



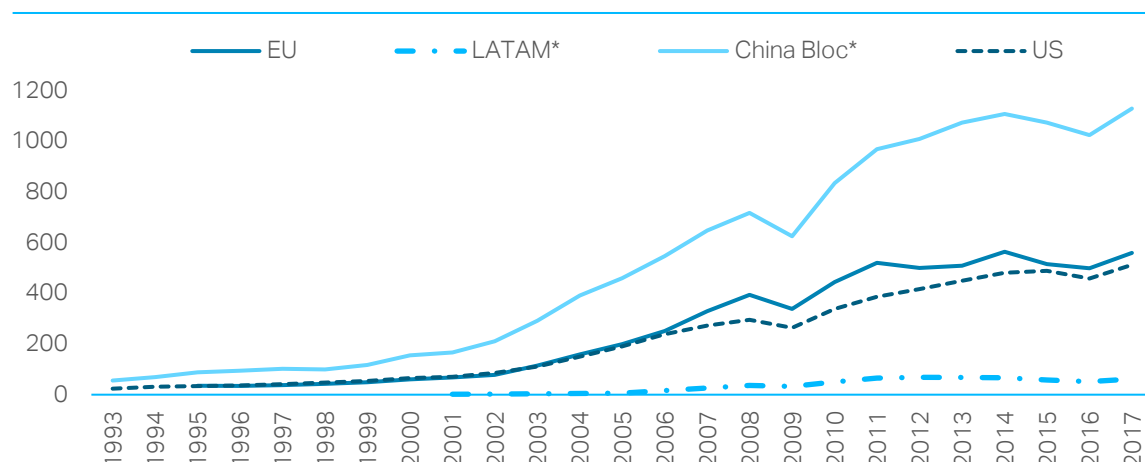
LSR View

FROM TRADE WARS TO TRADING BLOCS

Larry Brainard / Charles Dumas

- The US-China economic conflict will be long and ugly with little chance of a deal anytime soon
- Further US escalation to 25% tariffs on the bulk of Chinese exports is likely
- Markets will drive a re-globalisation of China trade and spur the creation of an Asian trading bloc centred on the PRC
- China's trading partners in East and Southeast Asia will reap positive benefits over the medium term
- Trump's goal of reshoring manufacturing jobs to the US will not be realised
- The degeneration of a globalised trading world into regional blocs will in the long run reduce CAPE and thus equity valuations
- A bear market is a major risk over the next two to three years

China's manufactured and intermediate goods trade, \$ bn



Sources: China Customs, TS Lombard.

*China Bloc: ASEAN (ex Brunei, Cambodia and Laos) + Korea, Japan, Taiwan.

*LATAM: Brazil, Chile, Argentina.

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US-China economic conflict is bringing risks of a new bear market

President Donald Trump's escalation of his trade war on Monday created few waves in markets, mostly because he set the initial tariff on \$200bn of Chinese imports at 10% rather than at the 25% level that investors had been expecting. He said he wanted to give US business time to find alternative suppliers, but he also threatened to raise the levy to 25% in January if China did not agree to alter its commercial practices. He went further and pledged to "immediately pursue tariffs on an additional \$267bn of imports" if China took retaliatory actions. Beijing responded a day later by announcing tariffs ranging from 5-10% on \$60bn in imports from the US. The US and China now appear headed for an all-out trade war with no near-term prospect of reaching a deal.

Below we analyse how markets will respond over the medium term to these new disruptions of global trade. While Trump is clearly trying to turn the clock back on the last several decades of globalisation, he cannot eliminate market forces. Our thesis is that market forces will drive a re-globalisation of China's trade in response to the new US barriers on trade and technology transfer that will result in the creation of a trading bloc centred on the PRC. A corollary of this development is that the disruption caused by Trump's assault on globalisation will further strengthen the European trade bloc.

The devolution of a globalised trading system into blocs will have important implications for global equity valuations. In the second half of this report we examine long-term trends in market valuation metrics and conclude that a bear market is a major risk over the next two to three years.

