

Daily Note

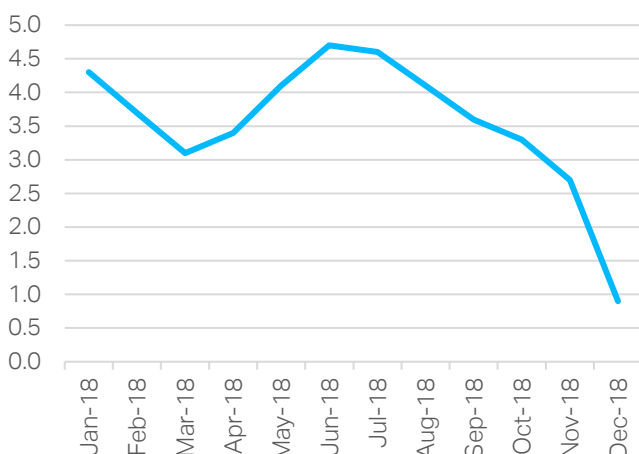
TRADE WAR FALLOUT: DEFLATION AMID EMERGENCE OF ASIA TRADING BLOC

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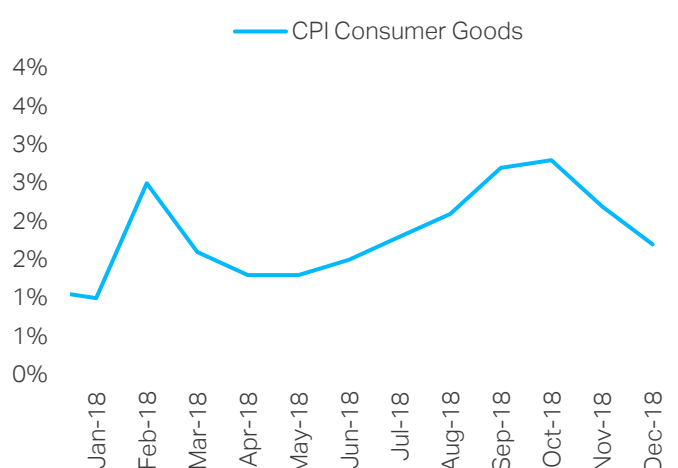
- **China's US exports to fall markedly in Q1/19**
- **Deflationary pressures building in China's domestic economy**
- **Emergence of Asia trading bloc is getting underway**

Amid all the current market optimism that the US-China trade war is finally heading in a more positive direction, we identify two important developments under President Trump's signal policy initiative. The first and most important is that the initiative has created conditions for the revival of deflation, a result that will not be welcomed anywhere. The second is the emergence of an Asian trading bloc, which will have longer-term implications for investors in the region.

The President's September decision to impose a 10% tariff on some US\$200bn of imports while threatening to raise the levy to 25% at the beginning of this year led to a large jump in Chinese exports to the US as firms sought to beat the higher tax. This frontloading of exports is now set to unwind; as a result, Chinese export growth is likely to plummet in Q1/19 owing to the build-up of inventories. US data from California's Port of Long Beach, for example, indicate record inventory levels of containers from China. Until such inventories are worked down, Chinese exports will slump, dragging down GDP growth in the current quarter and most likely increasing pressures on the yuan.

China PPI, % chg yoy


Source: Bloomberg.

China CPI Consumer goods, % chg yoy


Source: Bloomberg.

Facing existing tariffs and fearing possible new ones, Chinese firms will aggressively move to reorient spare capacities to production for domestic markets, likely modifying products to meet domestic market preferences and even manufacturing new ones. Parallel efforts will undoubtedly focus on increasing sales elsewhere other than to the US, i.e. other EMs, Japan and Europe. Domestic deflationary pressures are already evident in the slide last month of the PPI below the CPI for the first time since 2011, to 0.9% yoy from 2.7% in November. The CPI, meanwhile, eased to 1.9%, from 2.2%. The net result of these developments will be to increase deflationary pressures globally, beginning with China.

The return of deflation exported by China will undermine a slowing global economic recovery. Meanwhile, China's slide into current account deficit as a result of slumping exports and rising deflationary pressures on prices of manufactures should temper investors' optimism about current positive news on new stimulus measures. At the same time, these latest measures imply that the leadership is likely to redouble their stimulus efforts because they are unlikely to be sufficient to put a floor on the current slowdown if deflation emerges. We project that the PPI will dip to zero in the second quarter before recovering in H2/19 as the full impact of the stimulus measures plays out. Meanwhile, the growth of prices of retail manufactures is likely to fall to zero or below, while rising food and services prices will keep the average CPI around 2% for the year.

Unsurprisingly, Trump's trade war has altered global trade flows in major ways. Last September [we argued](#) that the trade war would change trade flows in ways that achieve low costs of production but not by bringing manufacturing production back to the US. We predicted that market forces would instead create a new Asian trading bloc with China at its centre. Although our thesis was for the medium to longer term, recent data provide some early signs of how this new trading bloc is emerging. Below is a detailed breakdown of Thailand's November trade data by region and major line of products that might form part of developing regional supply chains. As a major supplier of components to China for reassembly into export to the US, Thailand saw its exports to China fall nearly 10% yoy; meanwhile, its direct exports to the US rose sharply. On the import side, we see strong growth from China as well as from the US and ASEAN. These data are consistent with the redirection of exports of components from China and to direct exports to the US. On the import side, increasing purchases from China and other Asian countries dominate, highlighting the growth of Asia trading links.

Thailand export growth (US\$ %yoy, Nov)

	World	ASEAN	China	US	Japan	EU
Total	-1	+5	-9	+12	+4	-2
Machinery (16%)	-4	+1	-19	+4	+12	-9
Electrical (14%)	-6	-2	-10	-3	-12	-2
Vehicles (12%)	-6	+2	-32	-7	+42	+5
Rubber (6%)	-6	-13	-18	+14	-13	+7
Plastics (6%)	+4	+8	+6	+31	+9	+6
%Total exports		28%	12%	12%	11%	8%

Source: CEIC, TS Lombard.

Thailand import growth (US\$ %yoy, Nov)

	World	ASEAN	China	US	Japan	EU
Total	+15	+15	+15	+6	+14	-7
Electrical (18%)	+6	-1	+12	+7	-1	+8
Machinery (12%)	+11	-4	+26	+38	+6	-4
Vehicles (4%)	+15	+1	+45	-19	+22	-1
Plastics (4%)	+11	+8	+22	+2	+13	-1
%Total imports		18%	21%	6%	14%	8%

Source: CEIC, TS Lombard.