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Vimal Gor
Head of Income
& Fixed Interest

Trade wars are front and centre for markets at the moment and no amount of ink is being spared writing about it. While many have tried to quantify the effects of trade wars on economic growth, it's pretty much a waste of time as it is attempting to simplify the effect of a monumental change on the way that modern multinational corporates do business. Supply chains will be restructured, goods will cross borders in totally different ways and investment will occur in some places where it didn't exist before and will fall in other places. Inevitably some goods will replace others, with some markets having severe capacity shortages and others having huge surpluses.

Most importantly the political and fiscal reaction to these changes will have untold effects on not just growth and inflation, but a whole host of other economic measures. This also means more volatility as uncertainty about the effects and knock-on responses rises. Economists much prefer to be precisely wrong than approximately right, and I worry that the forecasts that are made now are at best useless and at worst could lead to disastrous investment decisions in a wide range of assets.

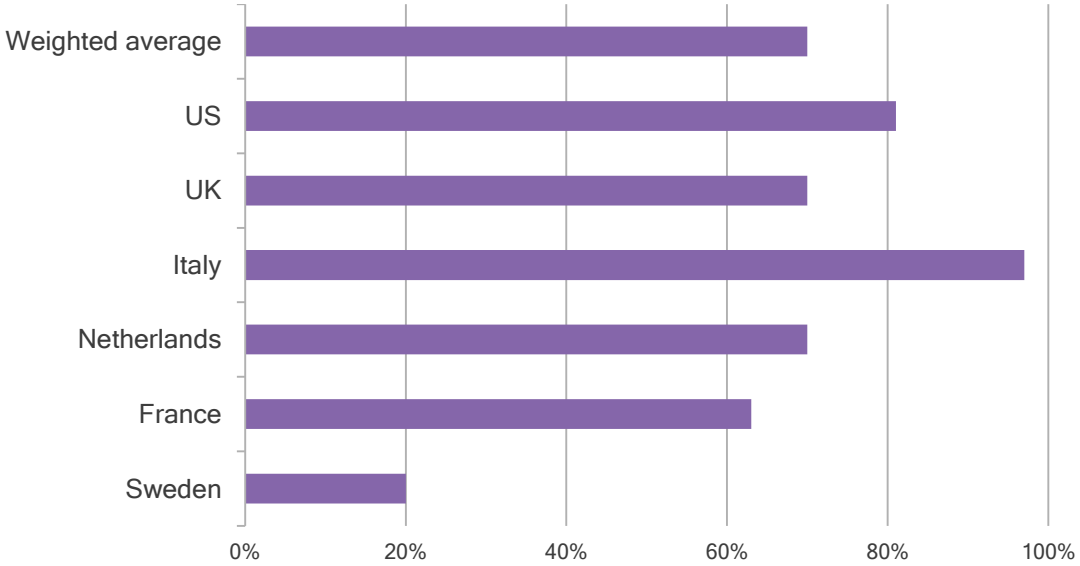
I am certain we are watching a key turning point in history unfold right in front of us. The way things have been done on the global stage over the last 40 years is changing at a lightning pace, as politics, diplomacy, immigration and trade relations are all in a state of transition. The dominant economic theory - commonly referred to as neoliberal economic theory - is no longer the playbook by which world leaders run their economies, and the new playbook has many blank pages. This will have further significant effects on fiscal discipline and debt management as governments feel their way forward, obviously impacting economic growth and inflation. All of these factors will then have a subsequent effect on the role of the central bank, as the focus shifts from the independent and inflation targeting model that has been the status quo for the last 20 years. This is just a snapshot of the changes we are currently undergoing. The rules of the game are changing.

Trump and trade wars

Talking about the sitting President of the United States in any social setting inevitably elicits some strong responses. The topic of tariffs and trade wars isn't any different when compared to the suite of other feckless policies that have defined his term so far with many of these policies being perpendicular to what has been the norm for such a long time. It's understandable that his policies are seen this way. Since globalisation and relatively open borders have been around, the world has got smaller and trade relationships have deepened whilst the world has experienced an unprecedented period of peace and advance in quality of life for the poorest in Asia and Africa.