World trade is heading toward major changes

Before globalisation international trade in goods was largely restricted to finished products. Globalisation triggered a revolution by disassembling this trade into components, such that a firm in the metropole market could outsource production along with its proprietary manufacturing know-how to other markets with much lower costs. Parallel improvements in logistics and IT to control and monitor production facilitated the creation of supply chains that cut costs and increased overall productivity via just-in-time delivery.

With globalisation, metropole firms add value via technology, design and branding - their comparative advantages - while farming out the production of various components to firms in other countries that have a comparative advantage in providing components or cheap labour. Apple's iPhone is the archetype of how such globalisation functions: workers in China assemble iPhones from components supplied by other Asian firms and export the finished product around the globe; Apple's headquarters in Cupertino provides the design, marketing and know-how to make all of this work.

A primary goal of Trump's trade war is to reverse globalisation and bring manufacturing jobs back to the US. To this end he has erected barriers to Chinese exports in the form of tariffs and restrictions on technology transfer via new legislation. Trump's strategy though contains a fatal flaw: the economic forces that led to globalisation are alive and well despite the disruptions of the trade war. Given Trump's tariffs, these market forces will now reassemble trade in ways that achieve low costs of production but not in ways the president is seeking. We expect the market will create a new Asian trading bloc with China at its centre. China has all the necessary prerequisites to make an Asian-based trading bloc work without the US: a large domestic

market, political support for open markets and manufacturing expertise. Trump's hopes for the reshoring of manufacturing to the US are unlikely to be realised.

China wakes up to the loss of constructive engagement with the US

For nearly 50 years US policy toward China has been guided by what has been termed "constructive engagement". As the substance of policy has evolved from President Nixon's first visit to Beijing in 1972 to more recent annual meetings of the so-called Comprehensive Economic Dialogue of senior US and Chinese policymakers, the US has always implicitly assumed that engaging Beijing in rules-based global market institutions such as the IMF and the WTO would lead China to become a "responsible stakeholder" in the global economy.

Trump has brought the curtain down on that era and ushered in a new period of "strategic competition". In the words of the US Department of Defense's 2018 [National Defense Strategy](#), "China is a strategic competitor using predatory economics to intimidate its neighbours while militarizing the South China Sea". What is more, Trump's strategy of hitting China hard, blaming it for the decline of US manufacturing and multiple transgressions in stealing technology and intellectual property from US firms, has found widespread support with the electorate and among Washington's Asia hands from both political parties.

Whatever the merits of the US criticism of China's transgressions of accepted economic behaviour, and the evidence for them is extensive, the US quest to preserve America's technological pre-eminence via a unilateral assault on China's ambitions to move up the technological ladder is profoundly misdirected. History is strewn with examples of poorer countries' successes in catching up with their richer trading partners via state-directed growth models; the emergence of Japan, Korea and Singapore over the past 30-50 years bears this out. In broad outline China's development strategy follows these countries' experiences. A better way to influence China's policies would be to take a multilateral approach, since other developed economies share America's concerns.

What sets China apart from these earlier development stories, however, is the country's huge domestic market and the aspirations of its one-party leadership to stake out a geo-strategic position commensurate with the country's global economic weight. As [Jonathan Fenby argued](#) recently, China's communist leadership sees the current conjuncture as "a turning point in which China is free to play a greater global role and use to the full its inter-meshed political, economic and strategic systems".

Viewed from Beijing's perspective, Trump's trade war is one element of a much broader and deeper confrontation between an ageing hegemon and an emerging power that is seeking to regain its place in the global order. In addition to the impact of Trump's tariffs on what were heretofore normal trade relations, the White House's initiatives to shut down technology transfer to China via the recently passed Foreign Investment Risk Review Modernization Act, or FIRRMA, is confirmation that China is without friends in Washington; the new legislation is seen in Beijing as an effort at containment of China's legitimate development goals, not unlike the role played by Western powers in attempting to limit the post-war development of the Soviet Union.

