



BANQUE
ERIC STURDZA

THE UNITED STATES AND
THE GLOBAL STAGE:
BETWEEN PROTECTIONIST
THREATS AND PRESSURE
ON IRAN. WHAT ARE THE
IMPACTS FOR MARKETS?

"There is no instance of a nation benefiting from prolonged warfare". Sun Tzu

Bruno Desgardins

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On the global stage, Donald Trump is apparently pursuing a two-fold objective, choosing bi-lateralism over multi-lateralism and destabilizing countries such as Iran and China, although we are bound to express doubts over his chances of success. For example, by withdrawing the United States from the Transpacific Treaty negotiated by Obama, Trump has harmed US influence in the region without preventing the other participants from continuing their trade. By imposing sanctions on Russia, he pushed down the rouble and thus restored competitiveness to Russia's energy producers, thereby adversely affecting US companies' chances of disposing of their gas surpluses in Europe. By threatening Iran with a boycott (a policy which has historically been unsuccessful) he simply pushes this large country closer to China and Russia. We could cite many other examples of such mistakes which are prejudicial to US influence in the world. Given that dictators in countries as impoverished, as weakened and as indebted as Venezuela and Syria manage to remain in power, one can only be sceptical when Donald Trump imagines disrupting the Chinese or Iranian regimes. In a multi-polar world, even small countries can survive sanctions, and so Trump is not only mistaken but is reinforcing cooperation amongst countries ignoring or opposing the United States.

We will begin by showing that the US economic cycle is still buoyant. Then we will discuss the protectionist theme rolled out by Donald Trump, focusing on the changes to the NAFTA agreement and relations with China. Finally, we will return to the pressure on Iran, which will allow us to update our view of the oil market. We will thus reply to four market concerns by ruling out, for the time being, the risks of a turnaround in the US cycle, of spiralling protectionism, of oil price inflation and of an excessive rise in interest rates.

I. A positive cyclical environment for the Americans:

Optimism:

In less than one year, if it continues, this economic growth cycle will go down in history as the longest since 1945. US GDP growth will be close to 3% this year, higher than last year, thanks to capital repatriation and fiscal stimulus of \$2,300 billion over ten years, and because of a deterioration in the budget deficit to 3.9% of GDP (\$779 billion as at 30 September 2018), a sad record at the top of the cycle.

The growth seems sustainable, because the reduction in the corporate tax rate from 35% to 21% has bolstered corporate competitiveness, the return on capital remains higher than the cost of capital, business sentiment remains high and wages, growing at 2.8% year on year, are increasing slightly faster than headline inflation of 2.7%, and core inflation of 1.8%. Also, although the unemployment rate of 3.7% is the lowest since 1969 and there are seven million job vacancies, there is no wage overheating because the labour force participation rate, at 62.7%, remains moderate.

Clouds hanging over US growth:

Let us avoid naive optimism and try to discern the potential inflection points. On the one hand there is the level of interest rates, i.e. real estate, and on the other hand wage costs, i.e. corporate profit margins.