This rapid advance in the quality of life of the poorest has unfortunately (but inevitably) come at the expense of the lower to middle classes in the developed world. Declining real wages and job opportunities are the symptoms of losing out in the game of globalisation where it has become impossible to compete against the far cheaper workers in the less developed world. These trends have been manifested in a constant decline in the percentage of young adults that can hope to earn more than their parents in the US, which has reached a new multi-decade low. It is no longer a given that the next generation will be more prosperous than the last in the US. This path backwards is at odds with the rapid advance of the next generation of Chinese workers.

Chart 1.
% of households with flat or falling income over 10 years

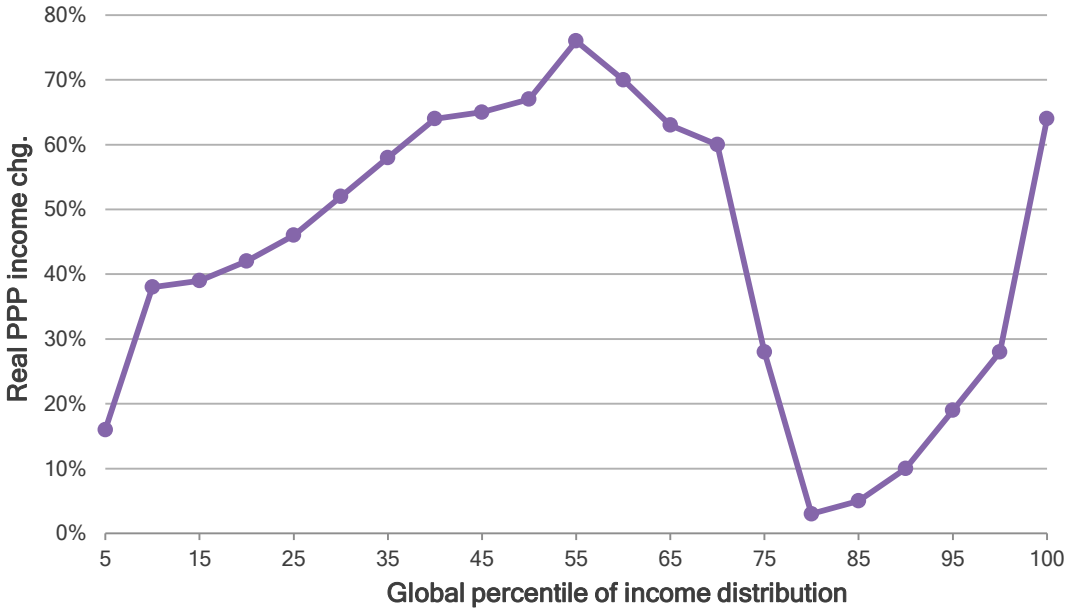


■ Market income from wages and capital

Source: Bank of Italy, CBS, INSEE, Statistics Sweden, ONS, CBO, McKinsey. Weighted average is of 25 advanced economies.

Of course not everyone in the developed world has suffered the same fate. While the losers from globalisation have been widespread, the winners have been the rich who have benefited from outsourcing, driving the wealth and income gap wider, compounding an already unfortunate situation. The democratic process allows everyone an equal say, and the repressed and downtrodden have been revolting in countries across the globe, as I've written about in this newsletter numerous times.

Chart 2.
Global 10Y change in real income



Source: World Bank

Writing about Trump can be difficult if not only for the powerful and opposing responses that are elicited by his policies. My job is not to set out my political stall but to try to understand what the changes being brought about by these policies will mean for the market. For this we have to try to understand what is driving Trump based on what his goals and incentives are, remembering that evaluating actions according to the 'old' way of doing things has to be thrown out of the window. So, the best way to tackle the topic of trade wars and tariffs is to try and understand why Trump has such an issue with China and Germany, which may make the fight more predictable.

