TS Lombard

China Watch

TRADE WAR IMPACT: ECONOMICS, FX AND EQUITY

China Team

Economics

- Beijing will calibrate stimulus to trade war escalation – we adjust our growth forecast to 6.2% to reflect trade and sentiment risks
- Without trade war de-escalation the yuan will break USD/CNY 7 level
- "Structural deleveraging" is set to take a backseat during trade friction

Markets

- Investors are particularly concerned about East Asian EMs and China
- US-listed Chinese stocks underperform the Chinese market
- But DM equity markets underestimate trade war dangers

Politics

- Cross-Strait relations will dominate Taiwan's presidential election
- The KMT front-runners are seeking, albeit with limited success, to disassociate the party from the mainland
- The trade war could erode KMT's appeal as the party for the economy

Economics: Stabilizing growth amid trade friction

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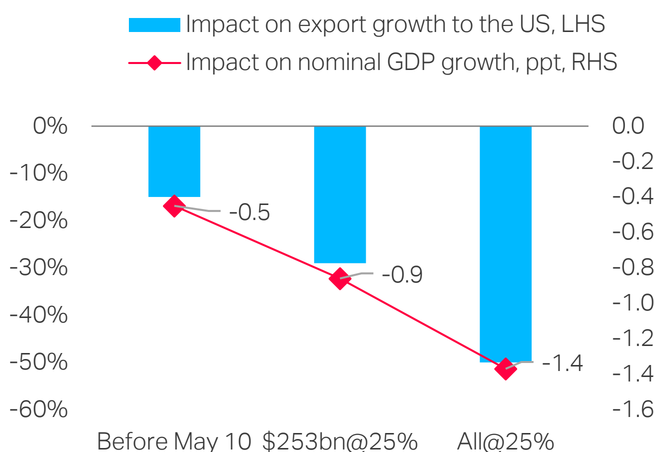
Seasonality has driven the China narrative in 2019. An unusually late China New Year shutdown in February boosted the March data and kicked off the market's "green shoots" rhetoric. The April numbers, which declined relative to March, quickly shifted the headlines to "losing steam". Last month, we turned slightly more positive on the growth outlook because the outsized fiscal front-loading smoothed the short-term growth fluctuation that we had previously expected in H1/19. Moreover, besides aggressive fiscal front-loading, the risk of outright PPI deflation has receded compared with the start of the year.

However, the escalation of the trade war forcefully made itself felt in May, overriding evidence of any "green shoots". Growth stabilization in China now hinges on the interplay between trade tensions and policy support. Although China is likely to maintain its policy of measured retaliation against US tariffs, it is clear that higher tariffs will weigh on China's short-term economic activity and planning. We expect the authorities to tone down language about "structural deleveraging" in the face of this uncertainty and to scale back their previous commitment to stabilize the renminbi in order to gain greater policy latitude.

On trade talks, the next key event is the G20 Osaka meeting between Xi and Trump. We believe the prospects of reaching a trade agreement in Japan are now dim. The likely outcome is that Trump will set another deadline of three to six months for a deal to be struck and if there is no agreement by that time, he will press ahead with the threatened tariffs on another US$300bn worth of Chinese goods. Our economic base scenario is that the existing tariffs are here to stay throughout 2019, while the US will continue to ratchet up non-tariff friction.

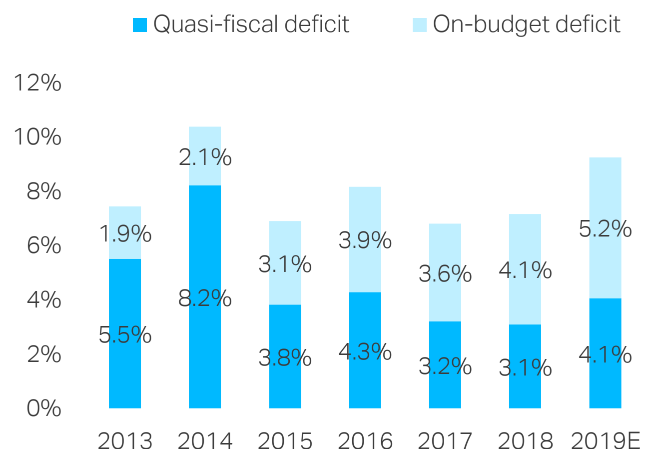
Quantifying the direct economic impact of the trade war, we estimate that the 25% tariffs already in place on US$250bn of US imports would reduce aggregate Chinese value added by US$56bn. Those losses would translate into a potential first-order impact of a 0.4% reduction in

US trade tariff impact on China



Source: TS Lombard.