- Interest rates: Many investors, and especially Trump, are alarmed at the rise in interest rates, because the debt of non-financial companies, notably as a consequence of share buybacks, has reached the record level of 73% of GDP, and government debt has moved above 100% of GDP, to which must be added household debt. However, the concern seems premature. Admittedly, the level of 3.26% for the 10-year rate, seen a few days ago, was the highest level in the past seven years, but, given an economic growth rate of 3% and a headline inflation rate of 2.8%, 4% would be more appropriate and 3.26% is by no means fatal. Furthermore, it seems plausible that the Fed, which is well aware of the risks, would control any spiralling rise in interest rates.
- Real estate: The seven interest-rate hikes adopted by the Fed and the rising cost of home loans from 4% to 4.9% for 30-year mortgages brought about a 5% reduction in housing starts in September, to 1.2 million, but for the time being real estate prices and transactions remain stable. There is no real estate bubble liable to burst, even though analysis shows a contrast between cities which are creating jobs, where real estate prices have risen sharply, and cities in economic decline. The construction figures point to more local shortages than excesses, and the Case-Shiller price index is only 2.5% above the 2006 level.
- Wages: Markets were impressed by the decision of Amazon, the second-largest US employer after Walmart, with 250,000 employees in the United States plus 100,000 seasonal workers at end of year, to increase its minimum wage by 16% to \$15 an hour. Some see this as a reflection of the Phillips curve, but it should be put into perspective. While this choice undeniably reflects a tightening of the US job market, it is also in line with the image that the group wants to give and in the tradition of Henry Ford, who advocated distributing purchasing power to his employees. Stock market investors fear the simultaneous nature of these interest-rate hikes and wage increases and are concerned that they may have an impact on corporate margins, but earnings growth will be close to 20% in 2018 and could still be as much as 10% in 2019. An impressive figure after more than nine years of economic expansion.
- Another factor of concern is the trend in household consumption: demand has slumped for products suffering from increased import taxes, non-automotive manufacturing activity has slowed, and the price of the gallon, more than \$2.90, could erode consumers' confidence and eat into their purchasing power. It is likely that Donald Trump will not hesitate to temper his aggressiveness toward Iran if this risk were to materialize, however.

- The last worry is a growth slowdown in many emerging countries which could have an impact on US growth, but remember that the country is not very open to trade, which accounts for less than 15% of US GDP.

Concluding from these various factors, what is the outlook for the US dollar? In the past twelve months, against all expectations, the euro has depreciated by only 3.3%. And yet, the dollar had every reason to strengthen: political confusion in Germany, economic concerns in Italy, the growth slowdown in Europe, incentives to repatriate capital to the United States, the substantial US tax cuts which boosted growth, the attractiveness of the US stock market with a wealth of technology stocks which represent 21% of the capitalization of the S&P500 compared with only 5% of the STOXX Europe 600 Index, and lastly the interest rate on dollar-denominated bonds. So, it is hard to anticipate a marked appreciation above a technical resistance level around 1.1450. While the ongoing interest-rate hikes in the United States, and hence a liquidity crunch, will favour an appreciation of the US currency, the widening of the budget deficit to 5% next year, the increase in the public debt and a further deterioration of the trade balance will adversely affect the dollar. In the stock market therefore, we will avoid shares sensitive to rising interest rates.

The election outlook:

It is hard to predict the outcome of the ballot, because the participation rate in mid-term elections is traditionally low, the country is divided, the Democrat camp lacks a leader, and Trump is rather fighting against himself. While Donald Trump still has a hard core of supporters of around 40%, the percentage undecided at present is still high and, in the past twelve months, the Republicans have lost one seat in Alabama and one in Pennsylvania. The customary swing states of Iowa, Pennsylvania, Michigan and Ohio will have to be watched. Many electors are disappointed by the weak growth in real income, 0.3% year on year versus 1.1% under Obama, and import taxes are expected to deduct \$400 from household income. Most likely, Congress will be completely renewed and dominated by Democrats, and probably the Democrats will win many of the 36 governors' positions to be renewed, but in the Senate the situation is trickier. The Republicans have a majority of only one vote, and although one-third of the seats are to be renewed, only eight Republicans' seats are up for voting. What can be considered certain is that any impeachment procedure would not obtain a two-thirds majority against Trump.

II. The protectionist theme:

Trump's attitudes have apparently evolved, but he is not yet steeped in the maxims of Sun Tzu which impregnate Chinese culture. Let us analyse his welcome calmer attitude to Westerners, the renewal of the agreements with Mexico and then Canada, and let us examine the state of relations with China.