China was prepared at a late May negotiating session in Washington to make concessions on trade but not on changes to its development strategy and its industrial modernisation plans. The tentative agreement that Treasury Secretary Steven Mnuchin brought to the president at that time was rejected out of hand by Trump; the first round of \$50bn in tariffs soon followed in early July.

Following these events China's leadership has concluded that the US is determined to check the country's rise via demands that strike at the heart of the economic model on which Communist Party power rests. As a result, China has adopted a harder line because its leaders cannot be seen to be negotiating with a gun to their head. The current mood in Beijing is to take a tough position on future talks by demanding that the US demonstrate its sincerity before agreeing to new meetings.

As the latest tariff escalation highlights, the president and his White House advisers are not prepared to meet China halfway at the present time. The president tweeted last week that "the US is under no pressure to make a deal with China, they are under pressure to make a deal with us". This response highlights that Trump feels in firm control of his trade war and that he confidently expects China to capitulate.

As we concluded in early May, the entrenched positions on both sides means the outlook is for a long and ugly economic confrontation. Over the next six months we expect Trump to gradually extend a 25% tariff to the bulk of China's \$500bn in shipments to the US.

How China's trade will be re-globalised

Faced with the setbacks in economic relations with the US, China's leaders have been forced into a fundamental reassessment of the country's development strategy. That review must take into account key changes facing China:

- Tariffs on the bulk of its exports to the US for the indefinite future, e.g. for years, not months;
- Binding constraints on acquiring cutting-edge technology via FDI in the US or licensing from US firms; and
- Domestic economic dislocation as firms are forced to adapt to these new conditions.

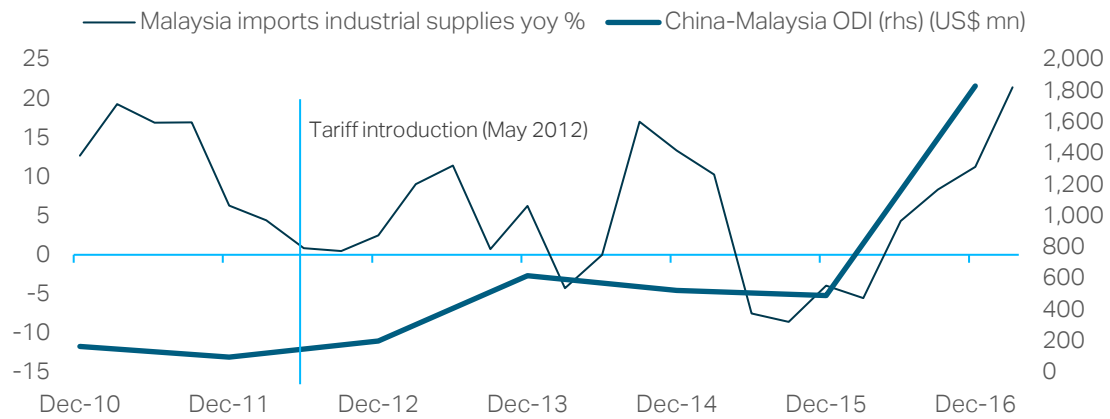
In effect, tariffs create a "Made in China" risk. Many Chinese manufacturing firms, however, can find ways around the tariffs they face by transferring production abroad, sourcing inputs from home or other regional economies and sending the finished product to the US. It makes the most sense for such production shifts to take place within Asia where new supply chains can be easily created and logistic costs minimised. In addition to evading tariffs for exports to the US, such a manufacturing model also benefits firms which bring finished products or components back to China.

A recent report by our colleague, China economist, Rory Green, provides an example of how this "production shifting" worked in a previous US tariff case. He details how Chinese firms evaded US levies imposed on solar panel imports in 2012 by moving manufacturing to Malaysia and other Southeast Asian countries. The share of Chinese solar panels in US imports fell from 69% in 2011 to 11% in 2017; however, US imports of solar panels from Malaysia and other Asian countries jumped to slightly more than 50% of total US imports from near zero in 2011; Green estimates 60-70% of those sales were from Chinese companies which shifted operations to those countries.

