Economics & Strategy Weekly

A China-US decoupling scenario

DBS Group Research

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- *While the markets are not pricing it, we think it is time to update our full-blown trade war scenario.*
- *Beyond the risk of further escalation, we also examine the ramification of an emerging hard-line view from the Trump administration, which is to decouple the US from China's economy*
- *Such efforts will have dire consequences for the global economy, and usher in a destructive cold war*
- *There will be plenty of pain to go around; China's economy will slow sharply, while the US corporate and agriculture sector will be hit severely, which will have political ramifications in the 2020 elections*

Tariffs as an end, as opposed to means to a trade deal?

Nearly a year ago, as the US began to draw up concrete plans to impose tariffs and restrict Chinese investment in various sectors of the US economy, we published our first scenario considering a full-blown trade war (link). At that time, it was a remote scenario, but unfortunately, it doesn't seem so any longer. We have seen multiple salvos from the US and retaliation from China, and news highlighting trade frictions are now a daily occurrence.

In that full-blown trade war study, dated July 3, 2018, we had estimated a 0.6% of GDP downside to US growth in 2019 (from a baseline forecast of 2.5%) and similar downside to China's outlook (from a baseline of 6.2%). At nearly the midpoint of the year, those risks have not quite materialised, but a few things are clear already. First, the Chinese authorities will take largescale stimulus measures to prevent the downside from magnifying. Second, at least for 2019, the US economy is in decent shape to absorb a few shocks. With that in mind, it is time to update our scenario for 2020 and beyond.

While keeping in mind that our base case (like that of the market) is for saner heads to prevail, we are inclined to contemplate a graver risk scenario than the one entertained last year. In this scenario, 25% tariffs on all trade between China and the US stay in place regardless of a trade deal. We consider this scenario as plausible because as of today, six months after signing the revised trade deal with Canada and Mexico, the US is yet remove 10% tariff on aluminium and 25% on steel imports from those two countries. This underscores the adage that once tariffs go up, it is very difficult to bring them down.

We are also increasingly finding validation in the view that tariffs are no longer a means to a trade deal, but an end in themselves. The Trump administration may well have come to the conclusion that no trade deal will resolve issues related to intellectual property, cyber security, or state subsidies. A permanent tariff wall could make China permanently less competitive and the revenues from the tariffs could be used to support potential losers from Chinese retaliation. This outcome, which would be similar to a sharp rise in consumption tax,

would hurt US consumers' pocket books, introduce a host of distortions and inefficiencies, and could even tip the US toward stagflation. But that could also be sold during the election season as the price for widening the gap between the US and China.

If trade negotiations go nowhere over the next couple of months and all tariffs head toward 25%, we will expect the following in 2020:

- China's real growth to fall to 5%
- US growth would ease to 1%
- RMB will head toward to 8/USD
- DXY will soar past 100
- Oil prices would correct by 20-30%
- The US Federal Reserve would cut policy rates by 50 to 75 bps
- China will postpone deleveraging to add substantial more stimulus
- Global growth to weaken by 0.5 to 0.75%

Infinity wars: a decoupling scenario

Beyond trade wars, the US is clearly keen on preventing China's emergence as a technology super power. This week's announcements barring companies deemed a "national security" threat to sell their products in the US and threats to blacklist Huawei from buying components from the US reveal the gravity of the situation. If carried through, the ramifications would be beyond the financial viability of Huawei; it would cause a sharp deterioration in the relationship between the US and China, severely slow the rolling out of 5G networks around the world in the coming years, and ultimately begin the process of decoupling between the two nations.

