U.S. - China Trade Tensions:
Impact on Property Markets

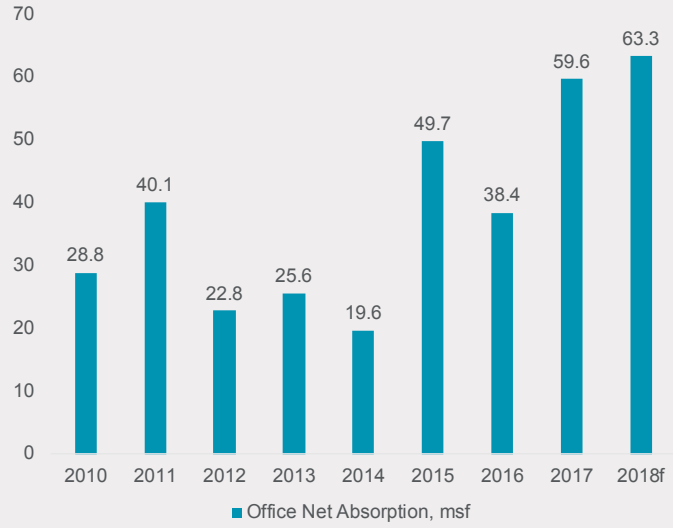
June 13, 2018

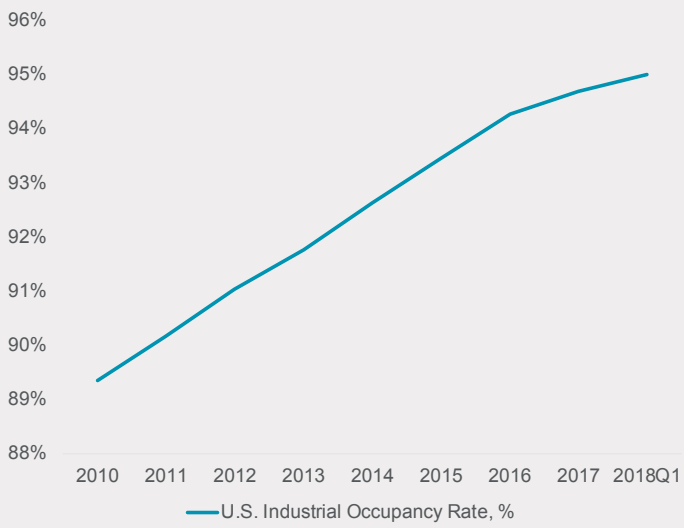
SUMMARY

- Most of the tariff proposals have not yet gone into effect. So far, a lot of bluster—not a lot of action.
- To date, the trade issue has largely been a non-factor in terms of any impact on property markets and capital flows.
- China and the U.S. continue to negotiate. Progress is being made but the situation remains very fluid.
- Major disagreements remain, particularly regarding the "Made in China 2025" development strategy and intellectual property and technology transfers.
- Given the strong economic ties between China and the U.S., the probability of a full-blown trade war is very low.
- BUT, a darker scenario still looms…

The U.S. and Chinese economies and property markets are powering through the current trade tensions and are performing well. Despite a few imposed tariffs and a flurry of trade threats this year, China's economy hasn't skipped a beat. In the first quarter of 2018, China's real GDP grew by 6.8%, on par with last year's robust pace. Looking at the 12-month moving average through March of 2018, China's exports to the U.S. actually increased—up 11.3%. China also continues to absorb significant amounts of real estate. In fact, since the beginning of the Trump administration, China has absorbed a record 72.1 million square feet (msf) of office space.

So Far So Good





Source: Cushman & Wakefield Research; f = forecasted pace based on 2018Q1 trend

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Similarly, the economic fundamentals in the U.S. seem to be largely unfazed by the Chinese retaliatory threats made during the first quarter of 2018. Job growth in the U.S. continues at robust levels, registering year-over-year gains in nonfarm payroll employment exceeding 2 million for a record 62 consecutive months and this year's first quarter growth strengthening to 20% year-over-year. Consequently, demand for office space across U.S. markets has also accelerated, up 14% year-over-year. The U.S. industrial-logistics sector, the one that would be most directly impacted by tariffs, saw its occupancy rate climb to 95% in the first quarter of 2018—the highest rate in 25+ years of tracking by Cushman & Wakefield.