Other examples of how foreign firms in China are likely to minimise Made in China risk are appearing on a daily basis. The *Nikkei Asian Review* reported on August 29 that Mitsubishi Electric had moved production of US-bound exports from China back to Japan while continuing to manufacture machine tools for the Chinese market at its Dalian plant. Komatsu, meanwhile, is relocating output of components for US-built hydraulic excavators to Japan and Mexico.

There is also a “Made in US” risk for firms domiciled in the US which export to China, including several German car manufacturers which ship US-manufactured SUVs to the PRC. Such production shifting is likely to continue as firms seek to evade retaliatory Chinese tariffs.

Chinese ODI leads Malaysian intermediate-inputs import growth



Sources: MOFCOM, Bank Negara Malaysia, TS Lombard

The environment that will evolve in this new Asian trading bloc therefore will be created by:

- The shift of production by firms selling into the US from China to elsewhere in Asia and to the US, Canada and Mexico; firms in this group include both Chinese and China-based foreign firms. The extent to which manufacturing moves to the US will depend on whether US-based production is competitive vs the cost of the tariff or manufacturing in third countries.
- The development of two-way regional Asian supply chains associated with the above production shifting, e.g. sourcing components in China for offshore manufacturing and assembly, and sourcing components in Asia ex-China for final sale in China’s domestic market.
- The migration of existing US production destined for China’s domestic market to third countries in Asia (where feasible) and elsewhere, e.g. Canada and Mexico. More complex manufacturing operations may gravitate toward Canada or Mexico, e.g. cars and light trucks, while operations that are less technology intensive could move to countries such as Thailand, Vietnam and Indonesia.
- With prospects of a severe cutback in technology transfers from US firms, China will aggressively build new business relations with technology firms in Asia and Europe. To achieve this, China appears to have recognised that it will have to provide its technology partners with effective protection of intellectual property; there are signs this is beginning to happen.

The complexity of US-China trade is likely to spawn a multitude of strategies to cope with tariffs. *The Wall Street Journal* noted on Wednesday that more than 1,000 Chinese companies export some \$10bn in auto parts to the US. Larger suppliers may be able to respond by shifting production to third markets, but many of the smaller firms will have to adapt to the tariffs via lower margins or higher prices.

Also, since technology transfer is also subject to disaggregation into its various components, especially human capital, China is likely to enter the market as a bidder for top global scientific talent. It can be expected to hire more foreign tech graduates and seek to lure established professionals with offers of attractive research facilities and funding along with competitive

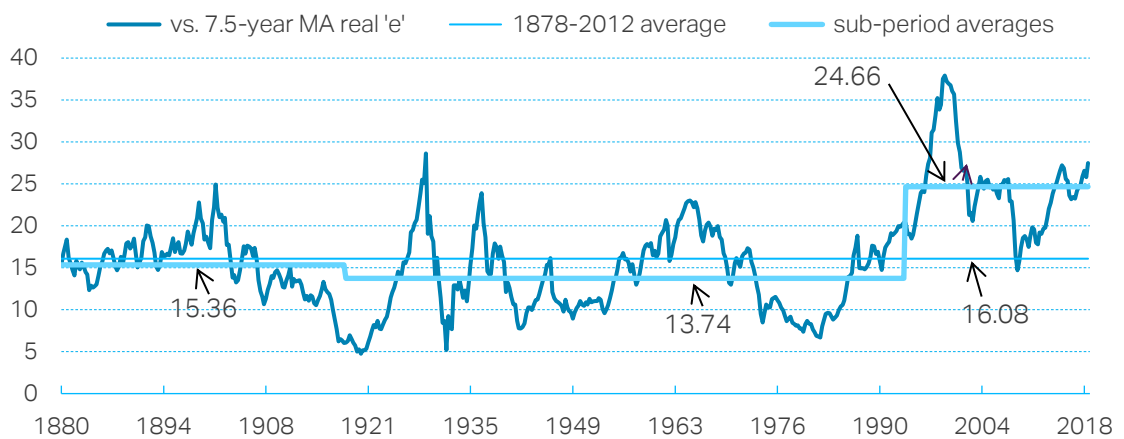
salaries. Meanwhile, policies toward existing and new direct investment are likely to continue to be welcoming insofar as that is possible amid escalating economic conflicts with the US administration. While China has no friends in the White House or Congress at the present time, the leadership is seeking to preserve good relations with American firms.

