Trade war

By Jan Dehn

The US has taken unilateral action to start a potential trade war with China. This is a policy mistake of gigantic proportions resting on a misunderstanding about how open economies work. The direction of US economic policy contrasts sharply with Chinese policies and we expect only a measured, proportional and targeted response from China, which will remain open to deeper trading ties with third countries. This week's research examines the likely ramifications of a US-led trade war with China for Europe, UK and Emerging Markets (EM).

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.4	–	-1.74%
MSCI EM Small Cap	11.5	–	-1.48%
MSCI Frontier	11.3	–	0.33%
MSCI Asia	11.9	–	-2.40%
Shanghai Composite	10.7	–	-4.44%
Hong Kong Hang Seng	7.2	–	-3.66%
MSCI EMEA	10.0	–	-0.29%
MSCI Latam	12.5	–	0.66%
GBI-EM-GD	6.06%	–	1.32%
ELMI+	3.21%	–	0.60%
EM FX spot	–	–	0.85%
EMBI GD	5.84%	299 bps	-0.25%
EMBI GD IG	4.60%	174 bps	-0.19%
EMBI GD HY	7.16%	432 bps	-0.31%
CEMBI BD	5.57%	277 bps	-0.36%
CEMBI BD IG	4.60%	181 bps	-0.24%
CEMBI BD Non-IG	6.80%	400 bps	-0.51%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.4	–	-1.99%
1-3yr UST	2.30%	–	0.06%
3-5yr UST	2.62%	–	0.08%
7-10yr UST	2.83%	–	0.10%
10yr+ UST	3.08%	–	0.20%
10yr+ Germany	0.51%	–	0.77%
10yr+ Japan	0.04%	–	0.29%
US HY	6.24%	352 bps	-0.25%
Barclays Ag	–	248 bps	-0.20%
VIX Index*	20.50	–	2.30%
DXY Index*	89.46	–	-0.91%
EURUSD	1.2383	–	1.16%
USDJPY	105.73	–	-0.75%
CRY Index*	196.49	–	2.34%
Brent	70.8	–	4.95%
Gold spot	1343	–	2.38%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

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Economists have known for hundreds of years that protectionism is bad for growth, encourages rent-seeking and destabilises relations between nations with negative implications for investment. Even so, protectionism continues to raise its ugly head when conditions are such that populist politicians can dress up tariffs as acts of defence in the national interest, i.e. usually during periods of economic stress or rising inequality. Ironically, impediments to free trade almost invariably benefit the few at the expense of the many. The poor tend to suffer most of all. Protectionism also tends to be contagious; when one country starts imposing tariffs, retaliation is easily justified on political grounds in the affected countries. The risk is an ever-expanding and mutually reinforcing cycle of escalation with spiralling costs to all involved.

Today, it is also impossible to ignore the historical parallels. Trump's unilateral imposition of tariffs mirrors the start of the breakdown of trade relations and growing isolationism, which characterised the aftermath of the 1929 Crash and the Great Depression in the 1930s. Discontent in this period ultimately fuelled the rise of Communism and Fascism as voters increasingly sought what, in the final equation, proved to be false comfort in strong authoritarian governments as the old economic order collapsed.

A protectionist America poses difficult dilemmas especially for Western economies. Europe and Britain in particular have deep historical ties with the United States. The UK and the US have stood shoulder to shoulder in defence matters for more than a hundred years, including two world wars. Europe and the US have been locked into the NATO alliance for decades. Cultural links are deep and both sides of the Atlantic have, until now, been in broad agreement about the role of markets, the importance of regulation and Democracy itself.

Yet, Trump's America appears bent on abandoning free trade, which has been such a key pillar of Western prosperity. The timing could not be worse. The European Union (EU) is only just pulling back from the brink of the Eurozone Debt Crisis. Some of Europe's banks are still far from healthy and the EU has yet to put in place a framework for centralised fiscal policy, which is so essential to avoid a repeat of the crisis of 2011/2012.

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Clearly, pending further progress in strengthening the domestic policy framework Europe can ill afford an external shock to exports. A trade war with its largest trader partner would seriously weaken Europe.

The UK is similarly vulnerable to US protectionism. Brexit not only promises to isolate the UK from the EU, but also reduces the country's relevance beyond the EU itself. Thus as the UK withdraws from its largest trading partner, it needs free trade with America more than ever. Never mind about Brexit, say the ever-hopeful Brexiteers, the UK can forge a bright future for itself outside the EU by striking a free trade deal with the US. However, Trump's lurch towards protectionism, which so far includes tariffs on imported steel and aluminium and last week's unprovoked attack on Chinese export to the US, shows that America's commitment to free trade is not what it used to be. Moreover, the changes are coming from the very top; Trump himself says there is more protectionism to come. It would be naïve of the UK to dismiss the threats.

