



## Matthews Asia Perspective

### Our Latest Views on the U.S.–China Trade Dispute

*Trade concerns are weighing on investor sentiment, which impacts stock prices, but the underlying fundamentals for China remains strong. In this note, members of the Matthews Asia investment team explain why the trade dispute may have a small impact on the long-term investment environment.*



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In my December issue of *Sinology* (“A Truce Over Steak and Malbec”) I wrote that “prospects for real progress on substantive issues with China are now better than at any point in the Trump administration,” because Trump recognized that “a trade war with America’s largest trading partner would damage the U.S. economy and equity markets, and thus the president’s re-election chances.”

The ensuing 11 rounds of negotiations over five months appeared to be on track for a deal—until they weren’t. The president tweeted in early May that “China should not renegotiate deals with the U.S. at the last minute.”

But I remain optimistic, based on my view that Trump continues to believe that his re-election prospects are best served by a deal.

At a late-May press conference in Tokyo, Trump responded to a question by saying that although China “would like to make a deal ... We’re not ready to make a deal.” A moment later, however, he added, “But with all of that being said, I think that there’s a very good chance that the United States and China will have a very good trade deal.”

Trump and Chinese leader Xi Jinping are scheduled to meet again in late June at the G-20 summit in Osaka, and we are likely to have more visibility at that time.

#### Not Just About Trade

Far more than trade will be on the table when the two leaders next meet. Trump will have to accept that the U.S. must share economic and strategic power with a rising China, while continuing to take steps to help shape how Beijing uses its influence. Washington will also have to accept that while the past three decades of economic engagement have promoted significant change within China—from no private sector, to an economy where 85% of urban employment is with small, entrepreneurial firms; accompanied by a broad expansion of personal freedom—fundamental changes to China’s political structure cannot be dictated by outsiders, but are very likely to evolve as the country becomes wealthier.

The Xi administration will have to accept that along with its professed desire to use its rising power within the existing global infrastructure, comes a responsibility to follow the rules of that system and to be transparent. Xi will also have to accept that his policies have consequences outside of China, and take responsibility for them. For example, just as the U.S. had to consider the impact of China’s new WTO commitments in the 1990s on its then-impoverished northeastern rust belt, Beijing must deal responsibly with the impact of its industrial policies on employment in developed countries.

In short, the two leaders will have to agree that rising competition between the two nations does not have to be a zero-sum game, and that it is cooperation and concessions, rather than confrontation, that will leave both sides better off.

In more practical terms, this will require Xi to agree to give American and other foreign firms the same market access that domestic firms receive, and to strengthen protection for intellectual property for all companies. Xi will also have to stop his security services from stealing foreign technology and handing it to Chinese companies.

At the same time, Trump will have to abandon his misguided focus on the bilateral trade deficit and take a more rational approach to issues such as visas for Chinese students and researchers in the U.S.

## Remember the Rebalancing

While we wait for Trump to decide if he does in fact wish to close a deal with Xi, we should keep in mind that the Chinese economy is no longer export-driven, so the impact of tariffs is limited.

Net exports (the value of a country's exports minus the value of its imports) account for less than 1% of China's GDP, down from a peak of 9% in 2007. In seven of the last 10 years, net exports were a negative drag on economic growth. By contrast, domestic consumption now accounts for more than two-thirds of China's economic growth and more than half of its GDP.

Last year, Chinese exports to the U.S. accounted for only 19% of total Chinese exports, limiting significantly the impact of new tariffs applied only by the U.S. Moreover, several studies by economists in the U.S. have concluded that most or all of the burden of the tariffs now in place have been borne by American consumers. Economists at the New York Fed, for example, found a "complete pass-through into domestic prices of imports, which means that Chinese exporters did not reduce their prices. Hence, U.S. domestic prices at the border have risen one-for-one with the tariffs levied."

Even if some of additional tariffs are absorbed by exporters in China, it is worth noting that much of that impact will not fall on Chinese companies, as about two-thirds of the 25 largest exporting companies based in China are foreign-owned.

