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Investment Talks:
US-China Trade War: Walking a Tightrope

INVESTMENT TALKS

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- **Recent escalation:** Donald Trump proposed additional 10% tariffs on a further US$300 billion worth of Chinese imports from 1 September. This is surprising, given that the two countries appeared to have found some common ground at the G20 meeting in June. However, the truce was short-lived and China responded with its own set of measures in form of a suspension of US agricultural imports and currency devaluation, which could further escalate the situation.
- **Economic implications:** Global trade will remain under pressure. There is no reason to expect a recession, but the impact on growth will be sufficient to change economic policies, starting with monetary easing. Most central banks in emerging countries are also in an easing mode. The risk now is that the trade war will turn into a currency war. The trade war will redesign the map of global value chains and some economies may therefore be able to benefit from new foreign direct investments.
- **Investment implications on emerging markets (EM):** A long term trade war could reduce global growth, caused by a slowdown in China and the US. However, this trade war could very well be a fight for global supremacy between the two leading economies. Some emerging countries more focused on domestic demand and restructuring of global supply chains may be better able to navigate the volatility, whereas others that are well integrated in the present technology chains would suffer the most. Investors should stay clear of any extreme positions and adopt a more defensive approach. On EM debt in hard currency we believe that liquidity by central banks will continue to be supportive, while we are more cautious on EM currencies, especially in Asia.
- **Investment implications on asset allocation:** The US formally designated China as a currency manipulator but it is not clear what specific actions the two sides would take. However, what's clear is that investors would not like the uncertainty and the impact it has on business decisions. We are in a late cycle phase and believe that a cautious approach is recommended through a positive stance on US treasuries (although somewhat reduced after the strong rally) and a cautious view on equity. We think that this phase of volatility may open selective opportunities in equities across the emerging and developed market spectrums. Investors could also look at gold to mitigate volatility. All in all, we prefer defensive themes in light of the current market backdrop.

Do you believe that the recent escalation on the trade war represents a turning point and what are the implications (of the additional tariffs) on global trade, the Chinese economy and global economic growth?

The truce in the US-China trade war announced in late June at the G20 meeting has proved short-lived. Donald Trump decided to "dig up the hatchet". It has become increasingly difficult to distinguish between simple announcement effects (aimed above all at pleasing his electoral base) and a more fundamental strategy of confrontation with China. Although it is possible that the American and Chinese authorities will eventually find a common ground, recent events clearly do not pave the way for an agreement anytime soon. Continued tensions between the US and China are inevitable, at least in the short run.

It will now be difficult for Donald Trump to calm things down. Even in case of a subsequent de-escalation, the damage is done. Global trade will remain under pressure due to uncertainty caused by trade tensions that have become recurrent and unpredictable. Macroeconomic simulations released by the OECD in the spring showed that this could cost a few tenths of a percentage point growth in advanced economies. Tensions are also disrupting global value chains and weighing on business investment, in particular in the trade-sensitive countries in both the developed and the emerging world. As a result, the manufacturing sector may weaken further. In the Eurozone, it is clearly the German economy that is the most sensitive. However, the Eurozone as a whole — that is twice as open as the US economy — would naturally not escape unscathed. Ultimately, growth might well fall below its potential level next year in the US, Europe and Japan simultaneously.

Do you think a recession is more likely now and would you expect the Fed to fasten the pace of rate-cuts to counter the negative impact of the trade war on the US economy?

"Global trade will remain under pressure. There is no reason to expect a recession, but the impact on growth will be sufficient to change economic policies."

At this stage, there is no reason to expect a recession, but the impact on growth will be sufficient to change economic policies starting with monetary easing. The Fed would probably continue to lower rates. In fact, markets are already anticipating a decline of more than 100bps within the next 12 months, although we believe it is excessive. For the time being, the services and the consumer sectors are showing resilience. The more accommodative monetary conditions should continue to support domestic demand and the latter should also offset, at least in part, the negative impact of global trade on GDP growth. Moreover, fiscal policies will become even more supportive if growth is really threatened.

