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Life After The Trade War

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A resolution of the trade war?

- The US-China trade war is heading for an armistice, because of politics:
  - ➢ Trump is under severe political pressure at home and needs a "win" on trade to help his re-election chances.
  - ➢ China has always wanted a deal because it needs a stable trade environment to manage its domestic slowdown.
- The deal will disappoint US hardliners who want to keep pressuring China to extract more structural concessions. With tariffs off the table, they will focus more on export controls.
- Efforts to "de-couple" the US and Chinese economies will not get far.
- The deal will be favorable for China, since it is not giving up that much, and gains breathing room.

What's in the deal (we think)

- Trump and Xi Jinping may meet in late March in Mar-a-Lago to sign a trade deal containing:
  - Substantial Chinese purchases of US goods such as soybeans and LNG
  - Strengthened Chinese protection for intellectual property, and a tougher enforcement process for US company complaints
  - Modest Chinese concessions on market access (phasing out of some JV requirements)
  - Chinese agreement not to competitively devalue the RMB
  - A schedule for ratcheting down tariffs on both sides
- It will <u>not</u> contain big Chinese concessions on industrial policy.
- Resolution of the conflict over Huawei will probably be kicked down the road.
- And there is still some chance the deal won't happen.

The forces driving US policy towards China

Business
Strategic concern: Build on US$250bn investments in China; more market access
Key advocates: Mnuchin, Kudlow

Defense Hawks
Strategic concern: Maintain US tech/ military superiority
Key advocates: NSC, DoD

Trade Warriors
Strategic concern: Scale back MIC2025; "de-couple" US/China economies
Key advocate: Lighthizer

Trump
Strategic concern: Get re-elected!
Alter-ego: Navarro

Policy outcomes

Short-term
Content-light trade deal

Medium term
Export controls on tech

Long term
'Strategic rivalry,' details TBA

Beyond tariffs: tougher controls on investment and exports

- On top of tariffs, Congress has passed two bills tightening tech investments to and from China:
  - ➢ Stronger CFIUS reviews of inbound foreign investment, including non-controlling stakes that grant access to non-public information or decision-making rights.
  - ➢ Stronger export controls, supervised by Commerce Dept's Bureau of Industry and Standards or BIS.
  - ➢ Both would control transfer or "critical, emerging and foundational technologies." Definitions are being devised by BIS.
- These aim to "decouple" China and US economies, by getting MNCs to shift investments elsewhere. For most companies, this is not realistic on a 3-5 year view: for many, China is the biggest and/or fastest growing market, and crucial to innovation processes.

