ASIA

# Our View as US-China Trade Tensions Deepen

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US-China trade tensions escalated in early August as US President Trump announced new tariffs on Chinese goods, and in turn, China announced it would stop purchasing US agricultural products. Amid an already-slowing Chinese economy, many investors were rattled. Franklin Templeton Emerging Markets Equity's Sukumar Rajah and Jason Zhu weigh in on the situation and explain why China's economy may be better able to absorb the trade issues than some observers fear.

On Thursday, August 1, 2019, US President Donald Trump announced an additional 10% tariff on a further US$300 billion of Chinese exports starting September 1, 2019. China retaliated by suspending US agricultural product purchases.

Then, on August 6, the United States formally labeled China as a currency manipulator, after the Chinese RMB depreciated to above seven per US dollar for the first time since 2009.

## Chinese Exchange Rate Surpasses 7 CNY per US Dollar First Time Since 2008

May 15, 2018–August 8, 2019

Sources: Franklin Templeton Capital Markets Insights Group, People's Bank of China (PBOC), MSCI, Macrobond. See www.franklintempletondatasources.com for additional data provider information.

These events sparked a broad and deep selloff across global stock markets. Since the start of the month  the MSCI EM Index and MSCI World Index declined 6.17% and 3.33% respectively in USD terms, while the MSCI China Index declined close to 7.39%.[1]

The US-China dispute has escalated from trade to technology, and now to financial areas. With accusations of currency manipulation, the risk of a deepening long-term confrontation appears to be rising.

## Our View on China

In the short term, the Chinese economy is slowing; second-quarter gross domestic product (GDP) growth was the lowest in 27 years. Persistent trade uncertainty has encouraged some manufacturers to diversify from production bases in China. There could be collateral damage to financial institutions if the resultant factory closures produce defaults.

Longer-term implications of continued trade issues include the acceleration of economic opening and deregulation in China, offset by a slowdown in de-leveraging efforts as the government seeks to prop up economic growth.

Policy changes in recent years that soften the US-China trade impact include a more flexible exchange rate, state-owned enterprise reform paired with support for private companies and looser monetary and fiscal policy. Additional infrastructure investment may also be a key near-term support for China's economy.

It is also important to note the following:

- China's growth is now less dependent on trade; China's export of goods and services (as a percentage of GDP) has declined over the last decade, from 32.6% in 2008 to 19.5% in 2018.[2]
- China's trade balance with the United States has narrowed, and at a current account level, China's imports of US services (as opposed to goods) has grown.
- China's economy is re-balancing and domestic consumption is the key driver of economic growth, representing 76% of GDP growth in 2018, up from 44% a decade ago.[3]

## Trickling Down to Technology

We think the impact of the trade war is most apparent in (1) technological areas that pertain to national security and cutting-edge technology (e.g., 5G, artificial intelligence), and (2) hardware products as part of global supply chains (e.g. smartphones, notebooks, tablets).

We expect tariff costs to be absorbed across supply chains, brands and the end consumer, mitigating the impact on any single company. However, this could nonetheless likely result in weaker consumer demand and sales volumes, as well as in the postponement of capex.

In the longer term, trade tensions may contribute to delayed adoption of key technologies (e.g., 5G), diversification of supply chains and fragmentation of industry standards.

Structural drivers not materially impacted include localized emerging-market innovation, ever-rising data usage/generation and resulting chip demand and a shift to online services and consumption, amongst others.

## Emerging-Market Companies Diversifying Supply Chains

The recent truce in the US-China trade conflict was notable for its brevity: the increasingly antagonistic stance between the United States and China suggests to us the trade war could persist beyond the 2020 US presidential election cycle, and investors should be prepared for ongoing market volatility.

Given prolonged trade tensions, many global companies have been highlighting supply chain diversification even before the developments in the first week of August. While this trend seems negative for China, it could lead to increased capital expenditure in other Asian markets and beyond. For example, Mexico's traditional links with US supply chains, geographic location and competitive wages could attract investments while China's retaliation against US farmers should also boost exports from South America as an alternate supplier.

Similarly, while China's trade with the United State has declined, certain Asian countries (e.g., India, Taiwan, Vietnam) have seen increased trade volumes in 2019, as well as movement up the value chain in recent years (e.g. South Korea, Vietnam).

The Federal Reserve's recent interest-rate cut alleviates upward pressure on the US dollar that the tariffs might otherwise boost, helping emerging-market currencies while also facilitating greater flexibility in monetary policy (e.g., rate cuts in South Korea, Indonesia, Thailand). In addition, history has shown that Fed easing cycles have generally supported emerging markets.[4]

## Our Approach to Volatility

Throughout this extended period of trade-related volatility, we have constantly assessed our portfolio risks, both through stress-testing individual stocks under differing assumptions as well as performing broader-market scenario analyses in collaboration with the Investment Risk Group at Franklin Templeton.

Importantly, beyond the near-term earnings impact, we think the competitive advantages of the companies we favor remain intact. We seek to invest in companies with sustainable, quality earning streams, and with strong cash flows and balance sheets that we think can withstand uncertain macro conditions.

Nonetheless, lingering and unpredictable trade tensions—exacerbated by daily headlines—impact consumer and business sentiment, hindering consumption and delaying investment decisions. It's difficult to avoid the risks, but we still feel optimistic there are investment opportunities to be found within this broad asset class. We think the potential opportunities remain strong, and valuations are very attractive.

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## What Are the Risks?

**All investments involve risks, including the possible loss of principal.** Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions.

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1. Source: MSCI. Data through August 8, 2019. The MSCI Emerging Markets Index captures large- and mid-cap representation across 24 emerging-market countries. The MSCI World Index captures large- and mid-cap performance across 23 developed markets. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future results. MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. No further redistribution or use is permitted. This report is not prepared or endorsed by MSCI. Important data provider notices and terms available at www.franklintempletondatasources.com.

2. Source: World Bank.

3. Source: National Bureau of Statistics of China.

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