TD Asset Management

NEW THINKING

forward
PERSPECTIVES

Beyond Trade War

A deeper dive into the persistent trade frictions between the U.S. and China

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Entering 2018, one of the biggest macroeconomic questions was how the U.S. would handle its trade relationship with China under the Trump administration. As we are about to close out the year, the answer seems clear – the world is witnessing the largest trade dispute in the past several decades, with the possibility of a full-blown trade war, or even a deterioration of the overall relationship between the two largest economies in the world – the U.S. and China.

Responding to this fundamental shift, Chinese equities[1] have slid more than 20% since February, sitting in bear market territory, while the Chinese yuan has also depreciated about 10% against the U.S. dollar during the same period. The dispute, while not having as significant an impact on U.S. markets, has also contributed to episodes of higher volatility for U.S. equities in the past year.

Chinese Equity and Yuan Slide

Source: Thompson Reuters Datastream. As of Nov 27 2018.

What went wrong between the U.S. and China? Is there something in particular about these two countries that caused the trade friction, or is the general free trade logic flawed? And how likely is it that these two countries can work out an agreement and avoid disrupting the global economic order?

Looking back for some clues

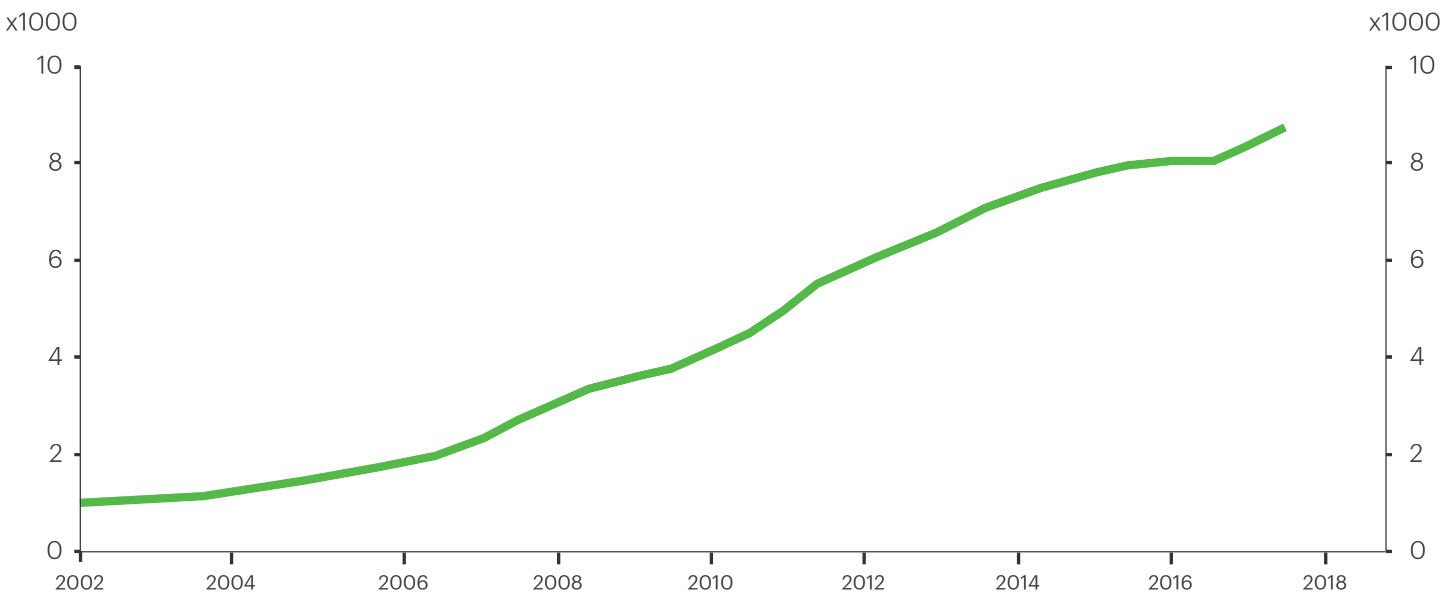
The deterioration of the trade relationship between the U.S. and China is deeply rooted in the past. When China was admitted to the World Trade Organization (WTO) in 2001, the move was strongly supported by mainstream economic theory and the strategic goals of the two countries. The classic trade theory is built on the concept of "comparative advantage". If two parties produce goods for which they hold a comparative advantage, and in turn trade with each other, then as a whole, they would enjoy higher productivity and more output.

