

Global Watch

TRUMP VS DEFLATION

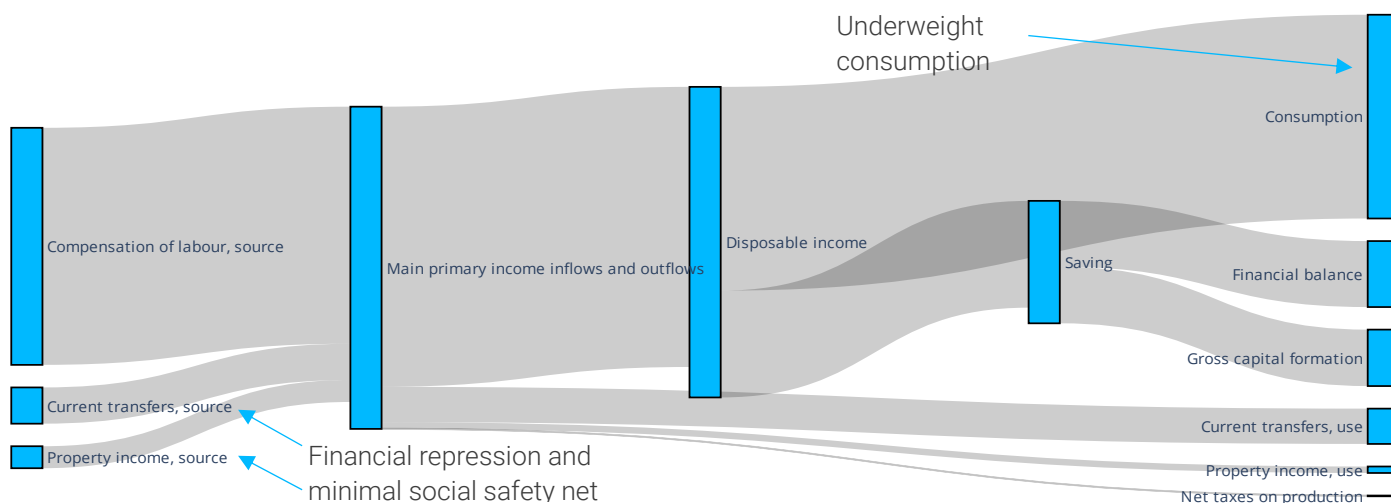
Freya Beamish / Christopher Granville / Rory Green / Grace Fan

- US inflation continues to bubble away as China wafts deflationary draughts
- Chinese debt saturation brings Chinese lack of competitiveness to a head
- ... Ensuring a collision course with whomever is in the White House... and the Bundeskanzleramt... and the Palais de Elysée ...

Summary

For several years now, we have talked about a reservoir of inflation in the US and deflation in China. This dynamic will cause friction as the US presidential election approaches. China's growth model has nowhere to go but abroad, if policymakers are not prepared to admit past mistakes. But over capacity cannot sustainably be remedied with fresh overcapacity, especially it puts China in direct competition with higher value-added DM producers. No matter who is in the White House, China's desperate need to export deflation will meet with a heated response. At the same time, China's deflationary draught is limited by the willingness of domestic workers to accept wage compression and investors to accept diminishment of returns. In the aggregate, the hyperglobalisation drag on DM wage growth is receding. But wage growth and returns in the CCP's favoured sectors are limited by continuing flow of Chinese excess savings. In this context, rationality seems unlikely to win out over political expediency.

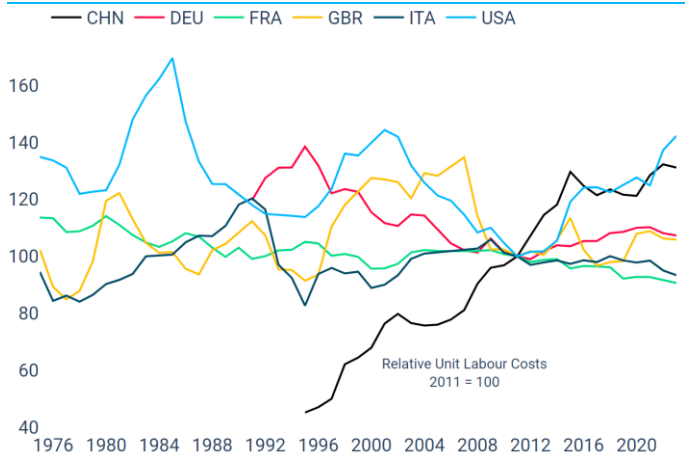
Chinese households are inadequately compensated for their capital; how low can EV returns go?



