What should investors do as USA-China tensions build over trade war, Hong Kong and COVID-19

The US-China trade war of 2018-20 followed by the COVID-19 global lockdowns in February-April 2020 have left many investors feeling jaded, as stockmarkets gyrated up and down. President Trump and Xi Jinping continue to battle with not much really being resolved. This time they are fighting over an investigation into COVID-19 and what will happen in Hong Kong. Hong Kong is the perfect example of the two super powers pulling in opposite directions.

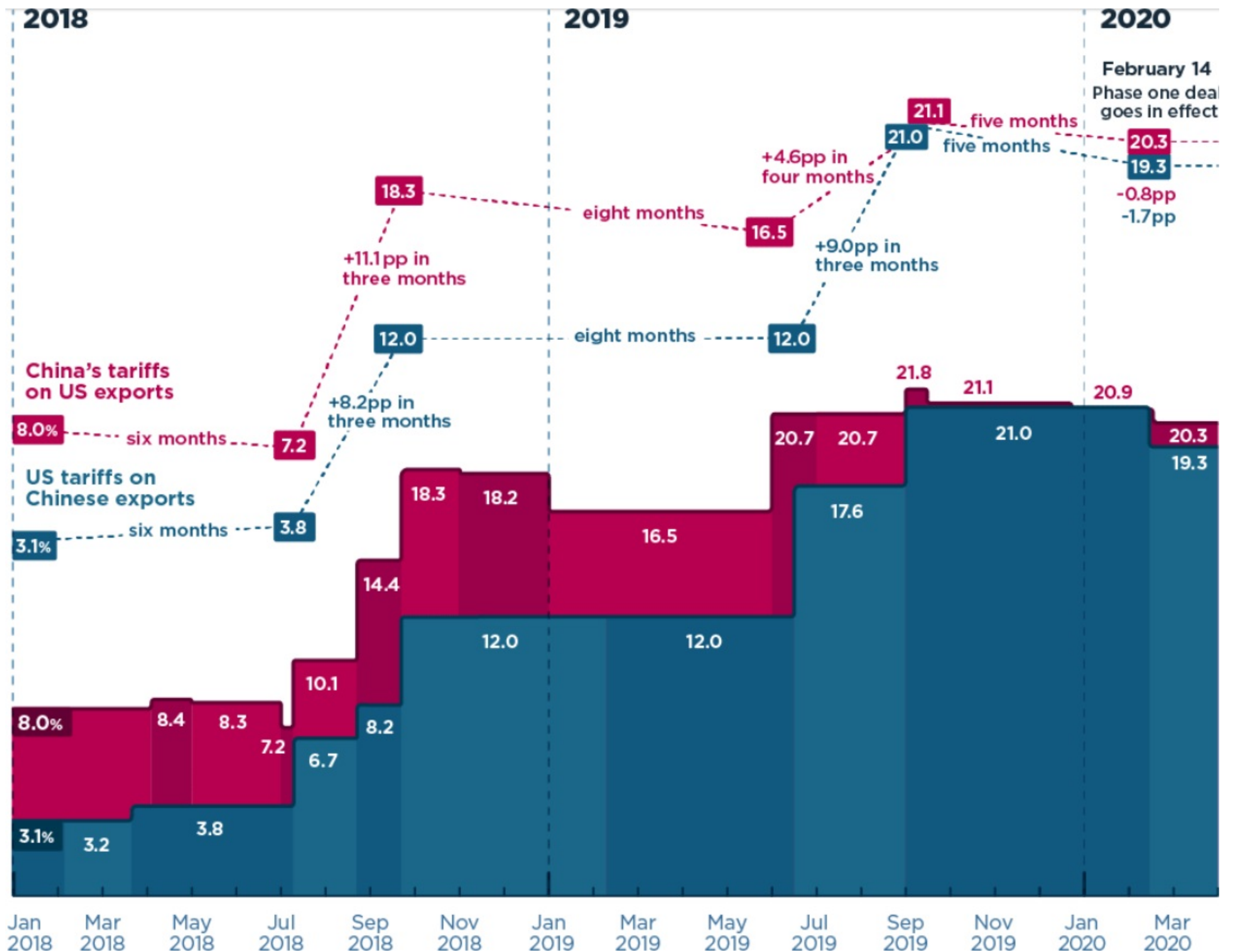
Today I look at some events that are likely to soon happen and how investors can navigate these tricky times.