Will big bear rear his ugly head?

Beyond the degeneration of the globalised, post-Cold-War world into regional blocs that we have highlighted, the effects on stock market valuations are likely to be significant. The key point that comes out of our trade bloc thesis is that increased risk and geopolitical/economic insecurity will lead to lower long-run stock market ratings.

To illustrate this, we revive here our analysis of the cyclically adjusted p/e ratio and the price-to-book ratio. Both of these have disappointed their advocates by failing to revert to mean, but we have described in some detail why this is: the broad point is that the long-run mean is depressed by the traumatic experiences of the 'short 20th century' (WW1 through to the end of the Cold War). Such long-run averages have therefore proved inapplicable to the past 25 years since the collapse of communism. But the shift from relatively pure globalisation to regional blocs has to increase the risk of 'hot' war, as well as entailing sub-optimal global trading patterns. So some reversion to the long-run stock market ratios prevailing in the short 20th century may result.

US S&P CAPE w. long-run & sub-period averages



Source: Professor Shiller, S&P, Datastream, TS Lombard

The cyclically adjusted p/e ratio, CAPE, is the ratio of the real (CPI-adjusted) price to the previous 7½ years' average real (CPI-adjusted) earnings. The S&P index is used, as it goes back to 1871, drawing on the data prepared by Professor Robert Shiller of Yale. Other analysts, including Shiller, use a 10-year average of real S&P earnings. But as the length of the conventional US economic cycle has been 7½ years, that is a better period: taking a 10-year average looks suspiciously like falling back on a round number.

The chart above shows the CAPE since 1880. The long-run average is just over 16, so it is little surprise that the post-Cold War average of close to 25 has induced persistent bearishness from the devotees of this ratio. But we have analysed this exhaustively, [most recently last March](#), and it seems clear that the subdivision of the post-1880 period is justified. The chief point is that in the period from WW1 to the end of the Cold War, confidence in the stock market was doubly blighted by events and insecurity:

- The First World War was followed by the Great Depression, then the Second World War and then, after 25-30 years of good recovery, by the Great Inflation and the oil crises;

- Throughout the period the world was threatened with, and in large parts of the world ruled by, a system of government, communism, which advocated confiscation and abolition of private property.

Given the relief of investors from these fears after the end of the Cold War, it is little surprise that the CAPE has typically been much higher since then. It did indeed revert to mean in the short 20th century, as can be seen from the chart, but has not been tied down by that average since 1991. Quite what the right long-run level for the CAPE should be in post-Cold War conditions cannot be specified. Determining such a mean requires a look at two or three cycles, and since 1991 we have not yet completed one.

The average length of the US stock market cycle is 30 years or more. For example, CAPE peaks occurred in 1901, 1929, 1965 and 1999, giving an average cycle length of 33 years. Troughs were in 1921, arguably 1949, 1982 and 2009, for an average cycle length of 29 years. But it seems fair to assume that the market is currently priced for a continuation of the post-Cold War environment with its 7½-year CAPE 11-12% above the average since the collapse of the Soviet Union.

How does bloc regionalisation affect US stocks?

The contention here is that the devolution of the world economy into regional blocs will reduce the long-run average CAPE. This does not permit a forecast of what the long-run CAPE should average because, to repeat the point, we have not yet had one full post-Cold War cycle.