The first thing to keep in mind is that the declaration of a trade war isn't just a Trump-led initiative. He has support from like-minded individuals like Robert Lighthizer and Peter Navarro. Both are well regarded and vocal about the ways in which China is circumventing WTO rules and effectively cheating the free trade agreements that were put in place to enable globalisation in a fair manner. This video of Navarro speaking about the US-China trade relationship is a must watch as it gives the background behind these claims.

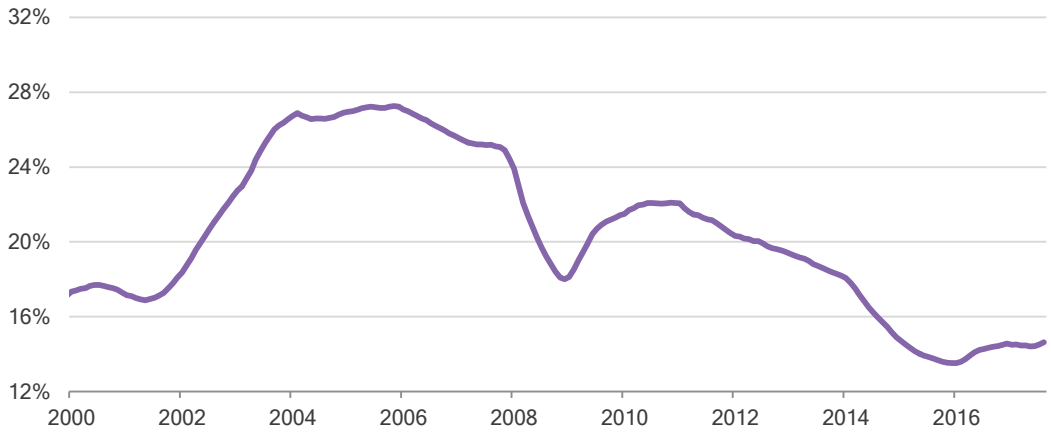
The case against China

There is also this seminal paper written on the subject by a Harvard Law Assistant Professor Mark Wu in early 2016. It outlines why China's party-state fits poorly within the WTO's legal restraints and argues that the reason why China likes the WTO is that it hasn't significantly constrained its industrial policy ambitions. Wu highlights that the trade war with China emerges from two main commercial complaints:

1. China has made it hard both to produce abroad and sell to China and,
2. China has made it hard to invest in China in order to produce and sell in China if your firm isn't Chinese.

This is supported by the amazing statistic that if you strip out the electronic components that China imports for its electronics exports, China's imports of manufactures as a share of its GDP are actually quite small relative to its peers—and they are lower now, as a share of China's GDP, than when China joined the WTO.