In addition to this economic theory were practical considerations for both countries. The U.S. had two well-known intentions: first, they wanted to enable its multinational corporations to tap into China's huge market and secondly, it hoped that the inclusion of China into the free trade system would, over time, give market forces a bigger role within the Chinese economy. As market forces generally work well in a decentralized system, this could create an environment that may give rise to a more liberal and democratic government within China.

From China's perspective, having learned from its past mistakes, China was determined to carry out its reform and open up policy. It was ready to do more business with the rest of the world and improve the quality of life for its people.

Looking back, some of the logic worked out well for China. Thanks to free trade, China has experienced tremendous growth in the last two decades. Its Gross Domestic Product (GDP) per capita increased almost nine-fold and China has become the second largest economy in the world[2].

China's GDP Per Capita (in Current U.S. Dollars)



Source: Thompson Reuters Datastream. As of Jan. 1 2017 (in current USD)

The U.S. has also enjoyed trade benefits: the U.S. dollar further solidified its reserve currency status in an expanded trade relationship, U.S. consumers benefited from cheaper goods and lower inflation and U.S. corporations enjoyed much faster growth than they would have otherwise.

However, there are aspects that worked less well than trade theory would have predicted. It's important to keep in mind that trade theory works best under certain conditions and assumptions. One implicit assumption is that total supply is a bigger bottleneck than total demand, i.e. increased supply as a result of trade and a boost in productivity will enable more consumption.

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This is not a problem in a simplified example, but the U.S.-China relationship is more complex. When the U.S. outsourced production to China, many U.S. manufacturing jobs disappeared. This negatively impacted income and total demand within the U.S. To maintain stable growth and compensate for this loss of demand, easy monetary policy and cheap funding were provided so that consumers were able to take on more debt in order to consume. This structural change on the demand side had a negative long-term impact to the health of the economy.

Trade theory also does not consider how the net benefit of trade will be divided among different groups. In reality, the net benefit was far from evenly distributed. Corporations and the wealthy took the lion's share, while the middle class suffered due to job outsourcing. This in turn caused serious social issues that spilled over into politics. Popular theory believes that this is a major factor that led to the populist movement in the U.S. and the election of Donald Trump.

Moreover, trade theory does not address growth in a dynamic setting and consider the different stages of economic development. In China's case, its success became its own enemy at times. Its over-reliance on the export sector delayed its transition to a consumption driven economy. Long periods of fast growth also encouraged corporations to increase capacity and take on too much debt.

Besides these side effects, there were miscalculations in strategic thinking. Chinese economic reform did not bring the political change the U.S. had envisioned. After new Chinese leadership took office in 2012, political power became even more centralized and the U.S. found China increasingly steadfast in exerting its influence, backed by its growing economic power.

All of these factors came together and shaped an unsustainable trade environment that is waiting to be changed. Against this backdrop, the Trump administration took a radically different approach to trade policy. The administration portrayed trade as a zero-sum game and explicitly suggested that a trade war could only benefit the U.S.

Fast forward to today

While global trade can have both positive and negative effects, one thing is for sure - it's not a zero-sum game, and most certainly not a "war". If we view the goods and services we purchase from other nations as a losing battle and aim to "win" by producing domestically, the world could arguably regress and surrender a significant part of the productivity gains achieved over the past two decades. Most importantly, this view does not address the fundamental reasons for trade imbalances.

For example, in the U.S.-China trade relationship, the large U.S. trade deficit means that it consumes more than it produces. Unless this over-consumption is addressed, an overall U.S. trade imbalance could remain. Even if large tariffs are imposed on Chinese imports, the economic system may simply adjust in one of several ways to offset it:

- The value of the Chinese yuan could fall to offset the tariffs,
- Some of the tariff costs may be passed onto U.S. consumers,
- Trade surplus could shift to other trading partners.