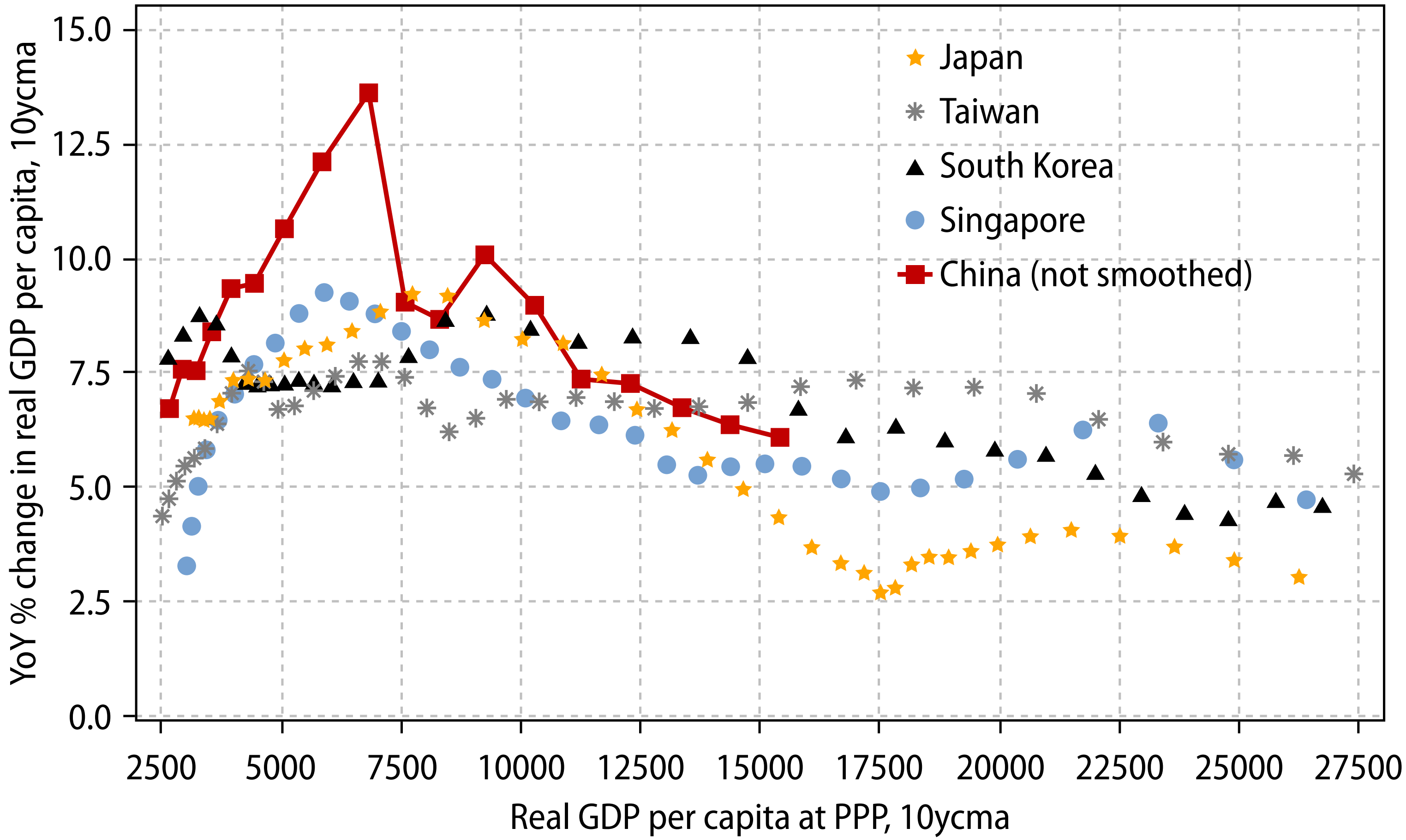
The view from Beijing

- Xi Jinping has a strong incentive to do a trade deal because he is trying to manage two slowdowns:
  - ➢ Short term: Cyclical factors mean 2019 will be a very tough year
  - ➢ Long term: Best-case structural scenario is China's GDP growth slows to about 5% in the 2020s.
- He also has ambitious long-run ambitions:
  - ➢ Make China a global technology leader by 2030
  - ➢ Make China a great power by mid-century
- To gain breathing space, China is happy to make many piecemeal concessions. But it will not give ground on its industrial policy / technology upgrading plans.
- China's leaders believe they have more staying power in a long conflict than the US.

A secular growth slowdown is inevitable—but how sharp?