Chart 3.
China Imports (Ex-Electronic Intermediate Inputs) % of GDP

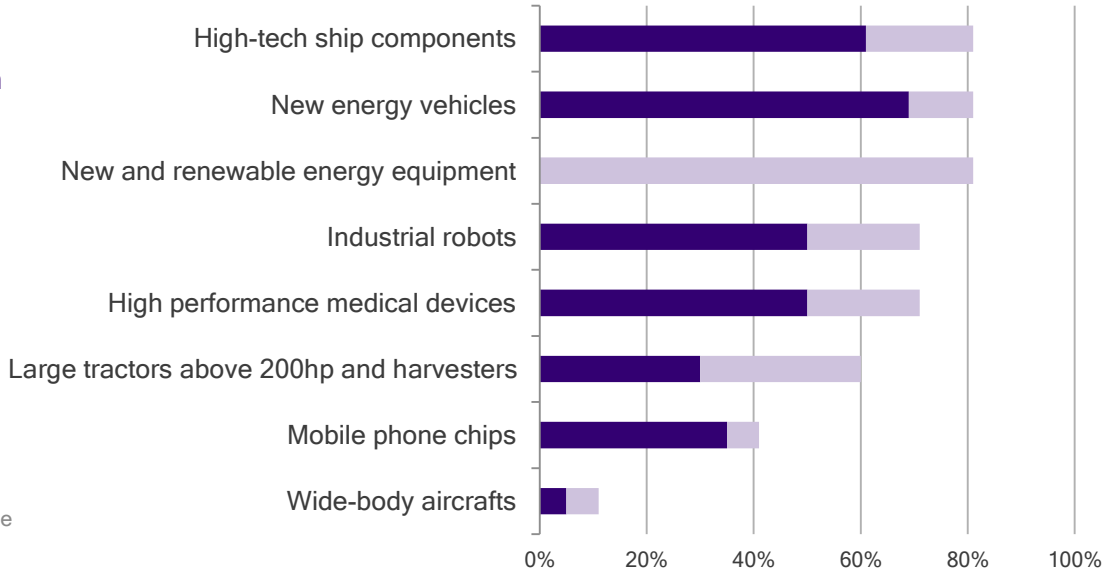


Source: Bloomberg, Pendal

In the sectors where China currently relies on imports, China is also investing massively to displace those imports, be they aircraft, semiconductors, or high end medical equipment. This is the core of China's Made in China 2025 plan.

From China's point of view, they are the sectors where it is still overly dependent on imported foreign technology. And in many cases, the policies that China deploys to support its efforts at import substitution aren't actually WTO violations. Three broad categories stand out. And in all three cases, the policies 'work' in part because of China's massive scale.

Chart 4.
China targets for domestic core component production



Source: Expert Commission for the Construction of a Manufacturing Superpower

The first is China's de facto technology transfer requirements, which relate directly to US concerns on IP theft. China has broad discretion to determine which sectors are open to foreign investment and which sectors are not, and it can condition approval of inward investment on forming a joint venture (JV) partner. Furthermore the JV partner (often a state company, given the nature of China's economy) can condition its participation in the JV on technology transfer. This technology transfer in turn often helps the Chinese firm meet China's goal of raising its level of "indigenous" innovation. For example, in China's development of its own high speed rail network, this policy has effectively led foreign firms to transfer technology that enabled the creation of an "indigenous" Chinese national champion. China's state is effectively the monopoly buyer of railway equipment, while competition between foreign suppliers of such equipment is high, so getting access to the market effectively meant giving your intellectual property away even if China didn't have a written policy that demanded it.

The second is domestic subsidies. Challenging China's subsidies in the WTO is often hard, as many of them are 'legal'. The WTO is meant to discipline explicit, sector-specific subsidies which are the kind that have a budget line item. But in China, the nature of the economy means that any firm that can borrow directly from the state banks rather than the shadow banking system gets low cost credit. This is clearly a subsidy but it is difficult to quantify and difficult to prove it is a sector specific subsidy. Is steel more subsidised by the banks than solar? There is no way to know.

Here again China's command economy model and its sheer scale matters. China doesn't need to just subsidise a single national champion as it can subsidise credit to multiple competing firms (often in different provinces) and then finance the consolidation of the industry around the most successful firms. No one else, for example, could set up 30 different provincial semiconductor funds along with several national funds. If all these projects are realised, the global supply of memory chips would outstrip demand by about 25% in 2020, estimates Bernstein Research, pushing prices down and battering profits of semiconductor companies globally.

The third and final policy is “Buy China”. This covers the systemic impact of informal “Buy China” policies that direct purchases toward domestic Chinese companies and force firms that want to compete effectively with the local, indigenous champions to make themselves more “Chinese” by producing more in China (ideally with a politically connected JV partner for protection).

The demise of the WTO

At face value a lot of the behaviour of the Chinese has been questionable but it does fit within the letter, rather than the spirit, of the WTO rules, and arguably most countries if put in the same situation would behave the same, especially if they were as well organised as China.

With this is mind Trump has decided to ignore the WTO and go it alone. While this is understandable we think that he has picked the wrong weapon to fight this war. Raising tariffs is a very blunt and weak tool to try and get pay back. Tariffs also have far too much collateral damage, and complicate the production of goods with inputs from different supply chains around the world. Crucially they can make local manufacturers uncompetitive, doing the opposite of what they intend to do, as this article on Harley Davidson highlights.

