US-CHINA RELATIONS: TRADE AND BEYOND

A 'POLITICS BULL TREND' CREATES A FERTILE GROUND FOR TRADE TENSIONS

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SUMMARY

US VIES TO MAINTAIN WORLD LEADERSHIP BEYOND COMMERCE

Today we are witnessing a redefinition of international relations and a new, although likely unstable, global equilibrium. The trade dispute unfolding today between the US and China should be seen in light of shifting structural trends that have developed over the last few decades. We expect rationality will eventually prevail, but the outlook is muddled by the Trump administration's unpredictable political agenda. Our core scenario remains that the conflict between the US and China will remain contained and limited to trade, with the door still open for negotiation. We expect the US will follow its current course, eventually extending tariffs to all Chinese imports, but will stop there; we do not expect a global slide into a vicious circle of tariffs and counter tariffs.

US-CHINA TRADE, THE BIG AND SMALL PICTURES

US-China trade considerations consist of both 'big picture' and 'small picture' dynamics, where distinguishing between the two is key. What is critical regarding the 'big picture' is understanding the trajectory of the Trump administration's strategy and what the end goal is. The 'small picture' consists of the concrete repercussions of the 'big picture' including any potential implications on US growth in the near term. We think there will be several iterations along the way before the US chooses one direction for good. We also think that bilateral negotiation will continue even if the US goes ahead with further tariffs. The journey could be bumpy.

US-CHINA TRADE - WHERE ARE WE NOW?

- 10% tariff applied to USD 200bn of Chinese imports to the US in September, on top of 25% on USD 50bn of imports applied over the summer - covering roughly half of all Chinese imports
- Donald Trump and Xi Jinping could hold discussions alongside the G20 Summit in Buenos Aires at the end of November
- The tariff rate is set to rise to 25% in January 2019; Trump has threatened to cover all Chinese imports with tariffs if China retaliates further
- Inconsistent US economic policy economic policy puts stress on markets
- Investors require higher risk premia as a result of the policy uncertainty

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INVESTMENT AND MARKET CONCLUSIONS

We expect that volatility will continue to spike in the wake of political events but without serious consequence to economic policy, free trade or free markets. Noise will impact volatility but nothing deeply disruptive will hit fundamentals. We believe tensions will remain elevated in the near term, but contained. Investors should take advantage of negative correlation in markets and diversify portfolios in order to smooth volatility spikes and drawdowns as political shocks continue to take place.

WHAT REALLY LIES BEHIND RISING TRADE TENSIONS AND THE SPREAD OF POPULISM

We see the world as being in the midst of a 'politics bull-trend' – and particularly since the Great Financial Crisis which triggered the acceleration of problems due to intensifying globalisation and dislocation-creating innovation shocks over the previous two decades. What we mean is that politics have become increasingly influential over macro and market developments. The pervasiveness of politics is in part due to its having two dimensions: domestic and international. The domestic form has manifested itself in the rise of populism, with the election of populist leaders on the rise globally. The international form impacts international relations and could lead to the reshaping of international relations through rising tensions between countries.

THE DOMESTIC SIDE OF THE POLITICS BULL-TREND

The domestic dimension is the rise of populism. This rise started in major developed economies and has now also reached emerging markets. Examples of this phenomenon in developed markets range from Brexit in the UK and Trump's election in the US to the rise of the Five Star Movement in Italy. In emerging markets we have seen Erdogan's consolidation of power in Turkey and a shift away from democratic principles, the election of strongman Duterte in the Philippines and most recently in Brazil, the outcome of the first round of presidential elections that propelled Bolsonaro to the leading position.

One economic explanation for this populism is that it is an expression of the demand for social and economic justice in the wake of not only rising inequality but also the spread of impoverishment across the broader population. This has been particularly perceptible in developed markets but has also affected emerging economies. In real terms, people have experienced the deterioration of their economic security while established political parties have been at the helm. This has led to a political supply and demand mismatch, where the traditional political parties have been unable to meet the economic and social demands of their citizens. This is because politicians have not adapted policy to meet the conditions resulting from globalisation and game-changing innovation shocks, particularly in technology and the automation of jobs. We are now contending with an era that is marked by innovation that is simultaneously:

1. Disruptive – where we once had taxi drivers and booksellers we now have Uber and Amazon,
2. Deflationary – the digital price index is clearly more deflationist than the consumer price index within the same categories,
3. Global – from inception, disruptors are global in nature and
4. Exponential – innovation is diffusing across the economy at tremendous speed