It is also clear that Xi's government will step in to provide financial aid to companies that are hurt by any Trump tariffs. Despite a tax cut of almost US\$200 billion last year, China's fiscal revenue increased 6% compared to 2017. Beijing has the resources, as well as the political will, to support its exporters, just as it did a decade ago during the Global Financial Crisis (GFC).

Even without a deal, China is likely to remain the world's best consumer story. Remember that last year, inflation-adjusted household income growth of 6.5% (vs. 2.2% in the U.S.) led to real retail sales growth of 6.9% (vs. 2.4% in the U.S.)



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## Matthews China Strategy

Trade conflicts between China and the U.S. have been an overhang for global equity markets for the past year and a half. Market observers worry that trade disputes could severely impact business environments in China. Over the short term, we may see potential supply chain disruptions as local businesses react to changes given political uncertainties and increased market volatility arising from the trade conflicts. The Matthews China Strategy, however, remains optimistic on the longer term opportunity set in China and is focused on positioning our portfolio holdings for growth opportunities that benefit from the rise of China's domestic economy over the next decade. Most of our portfolio companies have limited export exposure and derive the majority of their revenues from China. In considering export exposure, only five companies, totaling less than 10% of our total portfolio, have more than 5% of their revenues derived from countries outside China.

Further, China's monetary policies remain largely independent. China today also relies mostly on internal sources for growth and this can be seen from its services economy, which now contributes more than half of its GDP. As a result, the country no longer relies on trade as a source of growth and has other ways to spur domestic consumption and demand. As compared to a year ago, China has now completed its financial de-risking campaign and stands on stronger footing economically to deal with these uncertainties. While China is not shielded completely from external forces, we believe it will be able to weather most of the negative implications of global politics. Still, a full-blown trade war would be detrimental not only to both parties but also to the global economy. Accordingly, we believe it is in the interest of both the U.S. and China to eventually reach a deal.

Overall, we continue to position our portfolio according to our long-term beliefs that China's domestic economy remains healthy, and that there are secular growth opportunities in both China's new and old economy sectors that stand to benefit from the rising levels of affluence among domestic consumers.



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### Matthews China Small Companies Strategy

U.S.–China trade tensions should, in our view, have little impact on China’s smaller companies given their domestic focus. Our China Small Companies Strategy seeks innovative and capital-efficient small companies that are relatively insulated from macroeconomic uncertainties. As long-term investors, we look for secular growth opportunities that we believe may be relatively immune to tariffs and trade issues—only 3.4% of the portfolio revenue is derived from the U.S.

Our portfolio generally tends to have a consistent overweight allocation in the information technology health care and consumer sectors, as well as selective businesses within the industrials sector. In addition, the Strategy generally is structurally underweight in companies with cyclical business models and capital intensive sectors such as real estate. We will continue to seek companies with sustainable, quality earnings streams, strong cash flows and good balance sheets that can weather uncertain economic conditions.

From a macroeconomic perspective, we continue to believe China has the ability to stabilize its economy through fiscal spending, interest rate adjustments and currency management. In addition, steps taken to correct China’s structural issues are continuing on the right track, despite the near-term pains of a deleveraging economy. We are focused on seeking innovative and capital-efficient small companies that are relatively insulated from macroeconomic uncertainties. We will continue to seek companies with sustainable, quality earnings streams, strong cash flows and good balance sheets that can weather uncertain economic conditions. We believe sectors such as industrial automation, health care and technology are among the most attractive from a secular growth perspective. We remain cautiously optimistic about China’s small-cap market amid heightened market volatility as we focus rigorously on the sound fundamentals of our portfolio companies.



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### Matthews China Dividend Strategy

Our Matthews China Dividend Strategy holds a limited number of companies with significant exposure to exports. The Strategy focuses on Chinese firms selling goods and services to Chinese consumers, not on exports to the U.S., and firms that have a significant production base outside of China. We expect the outcome of the trade dispute, therefore, would not likely have a significant effect on earnings for our portfolio companies. The impact to consumer wealth is relatively small, but consumer sentiment is a factor, as it may dampen consumption, but this should be a short-term factor. This may be offset in part by a lowering of value-added taxes (VATs) for manufacturing and cuts in personal income taxes, both of which should provide a boost for the domestic consumption companies that dominate the portfolio.