An alternate and possibly better response would be along the lines of what Jennifer Hillman has suggested in her paper from 2017, She is a former member of the WTO Appellate Body and also served as a Commissioner at the US International Trade Commission and as General Counsel in the Office of the United States Trade Representative.

One reason why the Trump administration hasn’t pursued China inside the WTO is that many of the policies that concern the US aren’t necessarily WTO violations. Hillman’s conclusion is that the best way to address China’s unfair policies and practices is through a big, bold multilateral case at the WTO. This means that the right thing to do would be for the US to round up all of its allies that are members of the WTO, and take China to court to defend itself against these accusations. If the court finds China guilty of breaking WTO law then a suitable punishment would be administered. This would avoid the problems associated with tariffs while bringing China into line, once again competing on a level playing field.

But Trump isn’t the most subtle human being going around, and as “the Art of the Deal” reveals, his preferred approach is a combative one. It just wouldn’t be Trump if he didn’t approach things in this way and, to be fair, there is probably little chance that the WTO court would be able to hand out a sufficient punishment or that China would even recognise the outcome if unfavourable.

Trump’s move to sidestep the WTO court, while understandable, essentially invalidates the power that the WTO has, making the institution irrelevant almost overnight. Regardless of the credibility of Trump’s threat to just pull out of WTO membership, it is tough to see a future for an institution which only a few years ago was seen as rock-solid.

The rise of nationalism

While a lot of the talk on trade wars has been focussed on Trump, focussing on him solely misses the point that the global tides are shifting. The move of political parties away from the centre towards the left and right is a global phenomenon and the dissatisfaction with the current rigged system isn't going to stop anytime soon.

The image last week of Trump and the Italian Prime Minister Giuseppe Conte highlights that Trump isn't alone in the world. A gushing understanding between the two highlighted how much Trump and Conte (who is just a vessel for Salvini who really call the shots) have in common. Salvini, like Trump, has total distaste for the establishment, not caring the slightest bit about being accepted by Hollywood or being invited to the Clooney mansion at Lake Como. They both portray a strong sense of sovereignty, blaming outside forces for conspiring to reduce the quality of life of the American & Italian people. Whether this is true or not is not what's important - it's more about what they promise and how good they are at keeping support on this notion.

There is no question that this stance has been hugely successful. Salvini essentially ran his campaign on two issues - immigration and sovereignty. Since being elected he assigned himself as interior minister and has set on the path of "stopping the boats", fixing immigration and restoring an element of sovereignty the Italian people felt they had given away under Angela Merkel's immigration policy.

Disturbingly, Trump and Putin actually have much more in common than meets the eye and these commonalities are similar to what Trump and Salvini share. While everyone was freaking out about the summit between the US and Russia this month, there are genuine reasons why the two would want to meet. Both are approaching those outside their borders in the same manner, clearly choosing the path of isolationism and a strong identity of country as their main platforms. It is worth remembering, however, that Trump is still fighting against Russian interests in Europe, with the Nord Stream 2 pipeline being the most visible fight. Calls for Trump being an obvious puppet of Putin are (probably, but not definitely) representative of fear of change more than anything based in reality.

Looking across Europe the same type of leader is mirrored in Austria, Hungary, Slovenia, Czech Republic, Slovakia and Poland. Nationalist parties are also gaining ground in countries like Sweden and Germany, countries that have had larger than average issues with immigration and refugees. The really worrying thing about Europe is that there are some genuine racists amongst the parties that are gaining power. You may think Trump is a racist, but he pales in comparison to what is happening in parts of Europe.

The end of the liberal world order

The shift towards nationalism is in sharp contrast to what has been referred to as the 'liberal world order' which has been enforced by the US since the end of World War 2. After the war, the US took a more active role in promoting its view of how the world should operate which included such ideas as capitalism, the democratic process and personal freedoms. For a large part of this period the USSR was attempting to do the same, with a diametrically opposed system, and as a result the two world superpowers were engaged in a "Cold War" over that period.

Ultimately the US economic model emerged victorious, but the success of the spread of this ideology since the end of the Cold War has been questionable. The numerous disasters of US foreign operations, most recently in the Middle East, highlight the failure of being able to force these ideals onto populations that just aren't interested (for a unbiased view I suggest you watch Team America - World Police).

