Active is: Adapting to shifts in global trade

Do US-China trade tensions signal an end to globalisation?

by Neil Dwane | 25/06/2019

Summary

It looks increasingly unlikely that the US and China will reach an amicable agreement to end their ongoing trade conflict. If tensions between the two countries continue to escalate, we could witness the end of a decades-long period of globalisation – with several major implications for investors.

Key takeaways

- It seems there are good reasons for the leaders of both the US and China to avoid backing down in their ongoing trade dispute
- Higher US tariffs on imports may drive up inflation, which might compel the Fed to hike rates, boosting the US dollar but hitting US growth expectations and emerging-market assets
- The use of the dollar as an economic weapon may see the currency strengthen in the short term; this could undermine its appeal as the world's reserve currency over a longer horizon
- China might retaliate with a "don't buy America" policy, hitting US corporate profits for decades to come, and by denying US companies access to critical China-based supply chains
- Countries around the globe are likely to come under pressure to choose sides in the dispute, resulting in an increasingly polarised world

We've written extensively about the "tech cold war" that has developed between the US and China in the past year. We think it's likely to have some wider consequences for the global economy over the coming years, possibly creating two rival tech ecosystems. While there could be upside for some sectors – such as defence and cyber-security – major disruption may ensue for many of the world's largest tech and consumer company supply chains.

Like many, we expected that the more basic trade war between the US and China would be resolved by China agreeing to buy more from the US and being less aggressive in its acquisition of intellectual property (IP) and technology. Neither country would benefit from a full-blown trade war. But now we need to consider why negotiations have so far failed and what might come next.

There is little reason to think that either side will back down. In the run-up to the November 2020 presidential elections, it's clear that President Trump views the US-China trade relationship as a political opportunity at home; he considers a firm stance – against China as well as other countries – as an effective way of appealing to his voters and differentiating himself from his Democratic rivals.

Despite the apparent power that President Xi holds, it may be that he is simply unable to meet US demands regarding the legal implementation of patents and IP. Or he may face strong domestic pressure to discontinue current negotiations with the US – despite the threat of economic war. For its part, the Chinese Communist Party will be reluctant to lose face in a year when it celebrates seven decades in government. President Xi may be keen to "pretend and extend" negotiations with

the US in the hope of a change of US president.

If there's no deal...?

Any failure to reach a trade agreement could have a significant impact on the global economy into 2020 – so, what ramifications can investors expect?

- **Pain for US consumers** – Given that the US economy is 70% consumption-based, the country's consumers will be sensitive to rising import prices, in the event that the US increases or extends tariffs. The US Federal Reserve will be vigilant on US domestic inflation, although analysis suggests that inflation linked to trade war is transitory. A defensive, less dovish Fed may undermine hopes for rate cuts that would support growth, lessen the valuation support for US equities, and support the US dollar. This could also impact sentiment towards emerging markets and Asia.
- **Tensions over US dollar funding** – Taking advantage of the "exorbitant privilege" of the dollar as the world's reserve currency, the US could be tempted to use this as an economic weapon. The US dollar might strengthen in the short term, impacting both emerging-market economies and US corporate profitability. Longer-term, this course of action could undermine its appeal as the world's reserve currency, and countries may accelerate plans to reduce exposure to the US dollar – at a time when the US is issuing large amounts of Treasuries to fund its deficits.

  Moreover, recent political tensions in Hong Kong and the rising criticism of the treatment of the Uighur Muslims could also cause further financial friction, potentially jeopardising the US Hong Kong Policy Act of 1992 – which allows the US to treat Hong Kong separately from China in trade matters.
- **Pressure to choose sides** – Trade conflict could see both the US and China exert influence on their trading partners and allies, forcing them to take sides and increasing global tensions in the process. A recent flashpoint has been the arrest in Canada of Huawei CFO Meng Wanzhou, who has fought extradition to the US. Additionally, the US has exerted pressure across Europe. The swift, critical response from President Trump to the recent dovish comments by European Central Bank (ECB) president Mario Draghi may inflame tensions, not only across the auto and agricultural sectors but also towards the euro and ECB policies. This potentially widens the gap between historic allies and further undermines NATO.
- **"Don't buy America"** – For its part, China may enact a "don't buy America" campaign, which could seriously affect US corporations operating in the country and related markets, not just in the short term but for decades to come. China implemented similar – and highly effective – campaigns against Japanese and South Korean companies in 2013 in 2015 respectively, with serious implications for their Chinese operations.