Broad fiscal deficit, % of GDP



Source: TS Lombard.

nominal GDP in the following four quarters. If there were a blanket tariff of 25% on all Chinese exports, the reduction in nominal GDP growth would be 0.9% (see left-hand-side chart above)

Owing to the sheer size of the Chinese economy and China's declining current account surplus, the immediate impact on growth of the additional tariffs imposed in May should still be manageable through trade channels. On the other hand, standard economic analysis typically fails to take into account any second-order effects on confidence, the accelerator effects of business capex, the labour market, domestic consumption and the most sophisticated global supply chain, all of which are likely to be hit by trade friction. Beijing will certainly take measures to offset tariffs. Said measures will likely be the single-most important factor (overriding all others) in driving the short-term growth outlook.

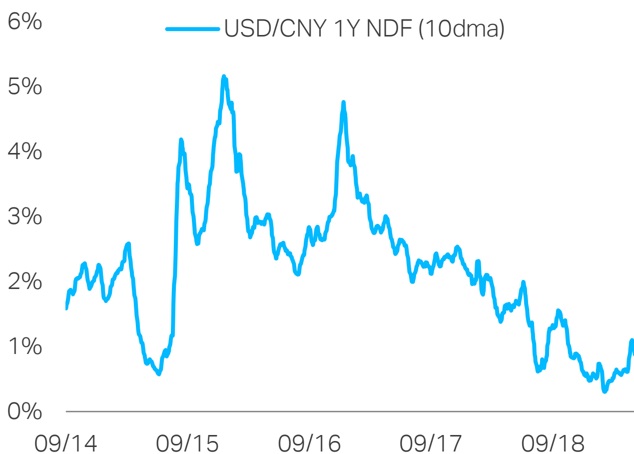
Faced with trade headwinds, we expect the Chinese authorities to soften the newly restated language on "structural deleveraging". Thus, the ongoing credit easing and fiscal stimulus will likely strengthen once again in H2/19. So far, China's deleveraging effort through controlling public debt and "measured easing" has been the key focus of the authorities in controlling financial system risk. The priority now for the PBoC, in our view, is to enhance policy transmission and channel existing liquidity within the banking system to the real economy, especially SMEs and private enterprises. But if the existing tariffs remain in force beyond June, we expect Beijing to recalibrate its policies to return to an easing bias. Additional RRR cuts, broad-based or targeted, are becoming more likely. Liquidity injection via OMOs and MLFs should be more proactive going forward, although interest rate cuts in 2019 remain unlikely.

RMB response – the unlucky number 7

Without a trade deal or material trade war de-escalation in the next three months, the RMB will break the USD/CNY 7 level in H2/19. Since RMB stability has been conditional on good-faith negotiations, we think Beijing may now choose to let the currency passively devalue against USD and the currency basket in order to partly offset the latest tariff escalation. However, prior to the G20 summit China will defend the 7 level to avoid further inflaming tensions.

