



# Sinology

by Andy Rothman

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- \* If either side chooses war, the impact on the Chinese economy and on the majority of listed Chinese companies will be quite modest, because ongoing rebalancing of the Chinese economy has already made it far less dependent on trade and more focused on domestic demand.
- \* At Matthews Asia, we are focused on Chinese companies selling goods and services to Chinese consumers—the largest and fastest growing part of the economy. The impact of a trade war on earnings growth of these companies should be very modest. *Across all of our strategies, less than 5% of our China holdings have significant exposure (greater than 15% of total revenue) to the U.S. market. As a result, the impact of a trade war on our strategies should be modest.*

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ANDY ROTHMAN lived and worked in China for more than 20 years, analyzing the country's economic and political environment, before joining Matthews Asia in 2014. As Investment Strategist, he has a leading role in shaping and presenting the firm's thoughts on how China should be viewed at the country, regional and global level.

## Battlefield Choices

Donald Trump and Xi Jinping will soon decide if they want to engage in a trade war. In this issue of *Sinology*, we explore the options available to both leaders. A key conclusion is that if either side chooses war, the impact on the Chinese economy and on the majority of listed Chinese companies will be quite modest, because it is not an export-driven economy.

## Not Your Father's Chinese Economy

Before I discuss the battlefield choices Trump and Xi may make, I want to emphasize that forecasts that a trade war will seriously damage the Chinese economy and its listed companies are based on an outdated understanding of that country. The ongoing rebalancing of the Chinese economy has already made it far less dependent on trade and more focused on domestic demand, which should mitigate the impact of a trade war with the U.S.

The Chinese economy is no longer export-driven. Net exports (the value of a country's exports minus the value of its imports) account for only 2% of China's GDP, down from a peak of 9% in 2007. In contrast, domestic consumption now accounts for the majority of China's economic growth and more than half of its GDP. 2017 was the sixth consecutive year in which the consumption and services share of China's GDP was larger than the manufacturing and construction share.

Because Trump would be fighting a trade war without the support of America's allies, the impact on China's exports would be relatively small. Last year, Chinese exports to the U.S. accounted for only 19% of total Chinese exports.

On a micro level, I believe much of the impact of Trump's import taxes will not be borne by Chinese companies; about two-thirds of the 25 largest exporting companies based in China are foreign-owned. Moreover, one-third of the value-added from all Chinese exports actually accrues to firms from other countries, including U.S. partners such as Japan, South Korea, Taiwan and Germany, as well as to U.S. companies.

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## Donald Trump's Smart Choice

There are many reasons why Trump may decide that his interests are better served by closing a deal with Xi to gain better market access and protection of intellectual property (IP) than by a trade war.

Tariffs are not an effective way to pressure Beijing to change, as China's economy is not export-led and the pain will be largely absorbed by foreign firms. The largest category of Chinese goods targeted by the initial Trump tariffs is computer and electronic products, but 87% of those are produced by multinationals, according to the Peterson Institute for International Economics.



China will clearly retaliate with reciprocal tariffs on U.S. goods, with a list designed to inflict pain on Trump supporters, which could help Democrats take control of the House in November. Of the 2,742 counties with employment in the industries targeted by Beijing's retaliation list, 82% of those counties voted for Trump in 2016, while just 18% voted for Hillary Clinton, according to analysis by the Brookings Institution.

Soybeans are high on China's retaliation list, and it is worth noting that 24 Republican Members of Congress represent districts which account for about 60% of the total U.S. soybean crop.

U.S. equity markets have already responded negatively to talk of a trade war, so actual conflict could have a significant impact on the valuations of the many companies which are doing well in China. General Motors sells more vehicles in China than it does in the U.S., and China accounts for about 20% of GM's global earnings. Boeing delivers more aircraft to China than to the U.S. China contributes roughly 15% of global earnings for firms such as Apple, Nvidia, Dolby and Tesla.

A trade war would jeopardize the many jobs at American factories and farms created by almost 600% growth in U.S. exports to China since that country joined the World Trade Organization (WTO) 16 years ago, including a 1,000% jump in agricultural shipments. Even imports from China create many American jobs. A 2011 study by the Federal Reserve Bank of San Francisco concluded that, "on average, of every dollar spent on an item labeled 'Made in China,' 55 cents go for services produced in the United States. In other words, the U.S. content of 'Made in China' is about 55%."

The president must also be concerned that an angry Xi Jinping may be able to scuttle a denuclearization deal between Trump and Kim Jong Un.

### On the Other Hand

There are, of course, a few reasons why Trump may choose war.

He may really believe his March 2 statement that, "Trade wars are good, and easy to win."

President Trump may conclude that economic policies which create chaos, confusion and conflict will energize his political base far more than *any* trade agreement, supporting Republican efforts to retain control of the House and Senate at the November mid-term elections. This may explain why Trump rejected Xi's offer to buy US\$70 billion more of American farm, energy and industrial goods, and why there do not appear to be any serious negotiations underway with China (or with the EU, Canada and Mexico).

### Xi Jinping's Smart Choice

Xi Jinping also has battlefield options, and his smart choice would be to decline to participate in a Trump-initiated trade war.

