China crisis? Not if Xi can help it

The election of Donald Trump and his focus on a more protectionist agenda has put China and Asia back in the global spotlight

Market Insight

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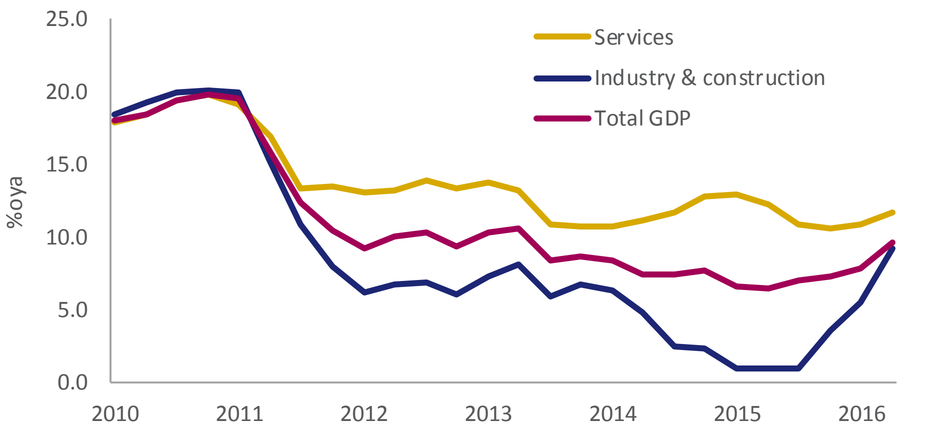
Only a year ago China was centre stage with concern over capital flight, over-leverage and fears of a hard landing, with global and systemic impact. But the latter concerns proved unfounded, with the fiscal stimulus imparted in mid-2015 and the lower/longer Fed policy stance breathing some more life into the China story. Perhaps also Brexit and the US elections took China risk off the newspaper front pages, preventing a vicious cycle from developing.

Trump's election brings a new risk to the fore, namely a US-China trade war that proves the straw that breaks the camel's back and exposes the same internal fragilities again. The impact would be felt across Asia, focusing attention on the region's structural challenges such as ageing populations and high levels of private sector indebtedness.

That said recent higher frequency indicators, including PMIs, are showing something of an upturn. Note the strong trade prints out of China and neighbouring manufacturing hubs for January and February, consistent with new-cycle highs for regional and global growth.

Fig. 1: China GDP (nominal value-add)



Source: China National Bureau of Statistics, BlueBay as at December 2016

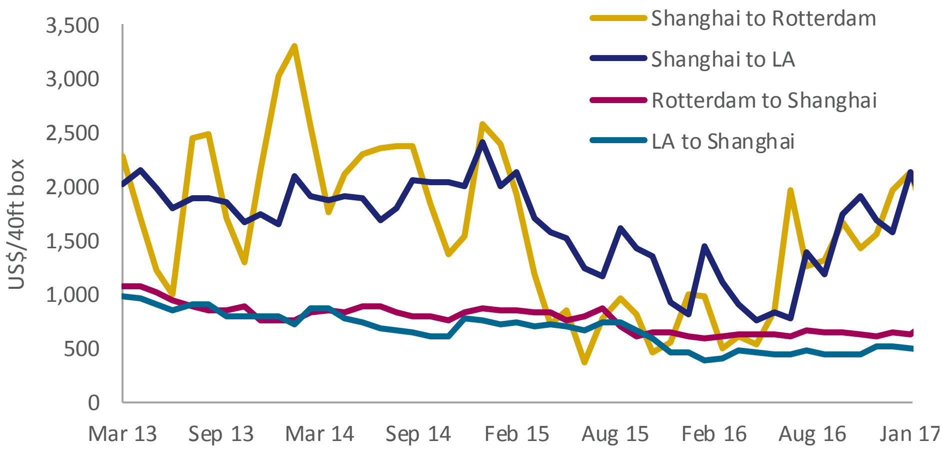
We see mixed messages in the data, however. New export orders and business confidence readings in the PMIs have lost momentum, and yet buoyant imports of capital goods and raw materials suggest manufacturing sectors that are planning to boost output. It is therefore hard to say with confidence whether China and the broader region will be facing up to any trade conflicts from a position of strength or as export performance is already slowing.

China is already in unprecedented territory

Logic and history suggest that there is very likely to be a major systemic crisis in China, likely focused on the debt overhang, but we no longer think that it will be this year. No developing economy, whether that is the UK during the industrial revolution, the NICs in the 1990s, Eastern Europe and the former Soviet Union in the 1990s, or Turkey in the 2000s has managed transition from one fundamental model of development to another without market dislocations and crises. It is traumatic but essential, in particular, to recognise the inefficiencies in the old financing model as a new one is put in place.

And having already moved a long way from central planning to a market-driven economy, China is now undergoing a second seismic shift from exports and investment to consumption-driven growth. It would therefore be a miracle if China did not also at some stage encounter major market dislocation, the only questions being timing, scale and global impact.