The impact on Treasury yields results from a traditional flight to quality when risk aversion rises. The decline in US long-term rates is all the less surprising because equity markets had already performed very well since the beginning of the year and the Fed has started to lower its key rates. Secondly, there is a shortage of liquid and safe assets worldwide and US Treasuries are almost the only ones to offer clearly positive returns in high rated developed countries. It is interesting to note that bond yields of all maturities have fallen (the spread between the 10-year and 2-year yields remains positive).

China has allowed the yuan to devalue and go past the 7.0 mark. Does that increase the risk that the People's Bank of China (PBoC) could proactively use yuan as a policy tool in the trade war?

"China is seeking to transform the RMB into a reserve currency, which is not compatible with a significant depreciation."

It is very unlikely that China will manipulate its currency proactively, as was also testified by the PBoC's action to limit the RMB[1] depreciation. The Chinese authorities have no interest in causing a significant depreciation because it could be counterproductive for the Chinese consumer. Moreover, it is important to note that China is seeking to transform the RMB into a reserve currency, which is not compatible with a significant depreciation. The RMB is expected to play the role of a regional anchor.

Chinese authorities are probably seeking to stabilise their nominal effective exchange rate to offset the negative impact of tariffs on the competitiveness of their products. The economic slowdown in China is inevitable and well accepted by the authorities. The latter will act first and

[1] RMB = Chinese Renminbi

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"The trade war will significantly impact global growth, particularly in Asia and in Latin America."

"Countries such as India, Vietnam and Thailand would be better able to navigate the uncertainty. However, South Korea and Taiwan may see potential disruption of supply chains."

foremost to safeguard China's long-term interests. The priority is to ensure an orderly slowdown. Therefore, measures to support domestic demand are more likely than exchange rate depreciation. However, it cannot be ruled out that the RMB may weaken further in the short term, as a warning to the US and Donald Trump.

What is your view on major EM central banks moves?

Most central banks in emerging countries are already in an easing mode. The weakening of the dollar sought by Donald Trump may lead them to lower their key interest rates even further. The risk is that the trade war will turn into a currency war. In an environment where central banks are simultaneously seeking to lower their rates, there should be more volatility in the foreign exchange market. Having said that, it should be borne in mind that trade war can favour countries — in the medium term — that will benefit from the relocation of production to their territories. It is therefore necessary to distinguish clearly in the current period, the short-term effects (harmful for all), from the medium and long-term effects. The trade war will redesign the map of global value chains. Some economies will therefore be able to benefit from new foreign direct investments. Rather ironically, heightened risks will offer opportunities.

INVESTMENT IMPLICATIONS ON EMERGING MARKETS

With trade war being one of the major risks for EM investing, how do you see the opportunities and risks evolving in the EM equity space and more specifically in Chinese equities?

The US-China trade war is one of the main issues investor must face when investing in EM, as it will significantly impact global growth, particularly in Asia including Japan, Korea and Taiwan and also in Latin America. Unfortunately, what started as a trade war looks more and more as a hegemony war between US and China. By simply annualising current growth rates, the Chinese economy will surpass the US in 10/11 years. It looks like US wants to try to stop this from happening or at least slow this process down as much as possible. Therefore, this is not only about trade. It is also about technology where the US, in particular in the semiconductor space, is still leading China. However, China is making quick technological advancements and is already the leader in domains like Electric Vehicles, 5G, and Artificial Intelligence.

In Asia, certain countries would be better able to navigate the uncertainty. For instance, India would benefit from a large domestic economy largely insulated from the trade war. Other ASEAN countries such as Vietnam, Thailand and Indonesia could benefit from relocation of manufacturing facilities out of China. Most of these countries, including the Philippines, would benefit from lower global and domestic interest rates. However, a potential stronger USD may be a headwind. On the other hand, countries which may be negatively impacted are the more global integrated economies of Japan, Hong Kong, South Korea and Taiwan that will see potential disruptions of technology supply chains and potential impacts in terms of export potentials.