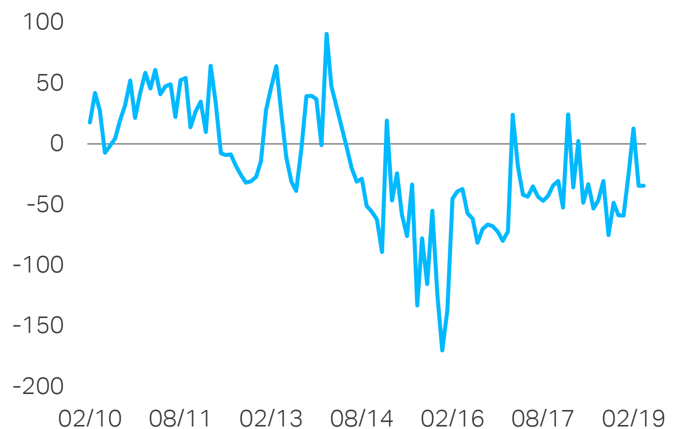
As we outlined in detail last year, a combination of economic, financial and regulatory changes since the 2015 devaluation has given the authorities more confidence in their ability to allow depreciation of the currency without excessive domestic turmoil. Beijing's confidence is well placed, despite the remarkable nominal fall of more than 9% against the US dollar from its April

Depreciation not expected



Sources: Datastream, TS Lombard.

China capital outflow (US$bn)



Sources: Bloomberg, TS Lombard.

peak last year, the feared exodus of money did not materialize. Neither households nor corporates panicked.

Shutting the household capital account. Since 2015, Beijing has instituted a slew of measures to increase the difficulty for HH to convert CNY to USD. These range from FX withdrawal and spending restrictions to facial recognition software on ATMs and tax initiatives. The OECD's Common Reporting Standards (CRS) initiative to prevent tax evasion is a game-changer. CRS allows Beijing to access citizens' offshore accounts in 102 different countries, including the US, the UK and Canada, which are the most popular destinations for Chinese money. Moving funds overseas is now just half the battle. Households must also hide those funds and/or find a way to legally justify their existence. If individuals are unable to provide justification, Beijing can repatriate the money. Even if the funds, are legal China is able to levy taxes on the assets.

Corporates squeezed into compliance. Dollar debt has risen marginally this year and remains far below the 2015 peak. Meanwhile, firms are better hedged against FX moves. More important, the widely publicized crackdown against Anbang and HNA, among others, has curbed corporate outflows. In 2015-16, private firms aggressively acquired foreign assets through leveraged financing from domestic financial institutions. In 2019, facing depreciation pressure, corporates will manage their balance sheet to reduce dollar exposures. However, given reduced access to leverage under Beijing's measured credit easing policy and the aforementioned crackdown, overall sector capital outflows will be smaller than during the last RMB devaluation episode.

Even as trade friction resurfaces, FX options show little evidence of speculative pressure. One-year non-deliverable forward (NDF) is pricing in around 1% depreciation. This suggests no great appetite to bet against the RMB. Meanwhile, indicators of corporates moving ahead of expected depreciation – dollar debt repayment, offshore borrowing and the ratio of FX purchases to export receipts –remain stable. The domestic political and economic environment of 2015, an initial RMB depreciation of 3% spooked investors, threatened a financial crisis and raised questions about authorities' economic competency, mandating support for the currency. Today, depreciation is a viable option, China is not in crisis, nationalism is running high and the PBoC is able to frame currency moves as a market-driven response to US trade protectionism.

Fiscal frontloading to quasi-fiscal stimulus

Our analysis of the official 2019 budget plan suggests that the broad fiscal deficit measure points to fiscal stimulus being more expansionary this year than in 2017-18: the deficit to GDP ratio is set to widen from 7.2% in 2018 to around 9.3% in 2019. The total on-budget fiscal deficit from China's four official fiscal accounts will widen from 4.1% in 2018 to 5.2% in 2019. Owing to the constraints of the annual fiscal budget, significant front-loaded spending and local government bond issuance in Q1/19 will lead to a decrease in the growth of on-budget fiscal expenditures in H2/19, particularly in Q4/19. If growth were to come under threat of further tariff escalation, there could be more proactive quasi-fiscal spending in the form of LGFV bond issuance as well as increased shadow-banking activities and local government land sales. One major move to expect in H2/19 is targeted measures to stimulate auto and durable goods consumption, which we expect to stabilize retail sales in H2/19.

