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CHINA AND THE TRUMP TRADE WAR

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Since January's stock market highs, both the Chinese market as well as the S&P have fallen. However, while the US market is only slightly lower than it's peak, the Chinese stock market is at two-year lows and over 25% down from its January highs. Could US President Donald Trump be correct in saying that "Trade wars are easy to win?"

To understand the current trade war, it's useful to have some perspective of the history that led us to this point. Over the past 20 years China has developed from a country with a GDP of less than 11% of that of the US in 1998 to a country whose GDP mis now over 60% of the GDP of the US today.

China achieved this by implementing two major reforms: it abandoned the communist economic system and adapted a capitalistic approach to its economy, allowed investors to essentially employ Chinese workers for profit. By putting 500 million people to work, China became the factory of the world, reducing the cost of everything.

This benefitted everyone. For developed markets it has meant cheaper goods from spoons, washing machines and toys to furniture, electronics and vehicles. The resultant savings have allowed developed market consumers to go on holidays, buy premium brands, and spend on services, food and leisure. For China, the transition has seen worker generated taxes and savings used to build a modern functioning economy to drive the greatest reduction in poverty in modern history.

The resultant explosion in trade created a trade deficit for consuming countries such as the US and a trade surplus for China.

The second major reform that boosted the Chinese economy was started far later and only really came to the fore after the great financial crisis. This was when China realised that the model of being the world's factory was coming to an end, and that a new era of unlocking the power of the Chinese consumer was at hand.

The Chinese government began a program essentially benefitting the Chinese people, providing policies that protected workers, increased disposable income of the masses, and providing security and confidence for the people to spend. Chinese consumer spending has since around 2010 dominated the second and ongoing growth phase.

The trade war moves away from the win-win dynamic established over the past two decades, moving to a lose-lose situation. The reality is that even if the US taxes everything from China by a crazy 100%, for many categories of products, China will remain the cheapest supplier. In addition, given its high labour cost, the US will just import from somewhere else other than China.

Also contradictory is that the US economy is close to full employment. If it was showing high unemployment there might be some merit in a trade war motivated by the need to put willing Americans to work. With the US at full employment, the only effect of the trade war is likely to be higher inflation.

So why is Trump fighting this trade war? Is it just for political gain, or is the reality is more complex?

China's rapid development is a massive worry for certain factions in the US, dominated by politely termed 'Trump supporters', who see China as a rival. In their view of the world, China is going to surpass the US if left unchecked. In effort to prevent this from happening certain policies that make no sense are pursued as long as they hurt China more than the US. These are seen as worth pursing as long as they assist in maintaining US superiority for as long as possible.

Because both countries can in fact stomach a trade war relatively easily, it is likely to play out very slowly. Out of the 230 or so countries with trade data, China and the US rank number 214 and 223 respectively when measuring total trade as a percentage of GDP - registering only 37% and 27% of GDP respectively, compared to most European countries in the region of 85% .

Although China is the largest trader in the world, what people forget is that the second phase of its growth in the past 10 years has been driven by Chinese consumers representing the largest consumer market in the world.

In the case of both the US and China, they are huge countries with extremely large internal populations that drive the economy. As such both can withstand a protracted trade war, especially if only with each other. With only the US fighting the trade war, China has flexibility to find new trade partners.

Finally, with President Xi Jinping essentially president for life, there is very little incentive to bow to the US, especially understanding that the worst-case scenario is another six years of Trump presidency, while the best case would be another two. China will continue with its development, and, so far has retaliated only in areas that affect supporters of the trade war, for example, purchasing less farm product taxing American cars. Admittedly, this strategy may yet backfire.

Question is, if the trade war is not such a big deal, what is affecting the Chinese stock market ?

The clampdown on shadow banking in China is actually the larger of the two issues. While the trade war contributes to negative sentiment, the Chinese financial system is undergoing much-needed reform and reduction of risk through formalising and regulating the shadow banking sector. Regulatory change will contribute to the long-term wellbeing of Chinese financial markets.

While the current correction in the stock market probably has more to do with ongoing financial regulation and disruption than the trade war, what might the latter mean for the market in future?

Interestingly, we believe that it represents a fantastic opportunity. Valuations are close to historic lows in a market weakened by continuous bad news. However, fundamentals are still relatively strong, meaning there is a mismatch between these and the market .

What we find is that China remains one of the few places left in the world where the market has the potential for some very meaningful upside. With most stocks already battered by trade war news, Chinese markets are home to thousands of growth opportunities at attractive prices. Should China start retaliating seriously in the trade war, global companies are far more at risk than the well-priced Chinese market.

For investors who have not looked at the Chinese market before, this could be a great opportunity to enter a growth market at an extremely attractive price. Prescient provides many solutions for investors to looking to invest in China. Please visit us at www.prescient.co.za for more details.

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