Source: CEIC, TS Lombard

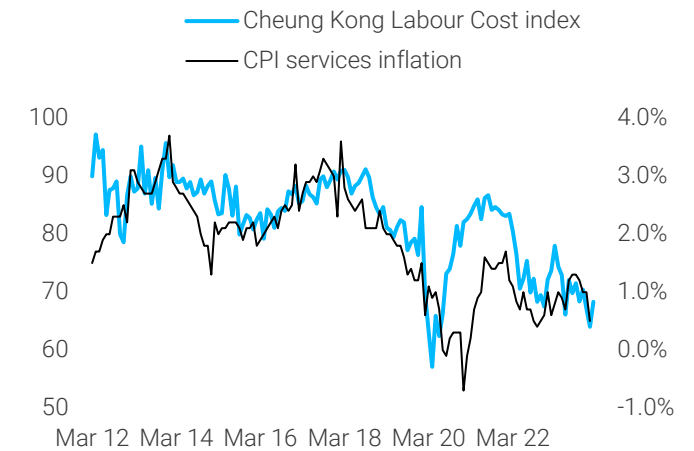
Let's consider the interrelation between two outlandish things: Donald Trump's reported mother-of-all-bazookas [import tariff plan](#) and our claim that Chinese uncompetitiveness is coming to a head. Regardless of whether Trump returns to the White House and then proceeds with the mooted 10% tariff hike on all imports with a 60% tariff on all Chinese imports, markets are taking note of the protectionist prospect: [as we noted last month](#), the old trade war trades are being revisited with pressure on USD/CNY. The supposed Trump plan for 2025 is more broadly significant in the here and now as a weathervane alert about the global implications of China doubling-down on one form of over-supply (domestic residential real estate) with another – in the form of an extraordinary industrial policy push ([China's new growth model will shake the world](#)).

China is no longer globally competitive



Source: GlobalData TS Lombard, Datastream, OECD

Unlike elsewhere, China's wage growth is receding



Source: GlobalData TS Lombard, Datastream

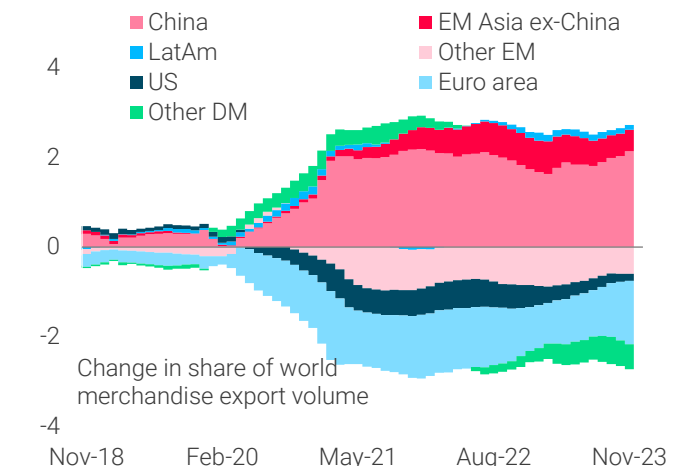
The reliance on external demand to absorb the resulting glut of Chinese EVs, PV panels, batteries and low-end chips is the backdrop for our controversial claim that the RMB has been uncompetitive in unit labour cost terms since as long ago as 2012. Having been previously camouflaged by the pandemic export surge, mainly just a reflection of China's unique capacity to meet leaping and inelastic global demand for goods, this reality may now seem belied by present-day surges in (notably) EV exports. Such apparent competitiveness is a mirage: global

China global trade at an all-time high



Sources: CPB, TS Lombard.

