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Featured G

Here Comes the Storm

Tracy Chen, CFA, CAIA |

President Donald Trump's show of force at the G7 summit, his historic handshake with Supreme Leader Kim Jong-un, and the temporary calm amidst his ongoing trade conquest with China are such fleeting details for investors to keep abreast of. Trump's flip-flop tweets add further uncertainty to the geopolitical situation. We sort through the noise and suggest what markets should focus on. Rather than intently watching both countries volley retaliatory measures, we think it's more valuable to look at renminbi valuations and the direction of China's interest rates. Of course, the future of trade will have an impact on the financial conditions of both countries.

The Fragile and Short-Lived Trade Truce

Markets reacted positively in late May to the joint statement issued after the U.S. delegation's trip to China. On the surface, it was definitely a step in the right direction and eased tension after rounds of tariff threats and sanctions. We detail the initial truce, how China could increase imports from the U.S., and how this initial agreement soured here.

The First Gunshot of the Trade War

The trade truce was very short lived. Fast forward to June 15, when the trade war seemed to resume and potentially escalate. The saga will not have a quick and happy ending that easily. There will be a long, drawn out stand-off between the two countries, revolving around three phases:

1. A near-term trade scuffle
2. A medium-term technology competition
3. A long-term strategic rivalry

With the continuous negotiation between U.S. and North Korea adding another layer of uncertainty and complexity to the trade negotiation, we don't think this tariff imposition is necessary as China has extended an olive branch by offering to purchase $70bn of goods including autos and food, on the condition the U.S. abstains from imposing tariffs. Furthermore, China has cut tariffs on auto imports from 25% to 15% and taken some other various measures to open financial market access, such as removing the lock-in period and repatriation restriction for both Qualified Foreign Institutional Investors (QFII) and renminbi QFII (RQFII) program. Onshore currency hedging permission is also granted. Due to this market access, portfolio inflows into China's onshore bond and stock market have partially offset the narrowing current account surplus.

If China shifted its import source from other trading partners to the U.S., the countries that currently rank as top partners could be negatively affected:

Chart 1: Ranking of China's Import Sources

As of 5/2018

	Beef	LNG	Chemical	Transport	Machinery & Electrical Equipment
1st	Brazil 28%	Australia 26%	EU 25%	EU 48%	Taiwan 17%
2nd	Australia 22%	Qatar 19%	Korea 15%	U.S. 28%	Korea 17%
3rd	Uruguay 21%	UAE 13%	Japan 13%	Japan 16%	Japan 12%
4th	New Zealand 13%	U.S. 10%	U.S. 11%	Korea 3%	EU 11%
5th	Argentina 12%	Malaysia 6%	Taiwan 7%	Thailand 1%	Malaysia 6%

Note: Numbers represent share of the country in China's imports by sector.

Source: CEIC, Morgan Stanley Research

Why the Sudden Change?

The sudden about-face turn from the temporary trade truce to the imposition of 25% tariff on $50bn of Chinese exports has three implications:

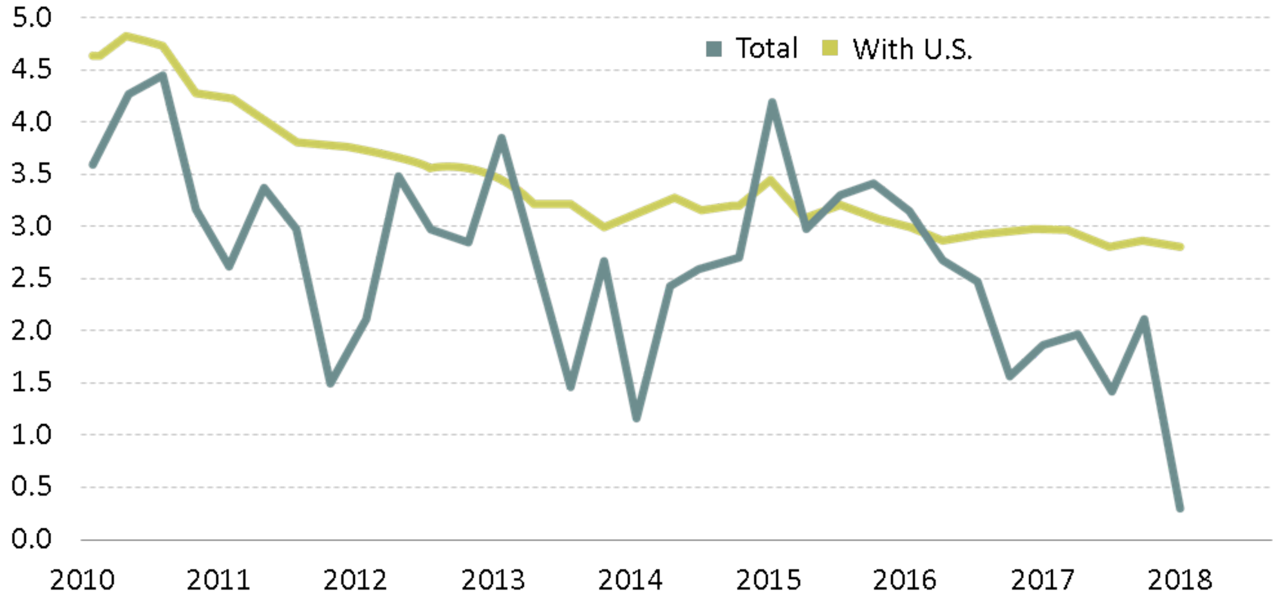
1. **There is disagreement between the dovish Secretary of Treasury Steven Mnuchin and hawkish members of the administration like the president's economic advisers, Robert Lighthizer and Peter Navarro. The debate centers on whether a quick win on trade before the U.S. mid-term elections or a tough stance demanding structural adjustment from China's industrial policy is a better solution. Both sides of the presidential administration are competing to win over Trump and jockey for his influence. This dichotomy illustrates the fickle nature of this trade negotiation and the internal contention with the president's own cabinet. Therefore, China—as well as other U.S. trading partners—know that anything agreed upon with the U.S. can be pulled back later.**
2. **This sudden change also runs parallel to the tariff that Trump has imposed on his allies like Canada and the European Union (EU). He can't afford to be tough on allies and soft on China. So if China is not an isolated case, this may turn into a global trade war.**
3. **The trade conflict will mostly intensify given the mid-term Congressional election is coming. Trump needs to appease to his base whereas Xi has less pressure on that front. Not until a new trade equilibrium is reached will we see escalations and the eruption of a tariff war. Therefore, we expect temporarily calm intermissions from behind-the-scenes negotiations that will bubble up into more retaliatory rhetoric and policymaking.**

A Snapshot of China's Economic Health

Despite the trade war noise, China's latest import and export activities have been quite robust, driven still by global growth, front-loading exports due to trade conflict and strong domestic demand via consumption. China's total trade surplus kept narrowing, but not with the U.S., indicating the trade imbalance is not an easy fix through administrative policies.