We also expect Q1/19 growth stabilization to carry through Q2-Q3/19 as the impact of front-loaded fiscal stimulus and further credit easing continues to support growth. But the major front-loading of fiscal policy support is set to fade in Q4/19 and the escalation of the trade war will drive down growth to 6% towards yearend. **Under our base scenario of no tariff de-escalation, we expect the Chinese economy to grow 6.2% in 2019 as a whole, after factoring in China's additional policy response to support growth.**

Markets: Differential pricing

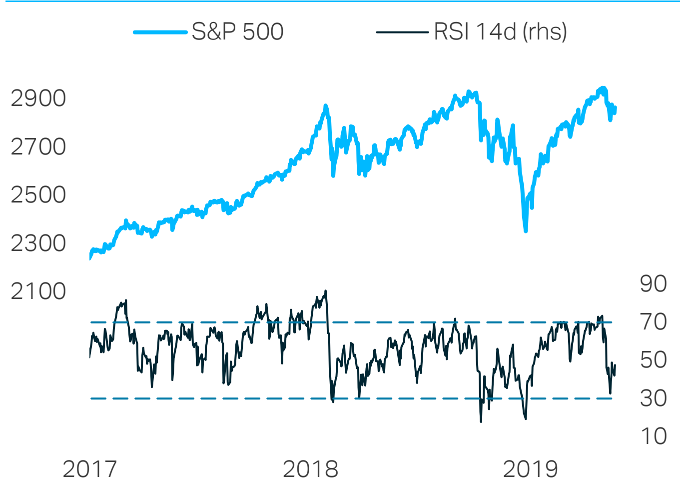
- **Investors particularly concerned about East Asian EM's and China**
- **US-listed Chinese stocks underperform the Chinese market**
- **But DM equity markets underestimate trade war dangers**

Much ado about nothing? If history is a guide, it is entirely plausible to believe that the latest flare-up in the US-China trade conflict is nothing to worry about, being simply the result of Trump doing what Trump does: putting extreme pressure on his counterpart, often at the last minute, in order to obtain the most favourable terms in a negotiation. His dealing with North Korea is an example of such a pattern, with the US president threatening 'fire and fury' shortly before a summit with Kim Jong-un, only to conclude a deal with him shortly thereafter. If this is indeed the case, we could see an easing of tensions at the G20 summit in late June in Osaka, where Trump and Xi Jinping could pave the way for a trade deal.

East Asian EMs, especially China, still hurting quite badly. This narrative seems to be what many investors are banking on. US equities experienced a relatively minor drawdown in May, along with other DM's, falling by around 5% from the recent peak. Moreover, some markets have seen a recovery from the low due to country–specific factors. Considering that the S&P was overbought and overdue a correction (see bottom-left chart) the market reaction to the trade tensions was remarkably composed. However, the same cannot be said for all markets. As the bottom-right chart shows, East Asian EMs and China in particular have sold off a lot more than the US and other major equity markets, and have not started to recover.

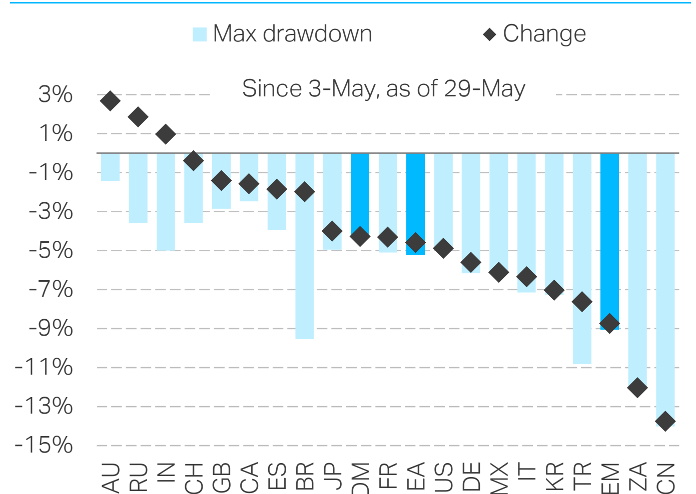
Underperformance of US listed Chinese stocks. Investors have been punishing Chinese listed companies on the US exchange. The drawdown from the peak in Chinese companies listed on the US exchange is 17% since the start of May, with some individual media and internet names down more than 30% over the period. The pace of this drawdown has been rapid and attributable to the latest escalation in the trade war, since prior to this drawdown it was nearing a 9 month high, returning 25% since the 28th of December 2018. This move has highlighted the vulnerabilities of Chinese technology and internet companies specifically, since the drawdown has outweighed the pull back of the Shanghai composite, which is down 13% since mid-April.