Protests in Hong Kong as US-China tensions rise again

From 2018 to 2020 both the US and China businesses suffered a steady increase in tariffs due to the US-China trade war. The biggest losers from the trade war were manufacturers of global goods, especially those traded between the US and China such as US agriculture. Globally the auto industry was hit hard, as was the electronics industry, as poor sentiment caused consumers to reduce their purchases. The main winners in the trade war period were cash, bonds, gold, rhodium, and palladium. In the US the best performing sectors were utilities, healthcare, and tech.

Then in 2020 we finally got a US-China trade 'deal'. Unfortunately many tariffs remain and the COVID-19 crisis has meant China has not been able to stay on track with its side of the deal, notably US agricultural purchases.

A history of US-China tariffs from 2018 to Feb. 2020



Source

Fast forward to today and given the US and China appear unable to settle their differences the following events are possible to occur next:

- The US may add additional tariffs on China if China goes ahead with "any decision impinging on Hong Kong's autonomy and freedoms".
- The US may raise existing tariffs on China if China fails to meet its current obligations.
- The US may look to boycott more Chinese companies, as they did with Huawei technologies.
- The US may force Chinese listing companies to delist from US exchanges. Last week the US Senate passed a new Bill (Holding Foreign Companies Accountable Act), effectively stating that Chinese companies must play by

American rules or be banned from U.S. exchanges. This requires Chinese companies being fully accountable both for their financials and their share registry (cannot be CCP controlled). Luckin Coffee (NASDAQ: LK) and Baidu (NASDAQ: BIDU) already have indicated they plan to delist.
- The US will work to secure critical materials and safer supply chains with their allies. This has already started with uranium, and is proposed with rare earths and other key battery materials (Onshoring Rare Earths Act – the "ORE Act") .
- China may retaliate with tariffs on more US goods, or boycott US companies and their products.

Reference for ideas: United States Strategic Approach to The People's Republic of China

The playbook for investors

Reduce exposure

- Reducing or selling completely exposure to US listed Chinese companies. It would also be wise to do the same for any Hong Kong listed stocks. The same could be said for any Chinese or Hong Kong foreign exchange exposure, property, infrastructure or bonds etc.
- Reduce or sell US companies with considerable exposure to China earnings. Some examples would include Foxconn, Apple, Qualcomm, and Starbucks.

Increase exposure

- US stocks in sectors with minimal China exposure – US utilities, US healthcare & aged care, US food and consumables, some US tech (Alphabet Google, Facebook, Amazon, and Netflix).
- Countries which will benefit from increased US trade or US supply chain shifts away from China – USA, Canada, Mexico, Australia, Vietnam, and maybe India.

- Critical materials companies including uranium. The recent US ‘ORE Act’ lists 6 key critical materials – rare earths, scandium, cobalt, graphite, lithium and manganese. Investors should look for quality sources of these materials in the US or in US allied countries.
- Gold stocks and physical gold ETFs (SPDR Gold Trust ETF (GLD) or iShares Gold Trust ETF (IAU)).
- Other valuable metals related stocks – Silver, rhodium, platinum, and palladium.

Closing remarks

The trade war and now COVID-19 has finally served a purpose to wake up the US to get their manufacturing and supply chains back under control, and away from China’s control. This will mean we can expect to see further moves to secure critical materials by the US. Already we have seen the US uranium reserve announcements, and now the ‘Ore Act’ to secure the US for rare earths and critical battery metals supply.

In these rapidly changing times investors need to stay nimble and look forward to what will likely unfold next. The next battlegrounds between the US and China will involve the biggest trends of the 2020’s – Securing critical material supply chains, 5G, electric vehicles, solar & wind energy, energy storage, and of course the top tech trends (AI, cloud, streaming, eSports, social media, and mobile payments).

Finally a worst case scenario is we may be in for a full blown US-China cold war. In that case investors will do well to add some cash and gold stocks to their portfolio. But don’t forget some exposure to the key critical materials (and companies that produce them) as they will be the foundation for the 2020’s as we move into a cleaner and more automated/connected world.

