BANQUE
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WHAT TO MAKE OF TRADE TENSIONS WITH CHINA AND POLITICAL TENSIONS WITH IRAN?

RISKS AND OPPORTUNITIES IN THE MARKETS

"The worst is not always certain". Calderon.

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Bruno Desgardins ***22 May 2019***

After a record near 120 months of growth, and with a view to the presidential election of 2020, Donald Trump is looking to avert the risk of a slowdown and is therefore implementing three policies. First, an expansionary fiscal policy, as shown by a budget deficit of close to 5% of GDP, which is exceptionally high at the top of the cycle; next, pressure applied on Fed chairman Jerome Powell to lower interest rates; and finally, ultimatums to US trade partners to obtain concessions, protect distressed sectors in the United States and increase industrial investments on US soil.

There are many question marks however: Should we worry about the worsening US trade deficit? Is that not logical in light of the growth gap? Is it credible that a policy of raising tariffs can be effective? What risks are involved with these protectionist measures? What is the potential for retaliation by trade partner countries? On the other hand, should we fear a war with Iran or at the very least fear a sharp rise in oil prices? And above all, what are the consequences for financial markets, sectors, sentiment indicators, corporate investment, interest rates and currencies?

Currently, with the trade negotiations between China and the United States turning ugly and given strong tensions with Iran, it is important to review the situation.

I. **The economic worry**: protectionist measures.

For several decades, Westerners viewed globalisation optimistically, because firms' foreign direct investment (FDI) was growing and still represented 3.3% of global GDP as an annualised rate in 2007, and because global trade was posting annual growth of twice the rate of global GDP and appeared as a growth driver.

Since 2009, there is no longer the same momentum, and criticism can be increasingly heard. Five reasons are given for this slowdown in trade and transnational investment: re-shoring of production (sometimes facilitated by automation), emerging economies that are less competitive, developed economies that are less dependent on industry and therefore more tied to domestic services, protectionist measures, and a reorientation of the Chinese economy away from exports to promoting domestic consumption. In short, although trade globalisation is stagnant, as shown by the reduction in the global trade/GDP ratio, financial globalisation continues to grow, boosted by the global accumulation of debt.

Long an apostle of free trade, the United States, under the rule of Donald Trump, is tempted by political isolationism, economic protectionism and trade war. Although isolationism is merely a policy stance, with the Americans are involved in the Syrian, Afghan and Ukrainian conflicts and in pressure applied on North Korea and Iran, the protectionist theme is starting to go beyond a rhetorical level, and the trade war is becoming a reality clearly expressed in the application of the principle of extraterritoriality.

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II. **The trade worry**: The China-US trade relationship.

In 2018, Trump signed two agreements, one with Mexico (who have a $50 billion trade surplus with the United States) and the other with Canada (who also have a surplus). However, neither will be ratified by Congress, because the Democrats do not want to help Trump before the presidential election of 2020. At present, the president still has his "allies" in line of sight: South Korea which has a surplus of around $15 billion, Japan, and Europe who he criticises for their surplus of around $170 billion (Germany in particular, with a rich bilateral surplus of around $70 billion). However his real fight is with China. The trade deficit was $6 billion in 1985, $100 billion in 2002, and $420 billion by 2018 (US purchases of $540 billion and sales of $130 billion). Let's first analyse the inefficiency of tariff hikes and then the potential for retaliation.

1. The inefficiency of tariffs:

- H**istory's lesson**: In the United States, the conflict between advocates of free trade and protectionism is age-old. It was one of the causes of the War of Secession between an industrial North advocating free trade and a protectionist, agricultural South. Historically, trade wars have created no benefits and, to take just one topical example, the US initiative of the Smoot-Halley tariffs in 1930 caused a 60% decline in US exports and slashed 10% off a US stock market index that had already been buffeted by the 1929 crisis. So far, the infringements of free trade rules remain limited, but if bilateralism were to become widespread, the losing stock markets would be those of smaller countries.

- **China, a heavyweight**: In the globalised world, China is the leading exporter, with a 12% market share, but 40% of Chinese exports are accounted for by foreign firms established in China, such as Apple, which makes 20% of its sales in the Chinese market and fears retaliatory measures. Clearly, behind its posturing in favour of free trade, China distorts the competition rules through government subsidies, protects its market with finicky regulations, encourages the formation of large industrial groups in numerous sectors, and does not hesitate to bail out firms in distress, thus making a mockery of free-market orthodoxy, but tariffs cannot be the appropriate answer.