A correction was overdue



Source: Bloomberg, TS Lombard

Different degrees of sell-off and recovery



Source: Bloomberg, TS Lombard

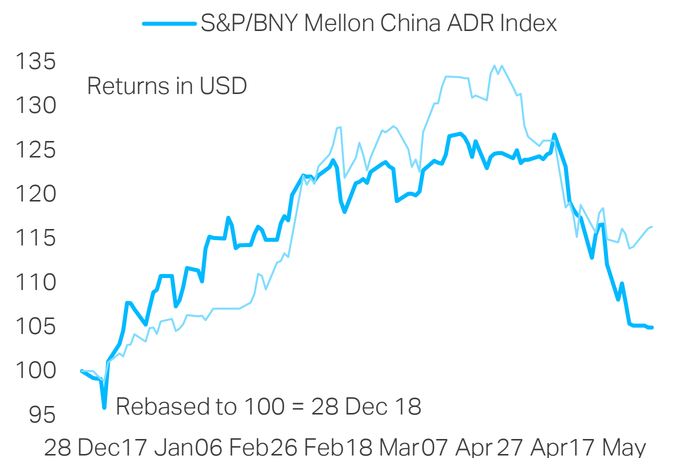
Investors mostly concerned about China and EMs. The bottom-right chart exposes a clear pattern in the reaction to trade war escalation across markets. The indices that have sold off the most are the ones that have not shown any recovery. This suggests investors are mostly concerned about EMs, especially China, and are less worried about DMs.

US not immune. We think that the market reaction betrays excessive complacency by investors about the potential impact of a trade war on the US and the rest of the world. A strong dollar – mostly the result of safe-haven flows and CNY depreciation – would hurt the foreign profits of US companies, which are now substantial (especially for Tech and Industrials). Additionally, there concerns are mounting around the possibility that certain US tech products will be "strongly discouraged" by Chinese officials, rendering the growth companies trading on higher forward P/E's particularly vulnerable. Additionally, US Tariffs on consumer products would be a regressive tax that would dent final demand in the economy and trade-related uncertainty would stop firms from making significant capex commitments further dampening growth expectations.

China's likely response: yuan down, stimulus up. China, on the other hand, will probably respond to any further ratcheting up of the row with further yuan depreciation and more stimulus, which together should help soften the blow (see economics section above). To be sure, the Fed could also react to heightened economic risks by cutting rates, as we expect them to do in Q3. It's unlikely, however, that such monetary easing would be enough to keep the US insulated from the risks.

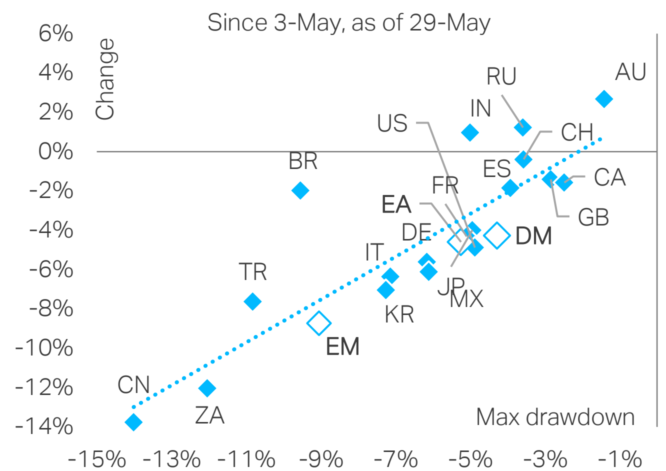
Our view is that the most likely outcome of the G20 meeting is an extension of the US China trade negotiations by three to six months. This would be better than continued escalation, but worse than our previous call of a possible agreement being sealed in short order. If we are right, uncertainty about trade will likely persist, undermining consumer and business confidence. The effect of this alone would warrant a downgrade of our global economic outlook; perhaps more importantly, making directional market calls would remain extremely difficult for some time.

