Chi Time

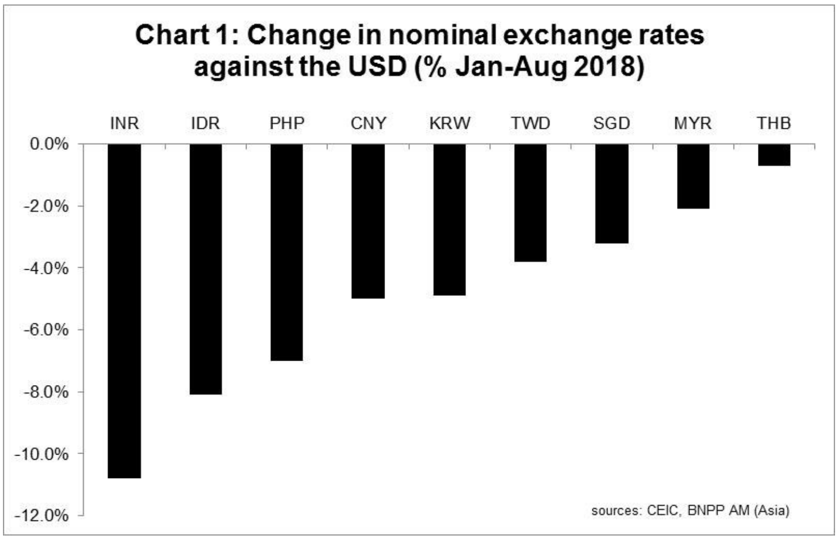
FOR PROFESSIONAL INVESTORS – 10 October 2018

COLLATERAL DAMAGE OF THE SINO-US TRADE CONFLICT

As history has repeatedly proven, one trade tariff begets another, then another - until you've got a full-blown trade war. No one ever wins, and consumers always get screwed

Mark McKinnon

Although the focal point for trade tension this time is between China and the US, collateral damage on the regional economies is rising. In particular, Asia's export-oriented economies are not immune to tighter USD liquidity stemming from risk aversion resulted from the Sino-US trade tension. The financial stress is seen in the year-to-date decline in Asian currencies against the USD (Chart 1). The collateral damage of the Sino-US trade friction clearly has risk implications on regional asset allocation.



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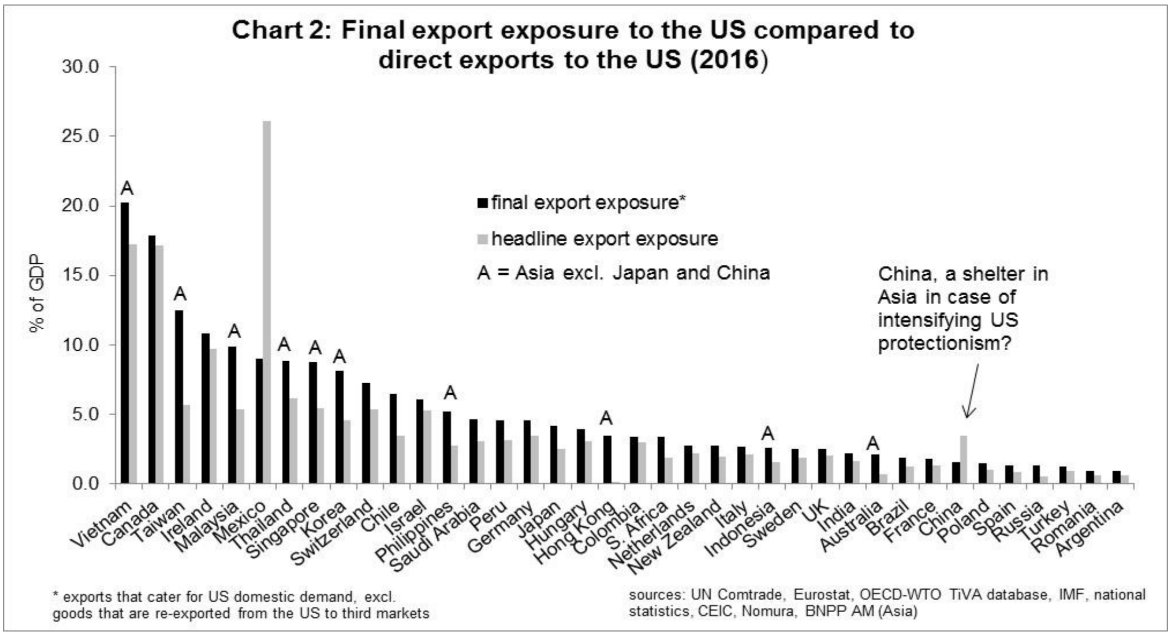
A slowdown in global growth due to the Sino-US trade war will lead to a loss of demand for emerging market (EM) exports. A recent market study[1] finds that in Asia GDP growth of Singapore, Malaysia and Thailand are the most sensitive to shifts in G3 (US, Europe and Japan) growth. China is not sensitive due to its large continental economy and the availability of domestic stimulus tools.

Collateral damage via China

However, just the bilateral trade dispute between China and the US could have significant effects on the regional economies through the global supply chain channel[2]. The potential collateral damage can be estimated by stripping out the foreign value-added content (averaging about 40%) in China's gross exports and reassigning them back to its original source countries to assess their ultimate export exposure to the US.