However, it is incorrect to say that things have got worse: in 2008, the Chinese currency was undervalued, which is no longer the case. The Chinese trade surplus, as a percentage of GDP, was 10%, far higher than its current level. Chinese exports, as a percentage of GDP, represented almost twice the current level of 18%, and the current account surplus was very large, whereas it now represents only 1.5% of GDP, far from the 8% seen in Germany. We can add that Chinese exports to the United States declined by 9% in the first quarter. Lastly, some countries still do reasonably well out of trade with China. Examples are South Korea, who post a trade surplus, and Japan who post a small deficit. The US trade deficit with the world, $891 billion excluding services in 2018, is the result of a shortfall in savings, over-consumption, and the lack of competitiveness of its industrial firms.

- **The harmful effects of taxes**: A tariff is revenue for the state, financed by a tax on household consumption which puts a strain on households' purchasing power, and a tax on the intermediate consumption of businesses which cripples their competitiveness. Raising taxes would not create more jobs in the United States, because the economy is close to full employment. Raising taxes would reduce the purchasing power of US consumers or encourage them to buy those goods from other countries such as Vietnam, which would not change the overall US trade deficit, as most

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Chinese exports to the United States have no American substitute. Raising taxes would increase inflation and therefore force the Fed to raise interest rates. Raising taxes would reduce the competitiveness of US businesses, because 60% of US imports are components. Accordingly, 25% taxes on $250 billion worth of goods, i.e. 8% of the $3,100 billion worth of US imports and 10% of the $2,650 billion worth of Chinese exports, will cost US growth 0.2% in a full year, and planned taxes on the remaining $300 billion or so could deprive the United States of 0.5 percent growth.

- **The alternatives**: The US decision to prohibit US companies from buying equipment from Huawei, and especially from selling equipment to them has serious consequences. Huawei acquires components worth around $10 billion from about thirty US companies. For example, from Qualcomm, the leader in electronic chips for smartphones, which could potentially lose 5% of its revenues and whose share price recently fell by almost 16%. Or, again for smartphone chips, from Broadcom, whose share price also recently fell by almost 17%, and Intel, Micron Technology, Xilinx and Altera Corp. If the Americans manage to convince the Europeans not to work with this group on 5G, this will also have negative consequences for Huawei. Ericsson and Nokia are expected to equip about 130 European operators, but at this stage these two companies will probably not be able to meet the demand, and so the deployment of 5G could fall behind schedule and there will be less price competition.

2. China's capacity for retaliation:

The United States appears to have a lot to gain from a policy of firmness with China. But US exports to China fell 30% in the first quarter. A power play with China would not necessarily turn to the advantage of the United States and could lead the Chinese to accelerate the implementation of the "China 2025" programme to reduce their technological dependence. The opposite effect to what Trump is aiming at. Taxes will probably adversely affect China's growth by around 0.4 percent, and taxes on all Chinese products would cost as much as 1 percent of GDP, but China has massive capacity for retaliation. The weapon of taxes on imports is not the best way to bring down a trade deficit, and in an interdependent world with intertwined businesses, it would not be easy to backtrack on globalisation.

The five weapons available to the Chinese:

- **The agricultural weapon**: Although the US has a large trade deficit in manufacturing, it has a large surplus in agriculture. The United States is still the leading agricultural exporter in the world, far ahead of Brazil. By itself, it accounts for one-third of global trade in maize (corn) and even 40% of soya bean exports. The 25% tax on US soya beans adopted by China in July 2018 reduced US sales to China (which amounted to $14 billion in 2017), to the delight of the Brazilians and Argentinians until a truce was reached between the Chinese and the Americans in December. The price of soya beans is now extremely low, even though it has risen slightly in recent days, and it we can be sure that retaliation by China will reduce the income of US farmers, where many of them already struggle to make a profit. Trump has unlocked $8.5 billion in aid and is considering an additional $20 billion, but renewed Chinese sanctions would affect the prosperity of Midwest states which traditionally vote Republican. With a

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view to the elections of November 2020, that would not be a booster for Donald Trump, even though the opinion polls are currently in his favour. According to the **Peterson Institute**, the curtailment of soya bean exports in certain provinces of the State of Missouri could cost up to 20% of jobs there.

