PENDAL

Understanding US-China tensions

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June 2019

Introduction

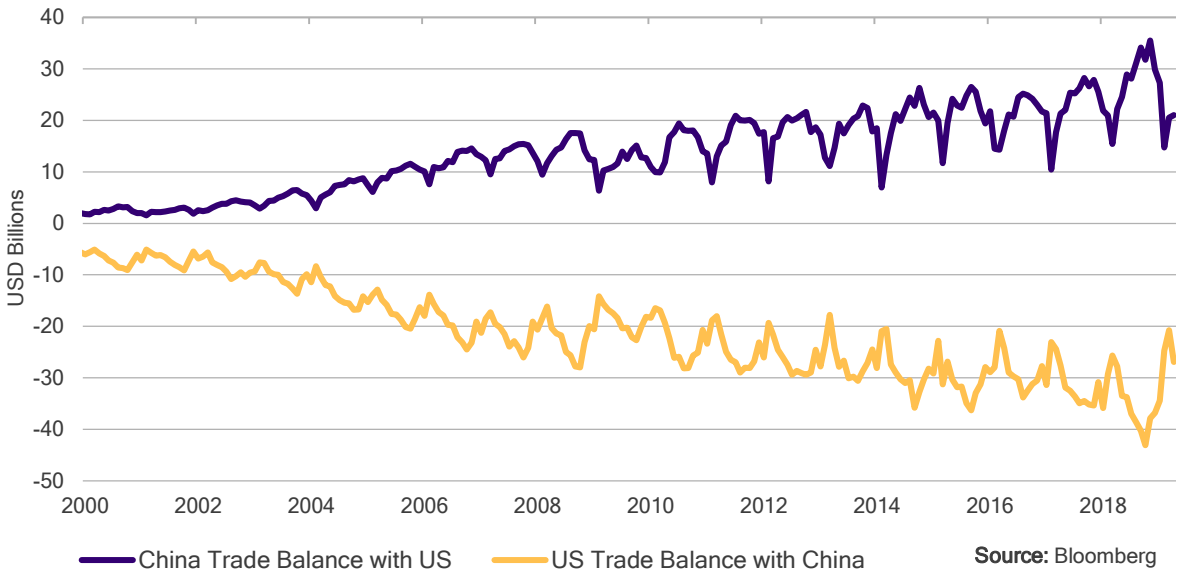
It has been nearly a year since Trump imposed the first wave of US trade tariffs on Chinese imports. Until very recently, it seemed his strategy had been working, forcing China to the negotiating table on everything from the size of the bilateral trade balance to issues such as industrial policies and the protection of intellectual property. A mutually beneficial currency agreement also seemed to be in the making, favouring a weaker dollar and stronger yuan. Not only did this help to promote a sense of calm on the trade front whilst talks progressed over the last few months, but provided the perfect bait to lure investors back into risk-hugging trades. Then just as suddenly "China broke the deal". It is our belief that the world has moved past the peak of globalisation, and now begins the messy and drawn-out process of individual actors working out the next-best way in which to interact with each other, be they friend or foe. Framing the outlook for global trade in terms of strategic competition will be more helpful than the extreme binary assumptions of full conflict or resolution. In this paper, we will visit the key issues surrounding these ongoing US-China tensions, including offering a perspective of the conflict from both sides. We provide our view of what drives continued tensions, as well as an analysis of the likely scenarios going forward and their potential impact on growth and policy responses.

A war beyond trade

The ongoing trade tensions between the US and China has often been likened to The Thucydides Trap, which is a term coined by Harvard professor Graham Allison to describe the conflict that inevitably arises as an established hegemony's power is threatened by another rising power. Whilst it may be too early stages just yet for actual war to break out, a version of it through trade tariffs is certainly already under way. Three waves of US tariffs against Chinese imports have already been levied since last year, and the latest escalation in trade tensions has turned analysts who were "trade bulls" only a few weeks ago into very worried bears.

Trade and its glaring inequalities has been Trump's chosen way to target the rising threat of China as the next global superpower. Whilst most have disagreed with the imposition of tariffs and other protectionist barriers to trade, Trump's choice to target the size of the bilateral trade imbalance at the very least makes the problem immediately tangible and measurable. It also makes the problem much easily addressable by China, who until the most recent escalation seemed very willing to "buy, buy, buy" their way out of the trade spat.

Chart 1: China and US bilateral trade balances (USD billions)



It has also been clear that the trade war waged by Trump is going after the relatively low-hanging fruit. He has been concerned with reducing the size of the bilateral trade imbalance between the two nations, and establishing a level playing field when it comes to trade going forward. As a result, he has demanded a reduction of America's bilateral trade deficit with China which must be rectified by China committing to buy more from the US, and demanded changes in Chinese behaviour regarding the treatment of intellectual property (IP) rights.