As China gets richer its growth will keep slowing

Trend growth rates and level of development for successful Asian economies

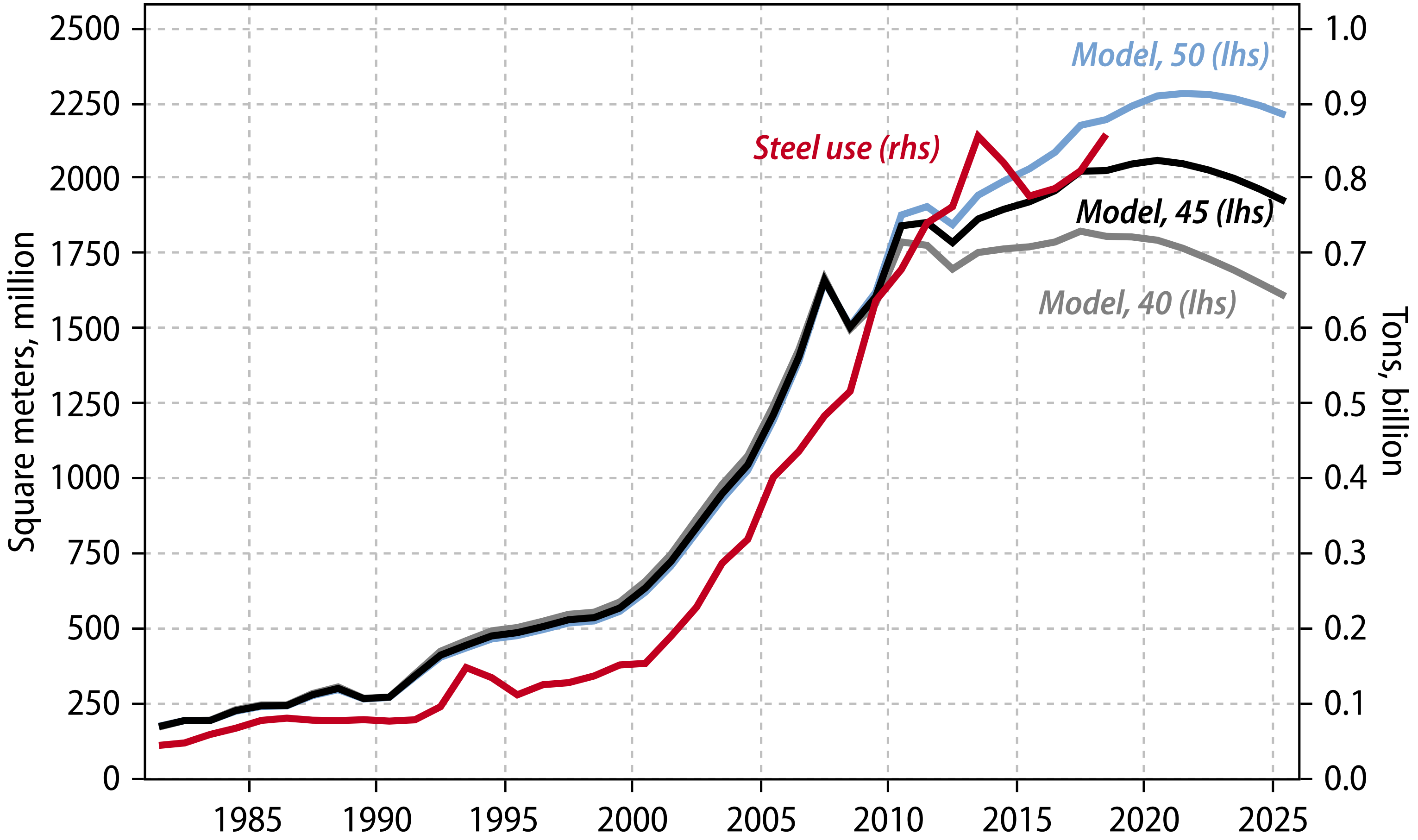


Gavekal Data/Macrobond

The long run: Construction-led growth is near a plateau

Model suggests a plateau in p.c. living space at 45-50 sq m

Models of annual construction volume with different terminal values of PCLS



WSA, Gavekal Data/Macrobond

China's long construction-led growth cycle is heading to a plateau.

The key variable is housing construction, and the key variable for housing is the peak in per capita living space.

Today China's net living space per capita is 32 sq m. Most countries see a peak around 40 sq m but we believe China could peak a bit higher, at around 45 sq m.

