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INVESTMENT MANAGEMENT

(It's Not War) Just the End of Love

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On 2 March 2018, a day after announcing his first round of tariffs, targeting steel and aluminium imports from China, President Trump tweeted that "trade wars are good and easy to win." So far, however, we aren't involved in so much of a trade war with China, but a deteriorating relationship that looks more like "just the end of love," to borrow a song title from the Manic Street Preachers.

Both China and the US have a lot to lose from a trade confrontation that escalates into full-scale war. Trade tariffs, restrictions and technology controls could disrupt China's plan to address its long-term debt and hamper the rebalancing of its economy. Overall this could disrupt its Made in China 2025 strategy, a government plan to upgrade China's industry through a combination of manufacturing and smart technology. For the US, political and economic considerations also weigh against a full trade war.

China's vulnerability: A great wall of debt

A decade ago China's growth was largely driven by investment spending. This spending and increases in debt did contribute to growth; however, the impact appears in recent years to have reduced. When global growth slowed in the aftermath of the financial crisis, the Chinese government tried to stimulate growth through this spending by mandating which industries or sectors should receive investments. The banks issued loans to Chinese state-owned enterprises (SOEs), which then proceeded to invest in those areas. SOE debt represents around 70% of corporate debt.[1]

As a result, debt has increased steadily since 2008 and is now close to 300% of Gross Domestic Product (GDP) *(Display 1)*. This level of debt requires interest payments of about 12% of GDP per year.[2] The largest source of debt is less-profitable SOEs *(Display 2)*, which have contributed to GDP growth in the past.

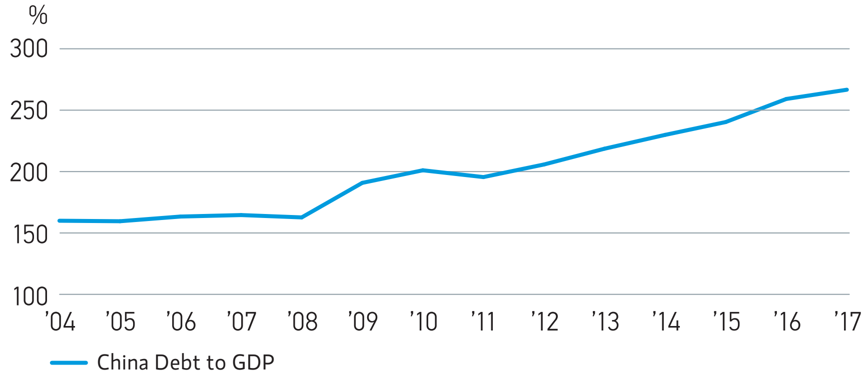
One of the objectives of the National Congress of the Communist Party of China has been to rebalance its economy and make it sustainable. Its goal was to shift the composition of GDP away from investment spending towards more household consumption, which has been growing and represents nearly 40% of GDP *(Display 3)*. It is worth noting though that investment spending can be seen as a growth leader, whereas consumer spending depends in part on consumer confidence, which is a rather less direct 'lever' if the government aims to boost growth quickly. A secondary objective is to increase productivity by shifting the investor base in China from low value-added to higher-end industries with a technological bias (i.e., the Made in China 2025 strategy).

High-tech imports and technology transfers—which the US views as forced or improper—are necessary for increasing productivity and shifting to higher value-added businesses. The Trump administration's proposed trade tariffs directly challenge these plans.

DISPLAY 1

China's massive debt buildup is growing…

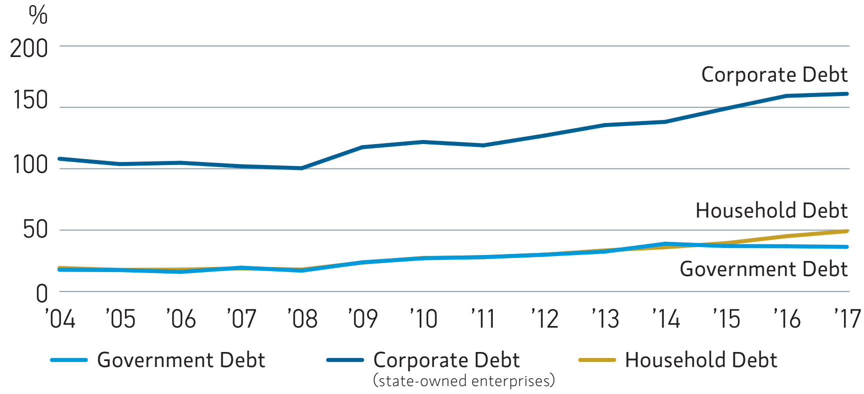
China's percentage of debt to GDP growth



Source: Bloomberg as of 31 December 2017.