Asia won; Europe lost

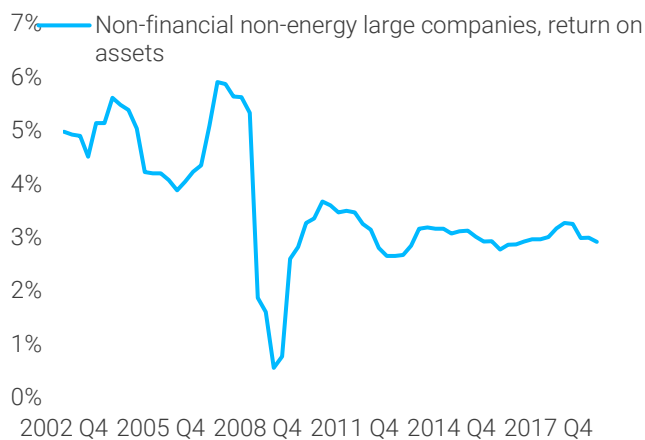


Sources: CPB, TS Lombard.

competitors in the sectors receiving strategic Chinese state subsidies are priced out at the expense of China's own returns on capital and wage growth.

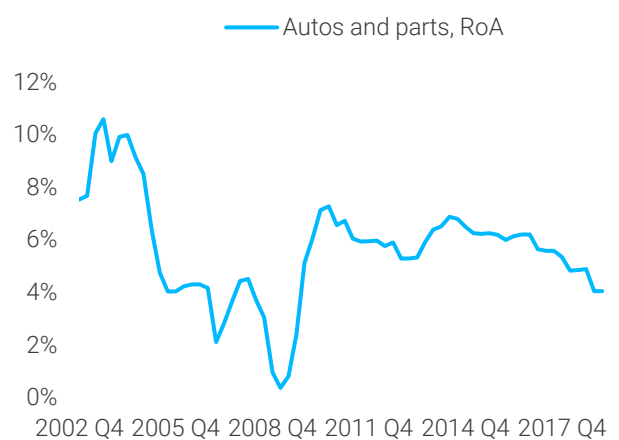
Although not over-valued compared with the dollar, due to the dollar's own strength, the RMB has likely been uncompetitive for a while. Indeed, the ratchet up in debt a percentage of GDP from 2011 is a symptom of that. No longer able to export the same degree of its excess savings, China was forced after the GFC to internalise part of the deficit, which is the counterpart to internal surpluses. Similarly, this is when we see the PPI going from inflation of 5-6% to deflation of 2-3%, prior to the oil price decline in 2015. It is also when it becomes clear that return on assets has been inexorably damaged. And even accepting the compression of RoA, China's share of world merchandise trade ceased increasing.

Chinese RoA has suffered under excess investment



Source: GlobalData TS Lombard, Datastream

Now autos are a major drag on China's RoA

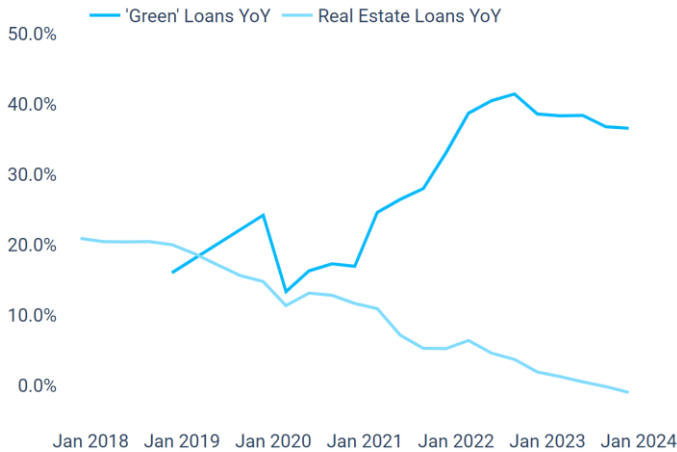


Source: GlobalData TS Lombard, Datastream

Debt saturation, therefore, brings China's lack of ULC competitiveness to a head, because it forces politicians wedded to control over excess savings flows to look abroad again, in search of demand for their production. The flow of funds must balance – surpluses must equal deficits – and if corporations, local governments and households are forced to deleverage by running surpluses then the government and foreigner deficit must pick up the slack.

