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Chinese reforms and American populism

By Jan Dehn

How will the relationship between the US and China evolve during Donald Trump's time in office?

The details are impossible to predict, but we expect two dominant themes to emerge in the course of the next four years. First, we expect China to increase its geopolitical influence significantly as America shrinks from the international stage. Secondly, the RMB will continue its pre-ordained path towards global reserve currency supremacy – to eventually replace the Dollar. These developments are the natural consequences of continued emphasis on reforms and greater openness in China and the descent into populism and protectionism in the US.

Global markets have been busy pricing in something approaching perfection in the US outlook since Donald Trump's election as president of the United States. The reality is likely to look rather different: fiscal stimulus and financial deregulation will create more inflation than growth and widen the trade deficit, while protectionism will lower the US trend growth rate. America's withdrawal from the international stage will also change the global geopolitical balance.

Countries and industries the world over will be affected by these changes. Some will benefit, others will lose. However, the most important question from a global investment perspective is how the relationship between China and the US will evolve during Trump's time in office.

We believe that two broad developments will emerge to dominate the relationship between the US and China over the next four years. The first is that China's influence as a global economic and political power will increase as America shrinks from the international stage. The second development will be the Renminbi's growing challenge to the Dollar's current status as the pre-eminent global reserve currency as inflation returns to the US.

At root, both these developments are the direct consequence of the policy priorities of the Chinese and US governments. China is continuously reforming and opening its economy and is about to embark on the largest consumption boom the world has ever seen. By 2050, China's economy will be four times larger than the US economy. By contrast, the US appears set to turn inwards and rely ever more on stimulus rather than reforms. In our view, investors with longer-term investment horizons would therefore be wise to fade the current jubilation in markets about the outlook for Trump's America and look more closely at the world's next economic and political hegemon, China.

China's influence as a global economic and political power will increase as America shrinks from the international stage

Trump's domestic policy focus

Markets have made a meal of Trump's campaign references to trade wars, 45% blanket tariffs on Chinese imports and the dissolution of trade agreements ranging from NAFTA to TPP. We think these risks are significantly overstated. In fact, we expect Trump to focus mainly on the domestic policy agenda in his first term, not least because it would undermine his chances of re-election in 2020 if he were to commit the cardinal error of focusing too much on trade and foreign policy in his first term.

Donald Trump's successful election campaign rested on a promise to fix a distinctly domestic problem, namely the declining quality of life of America's beleaguered working classes. To deliver on his promise his remedies must also primarily be domestic in nature. The American way is to raise growth rates, to create jobs, to lift all boats on a rising economic tide. Attacking foreigners will simply not achieve this, because foreigners are ultimately not to blame for America's recent stagnation and rising inequality. We therefore expect Trump's policies to have a clear domestic focus in his first term, where the new president will be kept extremely busy dealing with Congress on matters ranging from corporate tax legislation, infrastructure spending and budgets to repealing or materially altering Obamacare, America's climate commitments and financial sector regulation.

The lessons from history are also quite clear on this point – the political capital of newly elected presidents is highest in their first term, so this is when they must seek to pass legislation. It is prudent to preserve the discretionary powers vested in the presidency in the areas of trade and foreign policy to the second term, when most presidents have become lame

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ducks. Jimmy Carter and George Bush Sr. both became bogged down in foreign policy issues in their first terms and it cost them their second terms. They have gone down in history as loser presidents and Trump will not want the same fate.

This is why investors should not expect fireworks on the foreign policy front in Trump's first term. We certainly do not expect a trade war and the odds of a blanket 45% tariff on Chinese imports are poor, in our view, particularly since the US yield curve already faces bear steepening pressures, which could worsen significantly if China were to retaliate by selling its large stock of US Treasury bonds.

Indeed, the early announcement that the US intends to withdraw from the Trans-Pacific Partnership (TPP)[1] may turn out to be the major trade policy initiative of Trump's first term. Although we expect other trade policy measures, we think they will have more bark than bite, aimed as much at American businesses as foreign ones. Outright protectionism will be very industry specific and targeted at the most inefficient American industries, such as steel. In other words, the costs will be industry or even company specific, and as such will not pose a systemic risk to global trade.