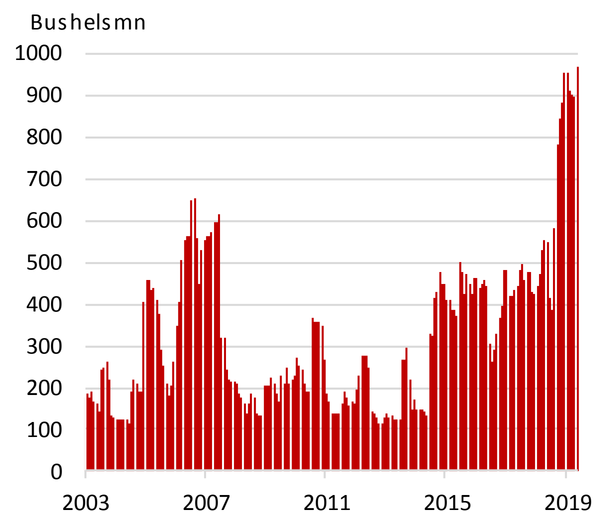
Taken to extreme, this would mean a return to the intense cold war decades between the US and USSR. While the ostensible battleground is commerce, it ought to be clear to observers that the perceived threat from the US is a challenge to its hegemony in the global landscape. By decoupling China from US markets and technological knowhow, the goal of this approach would be slow down severely China's rise.

What goes around, comes around

This combative approach, if followed through, is an unambiguous negative for the global economy. Without getting into the discussion of which country will suffer the most, it is obvious that there will be considerable pain all around. Global supply chains will be disrupted, capital spending will suffer, gains from economies scale will be diminished (in which no nation can match China), and geopolitical tensions will spike.

The US corporate sector, a major beneficiary of global supply chains, will suffer greatly as well. Walking away from a symbiotic relationship with China will deprive them from the largest consumer market in the world, not to mention one of the most productive places to produce goods. The US agriculture sector, which has increasingly become focused on producing with Chinese demand in mind, will be hurt as well, regardless of Federal subsidies.

US Soybean stock



Source: Bloomberg, DBS

Efforts toward decoupling are highly misguided and dangerous, but that doesn't mean they are out of the realms of possibility. The global economy, used to China's strong growth in recent decades and a highly integrated supply chain, will struggle under the weight of the Superpower conflict, if it comes to fruition. Like the equity market, we will continue to hope for the best; like the bond market, it is time to prepare for the worst.

Taimur Baig

Bank Indonesia stands pat on the back of heightened external pressure

Bank Indonesia decided to leave its policy rate at 6% yesterday as external pressure heightened. The decision was widely expected as Rupiah has been under pressure since mid-April, already losing the gain since the start of the year, as US-China trade war has worsened, and trade balances have widened significantly.

1Q growth has held up relatively well compared to the deeper slowdown observed all over Asia. Growth recorded 5.1% of GDP (vs 5.2% in 3Q18 and 5.1% in 1Q18). We expect growth so accelerate slightly in 2Q on wards resulting on annual growth of 5.2%.

Inflation has remained soft, edging close to BI's lower limit of 2.5%. Climbing oil price could pose risk to inflation especially if the government need to unwind domestic retail fuel price. Yet, even if domestic fuel price needs to be adjusted up, inflation is likely to stay below 3.5% this year. **The only constraint left for BI to cut rates is balance of payment pressure.**

1Q CAD recorded at deficit of 2.6% of GDP, compared to 2% in 1Q18. We think the CAD is likely to widen in 2Q19 onward as infrastructure spending will rebound after the election results, in addition to the rising oil price and re-escalation of US-China trade war which will impact Asia's trade negatively. In short, trade balance would remain under pressure as exports soften and imports are likely to start rising due to oil price and infrastructure development.

As inflation is expected to remain soft even with climbing oil price, BI will have room to cut policy rate if current account pressures ease toward the end of the year, especially if growth fell further. Before that, BI is likely to remain on guard during heightened external pressures.

Masyita Crystallin

FX: Keep those shorts in EUR, GBP and AUD

The euro is not out of the woods and a depreciation below 1.10 cannot be discounted. Renewed US-China trade tensions have potential to wither the green shoots in the Eurozone economy. The European Central Bank had, before the US tariffs on May 10, downgraded its 2019 growth outlook in March to 1.1% from 1.7% three months earlier. Real GDP growth stabilized in 1Q19, at the same 1.2% YoY rate as the previous quarter. On a brighter note, US President Donald Trump will decide six months later in November whether to impose US tariffs on cars and auto parts. The EU Parliament elections on May 23-26 could hurt the single currency on an increased representation of populist and far-right MEPs.

