

China monthly: Beyond trade war

Long-term rivalry with the US has just begun

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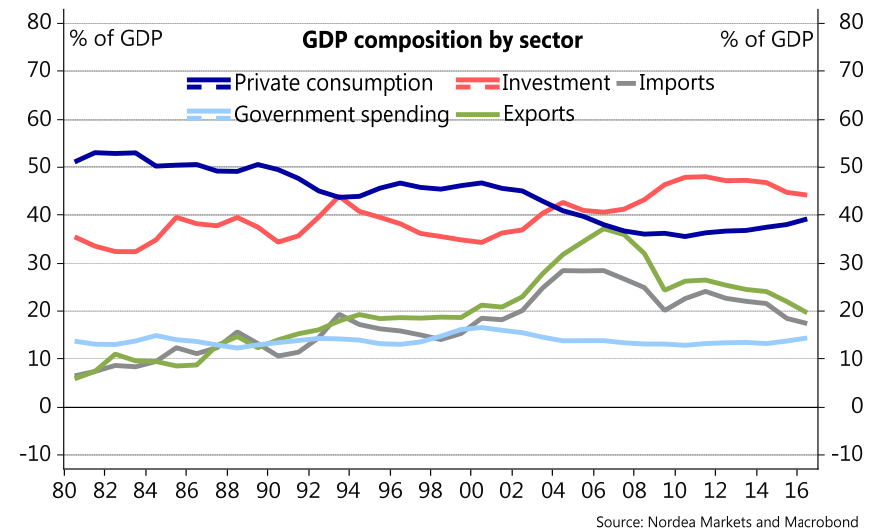
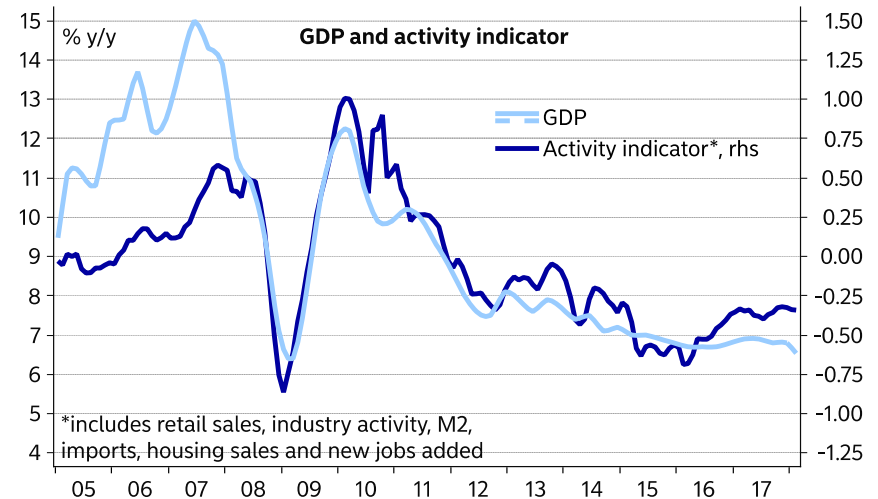
Executive summary

- The Chinese economy is showing signs of slowing down. Key indicators have peaked and will likely turn downwards in the coming months.
- One drag to growth this year will be the cooling housing market. Growth in housing prices and transactions have already been declining for some time. Sentiment is turning sour and construction growth will likely be the next indicator to deteriorate.
- However, we expect the housing bubble, along with the other systemic risk: leverage, to be under control this year. No hard landing is likely.
- The current trade conflict between China and the US have created many headlines. We do not expect a full-blown trade war. Neither do we believe that the FX reserves and the currency will be used as a weapon to retaliate the US. The long-term rivalry between the two countries will likely continue. That could be bad news to globalisation.
- The CNY will likely continue to be driven by the USD. We still expect medium-term strength in the yuan against the dollar. Currency strength can help eliminate the current depreciation expectation and avoid a repeat of the 2015-16 “currency crisis”.