However, what might have started out as a simple trade war has been morphing into a tech war, escalated by the US's decision to blacklist Huawei. As the technology discussion moves into the realm of national security, we think this is indeed where the latest escalation has become more serious than just a spat. However, we don't think raising concerns over national security, and in particular for the US, the issue of defence supply chain, necessarily mean that this latest round of trade tensions is irreversible. As far as the Trump-led tensions are concerned, note that at no point have the US side demanded the abolishment of State Owned Enterprises (SOEs) and their dominance on the Chinese economic landscape. The equally "untouchable" issue of the political system in China (one-party socialism) and its ideological dichotomy to the West has also been very purposefully avoided. Trump himself has not seemed particularly interested in the differences of systems and values, and the primary goal of pursuing a trade war with China was to buy votes from the "losers" of globalisation (i.e. American workers). Unfortunately, the latest turn in trade talks, if indeed sparked by China, has refuelled the true anti-China hawks in the US. Unlike Trump, they do care that it is an autocratic communist opponent who sits on the other side of the bargaining table. Under Xi, control and autocracy have gathered momentum in the Chinese system, and behind Trump, critical sentiment over such a system has transcended party lines. Mike Pompeo's remarks this month on US "hopes [that have been] dashed" regarding changes to China's society may mark the most significant escalation of the trade war to date.

Developments on Huawei, and if/how China retaliates should be closely watched from here. On the issue of technology more broadly, it is not clear that one side has more to lose than the other. Taking the example of ARM technology and how much it matters to Huawei, any meaningful restriction to the company on this front would likely mean a 10+ year set-back. (See article link here: https://gizmodo.com/arm-reportedly-directs-staff-to-stop-working-with-huawe-1834946238?IR=T). This would obviously be a huge blow to Huawei, but may not necessarily be fatal, as developing China's 5G network alone over the next few years can easily keep the company in business. The blow to the US, in the meantime, is to those corporates who have relied on the Chinese middle class as their fastest growing customer segment globally in recent years. An escalation of trade wars firmly into tech war territory is likely to send both sides' share markets into bear market territory once again. Whereas China can mobilise its "National Team" (government-

related or formed entities formed during the last Chinese stock market crisis who engage in direct buying of A-shares to reduce market volatility), the US must rely on the uncoordinated and scattered fire power of various corporate share buy-back plans. Full-blown tech war is also difficult for both sides to allow currently due to the deeply embedded nature of both sides' technology in each other's existing military operations (China relies on US software, US relies on China's hardware). Significant efforts to detangle this technology interdependence would be required before full tech war can be wagered.

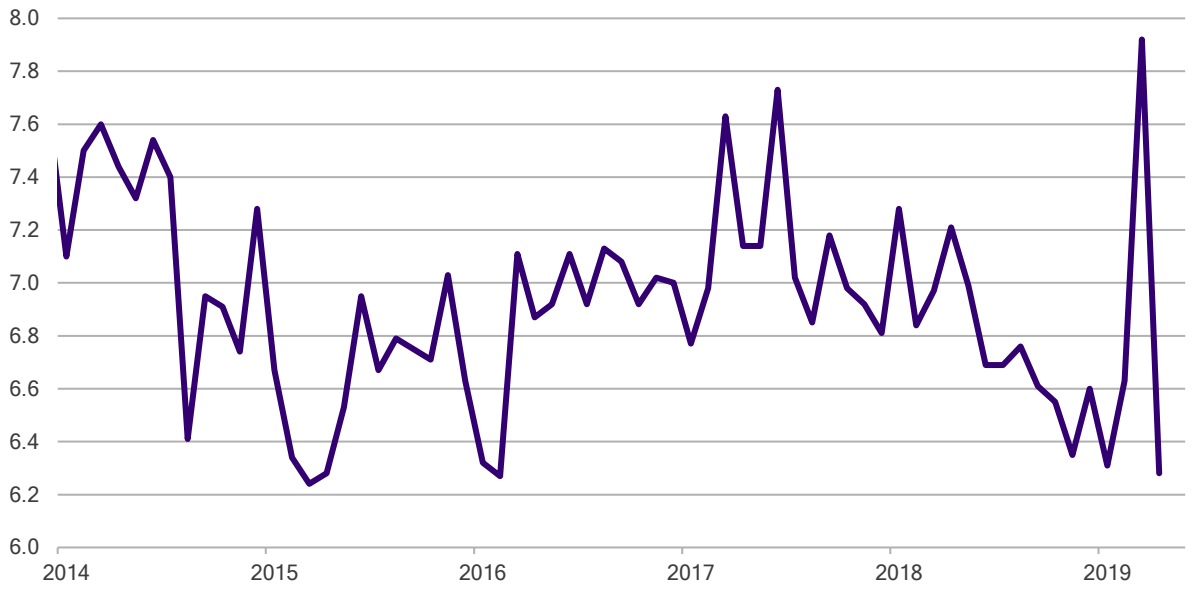
In due course, a full force tech war may eventuate. In this scenario, expect China to re-lever its balance sheet like it's 2008, and target the development of technology and human capital, whilst closing off its consumer base to its enemies, whilst carrying out in full its threat on shutting off the US from its rare earth exports. Expect the US to call on old political allies for support. For countries like Australia, whose economic fortunes are ever-more determined by China, but whose military alliance has always lay with the US, this will be the time to make the impossible choice. Until then, it is our view that this is the era that the trends of globalisation hand over to those of strategic competition, and that any "deal" struck between the two nations will hold no real long term meaning, but may soften any pain in the short term.

Sizing up the opponent

The latest flare-up between the US and China has been squarely blamed on the Chinese side by the US. Surprisingly, China has not denied reneging on the deal, and our recent tour of Beijing found a less surprise on the ground (compared with the US reaction) that there had been such a last minute set back in negotiations.