As portfolio managers, we position for the growth in consumer-related industries, including financials, health care and consumer staples. If weakness persists in the short term, we believe the portfolio has the right balance between more defensive, high dividend-yielding stocks and exposure to dividend growth companies. Any sell-off would increase the attractiveness of companies that can sustain and grow their earnings and dividends in this environment. We will continue to seek these types of compelling opportunities. We believe China already has transformed its economy into one led by consumption rather than export-driven growth.

We also are cautiously optimistic about a resolution to the trade dispute. The services portion of China’s economy has grown larger than that of manufacturing every year for the past seven years, leaving the economy less affected by exports, and the long-term growth story in China continues to center on how well it can manage its domestic economy.



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### Matthews Pacific Tiger Strategy

Chinese businesses represent roughly one-third of the Matthews Pacific Tiger portfolio. The Strategy looks to invest in companies across Asia that cater to domestic demand in the region, hence giving the portfolio a structural underweight to export-led industries, commodities and global cyclical factors. As a result, the Strategy's direct exposure to the export sector is very limited and the U.S.–China trade dispute is likely to have limited direct impact on the portfolio. This is because few of our portfolio companies export directly to the U.S. and their sales into China are limited. They tend to have little supply-chain exposure.

We generally look to invest in companies that can increase profit and cash flow, and benefit from evolving middle-class aspirations. Our bottom-up selection of businesses leads us to maintain overweight allocations in the consumer and health care sectors. These segments are helped by continuing productivity improvement and a related rise in income levels in Asia, and are less exposed to the sharp ups and downs of an export cycle. Our view is that China's economic and policy moves in recent years have helped established a sustainable middle class in the country that drives domestic consumption. We believe the trade dispute is unlikely to significantly alter this long-term trend.

To be sure, daily headlines around trade talks could have an impact on sentiment. If weak sentiment persists, consumer spending could weaken in the short term and there could be an earnings pullback in consumer and cyclical stocks and further bouts of market volatility. Looking ahead, however, policymakers in China have signaled expectations for healthy, but slightly slower, growth. In fact, these developments may further push policymakers to drive China's growth from domestic demand and the services sectors. We remain optimistic in our outlook for Asian equities over a full market cycle. Overall, we have a positive outlook for the broader Asian region, especially given a changed stance in Chinese policy vs. last year that indicates a willingness by policymakers to provide more fiscal and monetary support. We also are open-minded as we wait to see how policymakers address the trade dispute. Possible outcomes might include further opening of China's capital markets, which would present more opportunities to find attractive investments.



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### Impact on South and Southeast Asia

The further issue in the U.S.–China trade dispute is whether the U.S. will impose tariffs on the remaining US\$300 billion or so of Chinese exports. These differ from the other Chinese exports, as they include mostly consumer goods such as smartphones, computers and textiles, and U.S. consumers are more dependent on China for these goods. If the U.S. imposes these tariffs, it would clearly hit China's trade partners as many products on the list depend on global supply chains. In South and Southeast Asia, the more domestic-oriented economies such as India, Indonesia and the Philippines will be more resilient. Economies in the region that are more open, such as Singapore, Vietnam and Malaysia, are likely to be harder hit (although Vietnam and Malaysia are likely to see some offsetting benefits from trade diversion and production relocation in the medium term).

Policy tightening in India, Indonesia and the Philippines has also opened up some policy space that can be used to cushion the economy. Real policy rates are high in India, Indonesia, Malaysia and the Philippines, with Malaysia and the Philippines having made early moves to ease policy. For Indonesia and the Philippines, despite the positive steps taken to stabilize the current account and capital flows, the external uncertainty around regional trade tensions looms large for sentiment. This could limit in practice the extent to which monetary policy could be used. Thailand and Indonesia have relatively more fiscal space to provide stimulus, while India is also likely to run a wider central government deficit post-election.

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Sources: Reuters, Bloomberg, CEIC, Federal Reserve Bank of New York, Sina.com, Xinhua News Agency, FactSet, MSCI, Matthews Asia

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