Xi could explain to his citizens that Trump's tariffs will have a modest impact on the Chinese economy, and that his government will provide direct financial assistance to any injured companies and workers.

He could explain that Trump's tariffs represent a tax on American consumers, who will have to pay more for imports as well as for a broad range of goods made in the U.S. with Chinese components. Xi could state that it would be ridiculous for him to respond with similar taxes on Chinese consumers.

Rather, Xi could announce that he is retaliating against Trump not by raising tariffs on U.S. goods, but by lowering tariffs and market access barriers for America's competitors—the rest of the world. In recent weeks, Xi has taken some moves in this direction, lifting a ban on British beef, cutting auto import taxes, removing investment restrictions in industries such as autos, finance and power



grid infrastructure, and reducing tariffs for over 8,000 types of goods from India, South Korea, Bangladesh, Laos and Sri Lanka. Last month, China and the EU announced plans to accelerate talks on a bilateral investment treaty. With a state-controlled media, it would not be difficult for Xi to sell this approach at home.

This could also be an opportunity for Xi to boost his stature on the global stage, offering to step up in any international organizations, such as the WTO, where Trump is stepping back.

### On the Other Hand

As with Trump, there are a few reasons why Xi may choose war.

Xi may believe that Trump is determined to start a trade war, and will thus reject any offers made by China, as he rejected Xi's previous offer to buy more U.S. goods. Xi might worry that rejection of additional offers could make him appear weak at home.

Xi may also decide that taking the high road of opening his economy to the rest of the world and not issuing retaliatory tariffs on U.S. goods (beyond the initial US\$50 billion) could be perceived as weak at home, damaging his political power.

### Our Magic Eight Ball Says

It's tough to make predictions, especially about the future of U.S.-China relations, but this is my best shot:

I expect Trump to implement the first round of 25% tariffs on US\$34 billion of Chinese imports on July 6. Beijing will immediately respond with reciprocal tariffs (but nothing more).

Trump will proceed with the required public comment period for a second round of tariffs on another US\$16 billion of Chinese goods, and it is very likely that these will go into effect by early September. Beijing will immediately respond with reciprocal tariffs (but nothing more). Trump will talk about another round of tariffs on another US\$200 billion of Chinese goods.

The reciprocal tariffs on US\$50 billion of goods in both directions will have minimal impact in China. Based on our estimates of the price elasticity of Chinese exports and imports, we expect these tariffs to reduce China's GDP growth rate by about 0.1 percentage point. That would have reduced the 1Q18 GDP growth rate of 6.8% to 6.7%, for example, a modest slowdown that would not influence how we think about investing in China.

The impact on the U.S. political environment is, however, likely to be far greater. In recent days, the number of American companies voicing concern about the casualties from a trade war has risen significantly, and those voices should grow louder once tariffs actually take effect. There may be a negative impact on U.S. equity markets.

Xi Jinping will, I think, reach out to Donald Trump in September, either by phone or in person during the UN General Assembly meeting in New York, to propose a deal which would enable the president to declare, well ahead of the mid-term elections, that pressure from his tariffs forced Xi to make unprecedented concessions which will offer more market access and better IP protection than secured by any past American leader.

Back in Beijing, Xi will describe the deal as part of a market-based reform process that has been underway in China for decades, which will drive job creation and income growth just as successfully as the previous reforms. Both sides will then rescind the new tariffs.

Xi will also prod North Korea's Kim Jong Un into implementing some modest



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steps, including return of remains of U.S. soldiers who died during the Korean War, that he promised during his Singapore summit with Trump.

I know that many readers will be skeptical that such a deal can be reached, given Trump's tough talk about the size of the U.S. trade deficit with China. But keep in mind that Trump has continued to speak fondly of Xi, in sharp contrast to frequent belittling comments about most other world leaders (with, of course, the exception of Vladimir Putin). In April, Trump said, "I want to thank publicly President Xi of China, who has done more for us than he's done for any other administration, or than any leader of China has done for any president or administration." In June, while criticizing the bilateral trade relationship, Trump said, "I have an excellent relationship with President Xi, and we will continue working together on many issues."

Also consider that Trump has compromised recently on two important China trade issues. After the U.S. Department of Commerce issued a ruling that was an effective death sentence for the Chinese telecom company ZTE, Xi was able to persuade Trump during a phone call to commute that sentence in favor of a US\$1 billion fine and management changes. The second compromise involved Trump dropping plans to create a new regime to review Chinese investment in the U.S., instead accepting Congressional plans to update an existing national security screening process that applies to all foreign investment.

In closing, I want to acknowledge that this forecast could easily prove inaccurate. Trump may really want a trade war on all fronts. If that is the case, I want to reiterate a point made earlier in this note: At Matthews Asia, we are focused on Chinese companies selling goods and services to Chinese consumers—the largest and fastest growing part of the economy. *Across all of our strategies, less than 5% of our China holdings have significant exposure (greater than 15% of total revenue) to the U.S. market.* As a result, the impact of a trade war on our strategies should be modest.

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