A test of endurance is underway as Trump narrows trade war focus on China

After much drama and volatility, Trump announced a stunning reversal of tariffs on the world... except for China, where a series of back-and-forth tariff hikes have quickly escalated things into the endgame

Trump's trade war is now focussed on China

125% Trump's latest tariffs on China

Tariff escalation abruptly sends trade friction into the endgame

As my colleagues have covered in an earlier piece, Trump's latest sledgehammer tariff reversal was "not just chaotic, but crazy." In most of the world, investors likely were able to breathe a sigh of relief, but in China, no such tariff reprieve is on the table quite yet.

Markets were hit hard by the reciprocal tariff round, but have had smaller reactions to further escalations since. A big reason for this is that we have already moved into the endgame for tariffs, where further tariff hikes are less and less meaningful.

Our broad take on how this process has unfolded is below:

- At the lower end of tariffs, suppliers, importers, and customers end up sharing part of the burden and ultimately trade doesn't take too much of a hit. This is largely what was expected when tariffs were hiked around 10% or so, during the first round of fentanyl tariffs.
- As tariffs are hiked further, there's no more room for suppliers or importers to cut their margins, and further costs will have to be fully passed on to the consumer. Products with viable substitutions are swapped out to different suppliers and trade starts to plummet. This is where the biggest impact on trade and growth tends to occur, as each incremental tariff hike renders more and more trade non-viable. We likely started moving into this territory by the second fentanyl tariff hike and went well into this territory with the reciprocal tariff round.
- Past a certain point, hiking tariffs further doesn't do too much more damage to exporters, who have already likely been phased out if alternatives existed. Instead, importers could end up taking more of the burden; importers were already not going to buy the product if there were any viable alternatives, but would either still be forced to buy it if there were no substitutes, or cease that part of its operations altogether if tariffs made their business commercially non-viable. It's very likely that the subsequent escalation of tariffs has sent us into this territory already for numerous products.

Direct US-China trade will likely crater starting with the April data, but certainly won't disappear overnight. During the first trade war, a lot of China's price sensitive exports were already redirected or cut. It's hard to say exactly how much, but a sizeable portion of exports don't have a good substitution, nor is there an easy way to simply produce specific products elsewhere on short notice. Trump's tariff reprieve will keep re-export channels open for at least another quarter, and we suspect that this round of tariff shocks could lead to many importers frontloading imports again with more urgency this time around.

Moving forward, China is likely to respond again as it has already vowed to fight to the end. It's certainly possible both countries will get stuck in a continued loop of tariff hikes, but markets will likely start to phase these out. More meaningful escalations to watch for could take the form of expanded export or import controls, or measures to hit companies in terms of market access.

We expect a test of endurance to see who comes to the bargaining table at a disadvantage

Trump's backpedaling from global tariffs but escalation of tariffs on China at first glance feels like a bad development for China, as a wider tariff gap between the rates levied on China and the rest of the world on paper should increase the amount of viable substitution products.

However, despite these rapid escalations, our view is that China has averted the worst case scenario. The worst case scenario isn't infinity percent tariffs from the US, but rather a scenario where the US successfully leveraged tariff threats to coerce other countries into coordinated tariff action against China, which the Trump administration reportedly requested Mexico to do earlier this year. While we did indeed see many countries immediately try to start negotiations – as Trump himself mocked country leaders as saying "Please, please sir make a deal. I'll do anything.

I'll do anything, sir" along with other vulgarities at a Republican dinner event – it's possible that the EU's moves to formalise retaliation could've signalled that the world was not going to simply capitulate.

We see some voices in markets speculating that these rounds of tariffs mark a point of no return for US-China decoupling. We don't think this is the case – both sides have signalled to varying extents that they'd prefer negotiations, but the problem is that neither party wants to be seen as backing down.

Our view is there is a bit of a culture clash which further exacerbates the friction. Trump's 'Liberation Day' tariffs were a textbook case of negotiation anchoring, the theory where an aggressive opening offer leads to a more advantageous position for negotiations. US Treasury Secretary Bessent's comments after the tariff announcements discouraging retaliation and encouraging dialogue show the likely intention was to use these tariffs to force countries to the table. However, in China, there is a huge importance attached to mutual respect and negotiating as equals, as well as a strong importance attached to face.

As such, Trump's unliateral tariff hikes and years of anti-China rhetoric have added barriers to negotiations. The way that countries which have tried to negotiate have been treated so far this year also certainly has not done much to encourage China to sit down at the table as well. At this point, politics certainly appears to be trumping economics so no one can say with confidence when and how talks could resume, but for now it looks like policymakers are willing to put economic theory to the test to see who ultimately feels the pain to see who has the edge when talks resume.

Tariff spiral shows why intentional currency devaluation was never a viable option

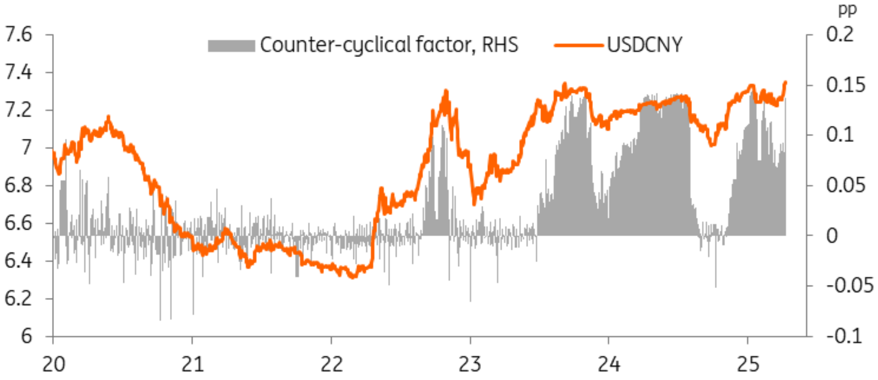
There have been many voices in the markets interpreting the People's Bank of China's weakening of the CNY fixing as a sign of devaluation in the face of tariff pressure, but this argument does not stack up. The moves higher have been very gradual, and certainly won't move the needle in the face of 125% tariffs. Instead, it is likely a managed response to the outflow pressure in light of last week's developments, and still shows a commitment toward managing currency stability.

The developments from the past week illustrate very clearly why we have been saying for the past half year that intentional CNY depreciation to offset tariffs was a heavily flawed argument – if China was truly planning to rely on devaluation to help offset tariffs, the CNY would need a truly significant devaluation in order to do so, and such a move could again easily be countered by further tariff hikes from the Trump administration. At most, a shock devaluation would only buy a very small window of time for exporters.

Furthermore, the damage of such a shock devaluation move to domestic purchasing power, market sentiment, and China's RMB internationalisation plans would far outweigh the benefit to trade. In an era of protectionism as well as economic transition where China is increasingly moving parts of its manufacturing abroad with domestic production increasingly focused on up the value added ladder, China's outward investments will continue to grow, and a stronger and stable CNY will help support these investments.

We're holding our baseline USDCNY fluctuation band at 7-7.40 for this year, and we expected the greatest pressure on the top end of this band to be in the second quarter. If this level does break, our bear case scenario has 7.50 as a ceiling for the year.

PBOC continues tight grip on currency stabilisation



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