Calmer attitude to Westerners: "There is nothing to prevent waltzing around, and everything to prevent overturning alliances", ARON

In our June report, we observed that attacking all countries indistinctly, both historical allies and virtual enemies could not be successful. Since then, Donald Trump has changed his stance. He has focused his fire and extinguished some areas of dispute. The abuse is no longer on all fronts but is focused against China. Since Juncker's visit, *Europe* seems to be (temporarily?) spared, although the mutual sanctions persist. Relations with *South Korea* and *Japan* on the thorny issue of the automotive industry seem to be improving, with the former promising to limit its steel exports and increase its imports of vehicles, while the latter is in the process of discussion.

The disagreements settled with Mexico and Canada:

In the case of *Mexico*, Trump complains that since the establishment of NAFTA in 1994, the United States had shifted from a situation of balanced trade to a deficit of \$68 billion. Note that the agreement signed (which is not very restrictive for the Mexicans and is vague regarding the required wage level of \$16 an hour, as unsure whether it concerns the average wage or the blue-collar wage) still has to be ratified by Congress.

An agreement has also been signed with *Canada*, but its ratification by the next Congress is far from certain.

Changing relations with China: "Although capable, be considered incapable; when ready for combat, don't let it be seen; when close, therefore, seem far; when far, seem close. Attract the foe by the promise of an advantage." KOUAN-TSE

China's tactics and the pragmatism of its leaders seem clear, but, regarding Donald Trump's approach to China, it can be demonstrated that the diagnostic is distorted, the action is clumsy and the reactions underestimated. In other words, where he thinks he is seizing an opportunity, he is running the risk of a boomerang effect.

- **The diagnostic of a weakening of China:** Artificial growth and growth artifices.

Donald Trump's analysis is simple, perhaps simplistic: Chinese growth is weakening, so let's exacerbate this trend by protectionist measures and perhaps the regime will wobble.

We make a distinction between the events of recent years and the present moment, i.e. the structural slowdown in Chinese growth and the hypothetical effect of Trump's measures. For some years China has had growth artificially boosted by over-investment in infrastructure and real estate, and that could not continue, for various reasons. Firstly, the experts at S&P (to mention but one group) estimate at \$6,000 billion, equivalent to half of GDP, the debt taken on by local governments to finance infrastructure, which is often excessive. Moreover, in the real estate sector, which is very important because in the strictest sense it accounts for 15% of GDP and in the broadest sense including appurtenances, almost 30% of GDP, many Chinese complain of overcapacity, falling prices and a low level of transactions. Finally, we could add the accumulation of corporate debt, from 1.6x GDP in 2008 to 2.5x at present, which could seem alarming, even though many of these firms are state-owned enterprises. In an economy which does not allow market mechanisms to come into effect, this could persist, but would leave a sword of Damocles hanging over the country.

In the nearer-term (and this is what will determine the stock market's performance) we are bound to raise questions concerning the artifices used to stimulate growth, such as lowering reserve requirements. Admittedly, despite the stimulus measures, with the Chinese Central Bank injecting \$175 billion to encourage banks to increase their loan volumes, Chinese growth is slightly weaker every quarter, and loan volumes are disappointing, because the small banks lack capital. Admittedly, the IMF has downgraded its expectations for Chinese growth in 2019 from 6.4% to 6.2%. Admittedly, the figure for car sales, -11% year-on-year in September, is the worst in seven years. Admittedly, the erosion of the Caixin index of Chinese manufacturing activity is perceptible. Admittedly, the sharp fall in the price of copper, a metal for which the Chinese absorb 40% of global production, reflects the slowdown in the economy, but concomitance does not necessarily mean consequence. The measures imposed by Donald Trump are recent, while the slowdown began several quarters ago. The GDP figure for the third quarter, 6.5%, extends the trend, and some sectors specialized in components for the United States will be affected, but this will remain marginal in relation to Chinese GDP and growth now driven more by services than by industry. If negative impact from Trump's measures were perceived, it would be balanced by stimulus measures offered by the Chinese government, through reductions in taxes and fees.