So, difficult as it may be for Europe and the UK to accept, the fact remains that the US is turning inwards and Europe and the UK's national interests may no longer be best served by always siding with the US, especially when it comes to economic policy.

Thankfully, there is a silver-lining to this particular cloud. Neither the UK nor Europe has to depend solely on US for trade if they so choose. The single most important development in the global economy in recent years has been the rise of China from the status of a secluded Asian backwater to one of the world's major economic powerhouses. For the first time ever the rise of China now offers genuine and realistic optionality for America's abandoned trading partners.

The key insight is that China's economy is now on track to be two to three times larger the US economy by 2050. This has numerous implications. For example, it means that London and possibly other major European cities, such as Frankfurt, Amsterdam and Paris should push hard for deeper ties with China. After all, size matters a great deal in finance. By virtue of the scale of China's economic growth over the coming decades China's financial markets are destined to replace US markets as the world's benchmarks for stocks, bonds and currencies in exactly the same way that US markets replaced those in the UK as global benchmarks in the interwar years. If London wants to retain its standing as the world's largest financial centre the UK must turn East, not West. If the UK makes a mess of Brexit, which is quite possible, then one or more European cities stand to gain.

The case for looking East extends far beyond finance, however. For the UK, the future as a free trading nation outside the EU can be made a great deal less precarious by deepening trade ties with China, the same applies to Europe, by the way. US consumers have been a great source of demand over the past thirty years, but they are now heavily indebted and their capacity to continue spending is likely to decline as the Fed gradually drives borrowing costs higher.

By contrast, China's consumption boom is only in its infancy. The savings rate in China is nearly 50%, which means that policies to encourage greater spending, which are now central to China's growth strategy, will unleash Chinese consumption as the single largest economic force the world has ever seen. If the UK and Europe want to export China offers significantly more upside than the US, regardless of trade policies.

A clear policy divide has been in evidence for some time between reform-friendly China on one hand and an increasingly populist America on the other.[1] Why has this divide emerged and will it be sustained going forward? Consider China first. President Xi Jinping's political standing was given a great boost in last year's Communist Party Congress and he is likely to use his newly found powers to open China's economy further. This does not mean that China will stand by idly as Trump applies tariffs, but China's response is likely to be measured and, importantly, targeted. There is no reason to expect China to U-turn on Xi's broader commitment to free trade made at Davos in January 2017. Indeed, the entire foundation of the current growth strategy in China rests on greater economic openness and China has far too much to gain from working with other nations to want to change path. Europe and the UK can therefore safely bet on China's success, because it rests on a vision of greater global involvement and China has an unremitting commitment to reform to ensure the vision is realised.

No such trust seems justified when it comes to the US. Trump's America is turning inwards based on a fundamental misinterpretation of how open economies operate. Contrary to the claims of the Trump Administration, America's trade deficit with China and other countries is not the result of the sudden adoption of unfair trade against the US. In fact, there have been no major or sudden changes in global trade policies in recent years, that is, until the Trump Administration began unilaterally to impose tariffs.

It is particularly disconcerting that the Trump Administration does not appear to understand that the reason why some, but by no means all, American companies are struggling to compete in the global market place is that US productivity is in decline and the Dollar is seriously overvalued. To even attempt to fix these problems using tariffs and debt financed fiscal expansion is not only economically illiterate, but actually likely to worsen rather than improve America's economic situation. For example, debt financing worsens productivity, while protectionism causes further real exchange rate over-valuation.

[1] For an earlier discussion of this policy divide see *'Chinese reforms and American populism'*, The Emerging View, November 2016.

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It is therefore clear to us that Trump's policies will not solve America's economic problems. Moreover, the record of countries resorting to heterodox policies in place of fundamental reform is that policies tend to get even more heterodox over time. This prospect holds no upside for the UK and Europe, who should recognise this as early as possible. See it. Act. Or burn.

Many of the considerations outlined above, which pertain to Europe and the UK apply equally to EM countries with a few important differences which are worth highlighting. First, most EM countries have more and recent experience with the full damaging ramifications of protectionism than developed countries. EM countries were heavily engaged in import substitution and other protectionist practices right up to the end of the Cold War in 1989. Many EM countries then went through hugely painful adjustment programmes to wean themselves off such policies in the 1990s and few will want to revisit the experience. Indeed, the past few years have been an important test of the commitment of EM countries to orthodox policies: EM countries went through major global headwinds between 2010 and 2015 without resorting to protectionism. Hence, the odds that they should do so now that their economies are doing better are low, in our view.

Second, a trade conflict between China and the US will not have major ramifications for other EM countries. For one, EM countries now trade a lot more with each other, while trade with China is actually a far larger share of total trade in the US than in most EM countries.[2] A slowdown in China and the US as a consequence of trade tensions will therefore only have a marginal impact on EM countries compared to the direct impacts on the US and China. Recall that EM economies suffered big downturns in trade during the economic collapse in Europe and the US in 2008/2009, yet came through surprisingly unscathed. Any downturn from unilateral US tariffs is likely to be magnitudes smaller.