Fig. 2: Freight rates to/from China



Source: World Container Index, Drewry, as reported by Bloomberg, as of 9 March 2017

It seemed from campaign and post-election rhetoric that the trigger for disruption could be Trump's protectionist agenda with China in the (metaphorical) firing line. It now appears that a more traditional Republican pro-business agenda is smoothing the edges of the White House stance, and a presidential summit could further that process in the coming months, if the two leaders can establish some personal chemistry.

A confrontational US stance is the last thing China wants this year. Ahead of the critical 19th Party Congress in October, the Chinese authorities are keen not to rock the boat or take undue risks. This was the clear message from the Work Report published at the start of the ongoing National People's Congress. The headline GDP growth target of "6.5% or slightly higher if possible" marks a moderate downgrade from 2016's 6.5-7.0% target.

More importantly, the leadership warned that 6.5% GDP growth is unattainable in the absence of reforms, and has signalled a retreat from the extraordinary stimulus of 2015-16. This is consistent with the continued tightening of monetary conditions, and indications that Guo Shuqing at the bank regulator has a mandate to rein in wealth management products and other aspects of shadow banking.

We think the broader market has been slow to appreciate China's commitment to stabilising the renminbi against a trade-weighted basket, which in turn leaves the bilateral USD/CNY exchange rate dependent on the dollar's moves against the other components. Tighter domestic monetary conditions and more rigid controls on capital outflows will nevertheless reduce the cost in reserve losses of achieving that stabilisation against the basket.

Trump and the art of the China deal

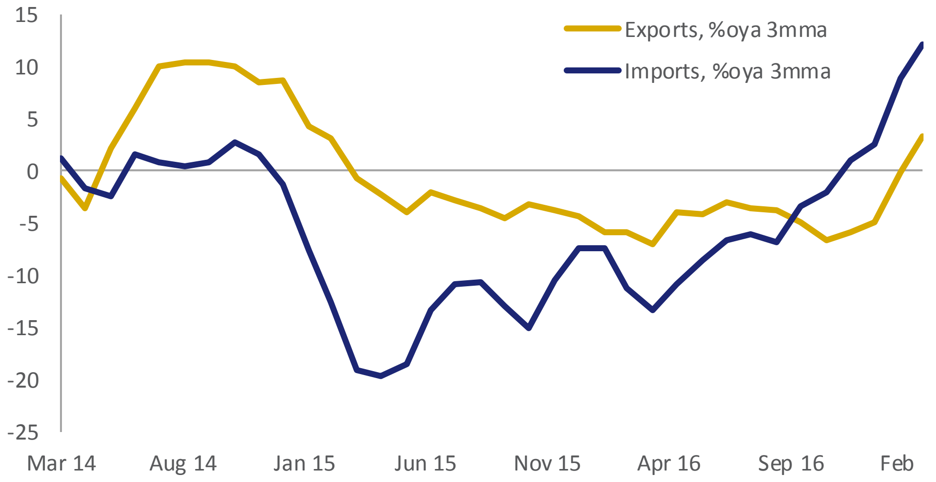
Some elements in the Trump administration appear serious about rebalancing the trading relationship with China. They have some common ground with foreign policy hawks that are looking to counter China's military/geopolitical threat. Trump himself started off on the front foot, questioning the One China policy and threatening to block Chinese expansion in the South China Sea. As with other aspects of the nascent policy stance, the past few weeks have suggested moderation, with Trump accepting the One China policy in the call with Xi. It remains to be seen whether this was a policy fumble or a tactical opening gambit in the art of the deal.

Trump likely wants to a cut deal on trade - securing better US trade access to China, in exchange for continued Chinese trade access to the US, but overall aimed at cutting China's still large trade surplus with the US. We have to assume the aim is a win-win outcome, but angled to slightly more Tweet-worthy wins for the USA. The tactics to get there will be fleshed out over the coming months.

The timing should favour Trump. As noted above, Xi is vulnerable this year ahead of the Party Congress. He will not want to risk a full-blown trade war with the USA which could spark a larger crisis. He will likely be willing to deal, but there are clearly red lines dictated by nationalist sentiment in China. Xi will not be able to back down on areas such as the One China policy and the South China Sea. Trade is a more promising area for compromise.

In 2016, China exported US$463bn of goods to the USA, and imported US$116bn. The contours of a deal will necessarily be complex, like all trade negotiations. China will be making common cause with domestic US lobbies from sectors such as food/agriculture, aerospace and energy to counter threats of disruption to their order books.

Fig. 3: China trade



Source: China General Administration of Customs, BlueBay, as of February 2017

The carrot will perhaps be better access for US companies in key sectors such as services, banking and even IT, although a big-bang liberalisation can be ruled out given ongoing Chinese fears of social upheaval. We may even see some pre-emptive efforts by China to reach out to warm the relationship, for example by announcing some high profile investment into the US manufacturing sector or support for infrastructure development. The threat of a Chinese sell-down of their US Treasury holdings will remain a last resort.

While we assume a positive outcome in China-US relations ultimately, as both have too much to lose, the challenge from a market perspective is getting the dynamics of that right. It seems likely that Trump will still try to heighten tensions in the run up to any deal. His fling with the Taiwanese president, and against the One China policy, is unlikely to be enough. We should expect some further near-term strains.

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