- **Trump's decisions:**

The action is justified but belated:

The action is justified, because the strategy of Chinese State-owned enterprises buying up foreign companies, stealing foreign technologies and investing without profitability constraints must be combated. One example is solar power, ignored in the early 2000s by the Chinese, who at the time constantly killed off the Western players by means of government subsidies, and which is now dominated by Chinese firms. But let's not be naive: China will not now become a market economy.

The action is also belated, because the time when China was 35% dependent on exports is now long gone. At present, this percentage has halved. Belated, because the 10% current-account surplus of 2007 no longer exists, and in recent months for the first time there is even a deficit.

The action is inappropriate in its form and uncertain in its effects:

Inappropriate action:

Accusing China, as Mr Mnuchin does, of having devalued its currency by 10% since April is unconvincing because the Chinese current-account surplus has vanished, its foreign exchange reserves are stable and, over the same period, the trade-weighted dollar has risen 7% against major currencies.

Accusing the Chinese of unfairly protecting their companies is accurate but should not lead us to overlook the fact that in 2009 the Americans did not hesitate to temporarily nationalize GM, and to bail out AIG, Fannie Mae and Freddie Mac.

Imposing 10% tariffs on \$200 billion worth of imports from China, then 25% in early 2019, is inadequate, because the effects on the growth of a country whose GDP exceeds \$12,000 billion will be tiny.

Expecting to reduce the US deficit in this way is just a pipe dream and, not surprisingly, given the acceleration in GDP growth caused by the \$200 billion tax cuts in 2018, the US trade deficit even increased to \$53 billion in September and \$390 billion at an annualized rate. At the same time, Chinese exports (which hardly slowed) increased by more than 14% in September, and the trade surplus increased to more than \$31.5 billion.

Even raised to 25% on \$250 billion, the tariffs would merely represent a trifling surcharge of \$60 billion. At 4% of GDP, China's exports to the United States are no longer critical. At 3% of GDP, the trade balance with the United States is neither a risk nor at risk.

What results can be expected of Donald Trump's policy? Protecting a few jobs in doomed sectors? Certainly. A repatriation of jobs in the steel sector? Possibly, but at what price, because retaliatory measures will cost jobs in dynamic aerospace firms, boost inflation and cause a loss of purchasing power for the US consumer. Concretely, between Boeing, for which China is its second-largest market, soya bean producers and GM for which China is its leading export market with four million cars sold last year, and all the others, there will be many potential losers.

In fact, this opposition between the two powers should be viewed in a broader framework: on the one hand, an ambitious power, China, busy on the Belt and Road Initiative since 2013, and on the other hand the United States, a power in withdrawal mode, which no longer wants to take part in multilateral organizations, which is reluctant to finance NATO and which intends to pull out of the Middle East. In the past ten years, the United States has accounted for 12% of global growth, and China close to one-third. In terms of GDP measured by purchasing power parity, China is de facto the leading power and it has many ways of retaliating. In research, China has made a spectacular breakthrough, whether it be in terms of the number of science graduates, which is infinitely larger than for the Americans, or the number of "unicorns" (young technology companies whose capitalization exceeds \$1 billion) - about sixty, or the number of patents filed, because in a few years China has moved into second or even first place in many sectors.

- **The reactions:**

China's monetary, economic, diplomatic, tactical and technological responses

Initially, the Chinese response was monetary and economic, and we saw both a depreciation of the yuan by about 10%, a reduction in purchases of American soya beans, and a rise in customs duties on US products. Added to this now are tax cuts, reductions in social security contributions for exporting firms, and non-tariff barriers (certification, etc.). In future, if the Americans were to attack the Chinese on one of their weak points, microprocessors (of which they still import 80%), the Chinese could retaliate by refusing to supply rare earths, products that are indispensable for Western high-tech firms, and where the Chinese account for more than 50% of global production. Remember that in 2010, at a time of diplomatic tensions, the latter threat had for a time been wielded against Japan.