Gradually slowing growth this year

Risks from trade conflict are still limited

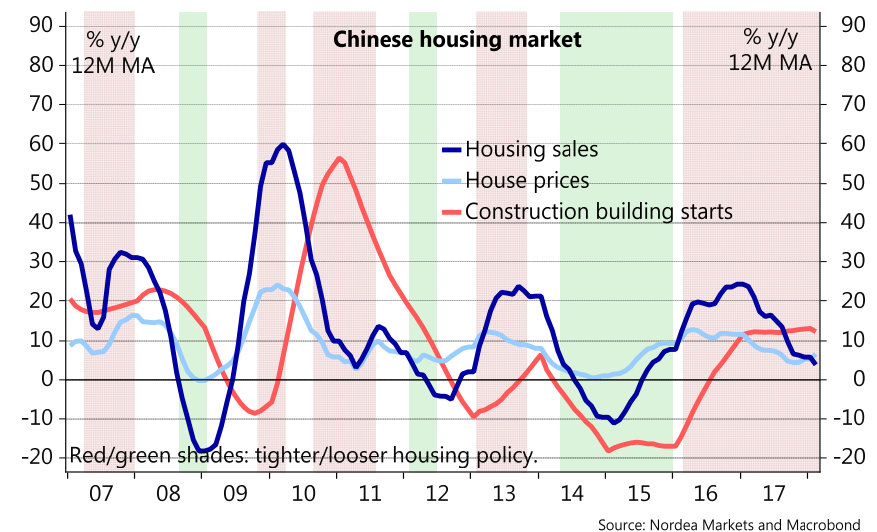
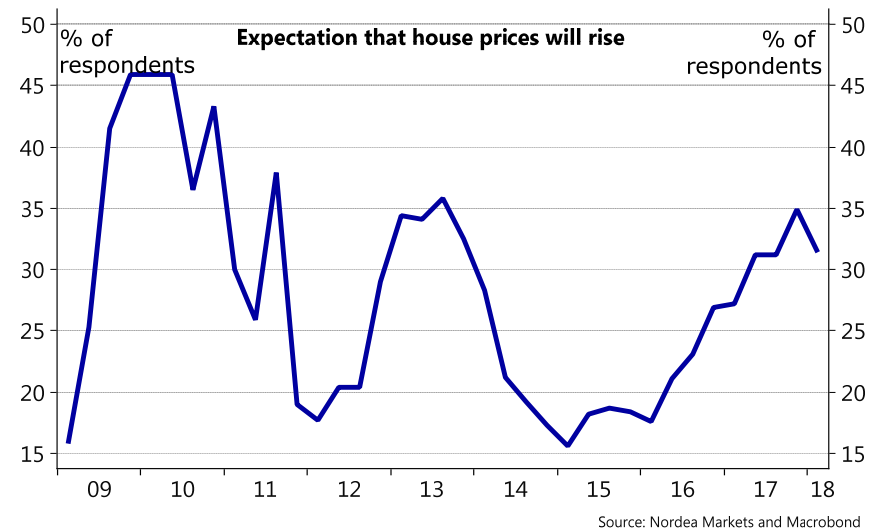
- The activity indicator seems to have peaked for now. We expect it to decline over the course of the year as a result of a cooling housing market and construction growth. In turn, overall industrial demand and GDP growth will likely be dragged down this year.
- We do not think lower growth increases the risk of a hard landing this year. The economy still faces systemic risks, such as an overheated housing market and excessive corporate leverage. But policymakers seem to have improved their ways to act ahead of the curve and reduced the probability of these risks being erupted compared to before.
- A new risk that emerged this year is the trade conflict with the US, which we do not expect to escalate into a full-blown trade war. Minor loss of export demand can fairly easily be replaced by domestic investment, thanks to the state's influence on the domestic economy. Net growth impacts will likely be limited.