- **The rare earths weapon**: The Chinese account for 70% of global production and could deprive US companies of components in retaliation for the sanctions against Huawei. As soon as this possibility came up, stocks such as Xiamen Tungsten Co, China Northern Rare Earth Group and China Minmetals Rare Earth saw their share prices rise.

- **The industrial weapon**: The United States wants to tax a whole series of products, but the Chinese can easily counter-attack and hurt US companies such as GM, who sell more cars in China than in the United States, or better yet, technology companies such as Apple, Qualcomm and Texas Instruments who generate a large proportion of their revenues in China. Not to mention big industrial firms such as Boeing and Caterpillar. Another possibility is a boycott on US products manufactured in China, which would be costly. This explains the current fragility of these companies in the stock market, and their rebound potential if the trade war is prevented.

- **The Treasuries weapon**: Together with the Japanese, the Chinese are the leading holders of US Treasuries, for an amount of around $1,120 billion, i.e. one-third of their foreign exchange reserves estimated at $3,095 billion. The fact that the Chinese sold $20 billion worth of Treasuries in March was of no consequence, because this is a relatively modest amount, but a substantial sell-off would raise US long-term yields above 3%, thereby making US debt more expensive and undermining the country's growth. However, this weapon is a double-edged sword, because a Treasuries sell-off would reduce the value of China's foreign exchange reserves and result in an appreciation of the yuan, not necessarily desired by the Chinese authorities.

- **The monetary weapon**: The Yuan is not convertible, so the Chinese authorities could devalue their currency by an amount equivalent to the tax placed on their goods, to neutralise its impact. Remember that the currency depreciated by around 10% in the first half of 2018, and had even reached a low of 6.97 against the dollar at end-October before recovering. Since the start of May, the currency has fallen 3% in value and the exchange rate is 6.91. A devaluation would make sense given that China exports more than it imports, but this is a possibility in which we do not really believe, and which the central bank governor, Yi Gang, appears to rule out. There are three reasons for this opinion. First, the Chinese are anxious to consolidate the image of a stable yuan. Secondly, they do not want to exacerbate capital outflows. Thirdly, devaluing the Yuan would require buying more US Treasury bills, which the Chinese are not

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currently inclined to do. Therefore, we do not foresee depreciation going beyond 7 yuan to the dollar.

To sum up, the Chinese will make some concessions regarding the deregulation of financial services, the opening up of their markets, equity investment thresholds for foreign groups in joint-ventures in China, patent protection and a reduction in the subsidies to certain state-owned enterprises. Donald Trump will have something to boast about, but the trade war will continue.

III. **The geopolitical concern regarding Iran and oil prices**:

The Iranian nuclear agreement signed under the Obama presidency in July 2015 froze nuclear development by the Iranians, and in return opened up the prospect of lifting US sanctions, and so increased foreign direct investment. Rohani expected $50 billion per year. But nothing happened as had been hoped. Firstly, Trump, wanting to destroy Obama's legacy, broke this agreement. Secondly, the Iranian population, disappointed by the fact that there has been no economic improvement (30% fall in the official exchange rate of the currency since the initial statements by Trump, inflation still above 37% reducing their purchasing power, contraction of GDP by around 4% between November 2018 and March 2019, high unemployment rate and costly military interventions abroad), has doubts about the line adopted by the moderate Rohani. US secretary of state Mike Pompeo, and the Head of National Security, John Bolton, both hostile to Iran, are proponents of a hard line. The former is a neo-conservative, close to the Tea Party movement, while the latter famously spoke in favour of military strikes against Iran. Faced with these threats, the Iranians plan to increase production of enriched uranium.

In March, Iran was no longer exporting 2.5m bpd as before the crisis, but 1.7m bpd, of which one-third intended for China and 20% for India. At present, US tolerance has ended, and it would seem that exports now no longer reach even 1m bpd. Some buyers such as South Korea and Japan have stopped buying, and China, or at least its big state-owned companies, also appear to have done so. Apparently, only a few small Chinese refiners remain.