The response is also diplomatic, as attested by the observed closer ties with Russia and Japan. With Russia, accounting for 15% of its trade, China is now the leading partner and the leading investor, and Russia is China's leading gas supplier. With Japan, a visit by Shinzo Abe to Beijing is scheduled.

The response is also tactical and technological, with acceleration in production plant offshoring to neighbouring countries, which thereby strengthens their ties (or dependence) at the expense of Washington. Malaysia is profiting from this in solar power and Bangladesh in textiles, and it is hard to imagine that the Americans could stop trade with these countries. China is also continuing to invest in the Silk Road Initiative, stepping up implementation of the 2025 plan for technological development and moving up the value chain.

In the American camp, conversely, although the political class and some business circles express complaints and fears concerning China, although the hostility to certain Chinese practices is shared, in the Republican Party or in corporate circles, there are unanimous comments showing and demonstrating that the US Treasury Department will collect virtually nothing, that US consumers will pay for the tariffs via a reduction in their purchasing power, businesses will lose competitiveness in their value chain and that there will be hardly any jobs created after these negotiations. Even worse, the image of the United States is damaged. There are many firms that plan to develop exchanges, and, at conferences on artificial intelligence held recently in Shanghai, Microsoft and Amazon even decided to set up a research facility in China.

To conclude, "peace through strength" is expected, and could be concluded at the next G20 meeting in Buenos Aires. In the stock market, the share prices of exposed US stocks, such as Harley Davidson (-27%), have declined since the end of January. In the rest of the world, especially in Europe, the fear is of a ricochet effect, an invasion by Chinese products that cannot be sold in the United States and a growth slowdown, and markets have been hit hard. Here the Trump effect is significant, because this year the Chinese market has been the worst performer. But the structural concerns are even more pronounced, because since 2009 the Chinese market has risen x1.5 times, compared with x4 times for the S&P 500.

III. Pressure on Iran and the risk for oil prices:

Let us consider four aspects:

- ***The possibility of blocking Iranian exports:***

Iran's crude oil exports of 2.5m bpd in June fell to 1.3m bpd during the summer, but are apparently now close to 2.2m bpd as a result of sales made by vessels without a flag chartered discreetly by the Iranians. In theory, as of November 4th, Donald Trump prohibits purchases of crude oil from Iran, but what can be expected? The barter agreement proposed by the European Union and supported by China and Russia does not seem yet ready to serve as a way of getting around the US sanctions; South Korea has stopped its purchases, Japan is preparing to do so, and India is apparently reducing them by half. However, Donald Trump knows that it would not be easy, in the current state of the market, to offset the 2.5 million bpd of Iranian exports, and he does not want to expose US consumers to a surge in prices at the pump which would adversely affect their purchasing power in the run-up to the elections. He could therefore close his eyes to Iranian sales via Qatar, given that the two countries share oil deposits, or via the Turkish border or to China (currently 0.6m bpd), a country where demand, at 8.5m bpd, is still growing.

- ***The desire to destabilize the Iranian regime:***

The Iranians obtained a diplomatic success at the International Court of Justice, which condemned the US decision to block exports of medical equipment, food and spare parts for civil aviation, but it is likely that the Americans will not feel bound by this condemnation.

Donald Trump's desire and hope is to undermine the Rohani government, and even to bring it down. It is true that, since the announcement of sanctions, many European companies have put their projects on hold. It is true that the Iranians cannot apparently really count on the Russian "ally", who does not hesitate to take reconstruction contracts from them in Syria and takes advantage of the situation to sell more oil. But, although there is strong opposition in Iran, although there is great discontent faced with a rise in inflation from 10% to 20% according to the official statistics, and probably 60% in reality, and although there is still irritation at corruption, we doubt the result. The Iranian stock market, up 88% since the start of the year, reflects no concern. Crude oil accounts for 70% of exports, but the decline in export volumes is partially offset by the price rise, and the Iranians have large quantities stored at sea.