Cooling housing market

But small likelihood of collapse

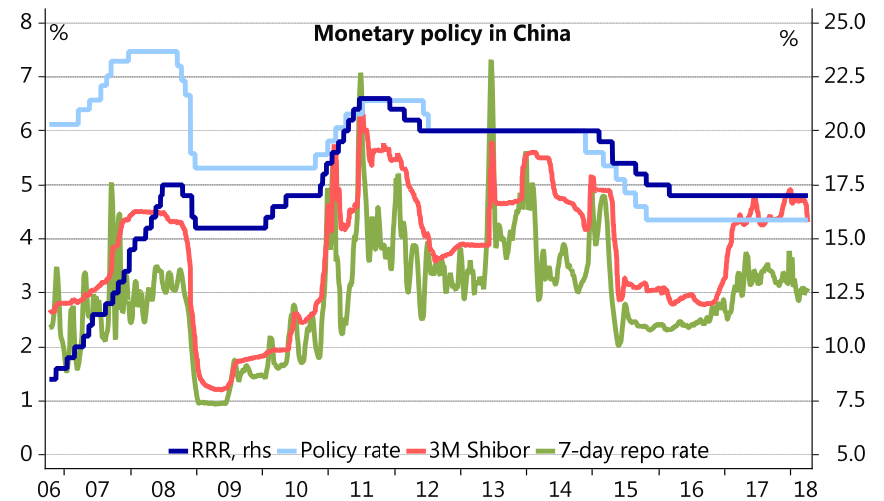
- The housing market is cooling down due to the government's efforts to deflate the bubble. In Q1 2018, housing price expectations turned less optimistically for the first time in two years. Soon, construction growth will be dragged down, but not to the 2015-low, thanks to inventory reduction.
- When the tightening started in early 2016, it was only modestly restrictive and was made stricter over time. We see the gradual changes in housing policies as an improvement of the government's way of controlling the housing market without creating sharp swings. This is one reason why we have become less worried about the housing bubble erupting.
- The housing market will likely remain status quo as long as there are no drastic policy changes such as introduction of investment options or opening-up of capital borders that trigger a sell-off of housing.



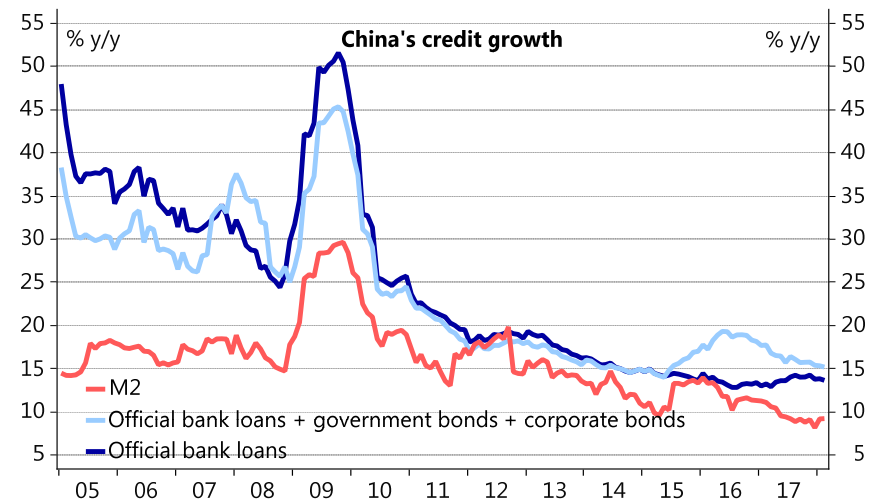
Deleveraging tops the reform agenda

Any progress will be gradual

- We think deleveraging will top the reform agenda this year. Not only has it been highlighted at all recent government meetings, but President Xi's trusted advisor Li He has been appointed Vice Premier, responsible for the economy. He has repeatedly warned about the risks associated with the high debt ratio.
- Liu He will likely start deleveraging by attacking speculation. Since 2012, lots of capital has been circulating in the financial system, likely related to the exploding growth of shadow banking products. Most of this capital is not channeled into the real economy and creates asset bubbles.
- Raising short-term market rates makes it more expensive to fund speculation and will likely discourages it. At the same time, leaving the benchmark lending rate untouched will keep corporate borrowing rates stable and thereby limit the impacts on the real economic activities.