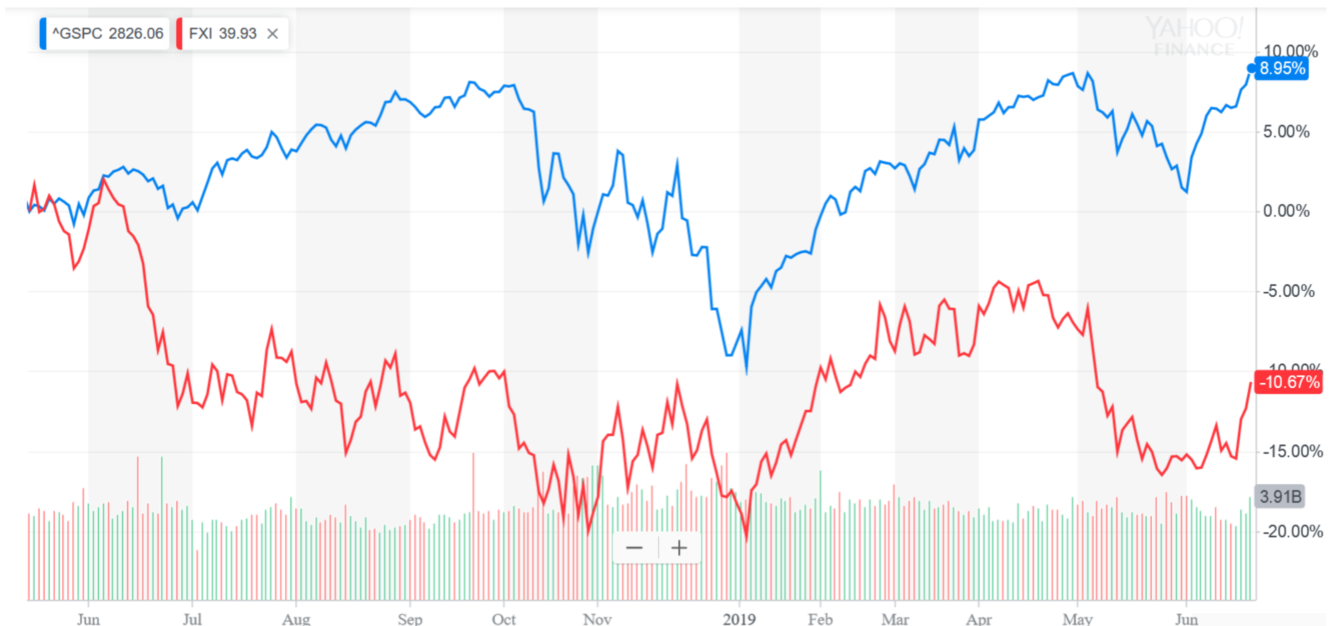
Winners from the US-China trade war (so far)

Trade wars – What will happen next? What will happen this week at the G20? Who are the winners of the trade war so far!

The US-China trade war has been ongoing for about a year now so I decided to take a look at the winners so far. It would stand to reason that if the trade war worsens these winners will continue to do well. Generally speaking US equities and defensive sectors have done well, whereas anything China related (includes many mining stocks) have done very poorly. Of course should the trade war be solved, the past years losers are likely to recover strongly.

The US share market has done well with China's share market doing poorly

The US equity market has been the clear winner (shown below in blue) as it is up 8.95% over the past year compared to the iShares China (red) which is down 10.67%. Note I chose the iShares China as it is in USD currency and hence it removes the currency effect for this comparison.



US S&P500 (blue) versus iShares China (red)

US domestic sectors have done well the past year

As we would expect US sectors that have no direct trade war exposure have done well. Returns quoted below are the past 1 year returns as of June 20, 2019. US real estate and utilities were big winners, with consumer staples and health care not far behind.

- **US real estate up 21.7%**
- **US utilities up 19.1% –** iShares U.S. Utilities ETF (IDU) – PE 22.0
- **US Consumer staples up 15.9%** – PE 25
- **US health care up 14.7% –** iShares U.S. Healthcare ETF (IYH) – PE 26.5
- **US manufacturing up 6%** – iShares US Industrials ETF (IYJ) – PE 21
- **US consumer goods up 3.2% –** iShares U.S. Consumer Goods ETF (NYSEARCA: IYK) – PE 19.0
- **Some of US stocks the past year** – Advanced Micro Devices (AMD) up 93%, Chipotle Mexican Grill Inc. (CMG) up 56%, Zerox Corp (XRX) up 32%, and Amazon (AMZN) up 11.3%.