In other areas, however, the trade tensions are having an impact. Volatility in the financial markets spiked in 2018, partly due to the strong trade rhetoric, particularly from the Trump Administration. On March 1, 2018, President Trump tweeted, "trade wars are good, and easy to win." In response, the CBOE volatility index jumped from a relatively calm reading of 15 to an anxious reading of 22. Certain companies are also being affected. For instance, ZTE Corp, a Chinese technology manufacturer, has struggled since Trump banned it from buying U.S. components. As of this writing, the U.S. government was going back and forth as to whether or not it would lift the ban on ZTE Corp. Nevertheless, the experience serves as a reminder that the trade debates can affect real companies and real people. There have also been notable macroeconomic impacts. Interest rates and inflation have been inching upward, in part due to new tariffs and the possibility of more to come.

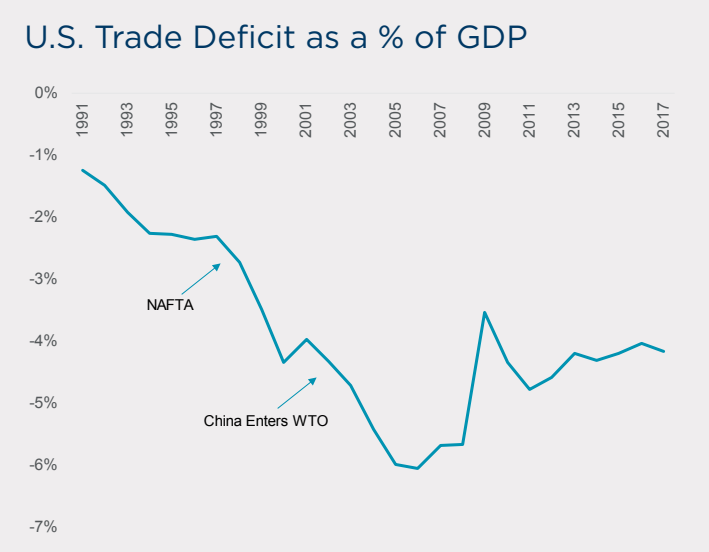
Chinese and U.S. authorities continue to negotiate behind closed doors. Progress is being made, but trade tensions continue to be among the greatest threats to the global expansion.

The timeline of the trade tensions

One of Donald Trump's key campaign promises was to challenge certain trade agreements like the North American Free Trade Agreement (NAFTA) and the Trans-Pacific Partnership (TPP). In particular, he publicly committed to confronting trade partners, such as Mexico and China, with whom the U.S. runs a large trade deficit. There is debate among economists whether or not the U.S. trade deficit is a positive or a negative factor in the U.S. economy. Economists do generally agree that bilateral trade deficits matter much less than do the fundamental causes of the overall deficit which simply reflects the fact that the U.S. is spending more than it makes.

The U.S. trade deficit worsened when the NAFTA agreement was signed in the early 1990s and again when China entered the World Trade Organization (WTO) in 2001. During those periods, the U.S. deficit was a drag on U.S. GDP and it also resulted in some job losses in the U.S. as certain businesses opted to move their production facilities outside of the U.S. to produce at a cheaper cost. Even in those instances, however, analysts disagree whether the larger trade deficit was truly a net negative for the U.S. economy. U.S. businesses and consumers also benefitted from lower prices during those periods because foreign imports were cheaper. Additionally, foreign capital inflows provided the necessary financing for Americans to spend more than was collected in revenue.

There are many things that influence the trade deficit, and its complexity is one reason why bilateral deficits have not been a major policy focus in the past. Nevertheless, the Trump Administration is focused on specific



Source: Moody's Analytics, U.S. Census Bureau, U.S. Bureau of Economic Analysis, Cushman & Wakefield Research

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Tariffs Timeline

January 30, 2017

President Trump withdraws the U.S. from Trans-Pacific Partnership.

May 18, 2017

Trump administration seeks to renegotiate the North American Free Trade Agreement; negotiations ongoing.

January 22, 2018

President Trump approves tariffs on imported washing machines & solar panels.

March/April 2018

- Trump administration approves tariffs on imported steel and aluminum; Canada exempted and Mexico initially exempted.
- China imposes tariffs of 15-25% on 128 products that account for US $3 billion, including pork, cherries, and scrap metal.
- Trump proposed introducing tariffs of up to 25% on 1,300 Chinese goods, primarily high-tech; representing $50 billion in goods.
- China's Ministry of Commerce announced plans to target $50 billion in U.S. goods per year. China plans to put a 25% tariff on imported US soybeans, cars, aircraft.
- Trump hints at an additional $100 billion of new tariffs on Chinese goods.