Drawdowns largest for Chinese ADRs



Source: Bloomberg, TS Lombard

Largest drawdown => smallest recovery



Source: Bloomberg, TS Lombard

Politics: Taiwan's open presidential race

- **Cross-Strait relations will dominate Taiwan's presidential election**
- **The KMT front-runners are seeking, albeit with limited success, to disassociate the party from the mainland**
- **The trade war could erode KMT's appeal as the party for the economy**

Taiwan's two dominant parties, the pro-independence DPP and the Beijing-friendly KMT, are gearing up to select their candidate for next year's presidential race. The incumbent DPP President, Tsai Ing-wen, is facing a challenge from her previous right-hand man, William Lai, who resigned as Premier in January, citing poor party results in the local elections. The two main contenders for the KMT nomination are Han Guo-yu, the charismatic but bombastic Kaohsiung Mayor, and Terry Gou, the founder and Chairman of Foxconn. Both back the 1992 "consensus" with Beijing recognizing "only one China", which the DPP rejects. The presidential election will most likely be a run-off between these candidates and Taipei's Mayor, Ko Wen-je, who has no party affiliation.

The DPP candidacy announcement has been delayed as Tsai and Lai fight over the procedures for selection, which is to be done by opinion poll. Lai opposes Tsai's attempt to introduce the use of smartphones into polling, since this would enable her to capitalize on her younger support base.

Better the devil you know. The polls currently show Tsai losing the nomination, but it is entirely possible that Lai's apparent lead is down to frequently dodgy polling – the heavily partisan media have a habit of producing inaccurate survey information in a bid to influence voting behaviour. The incumbent's support level has suffered from the implementation of unpopular pension reforms and her vocal support for gay marriage. But foreign policy credentials are particularly important in Taiwanese politics, and her record as both a defender against mainland intrusion and an arbiter of good US relations is becoming more central as cross-Strait tensions grow. Xi Jinping's New Year speech calling for reunification with Taiwan and, more recently, the US National Security Advisor, John Bolton's historic meeting with his Taiwanese counterpart, David Lee, have both provided a boost for Tsai (see Chart below right).

Candidate	Party	Background	Positions
Tsai Ing-wen	DPP	Incumbent President since 2016	Anti-1992 consensus, socially liberal (pro-gay marriage), backs a strong welfare state and is pro-pension reform
William Lai	DPP	Premier of Taiwan until stepping down in January	More actively pro-independence and socially conservative than Tsai
Han Guo-yu	KMT	Incumbent Mayor of Kaohsiung, rising star of KMT, relatively inexperienced politician	Supports 1992 consensus, socially conservative, inconsistent and with ill-defined economic policies
Terry Gou	KMT	Founder and Chairman of Foxconn, no political experience	Pro-1992 consensus, pro-business
Ko Wen-je	Independent	Incumbent Mayor of Taipei	Tentative support for 1992 consensus, promotes cultural ties between Taiwan and China; centrist economic policies

William Lai is a self-styled "Taiwanese independence worker" who wants to ensure that the island does not become a "second Hong Kong or Tibet". Such strong language appeals to committed "deep-green" DPP voters, who back de jure independence. Beijing is likely to curtail trade and investment if he wins the Presidency, as it did on previous occasions when a strongly pro-independence candidate came to power.