The collapse of TPP has left an enormous vacuum in terms of economic leadership in the Pacific Rim, which China is certain to fill

Shifting geopolitical tectonic plates

The geopolitical implications of Trump's first-term focus on domestic policy are far greater than the economic fallout. Take the Trans-Pacific Partnership (TPP) as example. Remember that TPP was a US-led initiative specifically designed to limit the growing political and economic influence of China in Asia and Latin America. Yet, now it is the US itself, which is pulling out as clear a signal as one can get that America wants to play a much smaller role on the international political stage.

The collapse of TPP has left an enormous vacuum in terms of economic leadership in the Pacific Rim, which China is certain to fill. Indeed, China has already made great strides in forging closer ties with several Asian and Latin American countries, including the Philippines, Malaysia and Chile. More will follow. For example, the demise of President Park Geun Hye in South Korea may well see power shift to the Minjoo Party, which favours a much more balanced relationship between China and the US.

But TPP is a mere detail in the broader picture of rising Chinese global dominance. A realisation is growing among Asian and Latin American countries that their interests may be far better served by getting closer to China. It is simply a matter of cold economics – Chinese consumption will grow even faster than the GDP and China will eventually become a current account deficit country. In other words, China is just starting what will eventually be the largest consumption boom the world has ever seen at a time when heavily indebted US consumers face greater debt service costs in a rising interest rate environment.

Seen in this light, it is entirely rational for Asian and Latin American exporters to shift their focus from America to China. A stagnating, deleveraging and increasingly protectionist America is simply no match for a reforming, consumer oriented and increasingly open China when it comes to serving the national interests of exporters all along the Pacific Rim and elsewhere. And needless to say, deeper economic and trade ties beget deeper political ties too.

Trump, inflation and the Dollar

We believe the most important change in the macroeconomic outlook under Trump is not an increase in the trend growth rate. Rather, it is the return of inflation. Inflation has the potential ultimately to solve the US debt problem, but this is not consistent with the strongest consensus view in global financial markets, namely a strong Dollar. We think the market is wrong about the Dollar. The Fed will not be able to raises rates enough to crush inflation due to overvalued financial markets, an overvalued Dollar, excessive debts and low productivity. This is why the return of US inflation will ultimately be positive for the RMB.

The warning signs of US inflation have been with us for some time. The approach of almost full employment, full household deleveraging and the end of negative housing equity over several years evidence this. US core CPI inflation is already above the Fed's 2% target. If Trump now follows through with his promises of tax cuts, fiscal spending and easier credit conditions for banks inflation will rise further.

Productivity on the other hand looks set to continue to stagnate under Trump, because, as all trained economists know, trade protection and higher fiscal deficits reduce rather than enhance trend growth rates.

Of course, much depends on the Fed. However, the Fed is likely to struggle to get ahead of inflation. Never before has the Fed allowed the US economy to approach full employment with only two hikes on its books (this is assuming it hikes on 14 December). The Fed would need to hike some eight times just to get to neutral, a feat that very few analysts believe possible without triggering a severe recession. It therefore seems more likely that the Fed will raise rates more or less in line with inflation. This will keep real rates well into negative territory for the foreseeable future and won't prevent inflation from rising. The Dollar should therefore sink rather than rise as real rates decline.

The rise of RMB

If, as we expect, Trump will pull America back from the international stage and oversee a rise in inflation then the world is going to need the RBM for two basic reasons.

First, the emergence of China as the dominant global economic power will inevitably require that the RMB replace the Dollar as the pre-dominant reference currency in global FX markets, because currency markets always benchmark against the largest and most liquid currency. The RMB will do exactly what the Dollar did to the Great British Pound in the inter-war years. For the same reason, it follows that Chinese Government bonds will also replace US Treasuries as the main benchmark for bonds. That is not to say that US markets would no longer matter. Of course

[1] TPP is a trade agreement between the US and US-friendly Asian and Latin American economies. Its member states are the US, Japan, Malaysia, Vietnam, Singapore, Brunei, Australia, New Zealand, Canada, Mexico, Chile and Peru.

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the US will remain an extremely important market for both FX and bonds, but US markets will now exist within a multipolar world, where they are no longer the largest – China's are.