Third, China's entire policy framework aims at greater openness, because openness is essential to realising President Xi Jinping's ambition of making China the next global economic and financial hegemon. A trade war with the US is therefore likely to be a strictly bilateral affair as far as China is concerned. Indeed, we expect China to continue to try to fill every vacuum left behind as America shrinks from the world, just as China did when the US withdrew from the Trans-Pacific Partnership (TPP). Meanwhile, China's influence will continue to increase in other areas. China's currency, which is already an officially recognised global reserve currency, will continue to gain gravitas as the Dollar declines under the weight of America's growing twin deficits. Last week China reached a major landmark when Bloomberg/Barclays announced that China will be admitted to the Global Aggregate bond index, a key benchmark for institutional investors the world over. Other fixed income index providers as well as equity index providers are likely to follow, in our view.[3]

In conclusion, there is no doubt that America's increasing proclivity towards protectionism is bad news. Protectionism is destructive. Europe and the UK in particular will be challenged to overcome their strong pro-American biases, but they should make the effort, because economic history clearly shows that once a country embarks on protectionism their policies get worse over time. Europe and the UK would be well advised to look to China, where the commitment to free trade is rock solid and where the prospect of strong consumption in the years ahead will reward early movers. EM countries are less enamoured of the US and better equipped to withstand US protectionism than ever before. They trade more among themselves and depend less on China than, say, the US. EM countries are also more acutely aware of the dangers of protectionism and their improving economies performances will, if anything, reduce the temptation to intervene in the free flow of goods and services.

[2] For more details see *'Intra-EM trade'*, The Emerging View, September 2017.
[3] For a detailed explanation of what Chinese bonds can do for EM investors please see *'How Chinese bonds can enhance your portfolio'*, The Emerging View, March 2018.

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Global backdrop

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.96%	2.31%	25.14%	10.04%	5.70%
MSCI EM Small Cap	-1.88%	-0.45%	18.06%	7.69%	4.81%
MSCI Frontier	0.62%	4.81%	25.80%	8.15%	8.53%
MSCI Asia	-0.76%	1.38%	26.63%	10.27%	8.78%
Shanghai Composite	-3.86%	-5.23%	-2.17%	-3.42%	8.97%
Hong Kong Hang Seng	-1.49%	4.17%	21.08%	4.59%	6.29%
MSCI EMEA	-2.81%	1.34%	17.87%	6.77%	1.23%
MSCI Latam	-0.85%	8.20%	19.36%	10.72%	-1.42%
GBI EM GD	0.97%	4.39%	11.88%	5.11%	-0.65%
ELMI+	0.69%	2.52%	8.72%	3.72%	-0.10%
EM FX Spot	0.34%	2.36%	4.01%	-1.74%	-6.29%
EMBI GD	-0.49%	-2.51%	3.45%	5.57%	4.51%
EMBI GD IG	-0.34%	-3.00%	2.30%	3.06%	3.15%
EMBI GD HY	-0.63%	-2.07%	4.58%	8.64%	6.08%
CEMBI BD	-0.46%	-1.40%	3.66%	4.97%	4.09%
CEMBI BD IG	-0.29%	-1.61%	2.32%	3.13%	3.36%
CEMBI BD Non-IG	-0.68%	-1.11%	5.58%	7.88%	5.02%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-1.91%	-0.12%	15.66%	11.22%	13.51%
1-3yr UST	0.11%	-0.24%	-0.06%	0.40%	0.50%
3-5yr UST	0.22%	-1.02%	-0.46%	0.55%	0.77%
7-10yr UST	0.48%	-2.61%	-0.93%	0.16%	1.01%
10yr+ UST	1.23%	-4.98%	1.59%	0.07%	3.00%
10yr+ Germany	2.34%	0.84%	0.51%	-0.85%	5.24%
10yr+ Japan	0.62%	1.18%	2.70%	3.97%	4.30%
US HY	-0.70%	-0.96%	4.59%	5.21%	4.98%
Barclays Ag	-0.33%	-1.96%	2.58%	2.62%	3.34%
VIX Index*	3.27%	85.69%	64.00%	36.03%	55.89%
DXY Index*	-1.27%	-2.89%	-9.78%	-8.05%	7.50%
CRY Index*	1.31%	1.35%	7.32%	-8.68%	-34.10%
EURUSD	1.55%	3.15%	13.97%	13.73%	-3.11%
USDJPY	-0.89%	-6.18%	-4.46%	-11.26%	11.94%
Brent	7.57%	5.82%	39.43%	25.44%	-35.49%
Gold spot	1.83%	3.03%	7.03%	12.00%	-16.36%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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