US sectors 1 year returns comparison (as of March 8, 2019)

US sectors 1 year returns to March 8, 2019

Global winners so far from the trade war

Vietnam – Vietnam is starting to benefit as the trade war worsens and firms start to relocate from China to Vietnam. The VanEck Vectors Vietnam ETF (VNM) is up 11.5% year to date.

Gold – Gold has just hit year highs on fears the trade war may soon get much worse. Physical gold funds such as the SPDR Gold Trust ETF (GLD) was up 9% the past year, whereas the iShares MSCI Global Gold Miners ETF (RING) was up 14.4% over the past year.

Miscellaneous – Airbus (EADSY) has done well at Boeing's (BA) expense, non-US soybean exporters (Brazil, Argentina) have done well, and the non-Chinese rare earth exporter Lynas Corporation (ASX:LYC) and other rare earths companies may do well if China bans rare earth exports to the USA. For more on the later investors can read "A rare earths war – What should investors do next?"

Top performing InvestorIntel members in the past year

- StageZero Life Sciences Ltd. (TSX: SZLS) – Up 153.33% on TSX
- Alkane Resources Ltd. (ASX: ALK | OTCQX: ANLKY) – Up 91.30% on ASX
- Western Uranium & Vanadium Corp. (CSE: WUC | OTCQX: WSTRF) – Up 59.30% on CSE
- Siyata Mobile Inc. (TSXV: SIM | OTCQX: SYATF) – Up 39.13% on TSXV
- Energy Fuels Inc. (NYSE American: UUUU | TSX: EFR) – Up 23.95% on TSX

The past year trade disputes have been ongoing between the US and several other countries and not just China. For example, the US has had disputes with Canada, Mexico, Europe, Turkey, Japan, and India.

Trump and Xi have agreed to an extended meeting at next week's G20 Summit on June 28/29 in Japan, so we will see very soon what happens next. It might be time to fasten your seat belt.

A rare earths war – What should investors do next?

This past week the Chinese press has hinted that China may limit the supply of rare earths to America. Although quotas/bans haven't been implemented (yet), tensions escalated Tuesday morning (May 28) when the editor in chief of a Chinese tabloid, Global Times, tweeted: "Based on what I know, China is seriously considering restricting rare earth exports to the US. China may also take other countermeasures in the future." The People's Daily weighed in with a rare Chinese phrase that means "don't say I didn't warn you." What could be ringing alarm bells is, that wording was used by the paper just before

China went to war with India in 1962.

China dominates global rare earth production with ~80-90% market share

Used as components in most electronic devices, electric vehicles, wind turbines, and the aerospace industry; Chinese restrictions on rare earth sales to the US could put significant supply strains on these sectors. In 2018 under the National Defence Authorization Act, Chinese rare earth magnets imports were banned in the US, however, the US Administration did a flip less than a month later and left rare earths minerals and the electric vehicle sector metals off a 194-page tariff list.

In what China probably sees as a trade blow to the US, a rare earth ban would risk its reputation as a trade hub with the rest of the world. The global supply chain is so complicated and intertwined it would undoubtedly affect many other countries that rely on rare earths.

What are the alternatives for the US to source rare earths minerals?

The answer is almost zero. Given 80-90% are produced in China the US would then be forced to source from the remaining 10-20%. The US's only domestic mine is California's Mountain Pass rare earths mine, owned by MP Materials. In an unnoticed rare earths switch, China has actually begun importing semi processed rare earth ore from the Mountain Pass mine.

The other main option for the US is Australia's Lynas Corporation. But Lynas already has contractual agreements and may struggle to meet all of the US's needs.

Lynas Corporation stated exclusively to Investorintel this week:

"Rare earths are essential to digital age technologies and

Lynas is the world's second largest supplier of rare earth materials. This sustainable position is based on our long life, high-grade resource at Mt Weld in Western Australia, and our proven operating assets. Lynas is well placed to continue to supply high purity rare earth materials to manufacturing supply chains around the world."

Investor options in rare earths (non-Chinese companies)

Below gives the range of choices for investors looking to invest in the non-Chinese rare earth companies, as well as an ETF. The main issue is the vast majority are not yet producers. Below in bold are the companies we follow closely at Investorintel.

