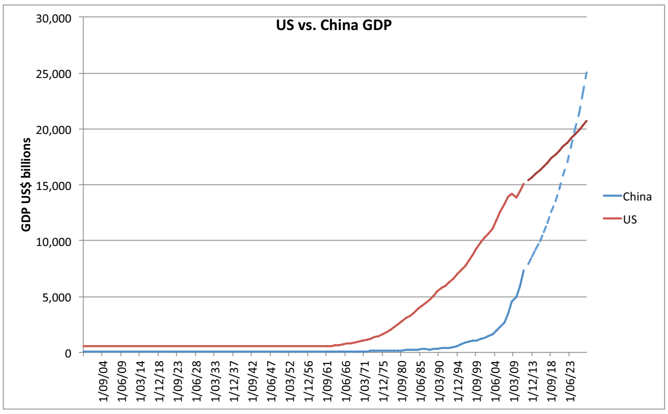
October 2012

Chinafication

By the early 1870s, the United States overtook the UK as it became the largest economy in the world. Some three decades later in the early 20th century, Americans caught up with the British in terms of wealth, as measured by per capita GDP. During this historical hand-off of power, Victorian Britain eventually came to terms with the relative decline of the Empire and its free-trade doctrine, as it sought to manage America's relative rise and trade protectionism.

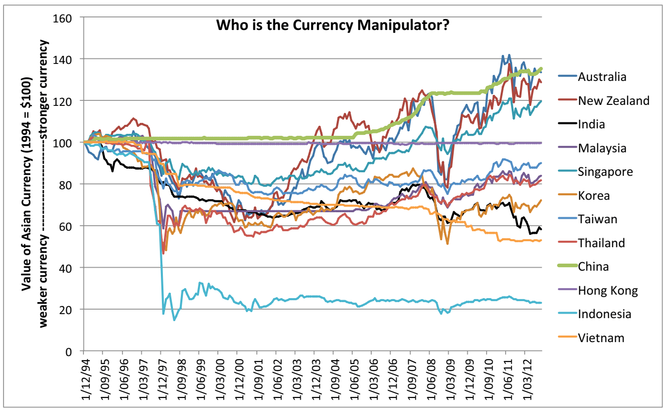
Over the next decade, the Chinese economy will likely begin to overtake the US in terms of total GDP, although with a population of over 1.3 billion, the catch-up in terms of average prosperity will take decades longer.



Source: World Bank, Chinese growth forecast at annual 8%, US growth at annual 2%

The eventual transition to China as the global growth leader requires extraordinary caution. Deng Xiaoping, the reformist communist leader who led China toward a market economy, once stated 'One should approach complexity and uncertainty as if crossing the river by feeling the stones.'

However, political tensions in both countries are straining ties and there appears to be more stone throwing than stone feeling. US policymakers, at risk of being criticised by opponents as being too soft on China, tend to publicly take a hard line. At a recent Asia-Pacific Summit, President Obama declared that China must play by global trade rules and act like a 'grown up.' US Treasury Secretary Geithner still refers to China as a currency manipulator. In the 2008 and 2012 election campaigns, both parties portrayed China as America's key economic and strategic rival, even though Chinese growth has sustained the world economy since the mid-2000's. In the 2010 mid-term election, the situation deteriorated further as China emerged as a scapegoat in campaign ads. The Senate began to weigh 'whether to punish China for undervaluing its currency and taking away American jobs.' The Senate's bill was stopped in the house. But policymakers cannot afford to be seen as neglecting the U.S. workers – a recent NBC/Wall Street Journal poll saw 62% believing China was an adversary while just 25% saw China as an ally. In its 9th World Trade Organisation (WTO) complaint against China, the US has asked the WTO to rule China is illegally subsidising cars and car parts.



Source: Bloomberg

On the other side, Chinese leaders remain appalled by the U.S. debt-ceiling impasse and the downgrade of the U.S. credit rating. Ongoing rhetoric would seem to carry substantial risks for both Washington and Beijing. Substantial trade tension with China could trigger a trade war and result in counter-measures and protectionism worldwide – similar to 1930 with passage of the Smoot-Hawley Tariff Act (raising US import tariffs to historically high levels), which turned a severe U.S. recession into a near-worldwide Great Depression – as the world learned the consequences of tariff retaliation (the WTO was designed to prevent implementation of unfair tariffs and protectionism – and China recently lost a WTO case and was forced to lift retaliatory US steel tariffs). More worrying is the Diaoyu/ Senkaku Islands dispute, which are claimed by both China and Japan. The recent release of a US long-term war planning concept with China as the enemy has angered the Chinese military and could potentially lead to an arms race.

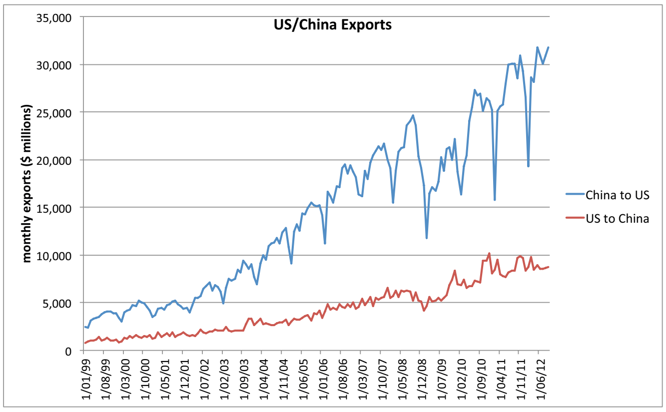
However, over President Obama's first term, U.S.–China discussions have improved through the Strategic and Economic Dialogue (S&ED), which has become the venue for a broad range of discussions ranging from political, social, security and economic issues.