THE INTERNATIONAL SIDE OF THE POLITICS BULL-TREND

One shared sentiment by populists is the promotion of nationalism that puts blame for domestic ills on foreigners, which leads to strain on international relations. Today we are witnessing a redefinition of international relations and a change in the global equilibrium through shifting influence in terms of both geography and structure. Since the end of the second World War, the US has held the position of the first hyper-imperialist power, with a world leadership position across five pillars: economic, financial, technological, military and cultural. However, this position has been deteriorating across all five pillars over the last few decades, starting with its military dominance in the wake of the Vietnam War. Today, its economic and technological leadership position is also waning as China increasingly closes the gap.

Over the last four decades, China's share of the world economy has increased rapidly at the expense of the US. This rise has also exacerbated Europe's relative decline, including Europe's gap to the US. Based on our estimates, the Chinese economy will overtake both the US and Europe by a wide margin over the next decade (see Table 1, for more details on this analysis, refer to Pictet Horizon 2018). The pace of Chinese economic development has been impressive not only from an absolute growth perspective, but also in terms of its composition. Chinese companies are now counted among world leaders across a broad range of sectors, including technology. No longer merely copying, China is now developing new technology of its own, including in the artificial intelligence space, which is being deployed in business models that propel economic activity. The lack of restrictions created by pre-existing infrastructure has enabled China to take advantage of a blank slate starting point and leapfrog ahead of the US in some areas of technological development. One illustration of this is in the online retail space, where internet sales make up over 20% of total retail in China, versus 10% in the US.

China is closing the gap with the US

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Table 1: US slice of the global economic pie shrinks as China's expands (Share of nominal World GDP)

	US	CHINA	EUROPE
1980	22%	2%	20%
2018	15%	19%	12%
2028E	12%	21%	8%

Source: Pictet WM, AA&MR, IMF October 2018

China's Belt and Road Initiative, President Xi Jinping's grand plan to connect Asia, Africa and Europe, not only bolsters its bid for economic imperialism, but could eventually lead to the relative decline of US business market share in various Asian markets and beyond, including in Africa and Eastern Europe. Therefore, the US-China trade dispute unfolding today should also be seen as the outcome of shifting structural trends that have developed over the last few decades. For the Trump administration, such trade tension is the manifestation of the reaction to these shifting trends. In our view, the US grievance with China extends beyond the trade deficit between the two countries and is a story of the US vying to maintain its leadership position in the global economy as China presents itself as a serious challenger.

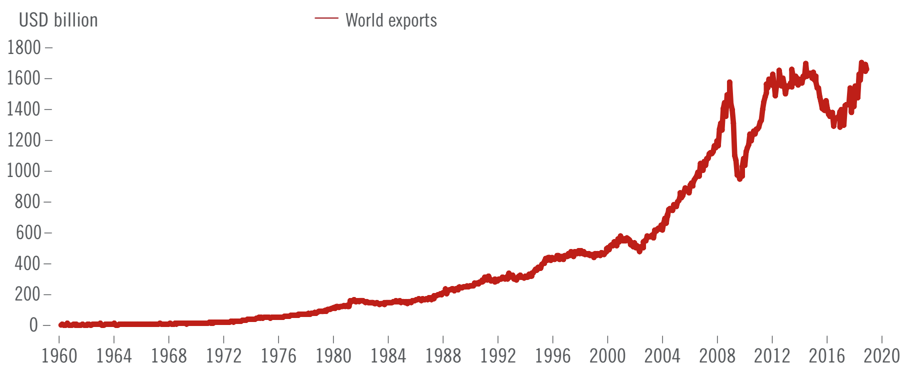
What is ultimately at stake in terms of the international economic order is a Sino-American confrontation as the US leadership position across the five pillars (economic, financial, technological, military and cultural) deteriorates relative to China, while Europe continues to decline on both a relative and absolute basis. This is alarming in part due to its implications for global trade. How much the expansion of trade over the last few decades has powered global economic growth should not be underestimated (See Chart 1). Capitalism's free trade and market liberalisation principles have enabled this extraordinary acceleration of economic growth, which has lifted millions of people out of poverty, particularly in emerging economies. If international relations are reshaped, particularly along economic and free trade lines, these foundations could be at risk.