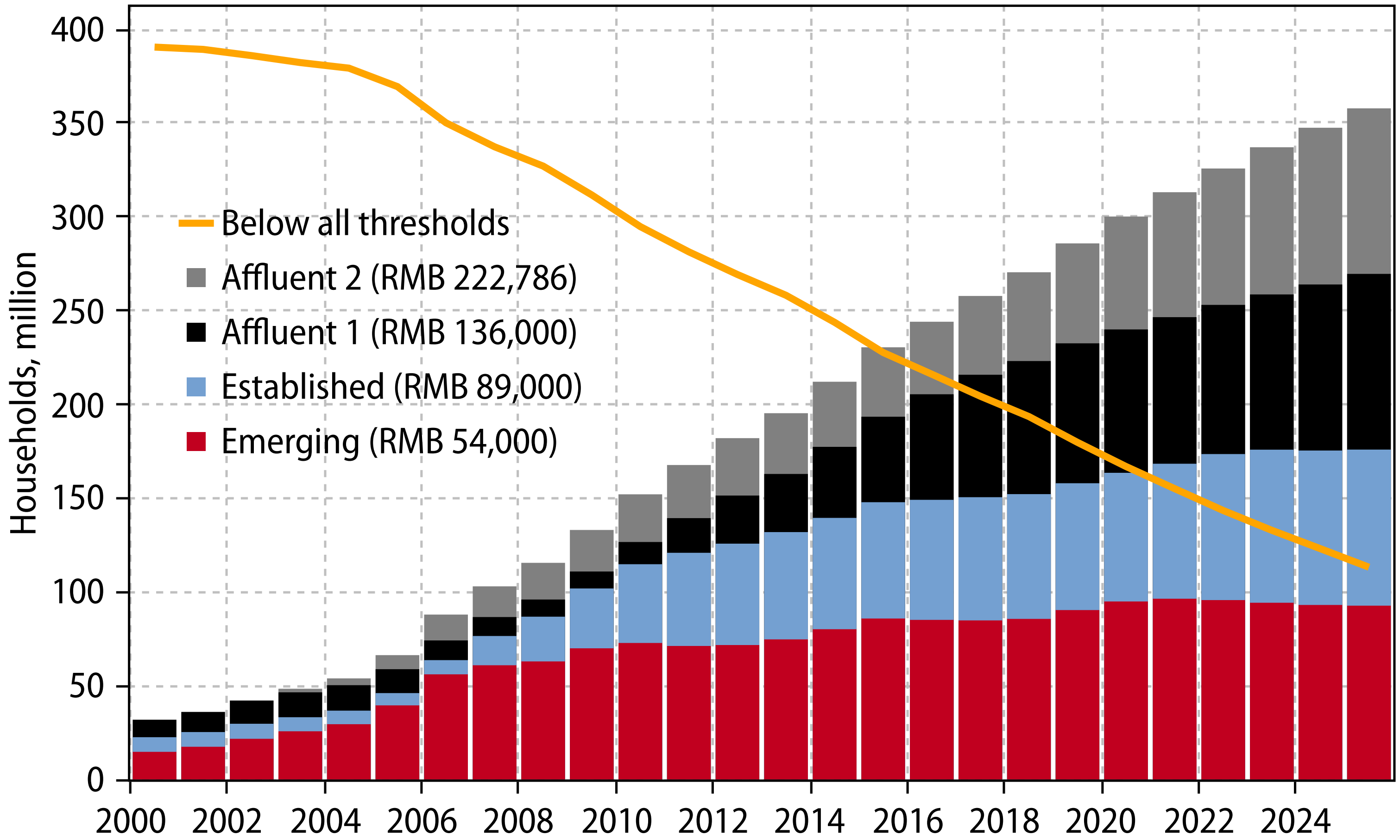
This implies construction, and steel demand, will continue at roughly present levels before starting to decline sometime between 2020 and 2025.

The long run: Past the export peak?

The long run: The pool of affluent consumers keeps growing

Affluent consumers are now the fastest-growing consumer group

No. of households in each income group, projections for medium growth scenario, 2015 price