Chart 2: China Goods & Services Trade Balance As % of GDP

% GDP, As of 3/31/2018



Source: Brandywine Global and Haver Analytics

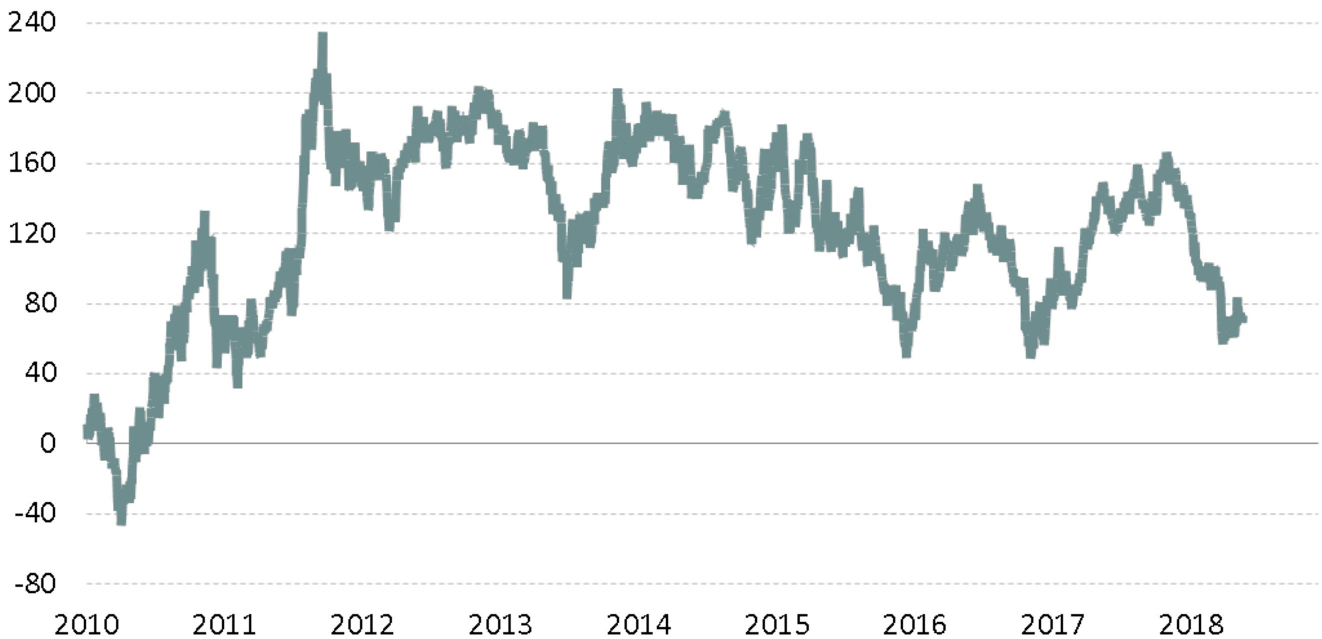
The direct impact from the above tariffs on gross domestic product (GDP) growth is very small, given China's exports to the U.S. is to the magnitude of $500 billion. However, it is disruptive in global supply chain and it is a sign of ratchetting up trade tensions with further retaliations from both sides possible. $50bn looks like just the first tranche of a potential larger tariff coverage. Mutual investments between the two countries will be negatively impacted as well. American multinationals with footprints in China are now bracing for a harsher operational environment. Consumers in both countries will endure more pain and potential price inflation. Furthermore, the review of China's ZTE Corporation—which faces U.S. Congressional sanctions—currently favors penalties as opposed to an outright ban, and may improve the chance of a trade deal between U.S. and China. However, the final verdict is still up in the air.

What Really Matters, At Least to Us

The ongoing uncertainty with respect to the trade conflict, technology competition, and the strategic rivalry between the U.S. and China has become the new normal. It is unavoidable due to the rise of China and its vastly different social system. The perception that the trade conflict can be easily resolved is probably naïve. One thing is certain: there are ebbs and flows with varying intensities. The big question for investors is the future direction of renminbi and China rates. The Federal Reserve (Fed) hiked rates in June, whereas the People's Bank of China (PBoC) did not follow suit as it is concerned with exogenous shocks from the incipient trade war. As the chart below shows, the narrowing gap between China onshore rates versus U.S. rates exerts downward pressure on renminbi versus the dollar.