If it was indeed the Chinese side that "broke the deal", we think there could be several reasons. Firstly, relative to the sharp growth slow-down being faced at the end of 2018, the first quarter of 2019 had gone off to a swimming start, thanks to a sharp little burst of old-style credit stimulus. For the Chinese side, this economic outperformance may have offered some sense of a growth buffer, providing an opportunity to make some demands of their own. Certainly, in the data we saw recoveries in every measure from credit growth to industrial production, PMIs to investment activity. Chart 2 below illustrates this bounce in economic health the best, where driven by all of these measures of economic activity, Bloomberg's monthly Chinese GDP growth tracker picked up the sharpest rebound seen since the GFC.

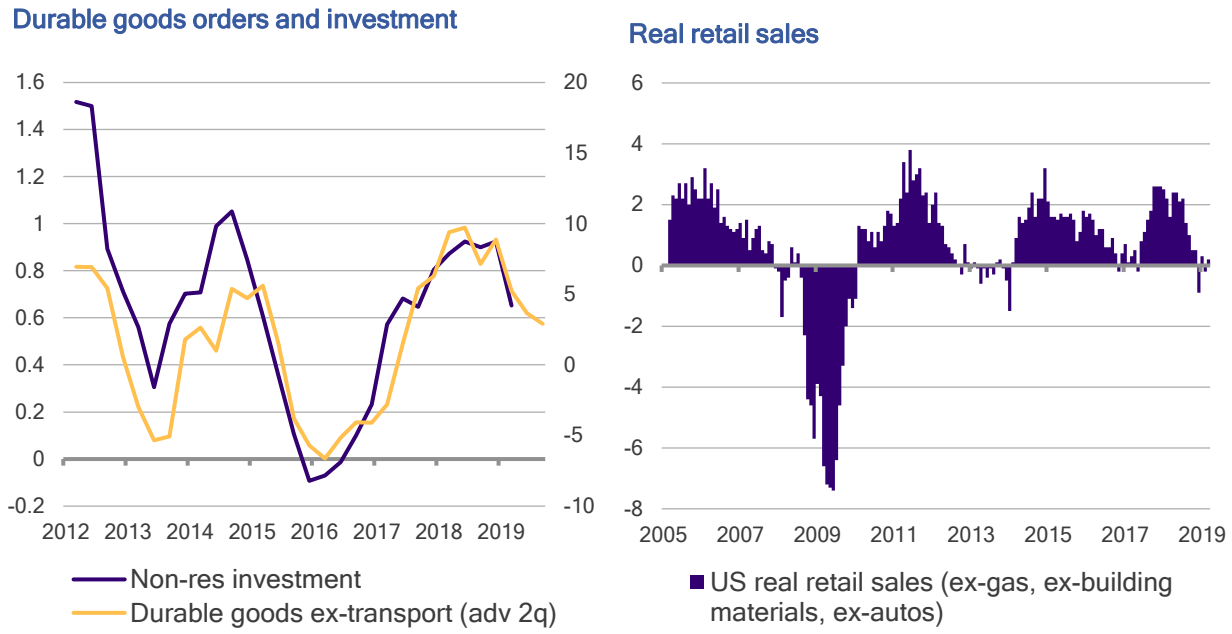
Chart 2: Bloomberg China Monthly GDP estimate (YoY%)



Source: Bloomberg

Confidence on the Chinese side may have also been reinforced by their assessment of the underlying health of the US economy. Whilst the now-famous "Powell Pivot" was most certainly driven by the sharp correction of US equity markets at the end of 2018, the weakening of economic momentum both at home and globally is likely to have played a large part in that pivot, as well as the increasingly dovish rhetoric that continues to be emitted from various Fed members. For the US domestically, it is likely the cycle that is finally catching up with the near-longest expansion in the economy's history. A combination of interest rate hikes, an economy running out of capacity, and passing the peak of fiscal stimulus led to what seemed to be a sudden stop in the fourth quarter of 2018. Consumers are exhausted and private capex has turned over.

Chart 3: US real consumption and private sector investment



Source: Bloomberg

From China's perspective, this underlying weakening momentum in the US economy is what gives them the "edge" in the trade war. Corporate America has been facing rising wage costs, but has mixed ability to pass on higher costs. These higher costs have been compounded by existing tariffs levied on Chinese imports since last year. Of course, tariffs on all Chinese imports into the US will hurt the Chinese economy, too, but the bet currently from the Chinese side is that the pain will be greater for the US economy. That is certainly the narrative being spun behind the very hawkish rhetoric on trade war being played through the state media outlets in China currently. Regardless of whether China plans to ultimately soften and strike a deal, given how steadfastly Trump has tied his performance scorecard to the health of US equity markets since taking office, the near-term rational game theory move is for China to go as hard on hawkish trade rhetoric as possible, in order to drive down US stock markets and force the US side back to the table. As mentioned above, should the same fate befall Chinese equity markets, there is always the Chinese National Team to come to the rescue.

Even if it was the Chinese side that broke the latest trade negotiations, the US side may still have something to gain from the recent escalations, or as far as Trump is concerned. With the entry of Biden on the US 2020 elections scene, and his relatively "pro-China" stance on trade, Trump has every reason to continue to push hard on the trade war in order to define and broaden the gap between them. In addition, having been so publically opposed to Fed rate hikes through all of 2018, a further escalation in trade tensions with China may help Trump to force a cut (or a few cuts) from Powell et al. As recent weeks have shown, now that the Fed is truly "in play", the outlook for the US dollar has become more uncertain, with a bias towards weakening. This helps the US trade deficit as well as Trump's popularity with Corporate America.