DISPLAY 2

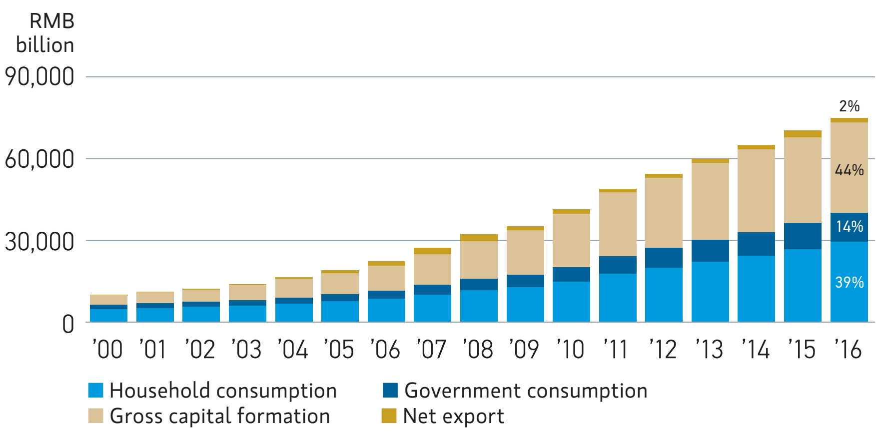
… particularly among less-profitable SOEs



Source: Bloomberg as of 31 December 2017.

DISPLAY 3

Chinese household consumption an increasingly important contributor to GDP



Source: Bloomberg as of 31 December 2016.

[1] Source: OECD, https://www.oecd.org/eco/surveys/china-2017-OECD-economic-survey-overview.pdf

[2] Bloomberg, using the 1-5 year benchmark lending rate of 4.75%, a very conservative borrowing cost.

A (politically) targeted response

China has responded to proposed US tariffs with significant sanctions against the US that will hurt regions that voted for Trump in the last election. These Chinese tariffs were designed with US politics in mind. Even if they also hurt China—for example, soybean imports are essential for the country's pork production—eight of the top 10 soybean-producing states voted for Trump in the 2016 election.

President Trump's aggressive and fast-paced approach to China may reflect his realisation that, after mid-term elections in November 2018, his ability to pass legislation is likely to be greatly diminished. And, his previous approach with steel and aluminium tariffs—headline-grabbing at first, followed by exemptions for Canada, Mexico, then the European Union (E.U.), South Korea, Indonesia and so on—lends weight to the view that this back and forth is more likely a tactic than an end game.

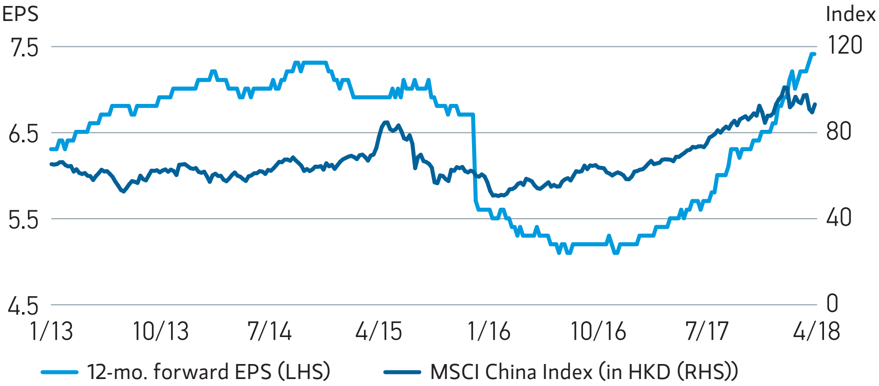
If China gets pushed into a corner, it could simply stop investing in US Treasuries. Or worse, it could start selling its $1.2 trillion[3] stockpile of US Treasury holdings. Also, the US is counting on China to help with managing North Korea, so there is an incentive from the US not to be recklessly aggressive with its policy.