In fact, since the U.S. imposed new tariffs on Chinese goods, the trade deficit has widened, not narrowed, even after considering that some export orders were rushed before the tariffs took effect. This is due to robust economic expansion in the U.S. resulting in greater consumption, which can naturally cause the trade deficit to widen. Historically, the U.S. has only seen its trade deficit decrease during a recession, something the U.S. government would prefer not to see.

If the Trump administration realizes that their strategy may not be working as expected, what are their options? If fixated on this zero-sum mentality, they may simply choose to double down, which could be devastating for the U.S. and world economy.

Is there a possible resolution?

Could the checks and balances within the global economic system force these two economies to work out a rational solution? Possibly down the road - but likely not right now. The cease fire announced at the G20 meeting is only a step towards that direction, but it is a temporary patch instead of a full and clean solution. A strong U.S. economy may reinforce the belief that a trade war will be beneficial for the U.S. Only if this changes will the Trump administration possibly alter its tactics and feel the need to negotiate on less aggressive terms with China.

Can the U.S. economy defy the negative impact from a trade war and continue its strength? The current boom can be largely attributed to the recent tax reform and spending which have stimulated corporate investment and household spending. However, this is not a free ride and the stimulus is burning a hole in the U.S. government's wallet as its fiscal deficit reaches the highest level in 4 years[3]. This runs contrary to the typical pattern where deficits decrease during an economic boom. In other words, the U.S. is depleting its fiscal room before the next recession, at a time when the unemployment rate is already running below 4%. This pro-cyclical use of fiscal policy has resulted in unusually strong short-term growth momentum in the U.S that might not be sustainable for the long run.

The real issue

The trade war can be a reflection of a deeper issue: the U.S. has fundamentally changed its strategic view on China. From the passage of the Taiwan Travel Act, to a cyberattack story reported by Bloomberg, to a controversial speech from U.S. Vice President Mike Pence, all show that the main theme between the two countries has gradually changed from "economic cooperation" to "overall competition".

Looking through a competitive lens, this confrontational trade relationship appears less irrational. For example, the Chinese government's "Made in China 2025" program aims to comprehensively strengthen and upgrade China's industrial capability, so that China can move up the global value chain. The U.S. has frequently cited this as a major hurdle to reaching a trade agreement with China. Given the U.S.'s dominant position in technology, the success of China's program is not in their best interest, as it may pose significant economic and security threats. In fact, recent trends are worrying for the U.S. China has already experienced some success in certain areas, including quantum technology, high speed rail, payment systems and e-commerce. Chinese technology giants such as Alibaba, Tencent and Huawei are also catching up with U.S technology firms in terms of their size and capabilities. China is currently working on many more areas, including aerospace and semiconductors, where the U.S. advantage could shrink further.

> Chinese economic reform did not bring the political change the U.S. had envisioned.

From China's perspective, failing to execute the plan is simply unacceptable as it's the most critical ingredient for transitioning to a high-quality growth economic model. Developing its technology capabilities is also viewed as a national security imperative. In 2017, China imported $260 billion of semiconductors, which already exceeded its crude oil imports[4]. A cutoff in the supply of semiconductors could negatively impact or may even paralyze many key industries.

In a nutshell, the rift between the two countries is wide and finding common ground may be more difficult than simply settling the trade dispute. It is also likely that frictions would endure even under a democratic administration as some of the strategic concerns regarding China are widely shared between both parties.

Investor implications

A sea-change in the U.S.-China relationship is likely under way, and a trade war may just be the beginning. A quick and clean resolution of the trade dispute is likely not expected. Realistically, the probability of resolution may be higher when the U.S. experiences some setbacks in its economic growth. This means there could be more volatility before the good news arrives. Curiously, despite a correction in October, the U.S. equity market has been relatively stable, in stark contrast with the sharp Chinese equity selloff. The impact of the trade war apparently has not been fully priced into the U.S. equity market. However, based on economic linkages, this divergence in growth expectations cannot continue forever. If the trade war is further escalated, the macro impact may eventually impact U.S. corporate earnings.