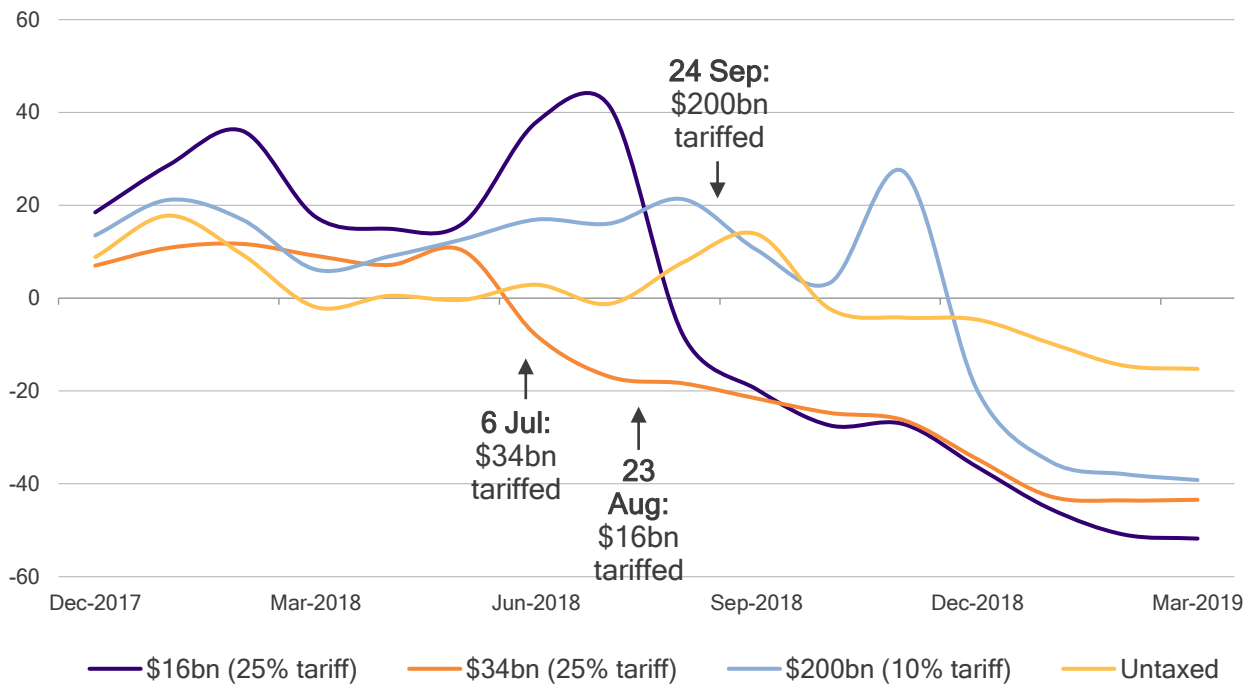
Of course, there could be a more benign explanation behind these latest set of events, and is likely to have been percolating underneath the rapid firing of headlines and retaliations on the surface. That explanation is of cultural misunderstanding. It has yet to be made public what *exactly* were the points of contention that led to the breakdown of trade talks at the end of April. However, much has been mentioned informally by both sides regarding the changing of Chinese laws. The US is a system ruled by law, and therefore the most credible way for China to accept the US's demands for change is to write those changes into law. China is a system ruled by administration, and guarded by "face". Administrative policies carry far more weight than the letter of the law in China, but the worst outcome for China would be to submit to law changes by order of an outside authority. There is no intention here to sound glib by referring to misunderstandings, as they are likely to occur repeatedly due to the fundamentally different way in which things are done in these two countries.

The impact of trade wars

What was once considered a tail scenario of 25% tariffs applied to all Chinese imports to the US must now be viewed increasingly as a baseline with the latest turn in China-US trade tensions. The direct impact of tariffs are easier to estimate than the indirect and second order effects. Of the existing three batches of tariffs of $34bn imposed from July 2018, $16bn imposed from August 2018 and $200bn in place since September 2018, year-over-year growth rates had already fallen into severe contraction of around 40-50% by March of 2019, compared to experiencing double-digit growth prior to the levying of any tariffs in the earlier part of 2018. Of course, the slowing of global demand has also weighed on exports, but relative to those three batches of Chinese exports, those that have not yet been caught by tariffs have only experienced a slowdown of around 15%.

