Manulife Asset Management™

Monthly Macro View

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"Trade Tantrums" worry investors. How serious are they?

The politically-induced volatility of March has replaced the market-based volatility of February. The Trump administration announced two sets of trade tariffs during the month, which raised global trade tensions and sent markets lower. At the same time, China, one of the main targets of US trade sanctions, held its annual National People's Congress (NPC), stressing policy continuity by removing the presidential term limits.

As markets may remain volatile, this edition of Monthly Macro View explains why investors should also pay attention to economic consequences: some countries in Asia are more exposed to potential trade losses than others. Indeed, trade tariffs have real economic impact, although they have not yet derailed global growth in the post-war period.

International trade takes centre stage

Worries about a slide towards global protectionism and a potential trade war are growing. The limited US trade actions so far have not yet been enough to reverse risk-on investor sentiment or cause a shift to a high-volatility regime. Yet we know there is more to follow, with the intellectual property copyright issue up next. However, the most important point for investors is that, in the post-war period, there is not a single instance of trade restrictions having de-railed global growth. The occasional market dip and spike in the CBOE Volatility Index (VIX) from trade fears could provide an opportunity for investors willing to take a contrarian stand and look through the short term volatility.

Markets in February: The all-encompassing fall[1]

February's market correction was only the second monthly fall in global equities in 16 months – a remarkable stretch by any standard. Global stock markets fell 4.1%, the US 3.7%, Europe 5.9%, Japan 1.5%, and Emerging Markets (EM) 4.6% (MSCI total returns in US dollars). No MSCI World sector posted positive gains, with IT faring best with a 0.2% drop. Bonds also posted negative returns due to investor concerns centred on growth, rates, and inflation.

Markets in March: Back in the black but then to red again[2]

By mid-March, markets appear to have regained much of their lost composure. Both Developed Market (DM) and EM equities are back in the black year-to-date, with positive returns to 15 March 2018 of 1.9% and 5.2%, respectively. Trade concerns were taking a back seat to economic optimism, following a

[1] FactSet, total returns in US dollar, as of 28 February 2018.
[2] Bloomberg, as of 15 March 2018.

standout US nonfarm payrolls report for February on 9 March that revealed strong jobs growth but no sign of pressure from wage inflation.[3]

With a much better monthly batch of February economic data from China mid of this month and a benign data-print on US inflation in February, investors had more reasons to keep the party going than the beginning of the month – at least until US President Donald Trump announced tariffs on 22 March of up to US$60 billion of Chinese imports, which weighed on global stocks.

President Trump's trade tariffs

It was clear to many that with tax reform completed, President Trump would turn his attention to foreign trade and the promise to his electoral support base to pursue “fair trade”, with the aim of significantly reducing the size of the US trade deficit and “bringing jobs back to America”. Since last August, the US Trade Representative has been examining trade issues with China in a number of areas, including intellectual property. The import tariffs announced on solar panels and washing machines in January, s plus steel and aluminium this month – are estimated to total around US$9 billion[4].

On 22 March, President Trump announced more tariffs on up to US$60 billion of Chinese imports. He also called for tighter restrictions on acquisitions and technology transfers between the two countries. As we wrote in a latest note, we believe this round of proposed tariffs, similar to the last, is not the opening salvo in a trade war. Rather, it is an invitation to enter serious bilateral negotiations to resolve structural economic imbalances in the US-China trade relationship.[5]

The US-China trade dynamic

From a macro-economic perspective, this is still quite a small “shock” when set against US$200 billion of tax cuts and a substantial boost to government spending[6]. But, clearly, more trade measures are on the way, with intellectual property rights a particularly thorny issue to tackle that can be expected to further strain the US-China relationship. Further market volatility from trade protection concerns is expected.

At time of publishing, the US is reportedly pressing Beijing to reduce China’s bilateral trade surplus by US$100 billion[7]. Even if the impact of trade barriers on the US and overseas economies is quite minor, foreign trade will be another source of volatility for markets in coming months that investors must contend with. Raising the rhetoric on trade protection could be a way to lower the US dollar and limit future expansion of the trade deficit by maintaining a more competitive currency. Governments that attempt to talk down a currency with poor fundamentals risk loss of control and substantial overshoot. The risk here is that either a sharp depreciation or a sharp appreciation in US dollar could prove equally disruptive.

[3] Bureau of Labor Statistics: The Employment Situation – February 2018, 9 March 2018.
[4] Strategas’ estimates, “Strategas Policy Outlook”, 13 March 2018.
[5] Financial Times, 23 March 2018; Bloomberg, 26 March 2018.
[6] Bloomberg, 9 February 2018.
[7] Financial Times, 11 March 2018.

Different effects on Northeast Asia vs Southeast Asia

For Asia, India and the Southeast Asian economies are more domestically focused, and so should be better shielded from trade wars compared to Northeast Asia. Asia Pacific accounts for about 40% of total semi processed and finished imports of US iron, steel, and aluminium. Within the region, China, South Korea, Japan, and Taiwan have the largest direct exposure, while Southeast Asia has negligible exposure.

China's marathon NPC

The annual National People's Congress (NPC) began in Beijing on 5 March. It concluded on 20 March – several days longer than usual. A lot was promised and much has been delivered with more to come. Of tremendous interest to the outside world, less so within China, has been the revision to the Chinese constitution limiting the president and vice president to two 5-year terms in office. The NPC voted to repeal presidential term limits, which gives President Xi more time to enact plans to centralise party control, increase the central government's authority, and curb financial and environmental risks.

Macro-economic policies[8]

This is the area that proved least interesting, with only minor changes to macro-economic policy settings. The overall message is continuity.

- China's GDP target stays at 6.5%, with no mention of "higher if possible" as in last year's Government Work Report. If this means the quality of growth is becoming more important than the quantity, it is a welcome development.
- The People's Bank of China (PBoC) will maintain an unchanged inflation target of 3%.
- There was a small surprise on fiscal policy when Li Keqiang announced a small cut in the Central Government (CG) budget deficit for 2018 from 3.0% to 2.6% of GDP (unchanged in renminbi terms at 2.3 trillion).
- The reduction in the budget deficit could potentially signal an intention to apply tighter scrutiny to local government spending in 2018, especially public-private partnership (PPP)-related projects.
- As expected, supply side reforms will continue as the government aims for further cuts in both steel capacity (around 30 million tonnes versus more than 50 million tonnes in 2017) and coal capacity.
- The government also announced some relatively minor tax reductions for enterprises and individuals worth RMB800 billion (versus tax cuts of RMB380 billion in 2017).

Financial Reforms

- Beijing will further ease or remove foreign ownership limits in financial services.
- There will be more market-oriented debt-for-equity swaps and corporate Merger & Acquisition, and improved regulations for shadow banking, internet finance, and financial holding companies.
- The government will also expand foreign access to areas including telecommunications, medical, education, elderly care, and new energy cars.

[8] Premier Li Keqiang's Government Work Report 2018 and Bloomberg, 5 March 2018.

- There will be even more pressure from the authorities on the more speculative parts of the Chinese financial system, such as entrusted wealth management products (WMP), following the path taken in 2017. Entrusted WMPs outstanding fell by RMB3 trillion last year.[9]

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[9] See “Passing the Baton”, China Economics, HSBC Global Research, 23 February 2018.