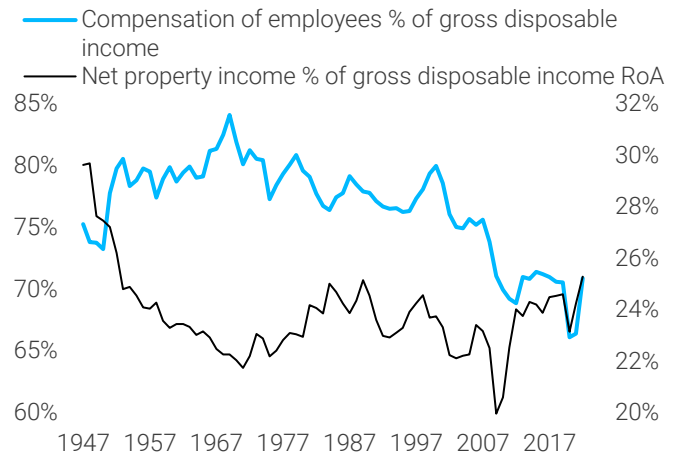
China's response to oversupply has been to reorient the state-led part of excess savings toward new sectors, which on the face of it will benefit the environment, but won't help China's shift toward private consumption-led growth. The deficiency of income in the household sector stems not from compensation of employees – as we've just said, China is not competitive on this measure – but from lack of returns on wealth. Rather than allowing failures to fail, freeing up resources for more productive investment, the failing growth machine has simply been reoriented. With the heavy capital injection in EVs, RoA in the autos sector has been a major drag over the past few years. So perhaps we should qualify our assertion of Chinese uncompetitiveness. China is not competitive *by market-oriented standards*. But willingness to compress returns in new sectors where the baseline is higher gives a fresh lease of life to China's deflationary potential.

China creating fresh overcapacity



Source: GlobalData TS Lombard, CEIC

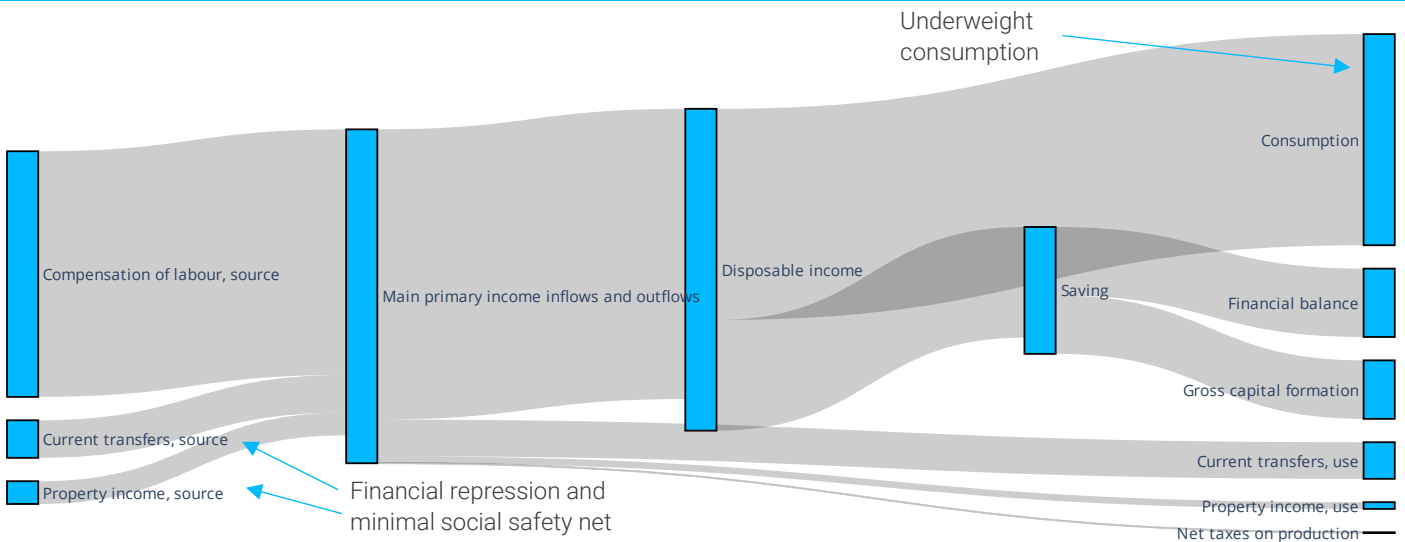
US CoE has suffered in the past two decades