Today

Negotiating but still with "rather large differences."

trade deficits. Given that the U.S. runs the largest goods (versus services) deficit by far with China—at -$375 billion in 2017—China has been one of the primary targets in trade negotiations.

Official trade actions against China began in earnest in early 2018. In late January, President Trump implemented tariffs on imported washing machines and solar panels, 20% on the former and 30% on the latter for the first year, with the tariffs scheduled to be cut in half within four years. China is the world's largest manufacturer of solar panels—accounting for two-thirds of global panel production—so that action was clearly targeted at China.

A few months later, in March, the trade threats began to intensify, when President Trump imposed tariffs of 25% on steel and 10% on aluminum. China is the world's largest steel exporter, and those tariffs were largely understood to be aimed at China's excess capacity. China retaliated with threats of its own, proposing $3 billion in specific tariffs: 15-25% on 128 U.S. products, including pork, cherries and scrap metals. The Trump Administration then struck back, proposing $50 billion more in tariffs, of up to 25% on 1,300 Chinese goods. China responded with a proposed $50 billion in new tariffs on U.S. goods, including soybeans, cars and aircraft. The tit-for-tat hit its peak when the Trump Administration hinted at an additional $100 billion of new tariffs on Chinese goods: if China were to respond in kind, all $130.4 billion of U.S. exports to China would incur tariffs.

Steel & Aluminum

Most of the threatened tariffs have not yet gone into effect; they are just proposals. To date, the only new tariffs that have gone into effect are those on solar panels, washing machines, steel and aluminum. Although the impact of these specific tariffs will create some challenges for certain Chinese businesses and manufacturers of these goods, the overall impact on China's economy will be small. Note that China is not the largest exporter of steel and aluminum to the U.S. The largest sources of U.S. steel and aluminum imports are Europe and Canada, both of which are now also being hit with the higher levies. China is the largest exporter of solar panels to the U.S., but solar panels represent a fraction of the total

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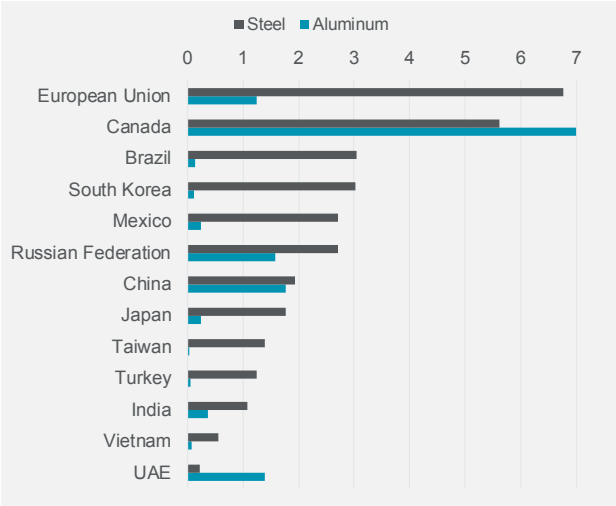
Countries Most Impacted by U.S. Tariffs

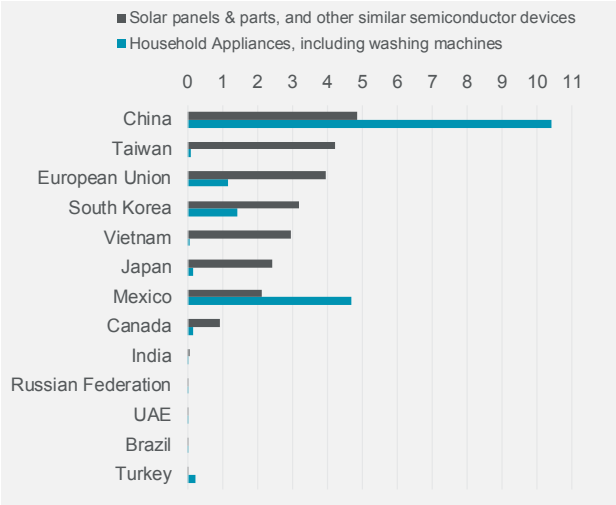
U.S. IMPORTS BY COUNTRY (US$ BILLIONS)

STEEL & ALUMINUM



Source: U.S. Census Bureau

SOLAR PANELS & WASHING MACHINES



Source: U.S. Census Bureau

Chinese exports. All told, the impact of the tariffs that have gone into effect on China's GDP growth is less than 0.1 percentage points.[1] Moreover, China's strengthening domestic economy (consumer spending accounted for 39.4% of the country's GDP in 2016), along with stronger trade relationships within the Asia Pacific region, could offset some of the weaker demand from the U.S. Similarly, the impact that these tariffs will have on the U.S. is also quite small. In general, U.S. manufacturers of steel and aluminum are likely to benefit as foreign competition is in a weaker position. American companies that use steel and aluminum as inputs in their products (e.g., American automakers), however, will face higher prices. Those price increases will be passed on to U.S. consumers.