This means that when China's exports to the US drop due to the trade war, exports from these countries will also fall. Our estimation shows that six of the top 10 most-exposed countries are in Asia (Chart 2). The damage on China is rather limited. From an asset allocation risk management perspective*, ceteris paribus*, markets with the highest US-China exposure tend to be hurt the most.



A market study[3] also finds that of the most-US-exposed Asian countries, the industries that could be hit by US trade measures are textiles, leather and footwear in Vietnam, computers and electronics in Taiwan and Malaysia and chemicals and petroleum products from Singapore.

Impact from contagion

Escalation of Sino-US trade tension has raised risk aversion, as investors reassess the economic fundamentals of EM and ponder who might be susceptible to financial contagion as the trade shock unfolds. The key economic fault lines under scrutiny include a country's current account balance, fiscal balance, external debt and inflation. When a negative shock hits, a country will likely fall into a crisis or suffer from financial contagion

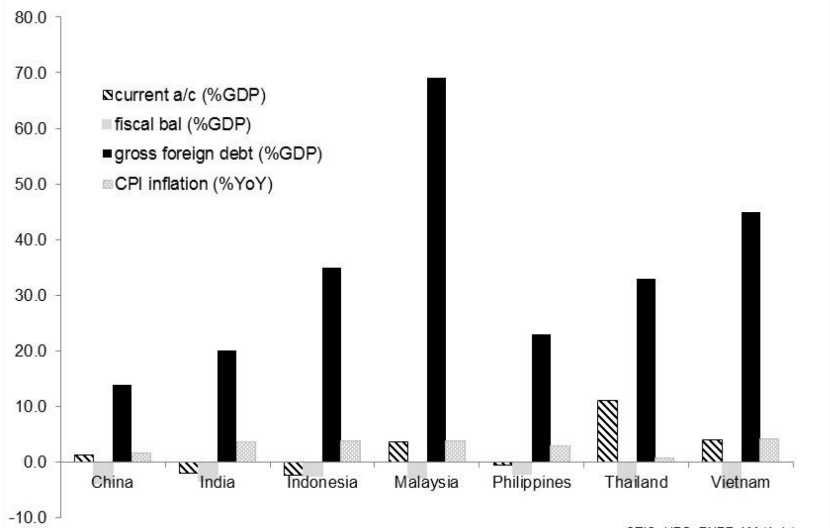
[1] "*ASEAN: Trade War Drags Growth Forecasts Lower*", UBS APAC Economic Perspectives, 18 July 2018.
[2] See also *"Chi Time: Implications of Sino-US Trade Frictions*", 23 February 2018.
[3] *"The Impact of US Trade protectionism Centring on China",* Asia Special Report, Nomura, 23 March 2018.

when it has a combination of a twin (current account and fiscal) deficit, a large foreign debt and high inflation triggering a loss of confidence.

China has none of these macroeconomic problems. Its current account is in a surplus, inflation is subdued, fiscal deficit is small at around 3% of GDP, and foreign debt is less than 15% of GDP (compared with FX reserves of 25% of GDP). Most importantly, the renminbi is not convertible so that its financial contagion risk is very small.

The three vulnerable major Asian economies are India, Indonesia and the Philippines due to their twin deficits and relatively high inflation. But their foreign debts are still small (Chart 3 and Table 1). While Malaysia has a large foreign debt, it runs a sizable current account surplus and has low inflation.

Chart 3: APAC EM Macro-stress indicators (2017)



sources: CEIC, UBS, BNPP AM (Asia)

Table 1: APAC EM macro-stress indicators (2017)

	Current a/c (%GDP)	Fiscal bal (%GDP)	Gross foreign debt (%GDP)	CPI inflation (%YoY)	Twin deficit
China	1.3	-3.7	14.0	1.6	No
India	-1.9	-3.5	20.0	3.6	YES
Indonesia	-2.3	-2.6	35.0	3.8	YES
Malaysia	3.7	-2.9	69.0	3.8	No
Philippines	-0.5	-2.2	23.0	2.9	YES
Thailand	11.2	-3.5	33.0	0.7	No
Vietnam	4.1	-4.7	45.0	4.2	No

sources: CEIC, UBS, BNPP AM (Asia)

Overall, APAC's emerging economies have solid fundamentals, though they are still susceptible to selling pressures from a rise in risk aversion. Every Asian currency in our analysis fell against the USD since the beginning of this year (see Chart 1), with the three twin-deficit countries falling the most followed by China (which saw a current account deficit in 1Q 2018).

Crucially, our research shows that the correlations of the movements between the renminbi and major Asian currencies have increased (at the expense of their correlations with the USD and the Euro) in recent years[4]. This suggests that if the trade war continues to exert downward pressure on the renminbi, Asia's currencies will also face more depreciation pressure.

Volatility to linger

Currency swings like these, especially in the course of only a few months, tend to cause market volatility and prompt tightening in overall financial conditions (as liquidity flows out of the region towards safe haven markets, or the regional authorities hike interest rates to calm the FX market, or both). This means that the resultant tighter credit, wider credit spreads and sputtering equity market in Asia will linger as the Sino-US trade conflict intensifies in the short-term.

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[4] See "*Renminbi Displacing the US Dollar by Stealth*", Chi Lo, BNP Paribas Investment Partners, 3 January 2013.

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