Allowing China to enter the WTO in the late '90s, with the US led goal of projecting this soft power into the East, was made with the mistaken superiority complex of the West. The intention was to push the Chinese economic and political model more towards that of the liberal West. Yet, you could make the strong argument that since joining the WTO, China has actually become more closed, and the one-party system is more powerful now with the establishment of Xi as a permanent leader.

These trade wars have been the first shot over the bow and the first real lurch towards isolationism for the US since World War 2. While 70 years may seem like a long time, in the context of American history it is only a short period of openness relative to the time it has spent only worrying about itself. Its geographical position allows it this luxury - unlike the Europeans, she has large oceans on both sides and friendly neighbours to the north and south.

There are few defenders of the old world order left. The most notable is Angela Merkel in Germany, and while she wields considerable political power at home and throughout Europe, this power is waning significantly. She is running out of allies with the same values in Europe. The unconstrained immigration she championed - while a noble pursuit - has ended up exposing the weak underlying economic strength of Europe. This has been the 'straw that broke the camel's back' which has put Merkel under significant pressure. The same global forgotten (lower to middle) class that elected Trump are the segment of the population that have had to deal with the consequences of such large migrant flows, with acute effects in the weaker southern countries where the flow inevitably had to come through.

Ironically Merkel's immigration policy, which was intended to help as many as possible, will end up reducing the number of refugees Europe will take over the next decade due to the political revolt that it has provoked. This is one of the many disappointing aspects of the changes we are seeing now. Less openness will mean less collaboration and less compassion for those who are worse off.

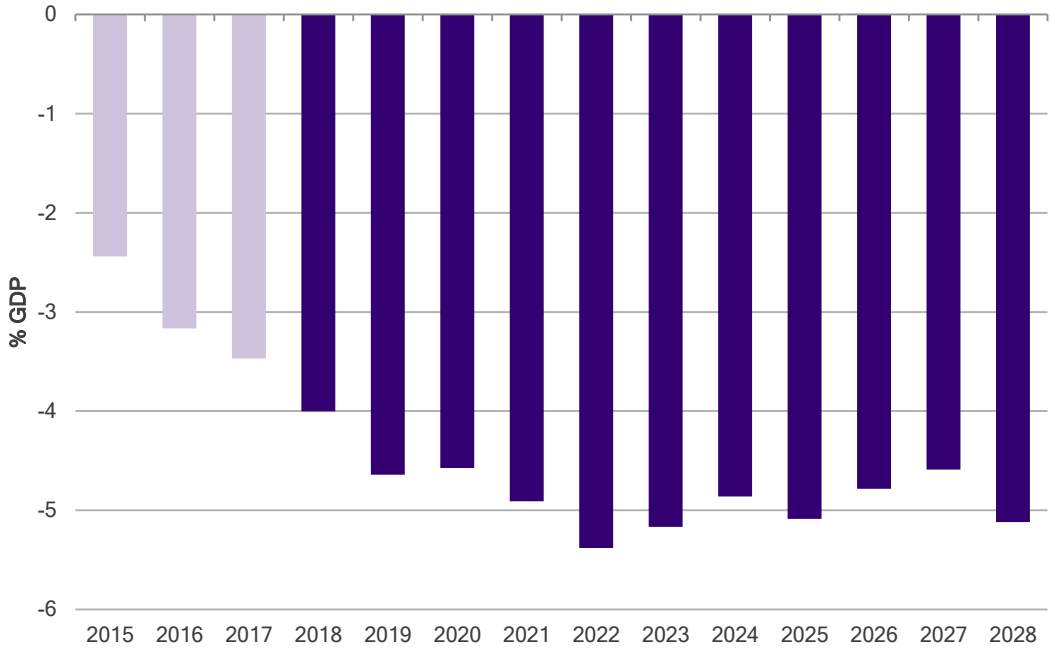
The one constant - China

Throughout the last 20 years, China has played a masterful game and has been mowing everyone's lawn while the world was sleeping. The model that built the country from nothing into a global superpower continues with force. The recent easing of monetary policy and fiscal stimulus shows that China's leaders still have their hands strongly on the reigns of the economy, and are ready to ease at the threat of external pressure.