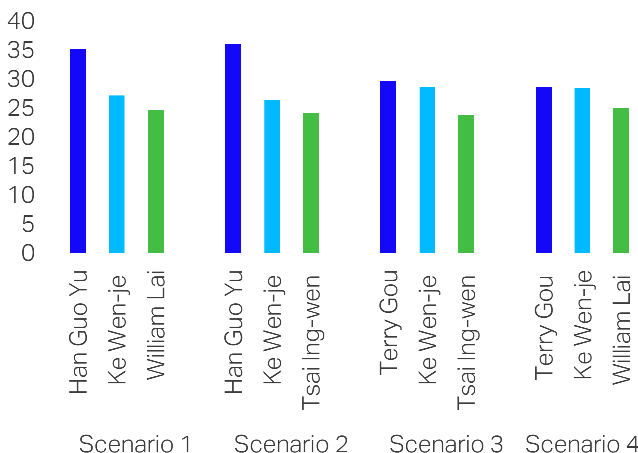
Ko Wen-je stands broadly in the middle ground between the DPP and KMT. After winning a landslide victory in the Taipei mayoral election in 2014, his pathway to the Presidency looked certain. However, his ambitions were undermined when he only narrowly scraped re-election last year. In a field of highly divisive KMT and DPP candidates, voters will be reluctant to cast their ballot for an independent who could split the vote.

The KMT is emerging from an embattled position. Han Guo-yu and Terry Gou, the two front-runners for the KMT leadership, are political outsiders seeking to break free of the party's image as Beijing's stooge. Public support for the KMT has been weak since the defeat of Ma Ying-jeou in 2016 in a landslide defeat by Tsai spurred by a backlash against his policies that were considered to have "sold out" Taiwan to the mainland.

Han Guo-yu, a political-outsider just one year ago, stormed to victory in the traditional DPP-stronghold of Koahsiung to win the mayoral election last November. His populist political style captured the attention of Taiwan's 24-hour TV cycle: one channel devoted 80% of its political news coverage to him. A few months ago, he was the clear front-runner for the KMT candidacy, but a series of gaffes and unclear economic policies have eroded his position. Terry Gou is prone to political gaffes too, which could hamper his electoral chances, as could questions about his suitability for the Presidency as Chairman of a company with extensive business operations on the mainland.

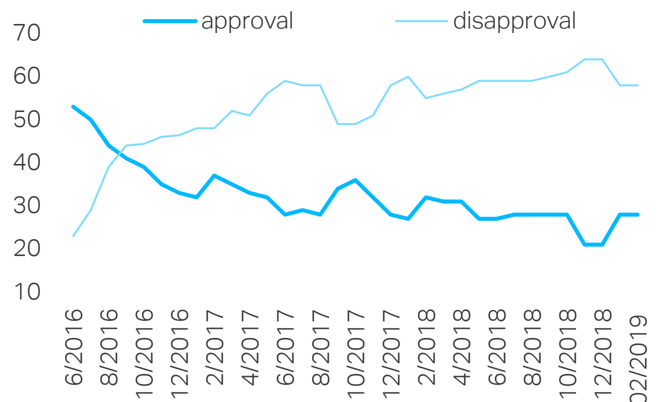
Han and Gou are both riding high in the polls, for now (see Chart below left). Support for them is likely to decline as the novelty factor of their candidacies wears off in the run-up to the election. Further, the US-China trade war is posing a challenge to the KMT's traditional appeal as the party of pragmatism that prioritizes economic growth (i.e. Chinese trade and investment) over political independence. Trade tensions are forcing Taiwanese firms to recalibrate their mainland business operations: anecdotal evidence shows that manufacturers are shifting factories from the mainland back to the island in order to evade US tariffs.

Average of 20 polls on voting intentions



Source: TS Lombard.

Tsai's approval/disapproval ratings (%)



Source: TS Lombard.

More significant, however, is the effect of the US export controls on the island's high-end technology companies. Trump's decision to include Huawei on the "Entity List" puts firms like TSMC, which uses US-technology in components sold to the mainland firm, in an extremely difficult position. TSMC has said it will continue supplying Huawei for the time being while it evaluates compliance with the US order. The recent slump in its stock price, which makes up around 20% of the TAIEX, will be a strong case study in the risks of relying too heavily on mainland business in the context of US-Sino economic decoupling.

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