Source: Nordea Markets and Macrobond

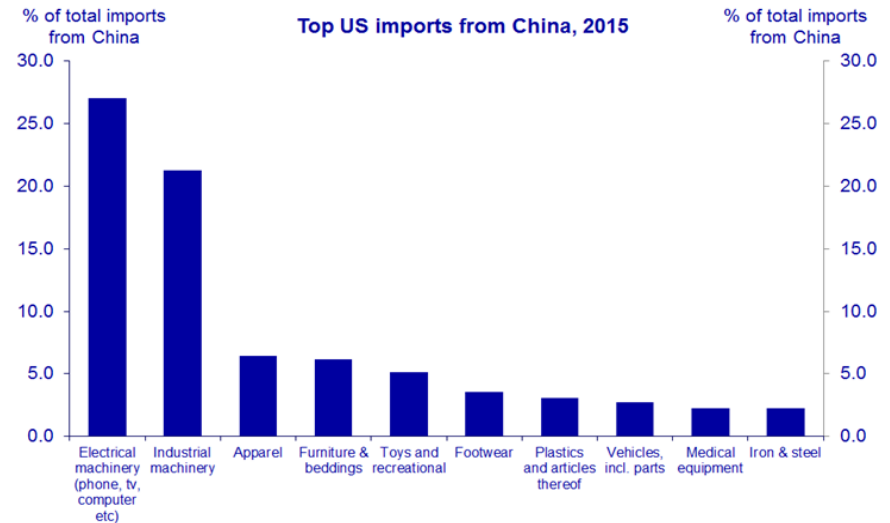


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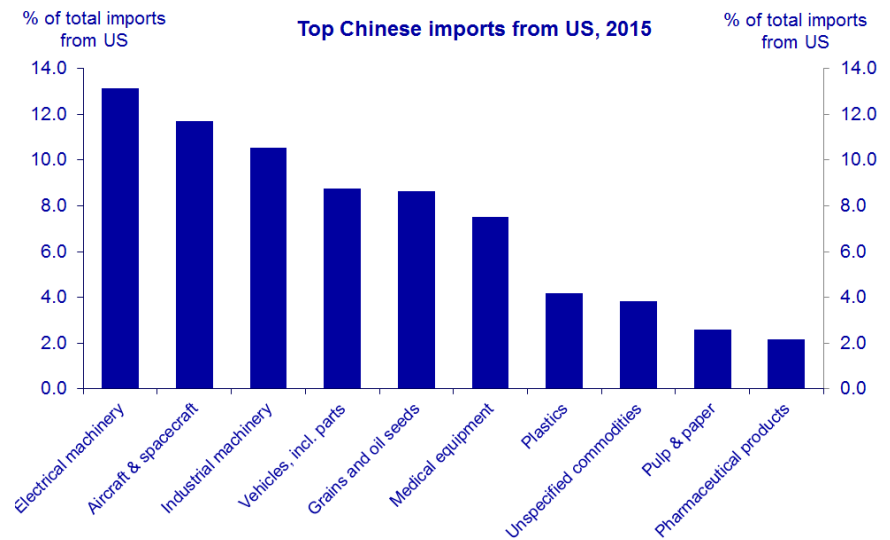
A trade war is unlikely

Current trade measures are very small

- Despite trade war is on everyone's lips, we still not think the current trade conflict will escalate into a full-blown trade war.
- So far, the announced measures are small and have limited growth impacts. US tariffs on USD 50bn worth of Chinese goods, accounts for 2.2% of China's total exports. China's announced retaliation of USD 50bn accounts for 3.2% of total US exports.
- Even as Trump has just called for new tariffs on China, we still see room for the tensions to ease. The US tariffs are subject to a 60-day public comment period, which gives time for Washington and Beijing to negotiate. Moreover, all of Trump's closest advisors have been downplaying the trade war risk. On the other side, China has always expressed willingness to reach a diplomatic solution and avoid escalation. We think that if Trump stands down with further actions, China will not proactively worsen the situation.