Source:

We have argued that China no longer being undervalued is enough to lift the lid on DM wage growth over the secular term, and we stand by that. There will never be a country the size of China entering onto the world stage at such undervalued rates as did China in 2001. That is a key shift in the trend of DM wage growth. **It means that DM wage growth is constrained only by the willingness of Chinese workers to accept wage compression and Chinese investors to accept RoA compression.** Given the drying up of liquidity and bank exposure to previous bad debts, that capacity to accept RoA compression must also be limited. From the Chinese side, it means that ULC growth must now be proportionate to US ULC growth. The socio-economic implications could be grave. China's economic model is broken because the Chinese Communist Party has nothing to tell workers or asset holders to keep them believing in the Chinese dream.

Chinese households are inadequately compensated for their capital; how far can returns be compressed?



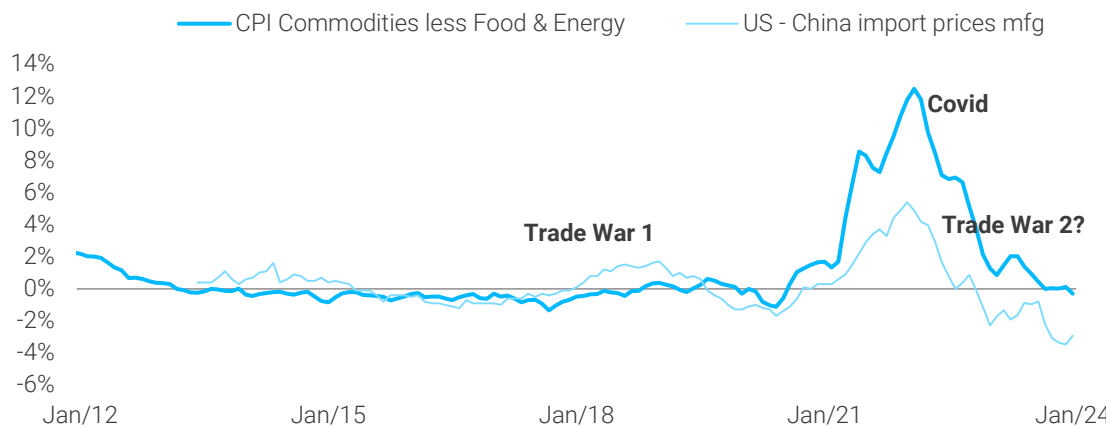
Source: CEIC, TS Lombard

The result is the renewed attempt to export deflation. The sectors that have been singled out as the new beneficiaries of the Chinese excess savings machine are blowing disinflationary draughts around the world. This limits DM wage growth in the CCP's favoured sectors, though, we reiterate that the extent of the constraint depends upon Chinese capacity to depress returns and wage

growth rather than a massive pool of offshore undervalued labour. And where deflationary draughts do escape, they will be met with a heated response.

Our title is again cheeky because, Trump or no Trump, there will be a global reaction to China's profit-blind dash for world market share as a way of cushioning painful domestic property deleveraging. In the richest Chinese export markets in Europe and North America, competition for jobs is sharpened by national security concerns.

Will US consumers stomach a new trade war?