Discussions have varied from military modernisation, maritime disputes, Taiwan, climate change, clean energy, human rights, currency policy, trade deficit, U.S. Treasury holdings, WTO commitments and intellectual property rights. Obama's election victory is likely to support efforts toward global rebalancing and a lower bilateral trade deficit; but it's difficult to envision an environment where China won't remain a major creditor nation and the largest foreign holder of U.S. public debt. Likewise, the U.S. will be the major debtor nation with massive trade and budget deficits. The recent Chinese elections promoting its next generation of leaders are also unlikely to materially change this outcome.

Despite tensions, economic ties have become deeper. The level of trade and investment between the two countries has grown, particularly as China moves from an export-led economy to a consumer-led economy with the growth of its middle-class. American companies invested over $60 billion in more than 58,000 Chinese projects in 2010 (the latest data available), up more than 20% from 2009. 2010 Chinese investment in the US was $3.2 billion, up 172% from 2009.

Politicians on both sides have concerns. A US congressional advisory panel is currently urging tighter screening of Chinese state-owned investment in the US. State controlled enterprises control as much as 50% of the Chinese economy. Recent proposals include a requirement to screen all Chinese state-owned companies which purchase majority stakes in all American companies, rather than just purchases with national security interests. There are also proposals to prohibit foreign investment in any industry in which the foreign government prohibits the same investment – which would have a significant impact on the future of the telecom and oil and gas sectors.

On the trade side, data shows the US still has a large deficit with China at $232 billion so far in 2012. But US exports, which were negligible a few years ago, have reached $79 billion this year and by 2009 China became the 3rd largest market for US exports, behind neighbours Mexico and Canada. As it stands today, General Motors sells more cars in China than it does in the US.



Future of China – US economic relations

US pressure for China to remain focused on appreciating its currency will continue. Given weak US manufacturing, the currency will likely remain a source of friction over the next decade. We believe it is unlikely that US pressure will have any meaningful effect on Chinese currency policy; rather it will be more of a political show. Competitive devaluations are not clearly covered under WTO rules which will make US court action more difficult. US WTO unfair trading cases will continue (dumping claims) and China will retaliate with its own claims, although they will likely eventually lose as tariffs are more clearly covered in WTO rules. China won't look for controversy here, preferring to focus on domestic issues as the once in a generation transition in power takes place.

Long-term future of the Yuan

It's difficult to see any changes to the current trend of a slowly appreciating Yuan. Given the continuing risks to the US and global economies, we envision continuing QE and a growing Fed balance sheet. This will continue to put pressure on the Yuan, as the slow revaluation continues over the next decade. It remains in China's interests to allow slow Yuan appreciation, as it moves from a low value-added, export-led economy to a higher value, consumer-led economy, thereby allowing economic benefits to broaden across more of its population.

Short-term outlook

We remain relatively optimistic over the eventual return to solid long-term global growth, albeit the process will extend longer than markets currently expect. While we foresee much volatility in the coming months, we believe credit markets are poised to continue delivering solid returns. We expect global data will continue to remain mixed, but the global economy is slowly recovering. Despite mixed jobs data, the US has turned a corner, in that job growth should remain positive, but not stellar. While the Federal Reserve's comments about keeping rates on hold until 2014/2015 should instil confidence in markets, we continue to believe the Fed will keep rates on hold beyond 2015 and maintain QE3 for the foreseeable future.

We do not believe the European Central Bank's latest operations will ease liquidity concerns over the medium-term. The severe austerity programs imposed on peripheral countries will eventually backfire in the form of further voter protest and greater public demonstrations against austerity, forcing fiscal restraint to the backburner and eventually leading to another Eurozone crisis. The upcoming Eurozone battles could drive global growth prospects lower and force markets to remain in a 'risk-off' mode, at least for some short period. Greece will remain at the forefront for the near-term, but Spanish and Portuguese risks are increasing.

While we have reduced the portfolio's high cash allocations from the highs of 2011, we remain concerned over the potential for a deteriorating economic situation in the short-term and will maintain a moderate risk level. However, we intend to maintain positions in US Banks and Asian corporates given their attractive yields. We prefer to focus on Australia and Asia as the macroeconomic environment, including the fiscal situation looks in much better shape than the rest of the world. We will continue to maintain our duration position of approximately 1.25 years as a hedge against a potential risk-off environment. We will maintain smaller positions in lower-rated credits as well as financials, where we are being adequately compensated for the level of risks we are taking. We are also looking to position for tail risk events in order to insulate the portfolio should the situation in Europe continue to worsen. We have recently implemented positions to hedge the portfolio against deteriorating credit fundamentals in the US and Europe.