Chart 4: Tariff impact on China exports to the US

China Exports to US YoY% | Breakdown by tariff bucket



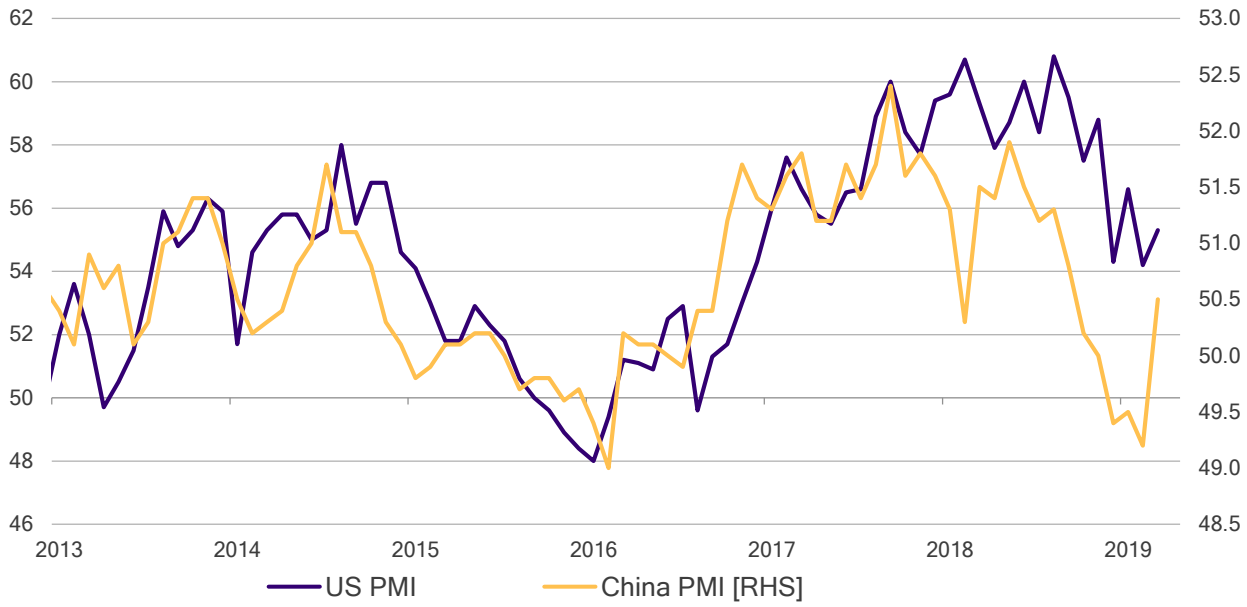
Source: USITC, USTR, Barclays Research

Our estimates of the direct growth impact of the latest round of tariffs rising to 25% (as is currently planned by the US) is a negative annualised 0.5% and 0.2% on Chinese and US growth respectively. Given we're already half way through the year, the strong start that the Chinese economy has the damage this would do to 2019 growth prospects would be very manageable for both economies. The impact is significantly worse for China in a full-blown tariff scenario where a full one percentage point would be shaved off growth whereas the US is still likely to only suffer three-tenths of a percentage point drag due to the relatively closed nature of its economy.

However, it is the second order and indirect impacts that are far harder to gauge and can often be more important. From the dent to business and private sector sentiment to the repositioning of supply chains, the theory points towards more pain and lower long-term trend growth. Certainly in the more leading indicators such as sentiment surveys and PMI indices, the coming quarters look to be challenged for both economies. Of course at this stage, it is difficult to disentangle the causes for this poor economic outlook. Our view is that absent of these latest trade tensions, the global economy was already on a weaker footing, owing to key drivers such as the slowdown in the Chinese economy as a result of its own deleveraging campaign since 2017, the effect of Fed hikes finally starting to bite into the US economy, and a slowing trade and semiconductor cycle reflecting an underlying softness in global demand and capex despite the headline improvements of this latest mini-upswing in the business cycle.

Chart 5: Leading indicators signal pain ahead for economic giants

US & China PMI



Source: Bloomberg

It is worth pointing out, however, that the same fears of second order effects had been raised around Brexit. Recall the doom and gloom that hung over the country and the financial markets in the immediate aftermath of the Brexit vote in 2016, and yet with the saga unresolved and lingering on three years on, the UK economy has remained resilient and is the only major developed market where interest rate *hikes* are priced in. The key shock absorber for the UK has been the pound, which fell precipitously after the event and remains 15% weaker against the US dollar still. For both the US and Chinese economies, it is harder to allow their currencies to act as the shock absorber in the same way. As much as the US could benefit from a weaker dollar in the face of rising trade tensions, the sentiment impact on risk markets is likely to cause a safe haven rush for dollars from investors globally. There is a doubly attractive incentive to hold the greenback currently as it remains the highest G10 currency by far. China has a very different problem of desiring currency flexibility in order to better weather shocks and downturns more generally, but each time finding itself unable to withstand the potential capital flight that may ensue if the yuan were allowed to truly move in line with market forces. Recall that the last attempt to devalue the renminbi cost the

economy over $1trn in FX reserves, massively threatening financial stability of the system and imposing a severe tightening of monetary conditions for the domestic economy.

Yet, it is worth a pause here to consider that the impacts of trade war need not all be bad. Consider what the US has so far asked of China: better protection of IP rights, fairer industrial policies, market liberalisation and opening up of various sectors to international participants. Whilst all of this may be happening at a faster pace than what China had originally intended on, the direction of travel is likely to be a good one for China and its longer term growth prospects. Stronger IP regulation supports innovation and technological progress. Fairer industrial policies and market liberalisation provide China with the prospect of a stable stream of FDI, which will likely both benefit key sectors of the economy as well as provide a source of dollar inflows at a time when the current account is moving into structural deficit. For the Chinese system as a whole, which has been moving in a more centralised and autocratic direction under Xi, the scrutiny now brought about through the Trump-led trade rampage at least puts a pause in this less friendly direction of travel, and offers at least a fighting chance for private sector actors to play a bigger role in the future of the economy. For the US, if they believe that dominance in frontier technologies secures the path for global economic dominance, then protectionist trade policies fired at China at least provide them with a chance to get ahead in the technology race. In the meantime, US domestic industries are offered a period of shelter during which to harness any budding efficiency advantages that had previously been too easily overpowered by a China circumventing the global trade rule book.