However, while there is a risk of escalation of tensions between the US and China, we expect rational decision making will prevail over what at times appears to be an emotionally-driven political agenda being advanced by the Trump administration. Our core scenario is that the conflict will remain contained to trade and that the US will follow its current course, eventually extending tariffs to all Chinese imports, but will stop there, while leaving the door open for negotiations. In the meantime, we will continue to monitor the potential risks of more undesirable scenarios playing out.

A less optimistic scenario would involve the extension of protectionism beyond China to other countries, including the EU, while more countries join the populist movement and adopt their own protectionist measures in turn. If populists gain ground within Europe, destabilising pressures on the Eurozone could rise as populist leaders put blame on Brussels for failing to protect the sovereignty of individual member states and its citizens from the negative effects of globalisation. Global tensions would rise in turn and could eventually lead to military conflict. However, we are not running for the hills at this point. There is always a worst case scenario that will remind us of how precarious global stability can be and to avoid complacency, but a lot has been invested in the current world order and we expect that ultimately, while interim noise will continue, rational heads will prevail.

> We expect rational decision making will prevail over what at times appears to be an emotionally-driven political agenda.

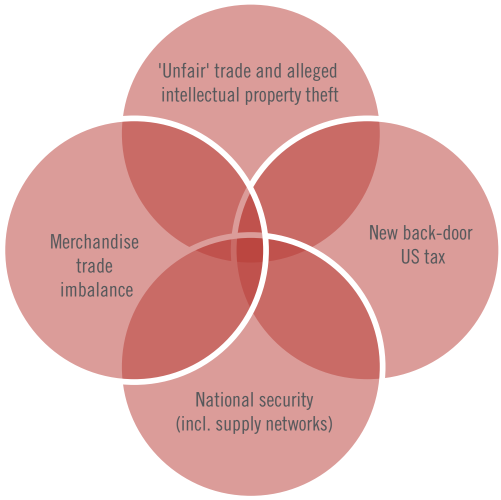
CHART 1: IN TRADE TERMS, GLOBALISATION HAS REACHED HISTORIC HIGHS



Source: Pictet WM - AA&M, IMF, Thomson Reuters

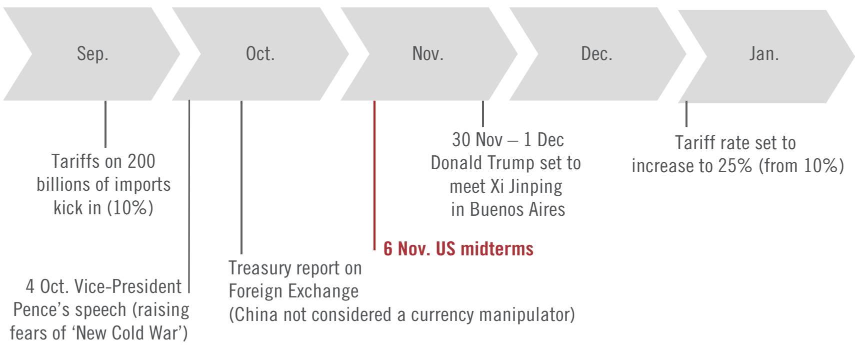
US-CHINA RELATIONS: TRADE AND BEYOND
US TRADE POLICY: THE BIG AND SMALL PICTURES

DIAGRAM 1: THE FOUR DIMENSIONS OF THE US-CHINA TRADE TENSIONS & TARIFFS



Source: Pictet WM - AA&MR, October 2018

DIAGRAM 2: US-CHINA DISPUTE: RECENT EVENTS AND NEXT KEY STEPS



Source: Pictet WM - AA&MR, as of 19 October 2018

US TRADE POLICY: THE BIG AND SMALL PICTURES

When it comes to US trade policy, we believe it is important to distinguish the 'big picture' from the 'small picture' while keeping sight of the right perspective.

The key to the 'big picture' is in deciphering the direction of travel for US trade policy. Is the Trump Administration genuinely pushing a protectionist and isolationist policy (i.e. a return to 19th century America) or is it just creating a momentary diversion that will ultimately conclude with mere tweaks to the current free-trade global order? Or, in a somewhat mixed end-game, is there an effort to keep America at the centre of a global trading system that isolates China? The problem is that the Trump Administration is not entirely clear about the end goal, with many divergent views within the Administration itself, a reflection of the eclectic personnel currently surrounding the President.

What are the latest clues suggesting? Recent actions and comments from the Trump Administration lend support of the third path, carrying several risks in the longer run. Indeed, the US Administration has renegotiated the North America Free Trade Agreement (now renamed as the United States-Mexico-Canada Agreement or USMCA), with the view of further integrating the North American market, while forming a "coalition" that will "stand up to China", in the words of President Trump's economic advisor Larry Kudlow.