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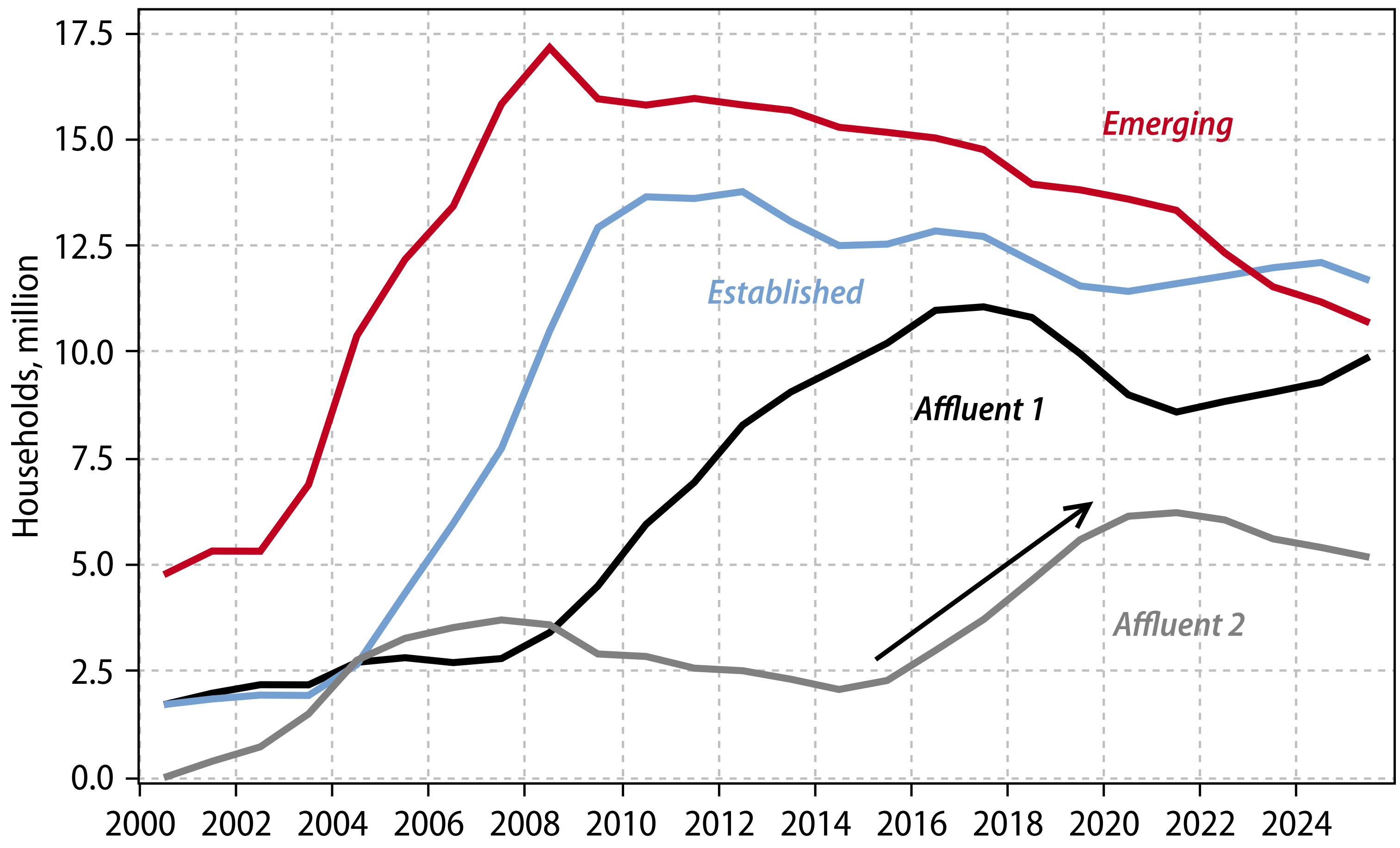
The long run: Higher income households drive demand

The acceleration baton has been passsed to higher-income households

Number of households crossing each income threshold, 5ycma, in core growth scenario



