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Q&A - Trade tensions & markets

The core assumption in doing this exercise is that a full trade war does not materialize. Instead, a series of tariffs and retaliatory measures (affecting a seemingly broad list of products) takes place.

1. **How intense could the effects of a US-China tariffs- war be for Emerging Markets?**
    - Indeed, a full trade war between the US and China threatens dispersed Asian supply chains, as some intermediate products are shipped to China for final assembly before their onward export to the US
    - This trade, however, is particularly concentrated in electronics and optical equipment.
    - In aggregate, **most** intermediate goods shipped to China from the region are used for products sold domestically. Therefore, the collateral damage should be limited.
    - The impact of the US imposing tariffs on Chinese exports will be a limited hit to growth in China (and other Asian EM), which can be offset by more expansive fiscal policy

2. **Which EM could be the most affected by a US-China trade war?**
    - The US will presumably reveal Chinese exports that may face enhanced tariffs in the next week. Such tariffs are likely to hurt Korean and Taiwanese suppliers, which are concentrated in the tech sector.
    - On balance the hit should not be debilitating, as the affected goods will be no more than 1% of their exports.

3. **What about the effects on the US economy?**
    - Increased tariffs will slightly raise US consumer prices, which may partially depress final demand.
    - This impact should, however, be offset by increased US capex, thanks to tax cuts.
    - Hence, the net effect should be a modest cut to growth and a small increase in inflation in both the US and China.

4. **Can the EM equity indices experience serious downturns?**
    - EMs are also vulnerable to a margin call in the event of a global sell-off, but the good news is that February's volatility already forced out weak hands. That is an important point, since long-term investors will focus on EM fundamentals, which look exceptionally strong, with earnings set to motor and equity valuations still unchallenging. This should help to limit the falls in these indices.

5. **Are there reasons to think that the EMs can make new highs?**
    - Just one year ago the MSCI EM was trading on 16x. Such a cheap valuations attracted many investors, yet the rally proved not to be a rerating as higher earnings can explain all gains. Thus, in aggregate, valuations are not challenging.
    - 2018 should be another strong year for EM corporate earnings due to a generally self-sustaining credit environment and a favorable global backdrop.

- A tight correlation between EM exports and earnings has persisted since the aftermath of the Asian crisis in the late 1990s. The latest global trade readings are fairly strong, so the outlook for EM earnings and equity indices remains positive.
- Our view of EM should not rest on relative economic growth rates, but whether earnings are growing faster than in developed markets. In that regard, EM firm's high operating leverage means that in global growth periods, their earnings will outpace those in developed markets.
- EM are high-beta play on global growth (with capital flowing into EM, which stirs credit creation. Such a cycle is now unfolding in EMs).
- EMs endured a forced "rebalancing" in 2013-15 after the US "taper tantrum" triggered large-scale capital outflows. Imports plunged in EM (the import-to-GDP ratios in most EMs have fallen to a 25 year low) hence, external imbalances have dramatically improved. A reversal now seems likely.
- Historically, a blow-out in the US trade deficit has been good for EMs as it expanded US dollar liquidity. The US current account deficit seems likely to increase in 2H2018 (US fiscal stimulus and tax cuts are a bonus).

6. **A global monetary tightening has traditionally affected EM negatively. Why should be different this time?**
    - Indeed, a key worry is that interest rate rises by the Federal Reserve derail economic growth. Should treasury yields rise only gradually (as is the case), EM's financing cost should be manageable as bond spreads remain tight.
    - US yield increases so far represent a "good repricing", which reduces the risk of overheating and can well be absorbed by EM countries.
    - Additionally, if the global growth cycle continues, the EM sovereign spread may narrow further.
    - Central banks in most EMs remain reluctant to raise interest rates and are preferring to stay slightly behind the curve. Real policy rates in EM Asia remain at or below their post-2009 average.

Best regards

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