A number of factors apply that, in conjunction, suggest that the long-run CAPE average will come down, but not to the average of the short 20th century:

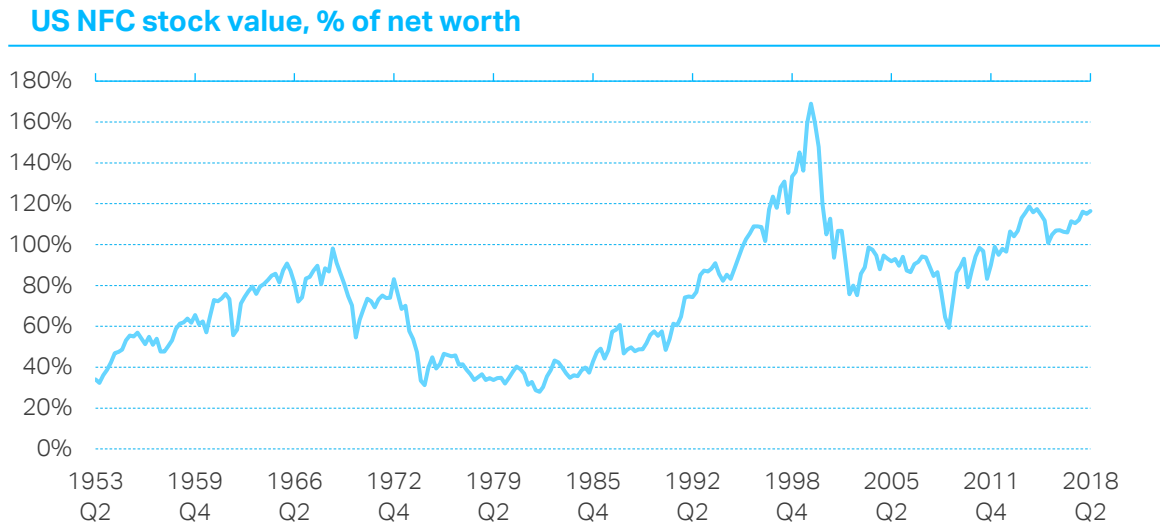
- Inter-regional trade could suffer substantially, as firms will not want to be committed to supply chains that could be rendered economically sub-optimal by arbitrary government action;
- Outside of the North American regional bloc, the probable desire to avoid being too reliant on dollar financing could reinforce the tendency towards low productivity of capital that is in any case prevalent outside the Anglo-Saxon economies, especially in China;
- Global mobility of capital could be further undermined by a tendency of firms to spin off subsidiaries in regions where inter-bloc tensions threaten their interests;
- The CAPE average since 1991 may have been artificially inflated by investors' euphoria and various temporary economic effects of globalisation.

The post-Cold War period was initiated in 1989-91 by the repercussions of the fall of the Berlin Wall on Eastern Europe; the dissolution of the Soviet Union; market reforms in India, which abandoned its semi-socialist ways; and China's resumption of market-friendly economics after the shock of Tiananmen Square. This meant the population of countries engaged in the global free market multiplying to four billion or more from about one billion. Access to this largely low-cost new labour pool substantially raised the value of existing assets, until such time as the extra labour had been provided with adequate capital. While the bubble of the late 1990s was about investors getting carried away with hi-tech, this factor was also partly responsible, contributing mightily to the high CAPE average since 1991.

Apart from investor euphoria, this is a more substantive reason for thinking that the long-run 'right rate' for the CAPE may be below the actual 1991-2018 average, even before considering the points in this View about the splitting of the globalised economy into trading blocs. Nonetheless, even if the right rate for CAPE is below the near-25 average since 1991, there is

nothing in the threat of such a split to cause it to fall to the under-15 average of the short 20th century.