Chart 3: China 10-Year Government Bond Spread to U.S. 10-Year Government Bond

BPs, As of 06/13/2018

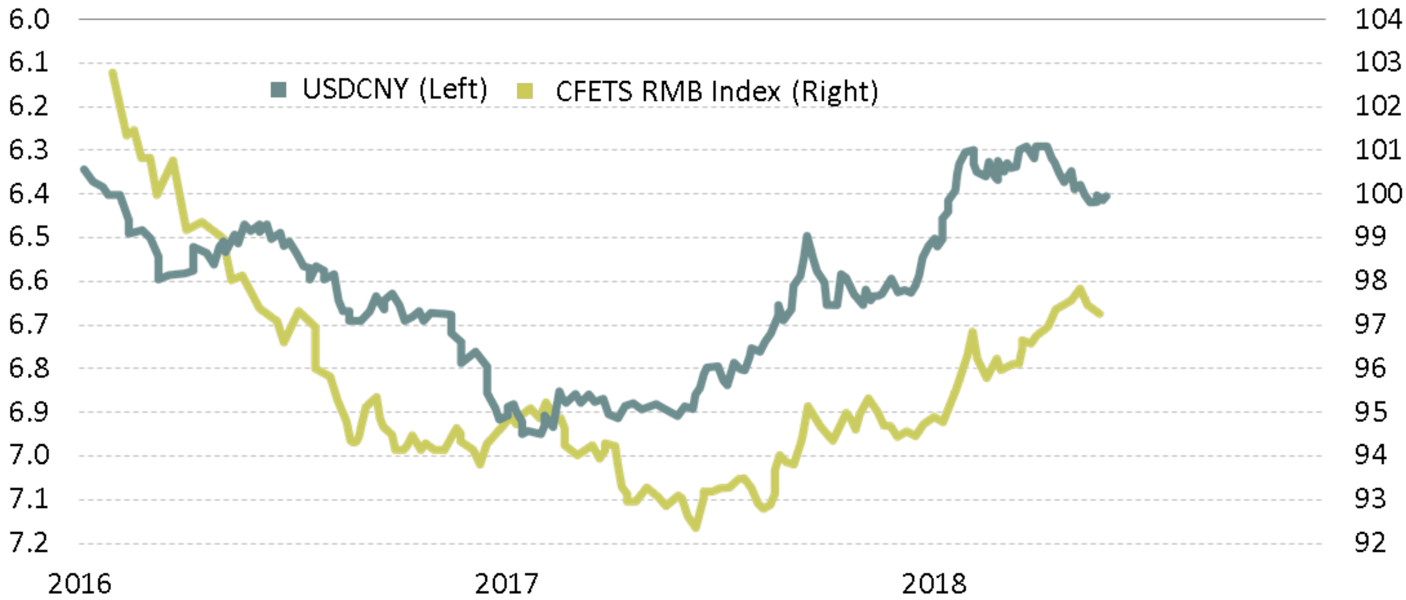


Source: Brandywine Global and Haver Analytics

China's renminbi has been strengthening against both the dollar and the basket of currencies (CFETS) since 2017, and reversed starting in April 2018 due to the acceleration of dollar strength as a result of China's reserve requirement ratio (RRR) cut. The renminbi's next move will depend on the dollar; if the dollar strengthens from here, the renminbi's rally against the basket of currencies will decelerate. If the dollar weakens from here, the renminbi will have the luxury of moderate weakening to ease monetary conditions. However, we don't think China will use the renminbi as a tool in a potential trade war.

Chart 4: Renminbi Valuations

As of 6/8/2018



Source: Brandywine Global and Haver Analytics

China's foreign reserves declined slightly recently, indicating there are some capital outflow leaks, which implies there is limited room for further monetary easing. Given the uncertainty of external trade negotiations and burgeoning corporate defaults, we believe China will ensure domestic stability and support growth through moderate easing of monetary conditions or fiscal support. More RRR cuts should be on the horizon to relieve a potential liquidity squeeze or a slowdown due to external pressure. This relative easy policy should portend better performance of Chinese assets, including equities and onshore bonds.

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