Does that mean we should keep cash under our mattresses and shy away from risk? Certainly not. Historically, the U.S. equity market survived the Cold War period and still generated strong returns. In the interim, if the U.S. and China can keep negotiations going and strive to establish a framework for discussion to stabilize the expectation, the equity market could be supported. But it does mean that investors must be mindful when choosing investments and constructing portfolios, so that the potential negative impact of the trade war can be minimized.

At this point in the economic cycle, and particularly given the risks discussed in this paper, we strongly believe in focusing portfolios on the high end of the quality spectrum. This can include quality investment grade corporate bonds, companies with the ability to consistently increase their dividends using growing free cash flow and low volatility equities.

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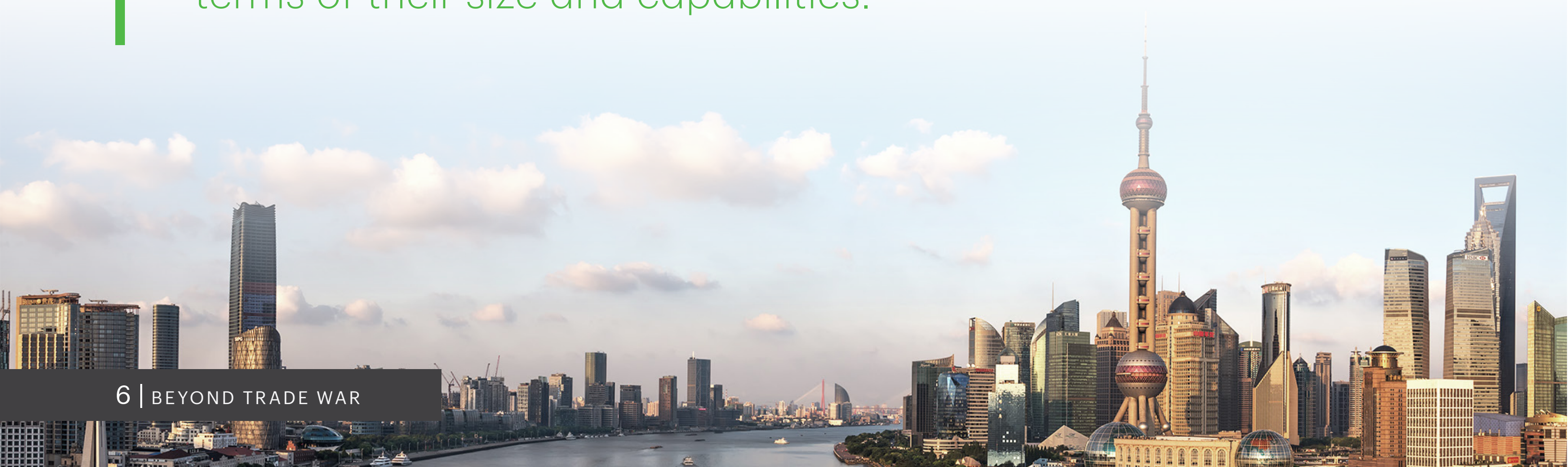

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About TD Asset Management

TD Asset Management (TDAM), a member of TD Bank Group, is a North American investment management firm. Operating through TD Asset Management Inc. in Canada and TDAM USA Inc. in the U.S., TDAM brings new thinking to investors' most important challenges. TDAM offers investment solutions to corporations, pension funds, endowments, foundations and individual investors. Additionally, TDAM manages assets on behalf of almost 2 million retail investors and offers a broadly diversified suite of investment solutions including mutual funds, professionally managed portfolios and corporate class funds. Collectively, TDAM manages over C$295 billion in assets as at September 30, 2017.

[1]Chinese equites are represented by the MSCI China Index, Data as of February 29, 2018
[2]IMF Data, in GDP current price U.S. Dollar terms
[3]U.S. Treasury Department. As of Oct. 16, 2018
[4]China Semiconductor Industry Association, 2017