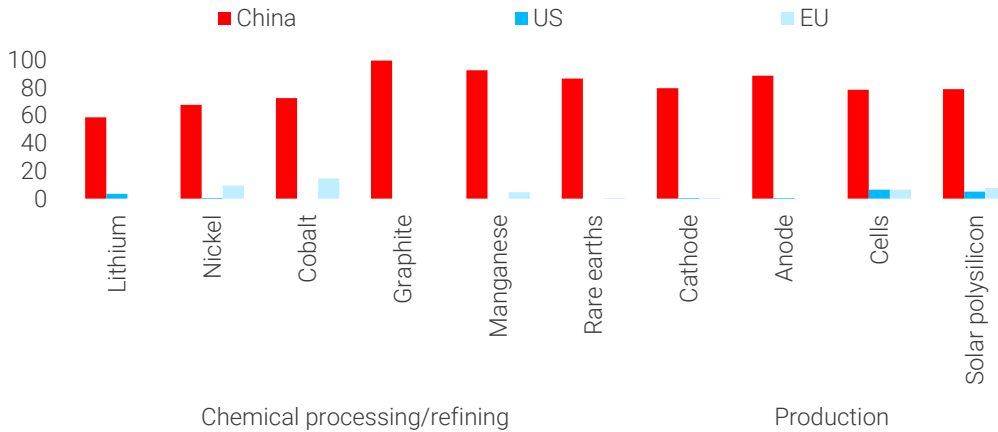


Source: U.S. Bureau of Labor Statistics

But there is another catch: this reaction to deflationary Chinese mercantilism will be more problematic in our present more inflationary times compared to first Trump trade war. This change may restrain trade aggression. As President Trump noted in December 2019: *“What we’ve done is we’ve delayed [tariffs on List 4B] so they won’t be relevant in the Christmas shopping season.... Just in case they might have an impact on people.”* Those tariffs were never implemented. Tariff lists 1-3 were enough to trigger consumer goods inflation (chart above). This must be a higher concern in 2025 and should work to moderate tariff hiking zeal. The purported Trump plan of slapping a 60% tariff on all Chinese imports would be particularly inflationary as the roughly half of Chinese imports that are now un-tariffed are those where China dominates supply, meaning a higher direct pass through to consumers. Even assuming, in line with most models, that such a tariff reduced direct Chinese imports to zero and replaced them with a more thoroughgoing version of re-routing (‘transshipments’) via countries like Vietnam and Mexico, increased shipping costs will feed through into final prices more than in 2018-19. More expensive iPhones will not be a popular policy, especially if it comes with higher interest rates.

The inflationary consequences of protectionist reactions to this latest instalment of Chinese mercantilism may be aggravated by potential Chinese retaliation. The prime potential supply shock here would be Chinese restrictions on exports of rare earths and other ‘weaponizable’ critical green supply chain inputs (see chart below). While this ‘nuclear’ option might materialise in the extreme Trump scenario, the more conventional playbook will be applied to protectionist responses from the US, EU and elsewhere. This centres on further de-Americanizing its supply chain, while other retaliation options include hits to China-based US firms and, as relevant, EU firms. These will be limited by the importance of those firms: Tesla (tech) and Apple (employment) should escape direct attacks. However, growing nationalism may trigger patriotic purchasing, which, combined with weaker spending power, could see Chinese consumers favour local brands over American ones. Huawei is already outselling the latest iPhone.

China share of critical mineral supply chains (% of total)



Source: IEA, BCG, Benchmark Mineral Intelligence, GlobalData TS Lombard

Europe’s dependence on the Chinese market makes protectionist responses to, in particular, Chinese EVs more costly. Were this to be coupled with Trump-style indiscriminate protectionism, Europe – which has pivoted its own external demand dependency from China to the US (chart below) – would be severely squeezed. This grim prospect of an intensifying European de-industrialization dynamic is reviewed by our colleague Davide Oneglia in his [latest Europe Watch](#) – along with upside potential of any such severe shock of catalysing an overdue policy shift to supporting domestic demand through large and permanent joint (federal) investment capacity.