Life after 7.0

The question of whether the 7.0 level on the dollar-yuan exchange rate will break has come up several times since the first waves of tariffs were threatened last year. The fundamental economic forces have certainly been working against the renminbi for some time. Not only does China no longer enjoy a healthy current account surplus, thanks to the growing number of Chinese tourists who travel abroad each year, but China's monetary policy has been in stealth easing mode against a backdrop of a Fed hiking cycle. On top of this, the threat and eventually the realisation of tariffs against Chinese imports have further pressured the fair value of the Chinese currency to be weaker.

Taking tariffs in isolation, a simple back-of-the-envelope framework for arriving at a fair value estimate of the exchange rate should take into account the direct impact that tariffs would have on Chinese exports to the US, and solve for the necessary amount of currency depreciation to offset such impact. This framework is of course overly simplistic, as it holds all else constant, including other economic policy responses, second order effects of trade wars, and any retaliatory escalation via further protectionist measures. However, it provides a starting point for gauging how much the currency *could* depreciate given the range of possible tariff scenarios.

Our estimates for fair values around a range of different scenarios are as follows:

Scenario	Scenaro 1: Trade deal with full tariff roll-back	Scenario 2: Partial deal with latest tariffs removed	Scenario 3: Status quo (10% tariffs on latest wave)	Scenario 4: 25% tariffs on latest wave	Scenario 5: 25% on all Chinese imports
USDCNY "fair value" estimate	6.4-6.5	6.6-6.7	6.8-6.9	7.3	7.8-8.5

Scenarios 1 and 2 were, until very recently, the baseline to which markets were working to. Now, Scenario 5 likely shifts more towards the base line, or is at the least presenting as a much fatter tail. The rhetoric from the China side has also been sounding more hawkish, seemingly aiming for both a scare tactic against unhelpful speculators, versus bracing real economic actors from

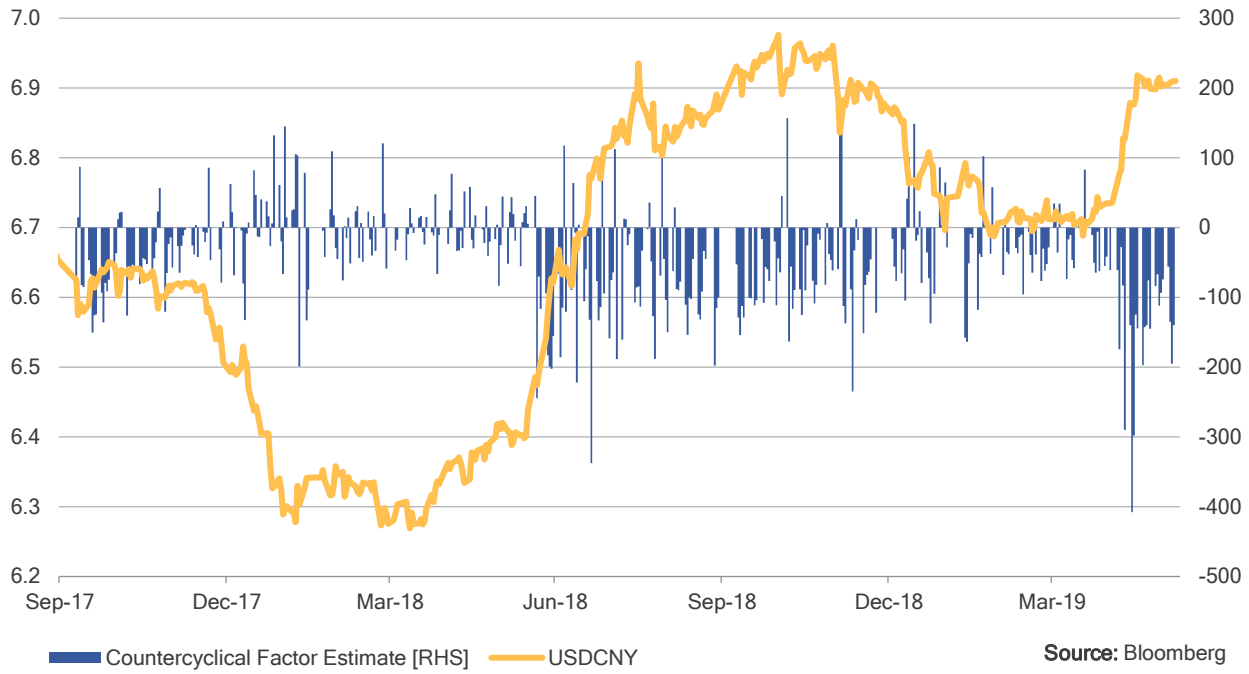
exporters to consumers for life after 7.0. Our baseline scenario is number 4, with the current wave of tariffs seeing the rate pushed up to 25% and an extended period of "trade war limbo" where tensions and some talking continue between the two sides. Under such a scenario, we expect greater monetary easing from PBoC. At least this time, the Fed shouldn't be hiking interest rates in the US, but nevertheless, we do not expect the interest rate differential to work to the yuan's advantage.

The complication is that under such a scenario, growth continues to slow, but not at a rapid enough pace for China to be willing to revert to the old levers of massive credit stimulus to save the economy. The slowing growth backdrop will likely continue to weigh on global growth via both the commodity and trade channels, and a world losing its growth momentum is usually a supportive backdrop for the US dollar. Our estimate of 7.3 for the exchange rate under Scenario 4, therefore, is likely to still be conservative.