Price/book ratio also likely to be lower

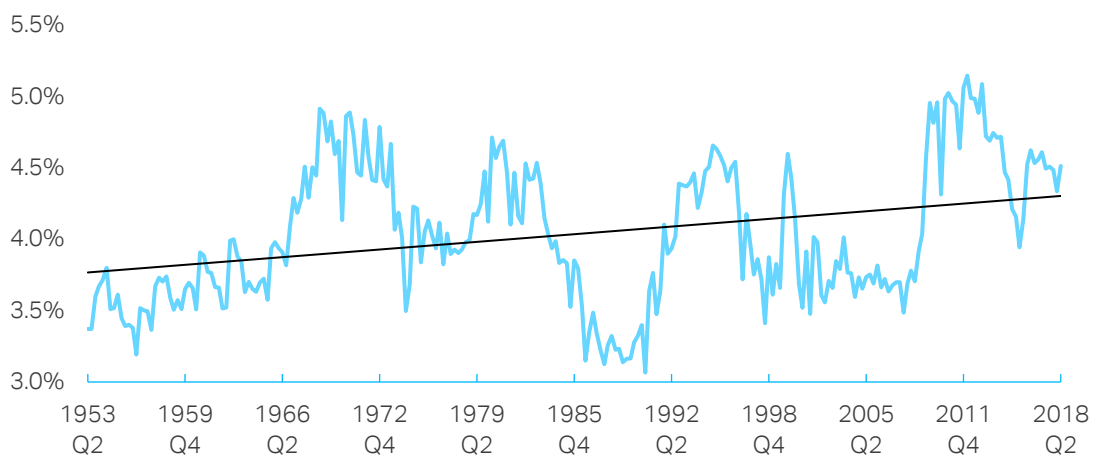


Source: US Fed, Datastream, TS Lombard

The best source for the price/book ratio of US non-financial stocks is the Fed’s flow-of-funds data, which have given both the numerator and denominator of the ratio quarterly since 1952. Earlier data have been derived academically, but those in the chart above are internally consistent. They are not fully representative of the stock market, however, as they include companies (with estimates of their shareholder value) that are not quoted. The chart follows the S&P index in its peaks and troughs, with due allowance for the build-up over time of book value.

The important point for the analysis here is that in the short 20th century the price/book ratio was way below the theoretical ideal of 100%, whereas since then it has been around, often above, that level. This reinforces the basic conclusion that until the end of the Cold War US stock market values were fundamentally depressed by the 20th century factors already cited.

Price/book ratio as % of CAPE, with trendline



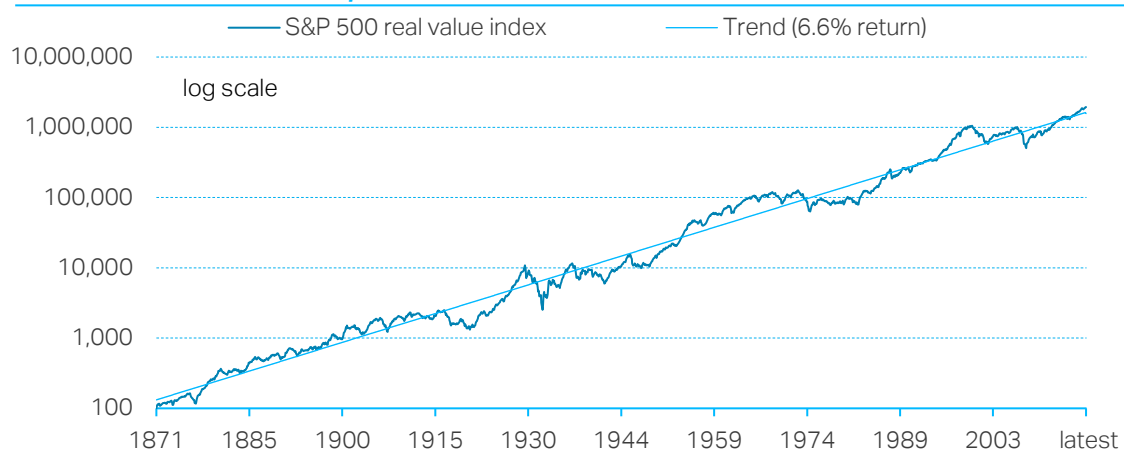
Source: TS Lombard

Theory says that the *p/e* ratio should be high when profits are low, and *vice versa* – investors are (apparently) expected to see through cyclical fluctuations. In reality, they do not always have quite the foresight formerly attributed to ‘rational economic man’ (or ‘woman’). But the chart

