rise disrupted the dominant state. Twelve ended in war and only four did not. In addition, in a 2017 survey by C100[8], 50% of Chinese citizens, 33% of Chinese business leaders and 35% of Chinese policy experts responded that war with the US was "very likely" or "somewhat likely".

I think the US-China conflict is different. Compared to adversaries of the past 100 years, economic linkages between the US and China are much larger. The chart below is something I've shown before. It measures the economic linkages between adversaries of past and present. I'm not by nature an optimist, but I believe these economic linkages will push the US and China toward continued compromise along the lines of what we have seen this week. I also think that if any other US administration had negotiated it, it might have received a modestly more favorable response. That's a topic for another day.

Michael Cembalest
JP Morgan Asset Management

China and the US: much deeper economic linkages than actual and potential adversaries of the last 100 years
% of combined GDP in specified year



Source: JPMAM, UNCTAD, World Bank, UN, US Treasury, Baribieri/Keshk COW Trade data, US Trade Repr. Office, Setser (CFR), Bank of England, St. Louis Fed, Eichengreen (Berkeley), Howson (Princeton), East-West Center, O'Neil (CNA), Ritschl (LSE), Accominotti (LSE), Wilkins (FIU), Villa (CEPII). 2016.

[8] The **C100** is an organization of Chinese Americans founded by IM Pei and Yo Yo Ma to promote political participation of Chinese Americans and encourage constructive relationships between the US and China.

In Hong Kong, this material is distributed by **JPMCB, Hong Kong branch**. JPMCB, Hong Kong branch is regulated by the Hong Kong Monetary Authority and the Securities and Futures Commission of Hong Kong. In Hong Kong, we will cease to use your personal data for our marketing purposes without charge if you so request. In **Singapore**, this material is distributed by **JPMCB, Singapore branch**. JPMCB, Singapore branch is regulated by the Monetary Authority of Singapore. Dealing and advisory services and discretionary investment management services are provided to you by JPMCB, Hong Kong/Singapore branch (as notified to you). Banking and custody services are provided to you by JPMCB Singapore Branch. The contents of this document have not been reviewed by any regulatory authority in Hong Kong, Singapore or any other jurisdictions. This advertisement has not been reviewed by the Monetary Authority of Singapore. JPMorgan Chase Bank, N.A., a national banking association chartered under the laws of the United States, and as a body corporate, its shareholder's liability is limited.

JPMorgan Chase Bank, N.A. (JPMCBNA) (ABN 43 074 112 011/AFS Licence No: 238367) is regulated by the Australian Securities and Investment Commission and the Australian Prudential Regulation Authority. Material provided by JPMCBNA in Australia is to "wholesale clients" only. For the purposes of this paragraph the term "wholesale client" has the meaning given in section 761G of the Corporations Act 2001 (Cth). Please inform us if you are not a Wholesale Client now or if you cease to be a Wholesale Client at any time in the future.

JPMS is a registered foreign company (overseas) (ARBN 109293610) incorporated in Delaware, U.S.A. Under Australian financial services licensing requirements, carrying on a financial services business in Australia requires a financial service provider, such as J.P. Morgan Securities LLC (JPMS), to hold an Australian Financial Services Licence (AFSL), unless an exemption applies**. JPMS is exempt from the requirement to hold an AFSL under the Corporations Act 2001 (Cth) (Act) in respect of financial services it provides to you, and is regulated by the SEC, FINRA and CFTC under US laws, which differ from Australian laws**. Material provided by JPMS in Australia is to "wholesale clients" only. The information provided in this material is not intended to be, and must not be, distributed or passed on, directly or indirectly, to any other class of persons in Australia. For the purposes of this paragraph the term "wholesale client" has the meaning given in section 761G of the Act. Please inform us immediately if you are not a Wholesale Client now or if you cease to be a Wholesale Client at any time in the future.
This material has not been prepared specifically for Australian investors. It:

- may contain references to dollar amounts which are not Australian dollars;
- may contain financial information which is not prepared in accordance with Australian law or practices;
- may not address risks associated with investment in foreign currency denominated investments; and
- does not address Australian tax issues.

With respect to countries in **Latin America**, the distribution of this material may be restricted in certain jurisdictions. We may offer and/or sell to you securities or other financial instruments which may not be registered under, and are not the subject of a public offering under, the securities or other financial regulatory laws of your home country. Such securities or instruments are offered and/or sold to you on a private basis only. Any communication by us to you regarding such securities or instruments, including without limitation the delivery of a prospectus, term sheet or other offering document, is not intended by us as an offer to sell or a solicitation of an offer to buy any securities or instruments in any jurisdiction in which such an offer or a solicitation is unlawful. Furthermore, such securities or instruments may be subject to certain regulatory and/or contractual restrictions on subsequent transfer by you, and you are solely responsible for ascertaining and complying with such restrictions. To the extent this content makes reference to a fund, the Fund may not be publicly offered in any Latin American country, without previous registration of such fund´s securities in compliance with the laws of the corresponding jurisdiction. Public offering of any security, including the shares of the Fund, without previous registration at Brazilian Securities and Exchange Commission–CVM is completely prohibited. Some products or services contained in the materials might not be currently provided by the Brazilian and Mexican platforms.

References to "J.P. Morgan" are to JPM, its subsidiaries and affiliates worldwide. "J.P. Morgan Private Bank" is the brand name for the private banking business conducted by JPM.

This material is intended for your personal use and should not be circulated to or used by any other person, or duplicated for non-personal use, without our permission. If you have any questions or no longer wish to receive these communications, please contact your J.P. Morgan representative.