Capital flight remains the key concern which prevents the PBoC from "letting 7.0 go". The narrative involves mass panic from onshore corporates and individuals that there is no limit to how far the currency could fall once 7.0 is "broken", and like in 2015, they will all head for the exit and look for safety in other currencies such as the US dollar. However, whilst we expect 7.0 to eventually break, it may become a less momentous event compared to what is currently etched in market expectations. This is likely for several reasons. Firstly, having learned from their experiences in 2015, the PBoC have relied much more heavily on verbal intervention, and other non-reserve tools to manage the volatility in the currency. China's FX reserves remain at the $3trn level, even after 11%-plus depreciation in the currency since its peak last year. One such tool has been the use of the countercyclical factor in the daily FX fixing rate, as per the CFETS methodology (see Chart 5).

Chart 5: The use of the "countercyclical factor" in CNY's daily fixing

USDCNY & Countercyclical Factor



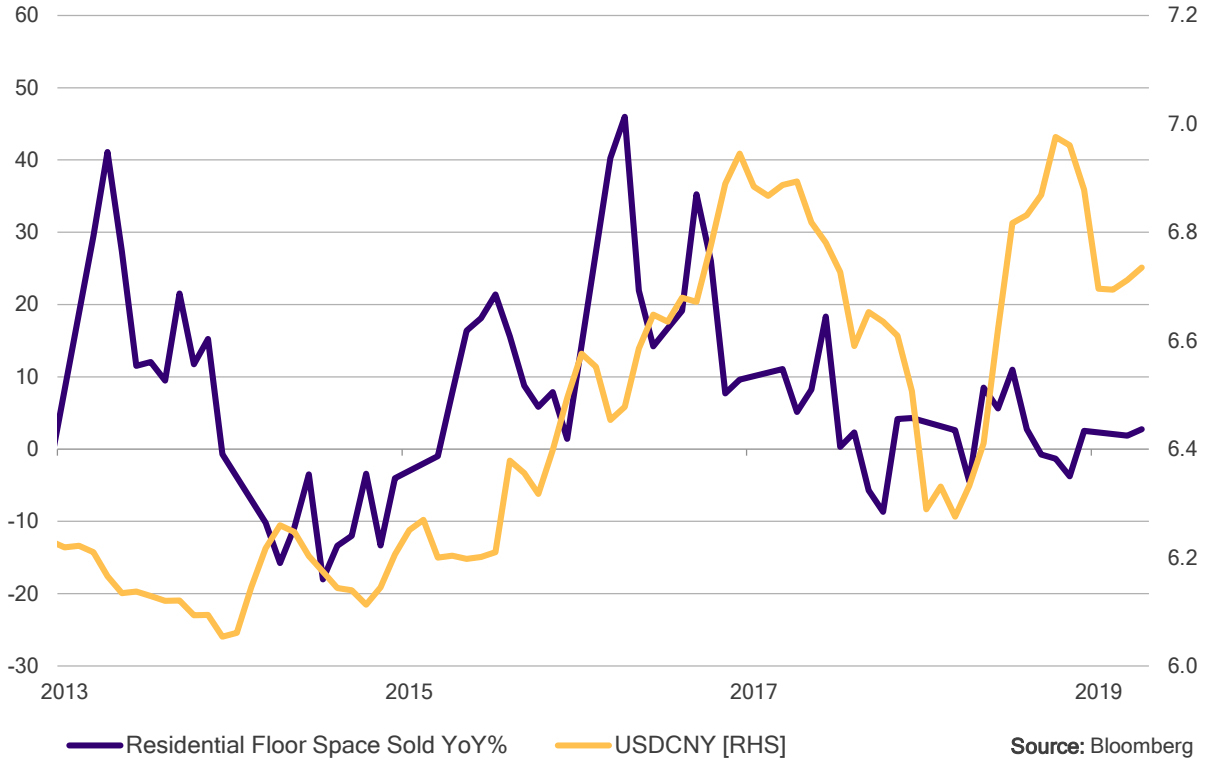
Source: Bloomberg

Secondly, relative to the 2015 where corporates in China had been heavily ramping up their borrowings in dollars, there have been measures to slow the growth of external liabilities since then. Those same corporates have also been more active in hedging the currency exposures of those offshore liabilities compared to the pre-2015 period. Inevitably, a sharp depreciation in the yuan would cause concern and a rush for dollars for corporates who still have heavy dollar borrowings, but the aggregate demand for dollars may be less pressing this time round. Thirdly, other private capital outflows that found their way out of the close capital account in 2015 and 2016

via the "Errors and omissions" line in the balance of payments last time are finding it far harder to pull the same wool over the eyes of the Chinese authorities this time round. What SAFE refers to as a clamp down on "suspicious operations that may be related to money laundering" are in fact a series of measures that have more firmly sealed the outbound capital gates in China. From requiring endless documentation to justify the conversion of any local currency into foreign currency, to requiring banks to lower the daily personal limit on foreign currency exchanges, Chinese wealth is finding it far harder to circumvent the system compared to four years ago. Of course, this is a tentative and balance that needs a stable housing market to be kept in equilibrium. Property has performed a crucial role as a reliable store of wealth for the growing Chinese middle class for the last two decades. Regardless of how tightly China tries to seal the capital gates, if the Chinese population feels their wealth threatened by a cratering property market, outflow pressures will eventually topple the determination of the authorities. As Chart 6 shows, the stability of the property market has been a key point of differentiation between now and the 2015/16 episode:

Chart 6: Stable property markets

China property & currency



Source: Bloomberg

Lastly, as for those pesky foreign speculators on the currency who express their views via the offshore deliverable version of the yuan (CNH), the PBoC have also developed various tools to squeeze liquidity in that market. Tools such as PBoC bills denominated in CNH work to ramp up the cost of shorting the currency to the points where short positions are forced out of the market.

