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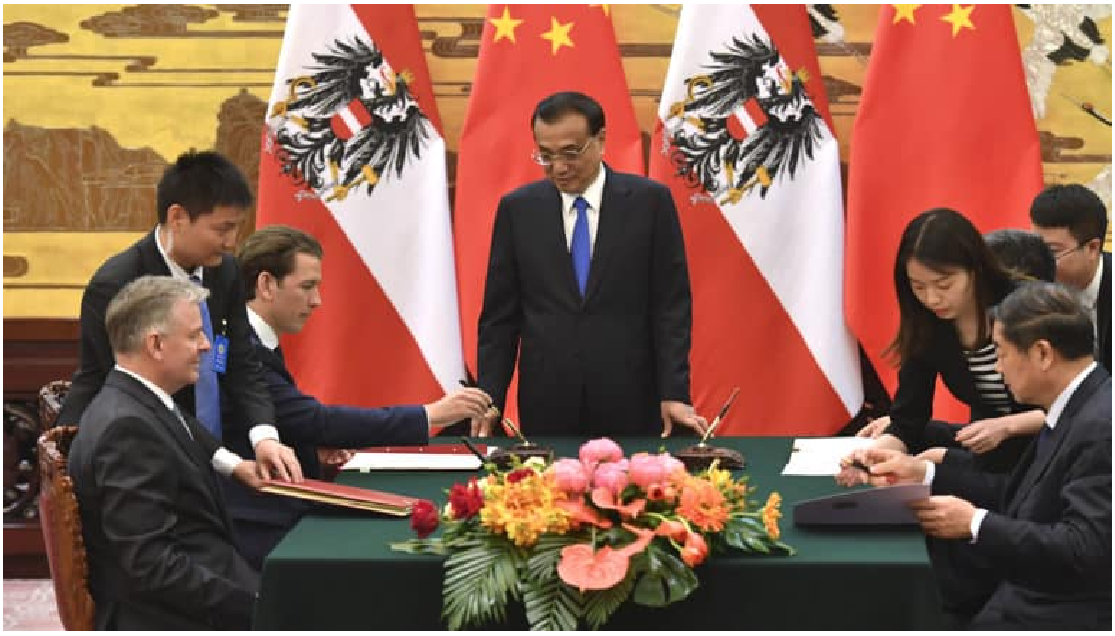
Rivalry USA – China dominating the markets

Gerhard Winzer



A glance at traditional economic categories such as economic growth, inflation, and monetary policy suggests a favourable environment for the markets. However, the possible escalation of the trade conflict between the USA and China has brought up a latent risk and has been the dominant factor on the markets for a number of days now.

Growth rates positive

We have seen three positive aspects in connection with real global economic growth.

- Economic growth increased relative to Q4 of 2018. This means that the stabilisation after the decline of last year has kicked in sooner than expected.
- At +2.7 percent (annualised), the growth rate estimate is close to potential. This is mainly due to the growth rates in the USA and China, which have exceeded the original forecasts. Only a few weeks ago we expected a rate of 2.0 to 2.5 percent.
- We have seen some survey-based indicators improve. As for the global Purchasing Managers' Index (PMI), the important sub-components production and order intake have increased, and the Chinese PMI recorded higher import demand. Also, growth expectations have improved.

Labour market supported

The strong labour market in the developed economies is an important supportive element for economic growth. The low unemployment rates and the robust development of employment growth are beneficial to income and thus consumption growth. That being said, the labour market is no leading indicator of economic activity.

Growth risks on the downside

The goods sector remains weak. This means industrial production, goods exports, and capital expenditure in the corporate sector. The latter are kept on low levels mainly by falling earnings growth and the declining business sentiment. The deteriorating sentiment is also due to the increased level of uncertainty with regard to the future relations between the USA and China.