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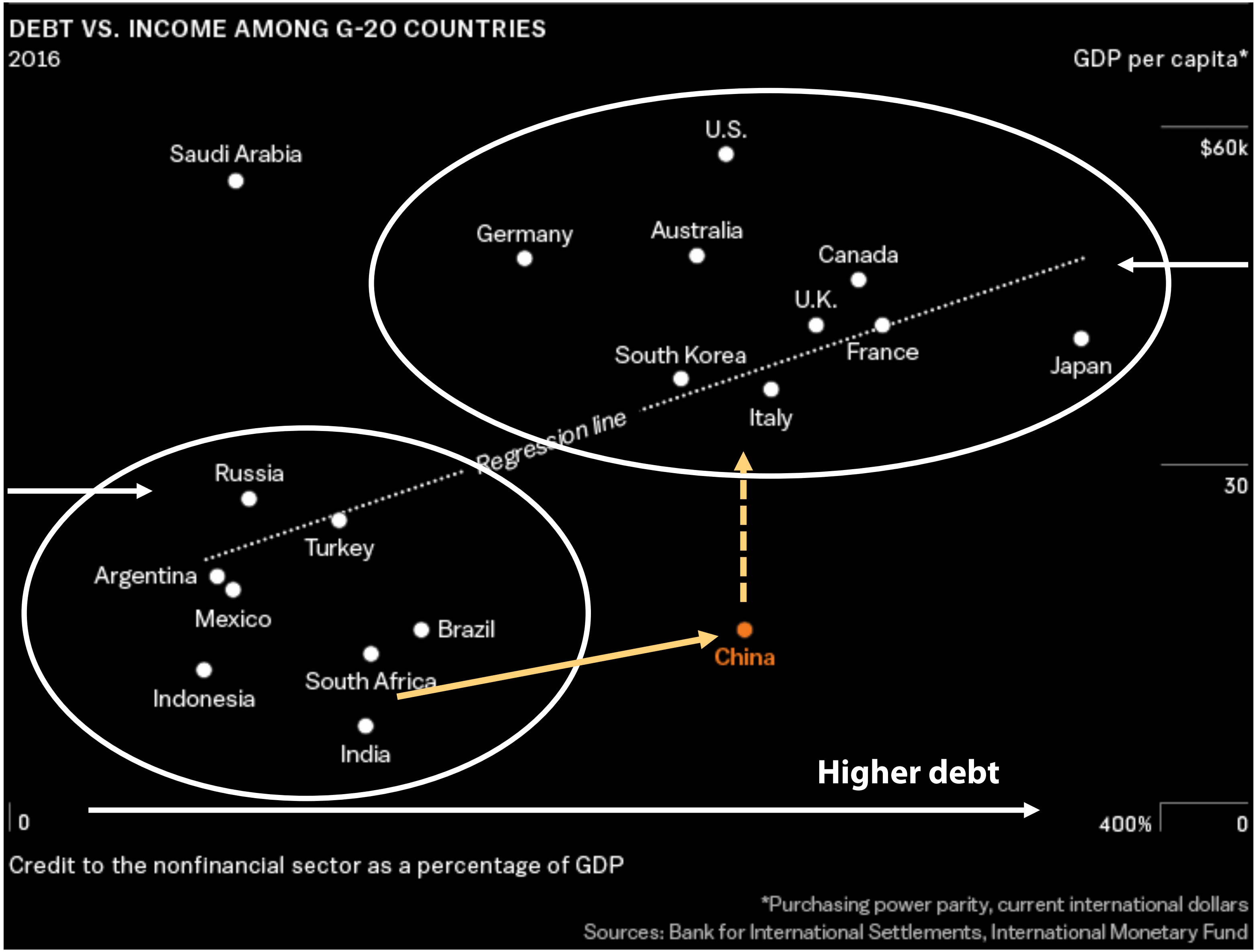
The fastest growth is now occurring in households with at least US$35k in annual income. Goods and services catering to this income group will see the strongest growth.

New households entering this bracket will rise from 2.3m in 2015 to 6.2m in 2021.