The British pound is setting its sights at the 1.25 lows seen last December when Prime Minister Theresa May survived a party leadership challenge. PM May is pushing a fourth vote, on June 3, on her unpopular Brexit withdrawal agreement. A defeat would leave two options on Brexit – withdraw Article 50 or leave the EU without a deal. It would step up pressure for her to resign. PM May had first offered in March to step down in exchange for her party's support of her deal. Tory members are more interested in her timetable to exit No. 10 and are reportedly considering a no-confidence vote on June 15.

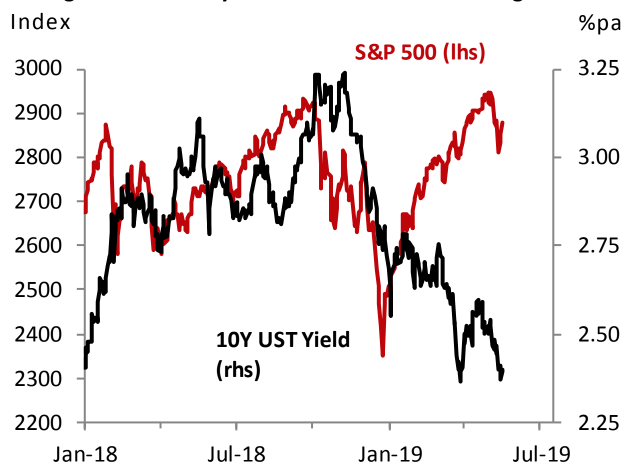
The bears are winning in pushing the Australian dollar farther below 0.70. The Reserve Bank of Australia will be less resistant to lowering its cash rate target by 25 bps to 1.25% at its next monetary policy meeting on June 4. Several things have changed since the last meeting on May 7 when the RBA resisted pressures to ease. Global growth worries have returned after the US increased tariffs on Chinese goods on May 10. In April, the unemployment rate hit an 8-month high of 5.2% while consumer inflation expectations retreated to a 30-month low of 3.3%. The path to a cut has already been paved by the RBA's downgrade for 1H19 growth to 1.75% from 2.5% previously. If so, this will be the first time since 2Q13 that growth fell below 2% and resulted in monetary easing.

Philip Wee

Rates: US yields hovering near 2019's lows

This week marked another push lower from US Treasury yields as market participants bought downside protection in the event of another escalation in the China-US trade war. 10Y and 30Y revisited their respective lows of this year at 2.36% and 2.80% respectively. The decoupling between yields and US stocks is disconcerting. Shorter-term USD rates have already in close to three cuts by end-2020, an event that is likely only if the US economy slows (no signs of that yet) or if the stock market crashes (15-20% decline in the S&P 500) and tightens financial conditions. With the S&P 500 resilient (just 2% off its all-time high), there is insufficient justification for the Fed to ease policy. It might require an all-out trade war to prompt a significant selloff in equity markets. In any case, **we maintain that USD rates are rich at current levels and it is better to avoid duration risks.**

Divergence between yields & stocks is disconcerting



Source: Bloomberg

The relentless fall in European Government Bond (EGBs) yields bears watching. In particular, 10Y German yields are at -0.1%, just shy of the all-time low of -0.2% registered in mid-2016. Persistently weak Eurozone data is probably to blame with market participants extrapolating that easy monetary policy is here to stay. Yields can push deeper into negative territory (the -0.4% deposit rate is probably a hard constraint) and we cannot see any meaningful rise in German yields unless fiscal spending picks up. **Generally depressed EGB yields will probably limit upside to US yields for the foreseeable future.**

Eugene Leow

Highlights of the week:

What's driving India's debt markets?
USD rates: What will prompt the Fed to cut?
South Korea chart book – An improving cycle vulnerable to trade wars
India: Market volatility to hurt June rate cut odds
Impact of escalating trade war on Taiwan
Chart of the week: Trade wars have yet to alter global investment dynamic
Macro insights video on our ETF strategy

Key Forecasts

	GDP growth, % YoY				CPI inflation, % YoY, ave			
	2017	2018	2019f	2020f	2017	2018	2019f	2020f
China	6.9	6.6	6.2	6.0	1.6	2.1	2.3	2.3
Hong Kong	3.8	3.3	2.5	2.0	1.5	2.5	2.7	2.5
India*	8.2	7.2	7.0	7.0	4.5	3.6	3.4	3.8
Indonesia	5.1	5.2	5.2	5.1	3.8	3.2	3.6	3.6
Malaysia	5.9	4.7	4.5	4.2	3.8	1.0	1.7	1.6
Philippines**	6.7	6.2	6.1	6.1	2.9	5.2	3.1	3.1
Singapore	3.9	3.2	2.6	2.8	0.6	0.4	1.1	1.5
South Korea	3.1	2.7	2.1	2.4	1.9	1.5	1.1	1.5
Taiwan	3.1	2.6	1.9	1.8	0.6	1.3	0.7	1.0
Thailand	3.3	4.1	3.8	4.0	0.7	1.1	1.0	1.3
Vietnam	6.8	7.1	6.6	6.3	3.5	3.5	3.8	3.4
Eurozone	2.5	1.9	1.2	1.5	1.5	1.8	1.2	1.3
Japan	1.9	0.7	0.7	0.5	0.5	1.0	1.1	1.6
United States***	2.3	2.9	2.5	1.5	2.1	2.4	1.7	1.6

* refers to year ending March ** new CPI series *** eop for CPI inflation

Policy interest rates, eop

	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
China*	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
India	6.25	5.75	5.75	5.75	5.75	5.75	5.75	5.75
Indonesia	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Malaysia	3.25	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Philippines	4.75	4.50	4.25	4.25	4.25	4.25	4.25	4.25
Singapore**	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95
South Korea	1.75	1.75	1.50	1.50	1.50	1.50	1.50	1.50
Taiwan	1.38	1.38	1.38	1.38	1.38	1.38	1.38	1.38
Thailand	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Vietnam***	6.25	6.25	6.25	6.25	6.00	5.75	5.75	5.75
Eurozone	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
United States	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50

* 1-yr lending rate; ** 3M SOR ; *** prime rate

Exchange rates, eop

	Mar 29	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20	Q3 20	Q4 20
USD/CNY	6.71	6.85	7.00	6.95	6.90	6.85	6.80	6.75
USD/HKD	7.85	7.85	7.85	7.84	7.83	7.82	7.81	7.80
USD/INR	69.4	70.0	71.0	71.5	71.0	70.5	70.0	69.5
USD/IDR	14248	14300	14500	14400	14300	14200	14100	14000
USD/MYR	4.08	4.10	4.20	4.25	4.20	4.15	4.10	4.05
USD/PHP	52.7	54.0	55.0	54.5	54.0	53.5	53.0	52.5
USD/SGD	1.36	1.37	1.40	1.39	1.38	1.37	1.36	1.35
USD/KRW	1137	1170	1180	1170	1165	1160	1155	1150
USD/THB	31.7	32.5	33.0	32.8	32.6	32.4	32.2	32.0
USD/VND	23201	23250	23300	23280	23300	23250	23200	23150
AUD/USD	0.71	0.70	0.68	0.68	0.68	0.69	0.70	0.71
EUR/USD	1.12	1.12	1.10	1.11	1.12	1.13	1.14	1.15
USD/JPY	111	113	115	114	113	112	111	110
GBP/USD	1.31	1.30	1.28	1.29	1.30	1.31	1.32	1.33

Australia, Eurozone and United Kingdom are direct quotes

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