It would be fair to say that China did not need the frictions caused by the trade wars while they were in the middle of their reform process and have had to adapt their course materially. Whilst China needs to maintain its longer term commitment to deleveraging and the opening up of its markets if it wants any hope of escaping the middle income trap, the recent significant shift in its policy stance highlights the relatively low pain-threshold that still exists among China's leadership.

Stability remains the number one policy priority, not just of growth or the currency, but of the socio-political order. The most recent commitments on the use of fiscal policy is likely to lead to a more than doubling of fiscal impulse in the second half of this year compared to the whole of 2017. Alongside the monetary easing already under way, and the regulatory easing that will speed up the implementation of fiscal stimulus, this shift in policy stance will no doubt boost growth prospects for the next few quarters.

Chart 5.
US fiscal deficit as a % of GDP



Source: Bloomberg, Pendal

This 'goosing-up growth' model clearly isn't lost on Trump. The fiscal easing delivered in the US through tax reform and the bipartisan spending deal earlier this year has put the US economy temporarily on very strong footing, and gave him the growth buffer to attack the long-term issue of trade. Using the fiscal lever and lifting debt loads has been the plan by which China has developed its own economy over the last 10 years since the GFC, and this model is now being adopted not only by the US, but eventually in countries like Italy.

A new playbook for markets

Forecasting the primary effects of trade wars or any other of the immediate effects of nationalistic agenda is both difficult and futile, as the secondary effects of responses and decisions made by any of the players are impossible to predict in this complicated game of geopolitics. However, a few things seem certain to us. The US will not feel satisfied on trade until it achieves a level playing field, and insofar as that would involve China softening its stance on industrial policy, it is difficult to see either side back down meaningfully from the current rhetoric anytime soon. The shift towards populist and nationalist political regimes has already started and will not abate until the gap narrows between the "winners" and "losers" of the liberal world order. This means that the trend of fiscal irresponsibility will only accelerate over the next decade, eventually bringing into question how monetary and fiscal policy should interact in the future. As these changes continue to ripple through the global economy, they bring with them necessary changes to long-standing trends and relationships in markets.