In the USMCA, the so-called 'rules of origin' have been buttressed. For example, 75% of car parts must now originate in North America in order to receive duty-free treatment, versus 62.5% previously. This translates to fewer car parts coming from elsewhere, including Asia. There is also a 'poison pill' that implies that if a member signs a trade deal with a 'non market economy' – i.e. China – it could result in the automatic cancellation of the USMCA. Commerce Secretary Wilbur Ross said that the USMCA, and its poison pill provision, is a template for future "bilateral" trade deals, including with Japan and the European Union.

The US Administration also holds an ambivalent view toward the World Trade Organization (WTO), which succeeded the General Agreement on Tariffs and Trade (GATT) in 1995. Today, 98% of global commerce takes place under the WTO rulebook

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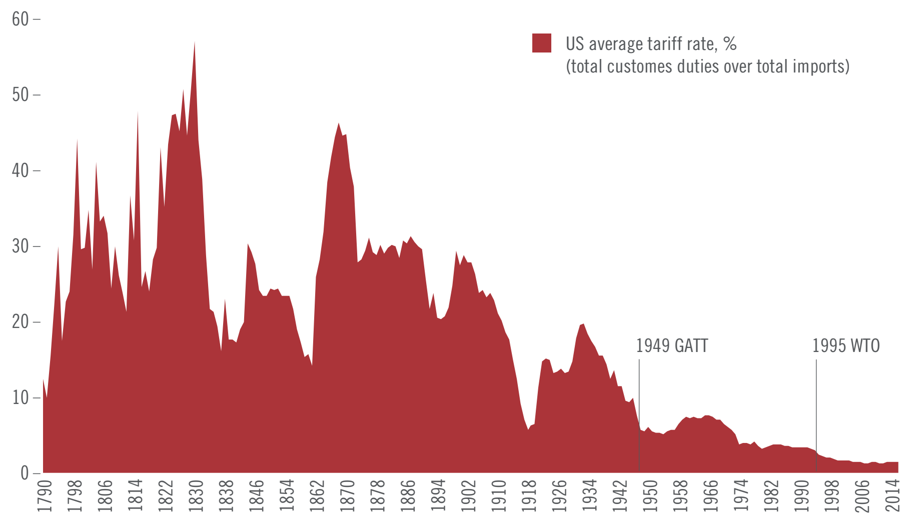
US TRADE POLICY: THE BIG AND SMALL PICTURES

CHART 2: THE GATT, AND LATER THE WTO, HELPED BRING DOWN TRADE TARIFFS



Source: Pictet WM - AA&MR, Global Financial Data, as of 19 October 2018

(See chart 2), to cite the Director General's latest speech. There seems to be within the Trump Administration some nostalgia for the GATT era, which allowed more carve-outs to the free trade dogma, as well as greater American influence on global trade disputes, via US veto power. For example, the GATT allowed the Multi Fiber Arrangement (MFA), which had quotas for some textile exporters from Asia.

The WTO is now based much more on hard rules and laws – as interpreted by judges from around the world – rather than politics and diplomacy, and the US has long contended that the WTO's decisions are increasingly detrimental to US interests. The US Administration has also stated that its allowing China to join the WTO in 2001 was a "mistake" as China's actions are "contrary to the fundamental principles of the WTO", in the words of US Trade Representative Robert Lighthizer. The US argues that the WTO is not equipped to handle and sanction China's "unfair" trading practices. Yet bizarrely, the US continues to bring disputes against China to the WTO, while at the same time blocking the appointment of judges at its highest dispute appeals body, thereby systematically undermining the organisation at the same time.

Another important element to add to the obscure mix composing the big picture is domestic US politics. An interesting development in recent months is how Democrats have shown increasing support for the Trump Administration's rupture to trade policy. Democrat and Senate minority leader Chuck Schumer, said in April 2018 that he was closer to Trump on trade than any other recent president including Barack Obama, believing that the US has "got to get tougher on China". This may mean there could be an element of continuity beyond Trump.

The 'small picture' consists of the concrete repercussions of the 'big picture' and understanding what they mean for US growth in the near term, including next year. One key takeaway from the above is that the change in US trade policy, and reaching the 'end game', will take time and may well go beyond Trump's first term. The USMCA took nearly two years to negotiate.