The 60-day clock: Creating a deadline

The Trump administration's approach has changed the dynamics of tariff negotiations. In the past, when the US attempted to renegotiate trade terms, it usually talked first, and then waited for a response before acting. But speaking without deadlines created delays; the US could talk itself blue in the face and nothing could happen.[4]

DISPLAY 4

Rising earnings driving China's market higher



Past performance is no guarantee of future results. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. See Disclosure section for index definitions.

Source: IBES, Datastream; data is in local currency terms.

In contrast, the Trump administration has announced a strict deadline and serious consequences if negotiations fail. These tariffs have a 60-day negotiation window before they kick in, which increases pressure for meaningful concessions on both sides.

The markets expressed concerns that this announcement would heighten the "threat, counter-threat" situation, but those are not the dynamics we are seeing. The Trump administration has no need to continue escalating its threats because it has what it wants: A reasonable period of time to reach an agreement with concessions, and a deadline to increase that likelihood.

There is a risk that the two parties will fail to reach an agreement by the deadline, triggering the tariffs. At that point, we could see an escalation. But we think it is more likely that concessions will be made that could start to resolve longstanding global imbalances.

Wild swings, but no downward trend

In an environment where investors are already jittery in the face of tightening monetary policy, an aggressive approach to negotiation between the two largest economies has ignited extreme market volatility and uncertainty. And this is not your usual kind of volatility; since the selloff in early February, which was triggered by rising rates, the market has experienced wild intraday swings, but hasn't really trended down. We expect this pattern to continue because we think that these trade threats are a negotiating tactic—not an attempt to destroy global trade.

Growing capital investment, a favourable GDP outlook and record levels of unemployment suggest a strong global economy. The outlook for Chinese equities is also supportive, with prices rising in line with earnings trends *(Display 4)*. Moreover, valuations remain supportive whilst analyst revisions of forward earnings have recently turned higher.

[3] Source: Department of the Treasury/Federal Reserve Board, Major Foreign Holders of Treasury Securities, published 16 April 2018. http://ticdata.treasury.gov/Publish/mfh.txt

[4] See e.g., *The US's Act First, Talk Later Approach to Tariffs*, Jim Caron, MSIM Global Fixed Income team, 5 April 2018. "In the past, the US elected to talk first, act later. As a result, China just used delay tactics until the US political climate lost its will to press trade talks any further. This has been a successful tactic for the Chinese. But that's over now."

Strategy: What to do, what *not* to do

This outlook implies investors should seek to trade around that volatility. When the market dives, it almost certainly—and we emphasise "almost"—sets off an overreaction that should lead to buying opportunities. Similarly, when it rallies again, it's likely an overreaction to selling. This is currently happening much more than usual.

Investors can choose to either refrain from trading and endure the volatility, or they can try to manage the volatility to take advantage of price distortions. This means buying into sharp declines to a limited degree and selling into rallies, while each time aiming to rebalance holdings to asset classes that appear to be relatively attractive at the time. The one thing they should not do is follow the momentum.

Given the positive economic backdrop for equities, investors should generally consider maintaining as much equity exposure as they can throughout the market's ups and downs. In a market this volatile, there is no way to anticipate when an upward trend will occur, so investors sitting in cash are likely to miss out if the market rebounds. They should, however, hold enough cash to avoid being forced to sell equities after a market downturn.

Selectivity is crucial

Should trade war tensions escalate, some obvious beneficiaries would be Latin American producers of soybeans like Brazil and Argentina and European sectors that would gain as China shifts trade out of the US. Some countries, though, may feel negative repercussions. Countries that are very integrated in the supply chain of products that are exported from China to the US—such as Japan, Korea, South Korea or Taiwan—could suffer from secondary effects resulting from a reduction in exports to the US.

We do not actually foresee a trade war. Therefore, we will be looking for opportunities to take advantage of market overreactions to headlines. One strategy would be to selectively buy sectors and countries that are expected to be hurt or oversold and selling those perceived to be beneficiaries or overbought.

An opportunity to harness the power of risk

So far, the tariff tantrum between the US and China represents more of "a love lost" than a full-blown trade war. Both sides seem unlikely to risk the significant economic damage, imbalances and political risks that could result from a prolonged trade war. We view the threats as negotiating tactics that may help resolve longstanding global imbalances.

Yet, markets have reacted to these tactics with dramatic intraday rallies and corrections. We can expect these overreactions to persist as long as the negotiations drag on. These swings are, in our view, opportunities to take advantage of price distortions, if one can to trade around volatility. Rather than blindly chasing momentum or sitting it out completely, investors should consider a more strategic approach.

Risk Considerations

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