The impact on property markets is also quite small. Both steel and aluminum are important raw materials in buildings and structures. Steel, in particular, is a primary component in the structural framework for larger buildings such as skyscrapers and high-rise apartments. The construction industry accounts for an estimated 42%[2] of the total steel consumption in the U.S., and roughly 16% of an average commercial project's costs are tied to steel, although this can vary greatly by asset type. Aluminum is a key material in energy-efficient building construction. Consequently, the net result of higher tariffs for these two metals will be slightly higher construction costs for certain property sectors in the U.S.

None of this will move the needle in terms of dramatically altering the future supply pipeline in the U.S. or in China. Indeed, input construction prices had already been rising significantly since 2016, and labor costs—a major source of constraint for U.S. developers—are also being pressured for reasons that have nothing to do with trade.

Progress is being made, but significant differences remain

There have been signs of the U.S. and China inching towards compromise. On May 19, 2018, both countries released a joint statement pledging not to engage in a trade war. In addition, both sides agreed to make minor concessions. In the latest rounds of negotiations, China agreed to increase its purchases of U.S. agriculture and energy goods and indicated it would consider increasing

1 Moody's Analytics
2 The Real Estate Roundtable

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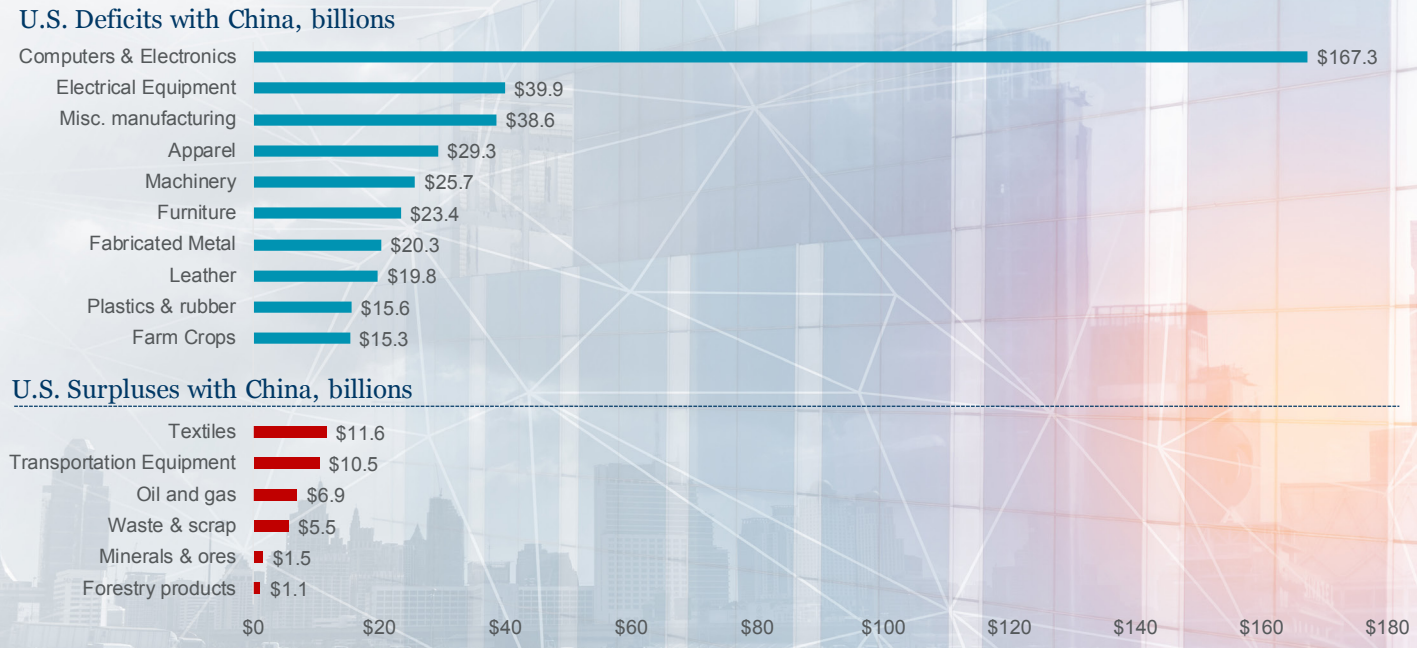
purchases of other U.S. goods and services at a later date. It also announced it would end its investigation on U.S. sorghum imports. U.S. officials agreed not to impose the first tranche of the tariffs on $50 billion worth of Chinese goods. Perhaps the most significant step towards compromise came after that joint statement. In a separate announcement, China said it would lower its tariffs on vehicle imports, from 25% to 15%, starting July 1, 2018. Moreover, it laid out a clear timetable to open its financial sector to more foreign investment, allowing foreign firms to compete on a more equal footing with domestic companies.