Collateral damage from heightened US protectionism would also extend to Mexico. Trump is the main, but not the sole, key to this risk of Mexico being denied its nearshoring ‘moment in the sun’ after overtaking China last year as the top exporter to the US. Strategic decisions on FDI into Mexico will now be inhibited by the mere possibility of a future baseline 10% tariff on Mexican imports under Trump 2.0 will inject an additional dose of uncertainty into FDI decisions (particularly for the auto industry as both Mexico’s top export sector and a longstanding focus of Trump’s NAFTA ire). This uncertainty will come on top of the **looming USMCA joint review process and sunset clause that kicks in starting July 2026** (inserted by Trump to maintain leverage in future negotiations) and alongside existing Mexican bottlenecks (e.g., water/energy deficits, skilled labour shortfalls, elevated crime levels) that are already slowing faster project implementation. To be sure, Tesla’s planned US\$5bn Monterrey Gigafactory whenever it gets the

New US-EU trade tensions would disrupt EA industry’s pivot away from China



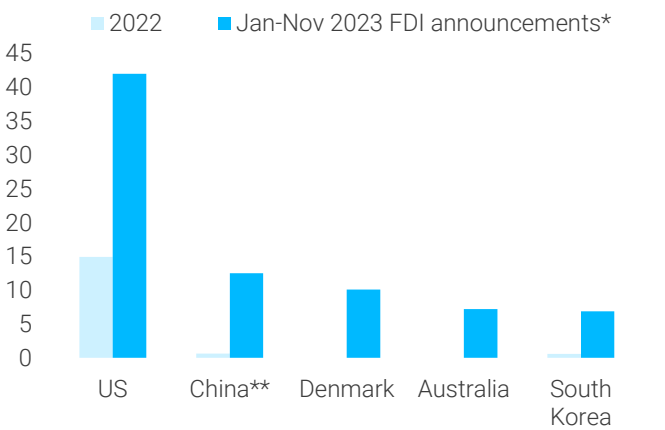
Sources: BEA, China customs, Datastream, GlobalData TS Lombard.

green light may well prove resistant to Trumpian threats, aided by Elon Musk’s GOP allies and the US military’s outsized dependency on Musk’s SpaceX.

However, other automakers and Tesla’s many Chinese suppliers looking to open up shop in Mexico may not be as lucky. In part to undercut Trump’s appeal to blue-collar workers in vital swing states like Michigan, **the Biden administration appears likely to impose more restrictions on Chinese-made cars and auto parts from entering the US market via Mexico** before the election. Alongside rising odds of higher tariffs (currently at 27.5%, with talk this could be bumped to 40%), the administration has recently expressed concerns about the **data security and surveillance risks from Chinese-made connected cars and auto parts – a development we have long argued would eventually force action from Western policymakers** and speed the bifurcation of the globally integrated auto market (see [here](#), [here](#) and [here](#)).

Chinese FDI announcements in Mexico jumped in 2023, trailing only the US by value

FDI announcements (US\$ bn)



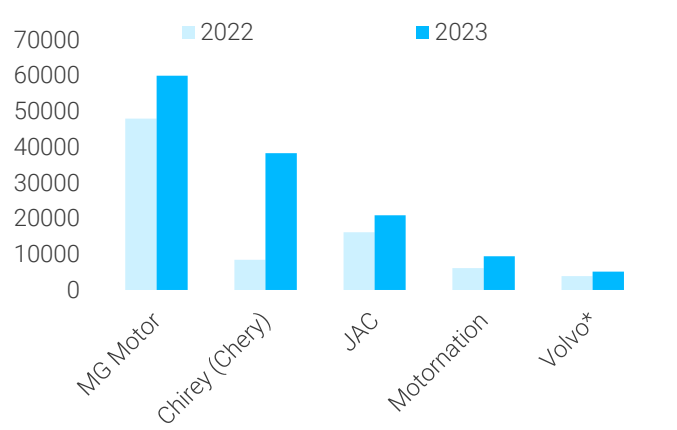
*Most of the big-ticket FDI projects have not yet materialized.