Constraint: Future growth needs to come with less debt

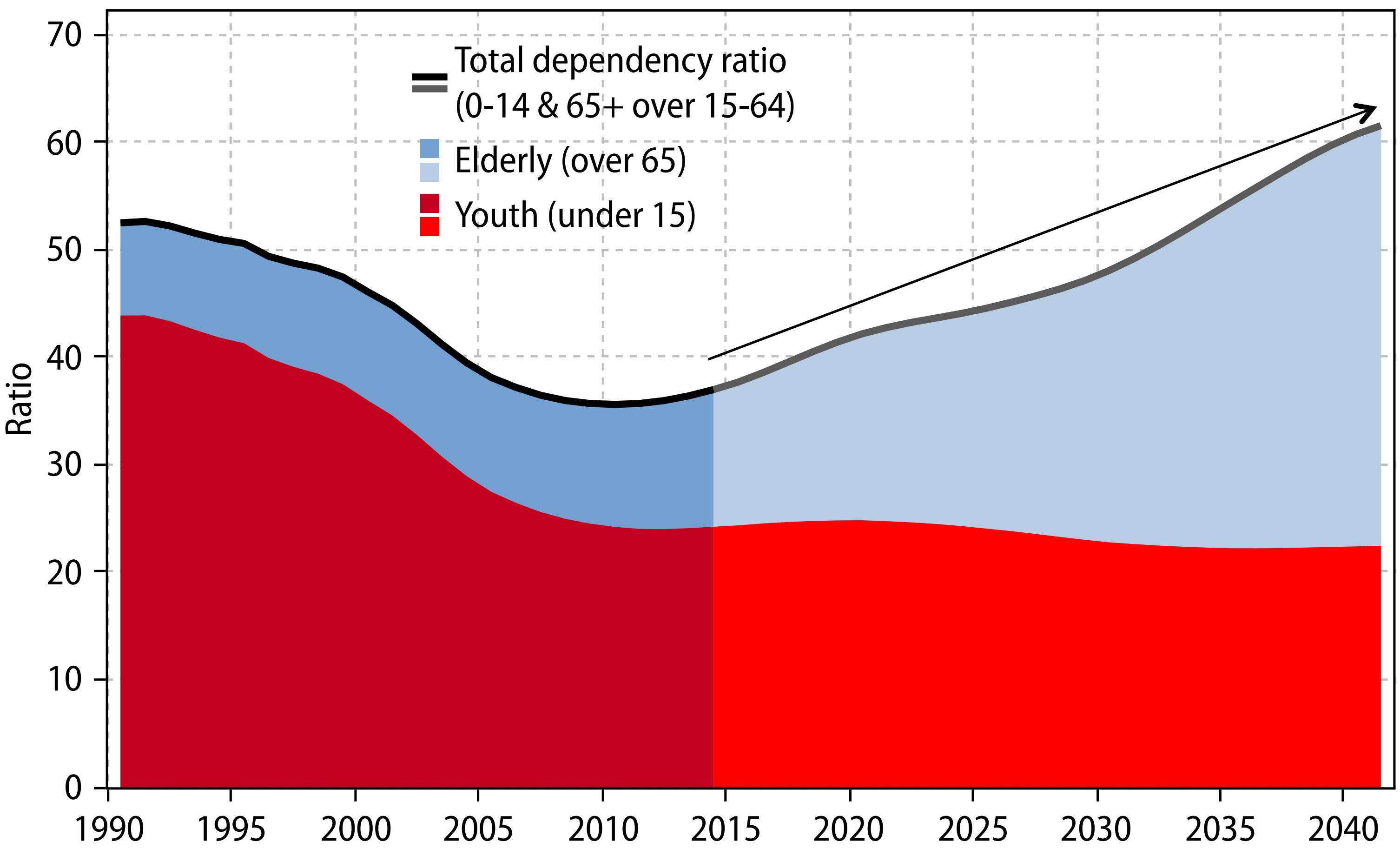


Source: Bloomberg News

Constraint: Demographics are getting ugly

A future of fewer workers and more dependents

Ratio of over-65 and under-15 population to working-age population



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Dependency ratio set to rise from 36 in 2010 to 60 by 2040.

Xi Jinping's recipe for "Making China Great Again"

- **Made in China 2025**: Comprehensive industrial plan for upgrading technology and industry
  - Aims to sustain growth by raising productivity
  - Aims to make China a global technological leader
- **Belt and Road**: Comprehensive plan for increasing connectivity between China and other markets
  - Aims to create new goods and services markets for Chinese firms
  - Aims to build a Chinese sphere of influence at the expense of the US
- Problem: Both programs have generated major backlash, not just from the US but also from EU and developing countries

Conclusions

- Even if there is a trade deal, powerful constituencies in the US (including both parties in Congress) believe China represents a strategic threat requiring a comprehensive response.
- Increasingly, people in Washington frame this threat not just as economic and technological, but as a competition of two incompatible value systems—like the Cold War.
- The predominant view in Beijing is that the US is a declining power struggling to maintain an over-extended position.
- But business constituencies in both countries are a powerful force in favor of competition being waged in a pragmatic way where open conflict is avoided.
- Countries in the middle will face an ever more difficult balancing act.

Contact and disclaimer

Thank you!

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