The trade situation is, however, far from being resolved. As of this writing (June 13, 2018), the Trump Administration reversed course and was vowing to proceed with its plan to implement the $50 billion in tariffs on 1,300 goods and China was threating to retaliate. Earlier in June China also offered to increase its purchases of U.S. agricultural and manufactured goods by $70 billion. So there has been some progress, but challenges remain.

While the worst case scenario of a full-blown trade war has been averted for now, significant differences persist. The two countries continue to be miles apart in two key areas: 1) the "Made in China 2025" development strategy and 2) concerns about technology transfers and intellectual property theft lodged by a growing list of U.S. firms. Until these two policy areas are addressed, the uncertainty surrounding the U.S.-China trading relationship will remain high. Both nations are filing complaints at the World Trade Organization (WTO) as part of the back-and-forth, from disputing technology transfers to the viability of the recent tariffs. WTO cases can take years, so these formal steps do not necessarily mean the issues will be resolved more quickly.

The Darker Scenario Still Looms

Until compromises are reached the darker scenario of an all-out trade war looms. Indeed, the consequences of a trade war between the U.S. and China would be felt nearly everywhere around the globe. It would result in a flurry



Source: U.S. Census Bureau, Cushman & Wakefield Research

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of tariffs from multiple nations that would be forced to retaliate in order to protect their own domestic industries. Currency wars would also be a natural consequence as countries go into a "do whatever it takes" mentality to keep their businesses competitive. With the benefits of specialization diminished, and with tariffs pushing up prices, global inflation would accelerate; that would have consequences for major central banks. The tariff increases would also shock supply chains, resulting in a massive disruption in the global flow of goods and services. All of this would roil equity markets, financial volatility would surge, and credit markets would tighten. In the end, a trade-war scenario could ultimately trigger a world-wide recession.

Although virtually markets and sectors would be affected, trading hubs such as Hong Kong and Singapore would likely feel the biggest negative impact. The Finance Secretary for Hong Kong estimates that a U.S.-China trade war would affect one in five Hong Kong jobs. China and the U.S. would also suffer negative impacts, though not to the same degree. China has become less reliant on exports over the years. Exports accounted for 36% of China's GDP in 2006; today they represent a much smaller 23%. The U.S. has less exposure since its economy is driven largely by domestic consumption, 65-70% of GDP, with exports representing 13% of GDP. Still, all countries would take a negative hit.