Another tangible repercussion is in the form of trade tariffs that cover roughly half of all Chinese imports (25% on roughly USD 50billion of imports since this summer, and 10% on USD 200billion of imports since September, which is scheduled to increase to 25% in January). We think the tariffs are the 'small' rather than 'big' picture, as we think they are part of the 'journey'. Trump himself seems determined to secure a deal with China, in line with his long-held posture as a businessman as articulated in his book "The Art of the Deal" in the 1980s. The tariffs are intended to exert pressure on China, although this 'tough' way of negotiating risks heightening tension. The good news is that the US and China continue to talk, and the media has reported a scheduled meeting between Donald Trump and Xi Jinping at the G20 meeting in Buenos Aires at the end of November.

In the meantime, the tariffs will undoubtedly affect the US economy (See chart 3), which is where the small picture matters. We have estimated that the impact of current tariffs on growth could be roughly 0.2 percent, rising to 0.4 percent if Trump makes good on his threat to cover all imports from China. Given Chinese imports are mostly consumer goods (electronics, including phones, furniture and textiles) Trump's tariffs are essentially a tax on the US consumer, similar to a value added tax. The tariffs themselves are not sufficient to trigger a recession, in our estimates. The US economy will remain driven by its strong domestic tailwinds, including the ongoing increase in corporate capital expenditure (including in the energy sector) and the gradual re-leveraging of the US consumer. However, the increased trade tensions and tariffs mean that repeating this year's 3%

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annual growth in 2019 may be in tall order, on top of the likely modest tightening in monetary conditions that we expect.

Another question is to what extent the small picture gets polluted by the big picture, which is where keeping a close eye on corporate business sentiment will matter. For now, sentiment has stayed strong as confidence in the US outlook has remained elevated, buttressing the corporate capex outlook in turn. Any drastic change in sentiment should be closely scrutinised. The recent volatility in the US stock markets could influence the Trump Administration to fine tune, and reorient, the trajectory on trade policy. At the end of the day, the markets do seem to care about the big picture too.

We think there will be several iterations along the way before the US chooses one direction for good; we think, and we hope that, bilateral negotiation will continue even if US goes ahead with further tariffs. Persistent US business cycle's strength, on the back of solid corporate investment, should propel the virtuous investment-employment cycle. While the journey could be bumpy, strong domestic fundamentals should ultimately prevail and keep the US economy afloat in 2019.

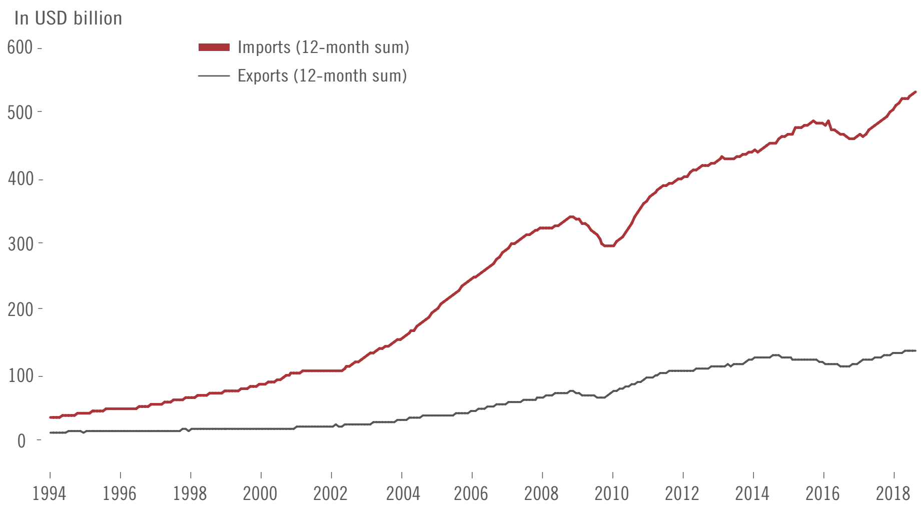
INVESTMENT AND MARKET CONCLUSIONS

What originates in the current politics bull-trend creates knock-on effects that ultimately translate into market impact. We highlight trade because this is where the domestic side of the politics bull-trend confronts the international side in the shape of economic policy, which has resulted in rising trade tensions as expanded upon in the US trade policy section above.