**Includes Hong Kong in the 2022 data.

Sources: Economy Ministry, El Economista.

China’s top five auto brands in Mexico accounted for nearly 10% of total sales in 2023 vs 1% in 2020

No. of vehicles sold



*Volvo’s parent firm is China’s Geely.

Source: AMDA.

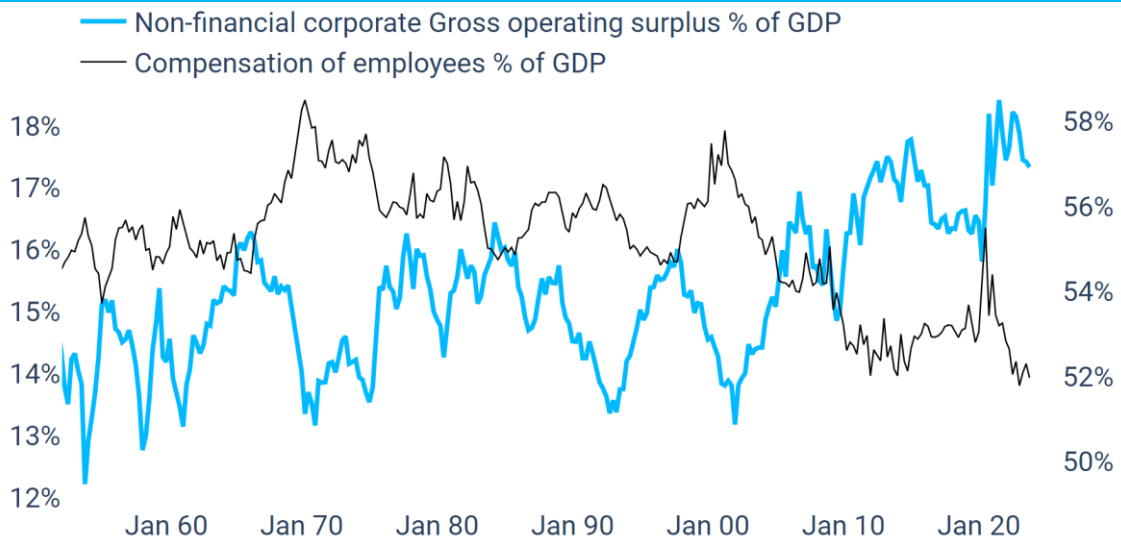
In 2023, Mexico was the second biggest market for Chinese car exports after Russia – adding further pressure on the Biden administration to close import loopholes that could otherwise be exploited to flood the US market.

The degrading of Mexico as nearshoring real estate is compounded by Trump’s embracing direct US military action against Mexican drug cartels. This moving of the Overton window as regards infringing on Mexico’s sovereignty is reflected in this argument from Trump’s former Attorney-General Bill Barr for fighting “narco-terrorist” Mexican cartels like ISIS that has increasingly gained more adherents as the border crisis has ballooned. Such talk **may trigger a negative feedback loop south of the border** by stoking an equivalent nationalist fervour that could be leveraged by the incumbent president Andrés Manuel López Obrador (AMLO) to clinch his party’s advantage in the run-up to next June’s presidential and legislative elections – potentially leading to further business-unfriendly policies worsening Mexico’s investment climate. The ironic net result could be to slow the pace of US-China decoupling.

Bottom line

It is hard for us economists to look at decoupling and deglobalisation and think it will happen, because we see all the ways it could go wrong and believe so firmly in rationality. We forget, however, that hyperglobalisation was not all it was cranked up to be for that critical middle-income swathe of the DM population. Covid has compounded that diminishment of the labour share of income.

Populism is a thing for a reason



Source: GlobalData TS Lombard, Datastream

While DM politicians know that fighting back against Chinese dumping of EVs is a minefield because China holds dominant positions all along the supply chain and could scupper the DM auto sectors, they also know that they cannot do nothing. So the likelihood of a further slide into deglobalisation is high.

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