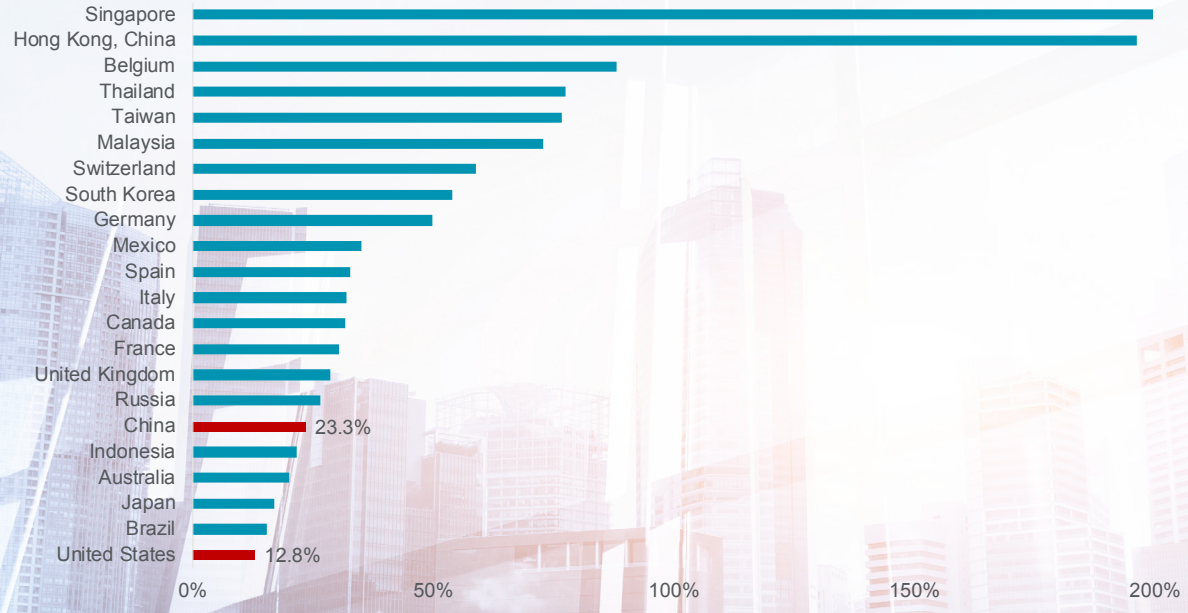
A trade war scenario would impact property markets as well. Most product types would eventually be negatively affected, but the industrial sector would be hit first and hardest. Commercial property prices would decline across most product types/geographies. In particular, the globe's largest cities which have benefitted greatly from foreign capital inflows would suffer the greatest losses as strict capital controls are implemented by many nations.

Play the Odds

Fears of a full-blown trade war are mostly overwrought. The future successes of both the Chinese and U.S. economies are highly interdependent. The U.S. is a big buyer of Chinese goods, importing $504 billion of Chinese goods in 2017 alone. While it is true that a trade war would be very

Most Exposed to Trade Wars

Exports as a % of GDP, 2017



Source: Oxford Economics, Cushman & Wakefield Research

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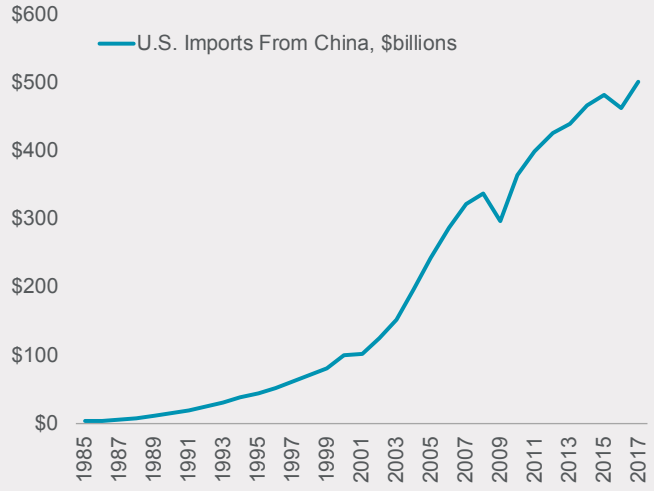
damaging to China's economy if the U.S. stopped buying, it would also be very damaging to the U.S. economy. The result would be much fewer immediate options and much higher prices in the U.S., both of which ultimately hurt most U.S. consumers and businesses. For the U.S. and China, the trade war scenario is a no-win situation.

Another concern of any trade war is the impact on the bond market. China is a large investor in U.S. debt, currently owning $1.2 trillion of U.S. Treasuries. Again, in a trade war both sides lose. It would be very damaging for the U.S. economy if China started dumping U.S. Treasuries because interest rates would likely shoot up. But it would be very damaging to China's economy as well because U.S. bond prices would plunge and China would suffer those losses. In a multitude of other ways, China is invested in the U.S. and the U.S. is invested in China; both have incentives to compromise.

Cushman & Wakefield will continue to monitor the trade discussion and will examine how the different trade scenarios will impact the various geographies and property types. So more to come, stay tuned!

Strong Economic Ties



Source: U.S. Census Bureau

Major Foreign Holders of U.S. Treasuries

	Holdings ($tril.)	% of total
China	**$1.162**	**18.6%**
Japan	$1.066	17.0%
Ireland	$0.328	5.2%
Brazil	$0.266	4.2%
Switzerland	$0.251	4.0%
All	$6.260	

Source: U.S. Treasury Department

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