Rivalry USA – China

The latent risk for failing negotiations between the USA and China has turned into an issue dominating the markets on the back of just one tweet by US President Trump from the beginning of May. The markets had not priced in this risk adequately. The tweet by President Trump, in which he threatened a further increase in tariffs, triggered a correction on the markets. There are basically six sticking points, and they do not all concern trade policies:

- The USA demanding a reduction of its balance of trade deficit with China. This is based on the assumption that balance of trade deficits are generally bad. While textbooks would claim otherwise, heterodox opinions are in fashion. Economists often point out that when buying a good from a supermarket, the consumer's "balance of trade" with the supermarket is negative, but this does not result in demands that they should produce the milk at home rather than buy it from the supermarket. Here, an agreement may be reached.
- China demanding an immediate cancellation of the tariffs already being levied. While the USA does not want to give up this trump card just yet, an agreement seems possible.
- Protectionism: termination of subsidies, reduction of barriers (including the abandonment of the forced transfer of know-how). Here, a compromise may be reached, too.
- Better protection of intellectual property. An agreement could be reached in this area as well.
- Demands of a change in Chinese industrial policies ("Made in China 2025"). China is unlikely to abandon its goals, i.e. to upgrade the Chinese industrial sector and to achieve technology leadership.

There are of course three possible scenarios:

- Extension: both countries allow themselves more time for negotiations. The persistent uncertainty continues to dampen the sentiment in the business sector.

- No agreement (i.e. escalation). Increased tariffs and additional restrictions in foreign direct investments on both sides would be negative for the global economy.
- Agreement / defusion. A compromise would be positive for the global economy.

Expansive central bank policies

Generally speaking, central bank policies have become even more expansive. The most important driving factor for the asset price increase in the first quarter was the changes in geopolitical positioning of many central banks, from "tightening, i.e. interest rate hikes" to "neutral" or even "loosening, i.e. interest rate cuts".

In the USA, the markets have already priced in interest rate cuts. At the same time, the signals sent out by the Fed suggest that it will wait patiently to see whether, after its earlier decrease, the underlying inflation (1.6 percent y/y in March) will bounce back towards the symmetric central bank target of 2 percent, or whether it will remain too low. This means that the reasoning for an expansive policy has changed. At first, it was the turbulences on the financial markets, later the economic risks. Now, the argument is that inflation is too low. The interpretation suggests that the management of the market expectations (i.e. guidance) by the central bank will not explicitly or directly contradict the priced-in expectations of interest rate cuts. As a result, a significant risk (interest rate hike expectations) has become less sizeable, at least for this quarter.

Outlook

Economic growth is currently neither too high (overheating) nor too low (recession); inflation is low. A potentially negative factor has become less pronounced with the fallen risk of interest rate hikes. The central bank policies remain expansive. These aspects imply an improved environment for the markets, *ceteris paribus*.

However, the risks are clearly skewed to the downside.

- Industrial production and capital expenditure by companies are still weak.
- Rivalry USA vs. China: whether the threats launched against China are of a tactical nature to build up pressure or whether they are based on a different sort of motivation, is ultimately not as important as the realisation that any further escalation of the trade conflict between the USA and China would come with negative repercussions for the global economy and thus for risky asset classes, both in the short and the long run.

Legal note:

Prognoses are no reliable indicator for future performance.

Gerhard Winzer

Gerhard Winzer has worked at Erste Asset Management since March 2008. Up until March 2009, he was Senior Fund Manager in Fixed Income Asset Allocation; he has been Head Economist since April 2009.

He holds a degree from a polytechnical college and studied economics and business at Vienna University with a special focus on financial markets. He holds a CFA charter and participated from 2001 to 2003 in the doctoral programme for finance at the Center for Central European Financial Markets in Vienna.

From July 1997 to June 2007, he worked in research at CAIB, Bank Austria Creditanstalt, and UniCredit Markets & Investment Banking. His last position was as Executive Director for Fixed Income / FX Research and Strategy. He was responsible for research on asset allocation at Raiffeisen Zentralbank (RZB) in Vienna from July 2007 to February 2008.