- ***The consequences of the tensions with Saudi Arabia:***

Saudi Arabia, the United States' main ally together with Israel, was previously the most ardent supporter of a hard line against Iran and guaranteed control of crude prices via timely increases in volumes. Donald Trump has too often spoken of his good relationship with the crown prince and too much boasted of an arms contract of more than \$100 billion to not try to overcome the diplomatic tension created by the Khashoggi affair. Saudi blackmail over a reduction in their production would ruin Trump's policy against Iran, because, with regard to

his electorate, he cannot risk a sharp rise in crude prices in the run-up to the November 9th elections. It would also weaken the partnership with Saudi Arabia, because presumably Republican politicians would want to block arms sales. Saudi Arabia, and especially the crown prince who has exposed himself with his programme of economic modernization aimed at attracting international investors, is playing for high stakes, as attested by the numerous withdrawals (e.g., Uber, JP Morgan, Virgin) from the "Davos in the Desert". Mr Erdogan, who managed the enquiry, knows this and will not hesitate to negotiate a possible toning down of the report in return for US economic assistance or Saudi investments, which he greatly needs in these times of economic crisis in Turkey.

- *Ongoing pressure on oil prices:*

For the first time, global demand for crude oil has reached 100 million bpd, and the trend is for further increases at an annual rate of 1.5m bpd.

At the same time, the low level of investment in exploration, which plunged 50% in recent years, has dried up new sources of supply, and therefore reduced overcapacity to a minute portion, 2.7m bpd according to the IEA, more than half of which is in Saudi Arabia, and increased the sensitivity of prices to any geopolitical event. In recent months the Russians have increased their production by 0.5m bpd to 11.5m bpd and, according to Putin, they could increase it slightly more. Saudi Arabia is producing 10.7m bpd, which is a record level, but that might not continue if the spat with the United States were to turn ugly.

For more than a year we have been positive on the price of oil because, with the deteriorating production outlook in Venezuela (from 3m bpd a few years ago to 1.3m bpd now), uncertainty regarding Libyan production, and the reluctance or inability of OPEC members to increase their production, there are numerous factors putting pressure on prices. But, if we expect Saudi production to remain unchanged, and this flexibility in applying the boycott against Iran, prices will not rise in the coming weeks.

Conclusion: SUN TZU: "To make the enemy move... you must offer him a sacrifice for him to take".

Sun Tzu suggested playthings, while Donald Trump wants mainly to be able to demonstrate his ability to conclude "deals" with clearly little concern for their substance, and we can be more optimistic than many investors.

- *From the trade viewpoint:* The world is too intertwined to go down the path of protectionism. A Chinese "sacrifice" could consist in facilitating purchases of listed Chinese companies or joint ventures majority-owned by Westerners. Beyond that, with all due respect to Mr Trump, China will not go down on its knees. It is too late. Especially since one-third of the value of Chinese exports in fact corresponds to imports, and around half come from groups backed by foreign capital, often subsidiaries of US companies.
- *From the political viewpoint:* The mid-term elections in November are expected to shed some light on the continuation of Trump's policy or not. Recently he was able to boast of some successes: Kavanaugh's election to the Supreme Court, the release of the pastor imprisoned in Turkey, the signature of trade agreements with a few countries, and the persisting positive economic cycle. But that might not be enough.
- *From the monetary viewpoint:* Trump's attitude, far from strengthening the United States in the world, is an incentive for major countries to accelerate the search for substitutes to the US dollar: Europe is working out such a mechanism to manage flows with Iran, Russia is considering it for oil transactions, while China is making numerous swap agreements in yuan and is expected to launch yuan oil futures contracts in the spring.
- *From the diplomatic viewpoint:* We have not mentioned North Korea, which apparently will agree to receive international inspectors and shut down a test site and the Yongbyon facility, but vagueness prevails regarding the "reciprocation" expected by the North Korean president.

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