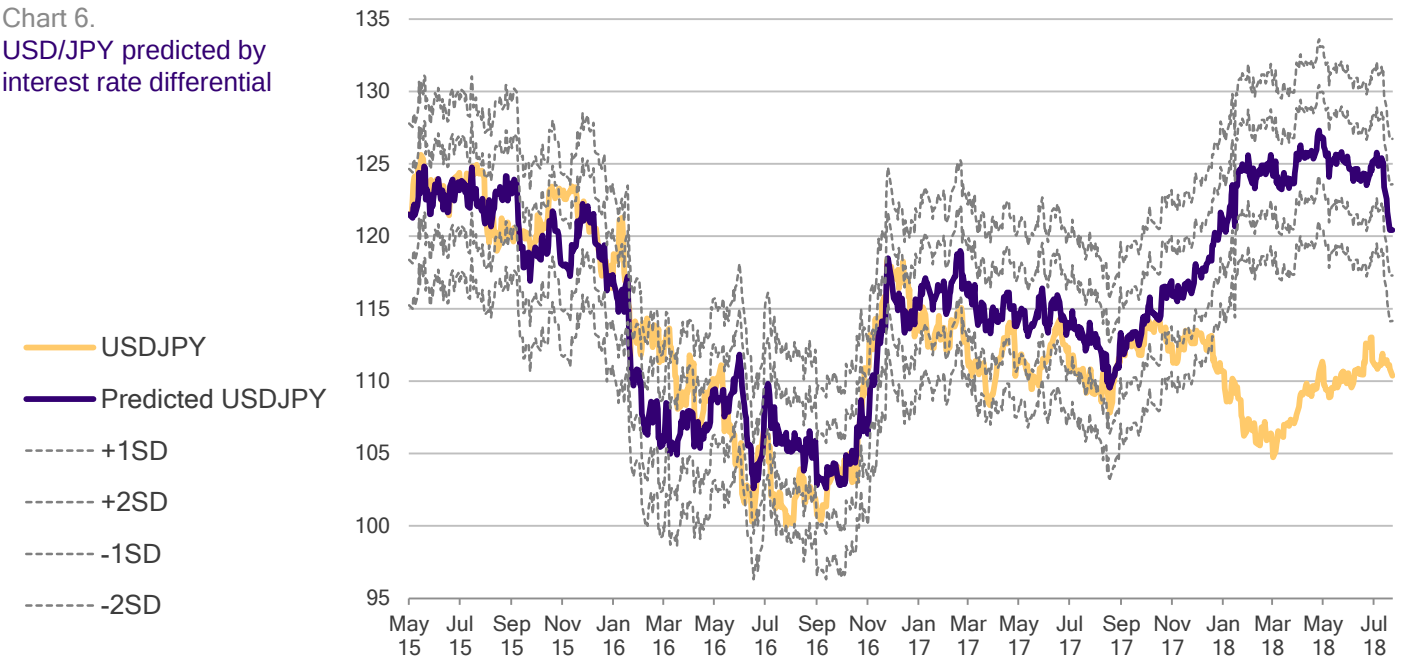
If the secular bond bull market was a function of the previous accepted practices which defined the interactions between economies and governments then it should follow that a shift to polar opposite practices should bring about a bear market in bonds. There is good evidence to support this assertion. The bond bull market has been driven by falling inflation, through a combination of goods deflation and weakening wage pressures due to the cheap pool of labour supplied by developing countries in the process of globalisation. In reverse, the process of de-globalisation therefore ought to lead to higher wage and other inflationary pressures driven by nations trying to produce everything themselves regardless of their comparative advantage.

Similarly equities have done extraordinarily well as corporate profits have benefited from better margins due to lower wages and higher sales volumes from more global consumption. In the background we have also seen an incredible leveraging up of the household and corporate balance sheet which has driven up valuations and has supported consumption and general asset prices. If populist government policies now try to rebalance the outcomes between capital and labour, the ride for equity markets is likely to be a lot bumpier over the next decade.

For so long, global trends in markets have been reinforced by a certain set of economic trends. For example, the bond bull market has been helped along by secular stagnation, ageing populations, and a lack of investment and productivity growth since the GFC. Similarly, the abundant liquidity pumped into the global system by central banks experimenting with extraordinary monetary policy, and the moral hazard that they have inadvertently created in the “central bank put” has fuelled equity markets and suppressed volatility of both markets and economic outcomes. But now, those trends are facing opposition in populism, nationalism, and global central banks who are yet to agree on what their reaction functions ought to be.

It is important to note that the above is neither a call for the end of the secular bond bull market, nor an expectation of the next equity bear market. More important than any directional call on risky assets, it is likely that the relationships between asset classes will become more uncertain. We have seen over the last 18 months, for example, that the relationship between interest rates and currency markets has become unstable. Over the last 12 months, the negative correlation between bonds and risk assets has started to turn positive (albeit for brief periods) more frequently. And over the last six months, market volatility has not only picked up meaningfully, but the volatility outcomes have been wide ranging across all asset classes.

Chart 6.
USD/JPY predicted by interest rate differential



Source: Bloomberg, Pendal

This conclusion clearly presents more challenges to investing over the next decade than the last. Investment trends will be tougher to identify as competing forces push and pull on the ultimate direction of global bond and equity markets. Economic outcomes in both growth and inflation are likely to become wider ranging, bringing with them higher volatility across all asset classes. And if central banks, led by the Fed, are currently determined on policy normalisation if only to build up dry powder for the next downturn, it is not clear how much room they have on this runway. In order to remain nimble and ride these waves, investment strategies ought to favour active over passive management. And in a world where bonds cannot always be relied upon for their negative correlation to equities, a positive exposure to volatility should be encouraged.