Some fear a blocking of the Strait of Hormuz, through which travel 17m bpd of the 53m bpd of crude oil transported by ship, i.e. more than through the Strait of Malacca (15m bpd) and far more than via the Suez Canal (4.5m bpd). What is involved in this case is all the crude oil of the bordering countries, Iran, Kuwait and Qatar, and most Saudi and Iraqi exports, but we do not believe in such a scenario even if drones have hit Saudi ships and a pipeline. Likewise, we do not foresee a war undertaken by the Americans or the Saudis against more than 80 million Iranians. The financial and human cost would be too high for what would be an uncertain result.

Given these considerations, we estimated that at $72 per barrel, the price of Brent is unlikely to increase much.

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Conclusion:

Is the current environment an opportunity rather than a risk? Pessimism is fuelled by political, economic, trade, monetary and stock market fears, but in this fog of uncertainty we would like to perceive a ray of sunlight for markets, because, as we have tried to demonstrate, some of these risks can be resolved:

- **From a political viewpoint**, Trump is excessive in his manner of antagonising the Chinese, but the Chinese have often obstructed the activities of US technology firms in the Chinese market. Consider Facebook, Google or Twitter as examples. Trump has cleverly chosen a time of strength in the US economy, with 3.2% first-quarter GDP growth, and a time of weakness in the Chinese economy, because despite massive stimulus measures at the start of the year, their retail sales growth in April was the lowest in the past sixteen years and industrial production declined in April relative to March. Trump has also understood that it is wiser to temporarily put aside his demands against his allies, by suspending the steel tariffs on Mexico and Canada and automotive tariffs on the Europeans.
- **From an economic viewpoint**, four comments: Firstly, the Americans need Chinese savings because they are faced with a structural deficit, and the Chinese need the US market and technology. Concretely, the US current-account deficit exceeds 2.5% of GDP, because the US savings rate is only 17% of GDP while the investment rate is close to 20%, and at the same time the Chinese have the advantage of a high savings rate, higher than the investment rate, and a current-account surplus. So for many years Chinese savings have been financing US consumers, and it is therefore in the interest of both countries to reach a settlement. Also, a trade deficit is not necessarily dramatic, because consumers and component buyers win through far lower prices on imported goods. Secondly, the global economy is too intertwined at a corporate level to be able to untangle the web of free trade. Finally, we believe that Trump, who has made a rising stock market an indicator of his policy successes, will temper his expectations, as he recently did by postponing the automotive taxes imposed on US "allies".
- **From an accounting viewpoint**, the increase in the trade deficit is the result of US fiscal policy and monetary policy, because both are stimulatory. Donald Trump is mistaken in fixating on the $420 billion deficit with China, because on a value-added basis, after deducting non-Chinese components, it is possibly less than half that value.

- **From a trade viewpoint**, tariffs have never been able to reduce a trade deficit in real terms. Rather than erect barriers, it would be better for the Americans to endeavour to open up markets, and for the Europeans to reflect on the impact of the agreements that China, as part of the Belt and Road Initiative, is negotiating with Eastern European countries. If a tariff war is averted, then, in the short-term, export-sensitive US cyclical stocks will regain popularity in the markets.

- **From a monetary viewpoint**, worsening tensions would boost the US dollar, the Swiss franc and the yen, and would adversely affect the yuan and emerging-market currencies.

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- **From a stock market viewpoint**, if protectionism were to spread, markets would have two reasons to be worried. Firstly, businesses would be less able to optimise costs and would therefore suffer an erosion of their margins. Secondly, rising import prices would strain purchasing power. A resurgence of protectionism would mean more inflation, and in that case it would be advisable to buy floating-rate bonds (TIPS). It would also mean a fall in the stock markets of very export-oriented small countries such as Taiwan and South Korea. All these markets should be watched cautiously in the short-term. These are all opportunities if, as we believe, an agreement is finalised. To the pessimists, we recommend buying rare earth companies, strong currencies, oil, etc. To the optimists, we recommend buying stocks such as Qualcomm which have fallen recently. If there were to be no agreement, then we may speculate that the Chinese would take further measures to stimulate their economy and that the Fed would be reassured about deciding to reduce interest rates. But, agreement or not, it will only be a temporary compromise in a trade and technology war that will persist.

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