  Such a policy could affect US companies' earnings and ultimately hit the S&P 500 index, especially given that its biggest sector – technology – is highly exposed to China, as an important end-market and as an intrinsic part of the US tech sector's low-cost supply chain. Furthermore, the US services surplus with China of around USD 50 billion could be vulnerable, since the role of US companies in China's banking, insurance and asset management industries is likely to be challenged.
- **Denial of access to critical supply chains** – China may retaliate by denying access to certain key areas of industrial and technology value chains, where it holds a dominant position as a supplier. This could severely disrupt the global supply chains of many industries, resulting in higher production costs and even preventing the production of some goods. One example is rare-earth metals, which are vital raw materials in almost all high-tech products – from mobile phones and computers to military and scientific equipment. With few alternative suppliers, and limited scope to stockpile, this arguably shows up the West's short-term attitude and lack of strategic planning.
- **Repatriation of Chinese companies** – China is keen to diversify and deepen its financial markets, broadening their appeal to domestic and foreign investors. This may be an incentive for Chinese companies currently listed in the US to return home to Shanghai or Hong Kong. US investors would become forced sellers and would be denied access to some of the fastest-growing companies in Asia. In another twist, US senator Marco Rubio has written to index provider MSCI expressing concern over the inclusion of Chinese stocks in its emerging-market index. Mr Rubio argues that this may expose US investors to companies with poor corporate governance. His letter is part of a wider campaign to crack down on Chinese companies operating in US equity markets, which could accelerate their return to domestic exchanges.
- **Fewer buyers of US Treasuries** – China is likely to continue to press on with its strategic policy of internationalising the renminbi, reducing its need for US dollar balances. Combined with geopolitical tensions elsewhere, the US may find there are few US bond investors to hold its booming US Treasuries issuance. China is unlikely to sell its existing US Treasury holdings as there is no other market deep or liquid enough in which to invest the proceeds.
- **China to become a better diplomatic partner** – China continues to advance its Belt and Road Initiative, offering strategic investment and market access to many emerging-market and other countries that are otherwise struggling to find growth and investment in this sluggish global economy. By filling a void left by the retreating and increasingly isolationist US, China is offering an alternative diplomatic route forward while increasing its presence and geopolitical status.

Geopolitics – a key risk factor

After a sustained period of globalisation, we are now seeing the world's two largest economies seeking to internalise more of their economic growth. They are also looking to bring other countries within their economic and political orbits. These trends could be highly disruptive to the multinational corporates that have prospered during a long period of relative international harmony, when the opening up of markets has allowed them to attract new customers around the world.

Geopolitics may play a greater role in investor decision-making from now on, as US-China trade tensions highlight visible differences in policy towards countries such as Iran, Taiwan and Venezuela. Such inconsistencies were sustainable in a growing, globalising world but will become harder to accept in a more competitive, polarised environment. Even key trading hubs like Hong Kong and Singapore might find that they are no longer able to appease both sides. With those far-reaching implications in mind, we hope the G20 in Japan at the end of June will provide a platform for a reset in relations between the US and China and an agreement to start "talks about talks".

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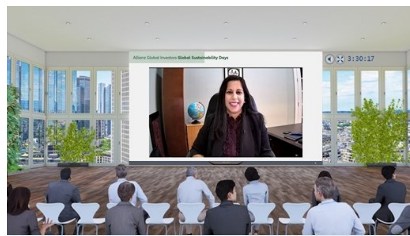

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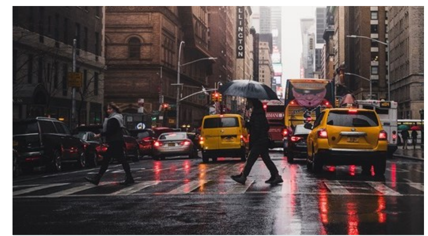

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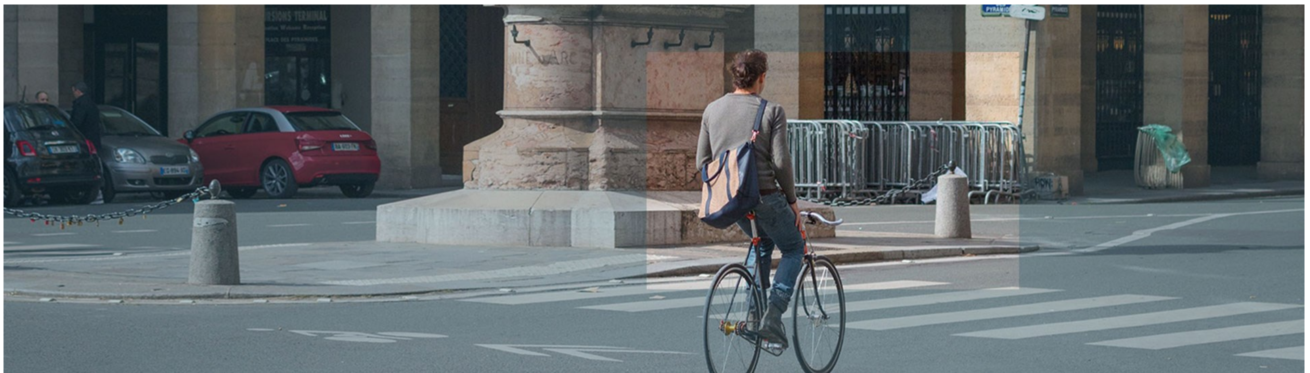

Summary

Departing EU President Jean-Claude Juncker leaves his successor with quite a to-do list. What should be the priorities for the incoming administration?

Key takeaways

- There has been limited progress made in resolving Europe's old challenges, and new ones have emerged, including how to respond competitively to large US corporate disruptors
- Nevertheless, Europe has tremendous inherent strengths, notably across the energy, industrial and consumer services sectors
- The EU should avoid the US model of "move fast and break things" by reinvigorating its scientific and engineering skills to "move slow and make things"
- Europe can offer an alternative model, which values individual freedom, tolerance, open trade and political and social freedom

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