At a sector level, investors may focus on real estate, REITs, consumption and services as these would be less impacted by the tariff war. However, financials and technology would hamper returns. In our view it is dangerous to take extreme positions, given the unpredictability of future events that could be quickly turned upside down by a new tweet from Trump and therefore we still believe investors should adopt a defensive approach.

The hunt for yield in EM bonds has been a major theme among investors in 2019. How should EM bond investors adapt to the increased risks?

The trade war escalation certainly raises downside risks to global growth. The weaker RMB will also have a global disinflationary impulse. Both make room for further loosening of monetary policy by global central banks. The impact on EM will be balanced by the collision of weaker growth vs more liquidity. While we are very cautious on the US-China trade war and see limited room for a meaningful long-lasting deal in the near term, we think global/US recession is not imminent, and more liquidity from central banks will outweigh recession risks. Therefore, we see room for further positive total returns in EM Hard Currency. In local currency, *“A scenario with no global recession and more liquidity from central banks should continue to support EM Hard Currency, while we are much more defensive on EM currencies.”*

we remain constructive on EM rates, which should benefit from downside risks to global inflation as well as room for further central bank easing in EM.
We are much more defensive on EM currencies, especially in Asia, as this asset class needs positive growth momentum. We view that to be lacking. As the next trigger, we will be watching any signs of relaxation on restrictions against Huawei as the 19th August expiration of the Temporary General License approaches.
Despite the strong performance of EM fixed income assets this year, they continue to look cheap relative to their DM counterparts. Real yields in the G10 economies are now at the most negative they have ever been. EM rates have also lost some value cushion in the recent rally, with real rates now close to taper tantrum levels of 2013. However, the differential between EM and DM real rates remains close to cyclical wides. Likewise on the hard currency space, we think EM sovereigns are better positioned than US HY to weather the trade war/growth slowdown storm. Even in the event of a further collapse in commodity prices, EM sovereigns benefit from flexible exchange rates which will help to dampen the negative impact on credit metrics.
In both external and local debt, selection is more important than ever. We have a preference for higher quality names in Emerging Markets and see room for decompression between IG and HY.

INVESTMENT IMPLICATIONS ON ASSET ALLOCATION

From an asset allocation perspective, what is your view on Developed vs Emerging Markets equities, US treasuries and Emerging Markets bonds?

“We keep a defensive approach, but we also see the recent correction in equities as a tactical opportunity to selectively search for entry points both in DM and EM equities.”

We think the latest development and the subsequent designation of China as a currency manipulator is symbolic but carries real risks for financial markets. While there is ambiguity on the precise actions that either side would take, formal consultations on currency movements is certainly on the cards. After the tariff announcement by Trump, the US formally designated China as a currency manipulator. The tariff announcement must be seen in tandem with this. All this increases uncertainty and would lead businesses to defer investment decisions, which would eventually impact global trade and economic growth.

From a multi-asset perspective, we are in a late business cycle phase. As a result, we have entered this summer period aware of a possible market correction with a positive view on US treasury duration and a cautious equity stance. We see the recent correction in equities as a tactical opportunity to selectively add exposure and search for entry points after the sell-off both in DM and EM equity universe. On the currency front, we have a positive view towards EM FX in the medium term, in order to play carry trade with USD that should progressively display levels more in-line with fundamentals. However, because of the unfavourable short-term dynamics in Asian and EM currencies caused by the sudden trade war uncertainty, we think that a temporary cautious view on EM FX would be helpful.

Given the trade war escalation, how should investors act to mitigate volatility?

“Investors may look to add gold to their portfolios and some positions in the US-inflation linked assets.”

Investors may mitigate risk by adopting adequate hedging strategy in form of physical gold or gold miners on the equity side. This would safeguard investors in case of an escalation in the currency war between the US and China. Investors may also consider to retain a positive view on US duration as a hedge, but look to marginally reduce it after an impressive rates rally. At the same time, there are opportunities in US-inflation linked assets which today display extremely low breakeven rates. Overall, the market are likely to favor defensive themes for the time being, not closing the performance gap with more cyclical sectors.

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