In the current environment, the major difficulty for investors is the stress inflicted on markets due to the inconsistency of economic policy that tends to play out under populist leadership. Taking the US as an example, the America First policy does not necessarily adhere to any conventional economic school. The corporate tax cuts implemented at the beginning of the year follow supply-side economic theory, which echoes Ronald Reagan's 1980s economic era, and relies on free markets and free trade. However, the protectionism imposed by Trump's trade tariffs sits at the opposite end of the spectrum.

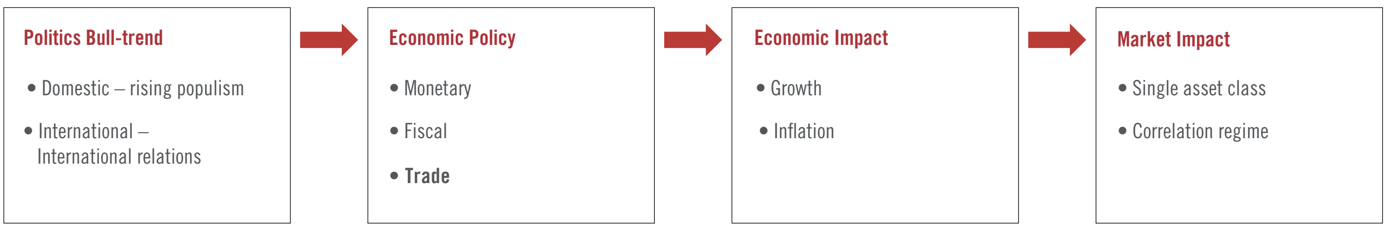
As a consequence, the visibility of US and global economic growth is deteriorating and markets require higher risk premia. This is what we have observed since February of this year, when equity-market valuations compressed.

CHART 3: US-CHINA TRADE: NO SIGN OF SLOWING FLOWS YET



Source: Pictet WM - AA&MR, Bureau of Economic Analysis, as of 18 October 2018

DIAGRAM 3: THE POTENTIAL KNOCK-ON EFFECTS OF A POLITICS BULL-TREND



Source: Pictet WM - AA&MR, October 2018

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US TRADE POLICY: THE BIG AND SMALL PICTURES

We envision two potential investment market scenarios, with (1) being our core and (2) our alternative scenario.

1) We expect that volatility will continue to spike in the wake of political events but without serious consequence to economic policy, free trade or free markets. Noise will impact volatility but nothing deeply disruptive will hit fundamentals. We believe tensions will remain elevated in the near term, but contained.

   – In the US, economic growth will remain healthy given strong under lying macro fundamentals in spite of uncertainty and tensions driven by domestic politics remaining high.

   – In the UK, Brexit tensions will persist while negotiations continue but a no-deal hard Brexit should be avoided. In the longer term, close trade relationships with the EU should prevail.

   – In Italy, tensions around the budget negotiations may run high but an agreement will eventually be reached that avoids a direct confrontation with the European Commission. Italian sovereign bond spreads should return to a better equilibrium level.

   – These tensions will contribute to the compression of equity market valuations as investors require higher risk premia in equities.

This scenario requires the cooperation of governments to maintain the international equilibrium of relationships across zones and countries. It also requires strengthening of the global economy's weakest links. We will need economic policies that create growth while distributing the benefits to match economic and social demand. In the meantime, investors should take advantage of negative correlation in markets and diversify portfolios in order to smooth volatility spikes and drawdowns as political shocks continue to take place.

2) Under the alternative scenario, deep disruption of economic trends would undermine the current economic regime, deteriorating growth dynamics as a result. The economic consequence could potentially lead to:

   – rising inflation or a switch to an inflation regime as trade tariffs generate higher prices,

   – increased geopolitical risk premia that sustains higher oil prices,

   – a potential 'commodity war' if not a 'rare earths war' with rare earths being essential to the development of much new technology,

   – regulators moving to break up tech disruptors in the way of Standard Oil and Bell System telephone services in the twentieth century

   – higher risk premia required for risky assets: equity valuation compression and rising spreads in high yield and investment grade bonds

   – a greater emphasis on physical gold as a safe haven asset

Such events could then undermine market fundamentals. As a result, the correlation of core sovereign bonds and risky assets would turn positive and a possible collapse in equity markets would be accompanied by rising interest rates and falling sovereign bonds. Traditional diversification across bonds and equities would no longer apply. The best investment options would be in real assets – gold for protection from rising inflation and systemic risks in the wake of the global political and economic climate, real estate and, to a lesser extent, private equity.

Noise will likely impact volatility but nothing deeply disruptive will hit fundamentals

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