Secondly, markets will need the RMB in order to safeguard the purchasing power of the world's savings. Unable to repay their debts amidst a secular decline in productivity, rooted in debt itself, the US and other Western economies will ultimately have to inflate and devalue their way out from under their debt overhangs. China has anticipated this; it the reason why China pushed so hard to have the RMB approved within the SDR basket. Today, the RMB is the only currency in the SDR basket which is not a QE currency and Chinese government bonds are the only bonds among the SDR members with positive real and nominal yields. As inflation becomes more evident in the US and later in the other QE economies the risk of significant – possibly explosive – RMB appreciation will steadily increase.

The key trigger event is likely the sudden realisation among central bankers that US inflation will undermine the purchasing power of their FX reserves, which just happen to be overwhelmingly invested in the Dollar and the other QE SDR currencies. US inflation will of course also require major portfolio allocations among other institutional investors most of whom are not only limit-long Dollars, but also hardly exposed to China at all, given that China's main domestic markets are not yet represented in the main benchmark indices.

Method in the madness: China's reform agenda[2]

Many EM countries will face a challenging adjustment to US inflation. Most have done well by exporting goods and services into the debt fuelled consumption binge in the West over the past 35 years. Many have also accumulated reserves, which they have invested overwhelmingly in Dollars. China is no exception. Indeed, China's growth model of the past three decades has been based explicitly on exporting to the West and, when required, aided by currency manipulation in order to gain export share at the expense of other EM exporters.

But China is different from most other EM economies in one very important respect: China realised earlier than any other country that the crisis in 2008/2009 and its QE aftermath will ultimately end in inflation. All of China's reforms since 2008/2009 have been geared specifically to enable China to grow when inflation erodes the real demand for goods in the West and currency weakness pushes the RMB higher. These conditions have yet to be realised, which is good for China, because there is still much to be done in order for China to be ready.

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The main thrust of China's reforms is to shift from an export to a consumption-led growth model. After all, there are only two ways to grow. Either you sell to foreigners or you sell at home. As macroeconomic policies in the US and other Western economies increasingly undermine its export potential, China is turning to domestic demand.

The good news is that China has a bright future ahead as a consumption-led economy by virtue of its formidable 49% savings rate. The bad news is that China faces serious, but ultimately transitory challenges in transforming its economy. The only way to do so is to liberalise interest rates, prices and the capital account as well as developing liquid domestic bond markets. These are deep reforms that will temporarily slow growth in China, but ultimately they are the right reforms and they will ensure that China is able to grow sustainably for many more decades.

China's large debt stock is often cited as a major risk to China's future, but we do not agree. At about 250%, China's credit to GDP ratio is high by EM standards, but lower than most Western economies. However, China's elevated credit numbers reflect its high savings rates. A high savings rate translates into deposits in the banking system of about 180% of GDP, so the banking system is in fact not very leveraged, especially compared to Western banks. Besides, not only are deposits the most stable source of bank funding, but most of the credit in China has funded infrastructure investments which have long-term benefits for the Chinese economy. China is, to put it simply, a high saving, high investment, high growth economy.[3]

Conclusion

Viewed from a great height America is a nation in decline embarking on a path of populism, while China is a nation in the ascendency addicted to reforming its economy. Investors should therefore look beyond the market's myopic kneejerk reaction to Donald Trump's ascent to the US presidency.

Ultimately, the severe limitations that impeded the US economy's trend growth rate are not likely to be addressed under Trump, so the economy will have little tolerance for higher real rates and a stronger Dollar.

The return of US inflation should therefore bring the Dollar lower in the course of Trump's first term. This may help America to emerge from under its debt overhang, but it will punish those with investments denominated in Dollars.

Today, the RMB and other EM currencies are the only currencies in the world that are not being undermined by the addition to stimulus in the QE economies. The RMB in particular is a safe haven currency, because China's growth model is based on reforms and a bright future of consumption.

Investors should begin to allocate steadily and meaningfully out of the QE currencies and into RMB and a broader basket of lesser liquid EM currencies. It is safer and it pays better.

[2] For a clear exposition of the Chinese reform agenda see *"China Roadmap"*, Market Commentary, June 2015.

[3] For more details on why we view developments in China positively see *"China's R&D Revolution"*, The Emerging View, May 2015, *"Bull in a China Shop"*, The Emerging View, March 2014 and *"RMB in the SDR: The start of a new era"*, Market Commentary, December 2015.

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