If at this point in time, the PBoC could be sure of tightly sealed capital gates against retail outflows as well as guard against excessive speculation by the international community, our belief is that they would have little hesitation to let market forces play a bigger role in determining the valuation of the yuan, and allow a slide past the 7.0 mark. Of course, the fact that trade talks haven't broken down irrevocably also keeps a lid on currency volatility in the near term. However, as illustrated above, should the economy need further easing, it would make little sense to not include the currency in their easily policy toolkit. It seems inevitable given the current momentum of economic and political forces that 7.0 will break. However, the follow-through may prove disappointing for the uber-RMB bears, and the Chinese economy will adjust to life after 7.0.

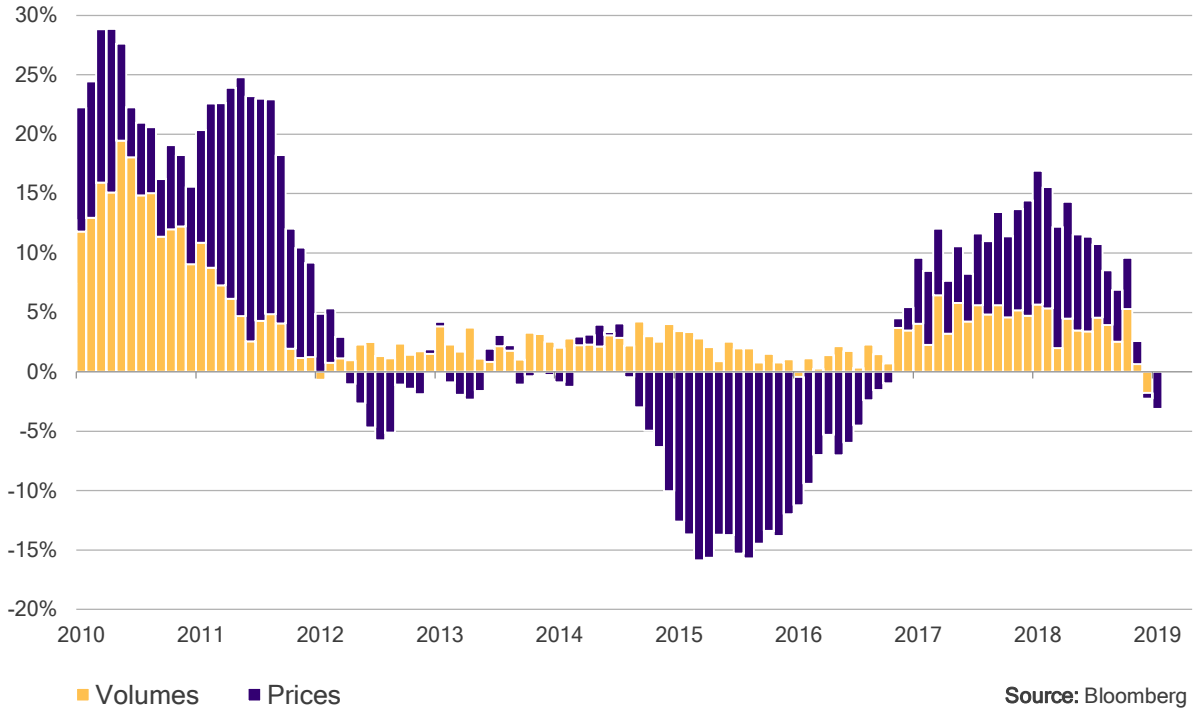
Positioning for a brave new world

The direction of travel for Sino-US relations seems clear: it would be foolish to expect a return to the friendly co-existence of the pre-Trump era. However, the fate of Sino-US relations is not yet sealed. In the near term, there is plenty of economic and political incentive for both sides to look for a deal of some sorts. Technological interdependence remains far too high to expect a full-blown war on tech. However, our view is that any such deal will likely be weak, and fail to address any of the fundamental gaps in ideology between the two sides. These gaps will cause tensions to bubble to the surface time and time again.

It is our view that the world has already moved past the peak of globalisation, and this is the start of a new era of strategic competition. The immediate outlook for global growth in this new era is not great. The trade cycle has not been this week since the GFC (Chart 7), and any stimulus that the economic giants of China or US deliver will likely be targeted at reviving their own economies with limited spill over benefits to the rest of the world.

Chart 7: Global trade volumes

World trade growth YoY



Source: Bloomberg

The global capex cycle is showing signs of strain, but thanks to supply-demand imbalances and the lack of a property construction crash in China, the commodities complex is more resilient today than compared to 2015. In this state of the world, there is a strong investment case for holding high quality government bonds. The US offers the best value at present, with a central bank that has the most capacity and likely growing willingness to cut interest rates sooner rather than later. That then presents the green light to more reluctant central banks elsewhere to engage more wholeheartedly with the next easing cycle. Look for income among only the highest quality investment grade credit, and don't be fooled by the ratings alone. The US investment grade space, for example, only provides a false sense of safety, as negative ratings migration is likely to be an ongoing theme for US corporates as this period of economic expansion gradually grinds to a halt. As for the renminbi, position patiently for a break of 7.0.

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