above showing the ratio of price/book to CAPE displays some cyclicity, plus some reflection of the tendency towards crowd behaviour at market peaks described by [my colleague Andrea Cicione](#). It shows a statistically significant upward trend of the price/book ratio, reflecting the shrinking importance over time of its denominator, basically the net capital stock. With the explosion onto the scene of tech stocks in the past 30 years, this trend is likely to continue. It follows that even if CAPE settles back a bit over the medium term, 'Q' (slang for the price/book ratio) may stay around current levels, i.e. not relapse from 100% in any marked way. But this probably reflects the increasing irrelevance of book value and is not any special reason to be bullish about stocks.

Real value index looks toppish

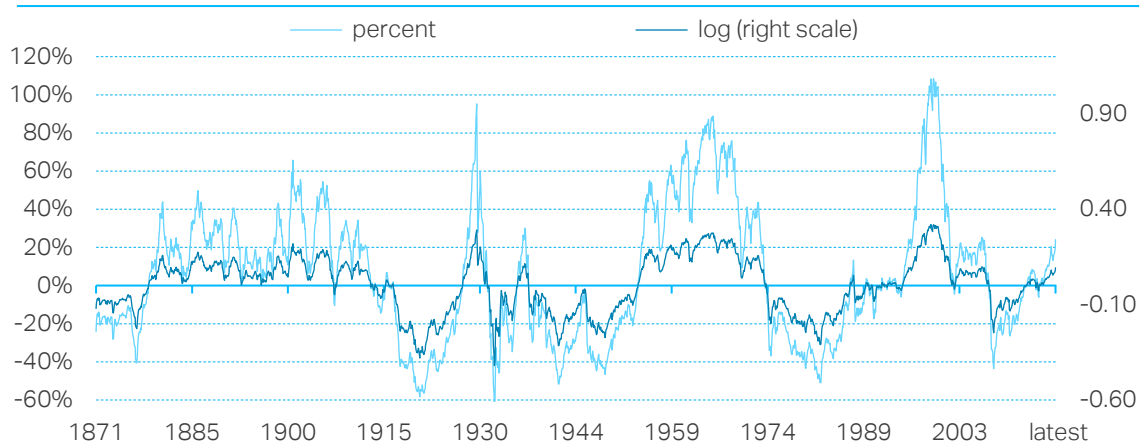
US S&P real value index, Jan-1871 = 100



Source: Prof. Robert Shiller, Datastream, TS Lombard

The long-run valuation metric that has continued to prove its worth before, during and after the short 20th century is the real value index (RVI), i.e. the S&P index with dividends reinvested and corrected for CPI inflation. It has consistently stuck to trend over 150 years: \$100 invested back then is now worth \$1.9m in 1871 dollars (about 20 times that in current dollars) with a steady annual trend return of 6.6% in real total value.

Deviations from trend of S&P RVI



Source: TS Lombard

This chart shows the deviations from trend of the RVI. These are the best indications of the cycles in stock market values. The deviations on the upside peak at about 100% (i.e. two times the trend) and trough at about 50% (half the trend). So the maximum deviation tends to be a

factor of two. (The log-scale deviations are correspondingly symmetrical.) While the current upside deviation of 24% is not excessive – nor does it decisively suggest overvaluation – it is close to the peak achieved in the pre-crisis period, which was 25% in May 2007. This suggests little support for the current CAPE rating of the market that is now likely to be undermined by the introduction of geopolitical and inter-regional risks greater than we have seen since 1991.

Given the underlying long-term RVI real return of 6.6%, today's above-trend level discounts nearly four years' future returns. With the pursuit of trade war pointing to the threat of a dollar appreciation that could hurt earnings, and with stock market values undermined by the breakdown of globalisation into regional blocs, it is entirely possible for the current market premium to the RVI to swing to a discount. Normal above- and below-trend periods tend to last a dozen years or so, the total cycle being about 30 years in length. The post-crisis, below-trend episode lasted only 5½ years and was to a degree artificially ended by QE. These factors combine to make a bear market a major risk over the next two or three years.

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