- **Alkane Resources Ltd. (ASX: ALK | OTCQX: ANLKY)**
- **Avalon Advanced Materials Inc. (TSX: AVL | OTCQB: AVLNF)**
- Arafura Resources (ASX: ARU)
- **Critical Elements Corp. (TSXV: CRE | OTCQX: CRECF)**
- Lynas Corporation (ASX: LYC)
- Northern Minerals Limited (ASX: NTU)
- Peak Resources Limited (ASX: PEK)
- Rare Element Resources Ltd. (OTCQB: REEMF)
- **Search Minerals Inc. (TSXV: SMY)**
- Ucore Rare Metals Inc. (TSXV: UCU | OTCQX: UURAF)

A final thought

Investing in the quality rare earth miners is a good long term strategy, as rare earth demand is set to outstrip supply. That being said investors buying now have missed a great run-up in prices this week, so some caution is required in case we get some pullbacks.

Investors should also be aware in 2014, the World Trade Organization (WTO) ruled that China can't put limits on rare earth exports. Whatever China does next, the US would be sure to counter-retaliate, and we would move into a spiral of trade decline, a global slowdown, and perhaps a global recession. At

some point, the US and China will need to both act like reasonable trade partners, which quite frankly is to remove all tariffs and all government interference (including subsidies) in trade. Only then can businesses get back to doing business.

Some possible winners from a US-China trade war deal

A brief trade war background

Even before taking office in 2016, US President Donald Trump had been complaining about China’s trading practices. An investigation into Chinese trade policies was launched in 2017, which lead to billions of dollars of imposed tariffs being placed on Chinese products in 2018. So far the US has imposed three rounds of tariffs on Chinese goods, totaling more than $250 billion, with US threats of more to come. Beijing has hit back with tariffs on $110 billion of US goods, accusing the US of starting “the largest trade war in economic history”.

After months of hostilities, a breakthrough of sorts came in December 2018, when both countries agreed to halt new trade tariffs for 90 days to allow for talks. The deadline for a deal is March 1, 2019.

Investments that stand to do well if the US and China can make a good deal and end the trade war

As a general guide most stocks and funds that went down the worst in H2 2018 due to the trade war have the best potential to rebound. Some examples include:

China stocks and funds

iShares MSCI China ETF (MCHI) – The fund was down 19.18% in 2018, and trades on a PE of 11.9. China's internet giants, the BAT stocks (Baidu, Alibaba, and Tencent) are all now much better value and also worth a look.

Mining

Given China is by far the largest global consumer of commodities such as steel, copper, aluminium, energy materials, and electric vehicle metals, then the resources sector stands to make a sharp recovery. Investors can choose a broad based fund such as the iShares Global Materials ETF (MXI) which was down 15.8% in 2018, and trades on a PE of 15.82. Or investors can buy into discounted miners of their favourite sector. Copper and nickel look very oversold.

The electric vehicle (EV) metal miners were heavily sold down in H2 2018 and they are now much better valued. For a general lithium play investors can consider the Global X Lithium & Battery Tech ETF (LIT) fund which was down 28.6% in 2018, and is on a PE of 19.3, For a general cobalt play consider Cobalt27 (TSXV: KBLT) a broader Cobalt (and nickel) play which was down 66.7% in 2018, with a 2020 PE of 13.7. For nickel I still like Norilsk Nickel (LN: MNOD). And for lithium producers Ganfeng Lithium (HK: 1772), Galaxy Resources Limited (ASX: GXY), and Neometals Ltd. (ASX: NMT) all look very attractive.

Semiconductors

The iShares PHLX Semiconductor (SOXX) fund was down 6.47% in 2018, and trades on a PE of 15.01. For individual semiconductor stocks there are countless oversold names with appeal – Micron Technology (MU) on a 2019 PE of 5, Samsung Electronics (LN:SMSN) on a 2019 PE of 9.3, Skyworks Solutions (SWKS) on a 2019 PE of 11.9, Qualcomm on a 2019 PE of 18.1, and Nvidia (NVDA) on a 2019 PE of 20.8. All of these names

should do well on a trade war deal and recovery in smartphone sales hopefully in 2019. They should also be boosted by consumers upgrading to 5G enabled smartphones in 2019 and 2020.

