April 2018

Matthews Asia

Matthews Asia Perspective
What a Trade War Means for Asian Bonds

Teresa Kong, CFA
Portfolio Manager
Matthews Asia

Media reports have been focusing on a "trade war" following President Donald Trump's decision to impose tariffs on up to US$60 billion in Chinese imports, targeting technology products. Beijing responded by imposing its own taxes on U.S. imports. The result has been an increase in market volatility on both sides of the Pacific. We believe news reports of protectionist measures are mostly noise and that investors should instead focus on long-term fundamentals.

Both good and bad trade war scenarios are possible. The good scenario is that tariffs are meant to get other countries to the negotiating table to encourage them to open their markets and initiate economic reforms. The United States-Korea Free Trade Agreement (KORUS FTA) is an example of U.S. actions to induce open markets. The bad scenario is one where countries are imposing tariffs for the sake of imposing tariffs, introducing more protectionism. Even in this scenario, the tariffs on US$60 billion of Chinese imports would affect only a small fraction of the Chinese economy.

We believe a good trade war is more likely than a bad one. Our analysis of the U.S. tariff list in response to Section 301 investigation (USTR301) reveals that the U.S. has carefully chosen strategically high value-added manufacturing sectors rather than a blanket tariff on the largest sectors. Largest trade categories such as toys, furniture, lamps, shoes and textile have all been spared despite their large percentage of U.S. imports from China. Instead, the USTR301 list has focused mostly on categories that China has stated in its "Made in China 2025" initiative such as semiconductors, machinery and various industrial goods. Similarly, the Chinese retaliation to USTR301 has been focused on maximizing the political impact to President Trump's base by targeting specific interest groups such as U.S. farmers, car makers and airplane makers. Even almond farmers in the Republican districts of California's Central Valley were taken into consideration. Combining all this technical information together, it is not difficult to see that both sides are playing a tit-for-tat game of trying to gain the maximum advantage in an eventual negotiation. While the eventual timing and outcome of such negotiation is still uncertain at this point, we believe it is likely that both sides are willing and able to negotiate for a political win-win.

Given this base case, we suggest that investors focus on the pillars underpinning our expectations of continued strong returns for Asian bonds. Historically, these pillars have been: stable U.S. growth; stable commodity prices; fairly valued currencies; fairly valued credit spreads; and low default rates. All of these factors are still in place. U.S. growth continues to be robust at 2% to 3%. Commodity prices have risen from multiyear lows and are relatively stable. Asian currencies have been appreciating since the end of 2016, but are not yet overvalued by nominal or real measures. Asia credit spreads also are near historical averages, unlike the overvalued credit spreads in the U.S. and Europe as a result of quantitative easing. Finally, default rates are hovering at historical lows of around 1.5%.

With these pillars supporting Asia's bond markets, we still expect solid positive returns for Asian bonds in 2018. We do expect more volatility this year, however, amid headlines that impact short-term sentiment. Overall, though, we believe the proposed tariffs will have no significant impact on Asia's long-term credit, currency or interest rates.

Risk Considerations

Investments involve risk. Past performance is no guarantee of future results. Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation. Fixed income investments are subject to credit, currency, and interest rate risks. Credit risk is the change in the value of debt securities reflecting the ability and willingness of issuers to make principal and interest payments. Currency risk is a decline in value of a foreign currency relative to the U.S. dollar which reduces the value of the foreign currency and investments denominated in that currency. Interest rate risk is the possibility that yield will decline due to falling interest rates and the potential for bond prices to fall as interest rates rise.

Important Information

Matthews Asia is the brand for Matthews International Capital Management, LLC and its direct and indirect subsidiaries.

The information contained herein has been derived from sources believed to be reliable and accurate at the time of compilation, but no representation or warranty (express or implied) is made as to the accuracy or completeness of any of this information. Matthews Asia and its affiliates do not accept any liability for losses either direct or consequential caused by the use of this information. The views and information discussed herein are as of the date of publication, are subject to change and may not reflect current views. The views expressed represent an assessment of market conditions at a specific point in time, are opinions only and should not be relied upon as investment advice regarding a particular investment or markets in general. Such information does not constitute a recommendation to buy or sell specific securities or investment vehicles. This document does not constitute investment advice or an offer to provide investment advisory or investment management services, or the solicitation of an offer to provide investment advisory or investment management services, in any jurisdiction in which an offer or solicitation would be unlawful under the securities law of that jurisdiction. This document may not be reproduced in any form or transmitted to any person without authorization from the issuer.

In the United States, this document is issued by Matthews International Capital Management, LLC. In Singapore, this document is available to, and intended for Institutional Investors under Section 304 of the Securities and Futures Act ("SFA"), and to Relevant Persons pursuant to section 305 of the SFA, as those terms are used under the relevant law. It should not be circulated or distributed to the retail public in Singapore. In the UK, this document is issued by Matthews Global Investors (UK) Limited, which is authorised and regulated by the FCA, FRN 667893. In the UK, this document is only made available to professional clients and eligible counterparties as defined by the Financial Conduct Authority ("FCA"). Under no circumstances should this document be forwarded to anyone in the UK who is not a professional client or eligible counterparty as defined by the FCA. This document has not been reviewed by any regulatory authorities.

©2018 Matthews International Capital Management, LLC

BY369_0418

Matthews Asia