US agriculture (soybeans)

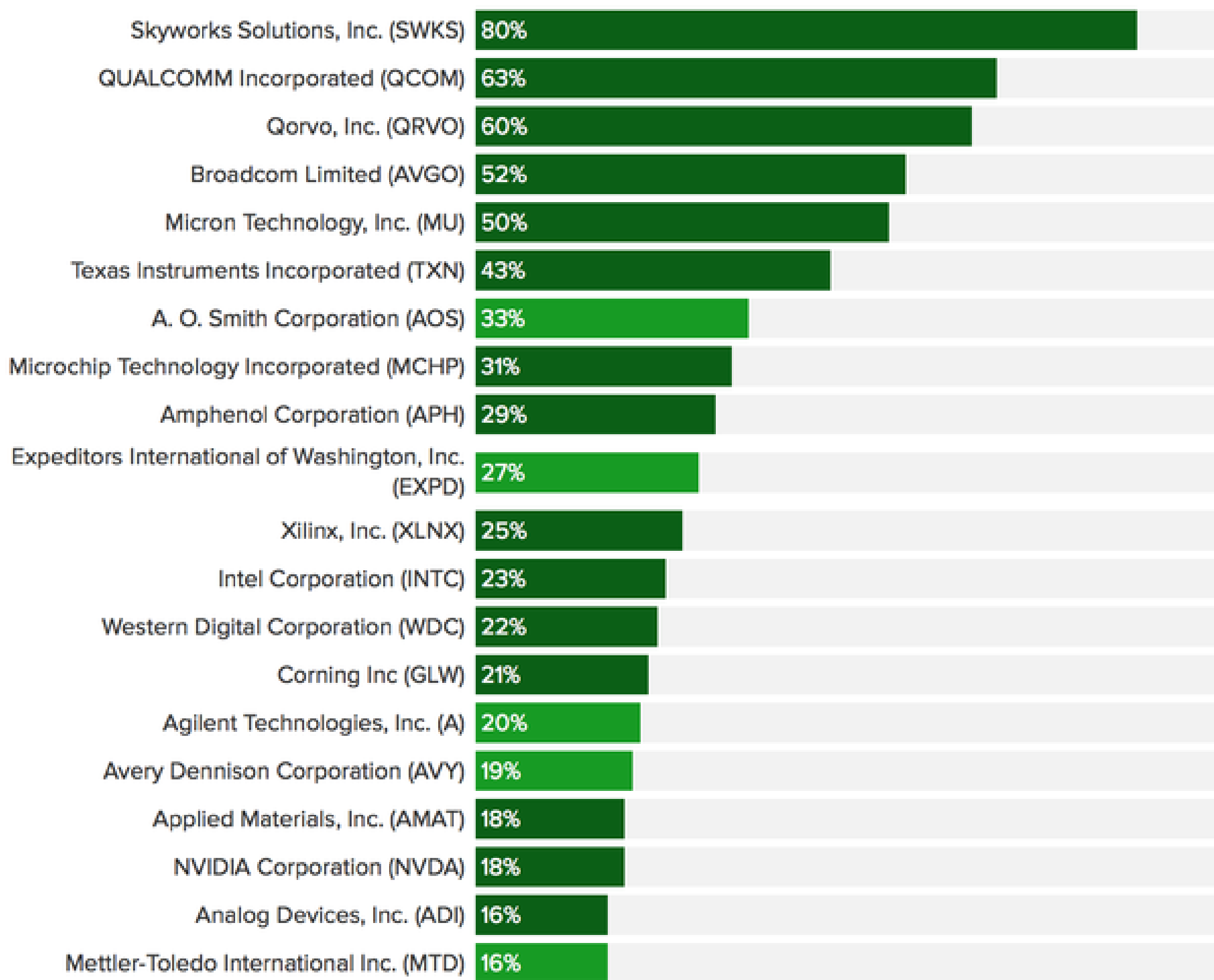
The Teucrium Soybean ETF (SOYB) was down 9.62% in 2018, with no available PE. Soybeans are expected to be a key winner from a US-China trade deal, as well as other US agricultural exports to China.

US aerospace

US aerospace companies such as Boeing also stand to benefit. Valuation is reasonable on a 2019 PE of 18.10; however increased competition from China's new plane manufacturer Comac may be an issue in the mid-term.

Other companies heavily reliant on a China supply chain such as Apple (AAPL) and Broadcom Limited (AVGO) can rebound well.

Companies with the most China exposure – Courtesy UBS



Companies with the most China exposure – UBS

We live in interesting times and the next month may play out to be a significant month in trade history. If we get a significant trade war deal next month by March 1 (or shortly thereafter) and a strong relief rally, then the current prices for many of the oversold stocks and funds discussed will look like a bargain.