Source: Nordea Markets and UN Comtrade

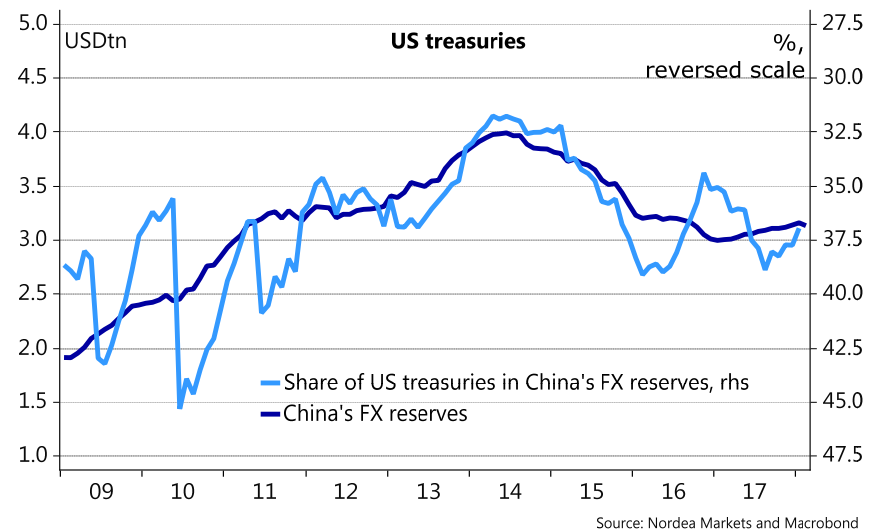
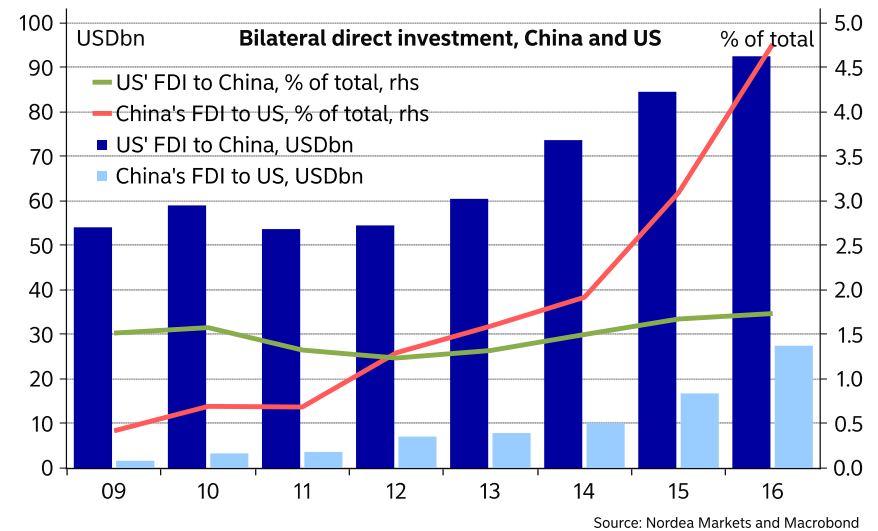


Source: Nordea Markets and UN Comtrade

Trade conflict does not limit to trade only

Bilateral direct investment will be affected

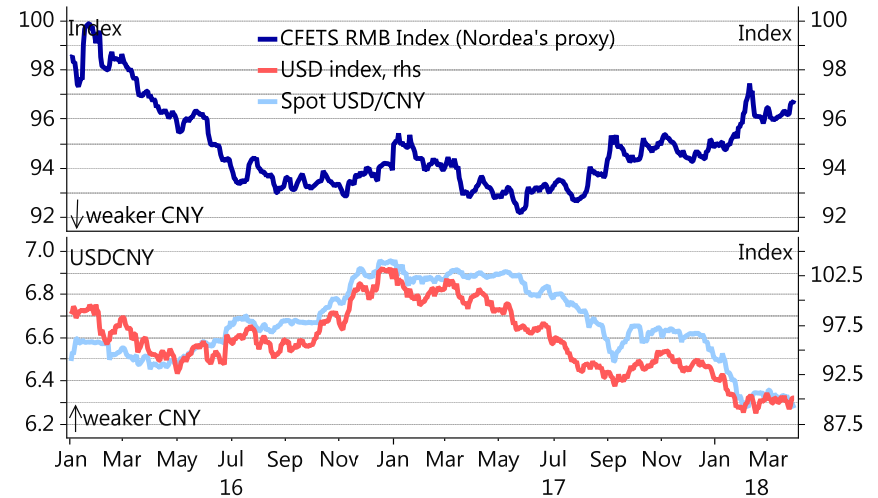
- Direct investment will likely be used as a bargaining chip in the current trade conflict. In fact, Trump has asked the Treasury Department for a proposal to restrict Chinese investments. Although the FDI amounts are much smaller compared to the bilateral trade in goods and services, restricting investments have longer-term impacts on globalisation.
- In contrast to direct investment, we think portfolio investment will not be affected to the same extent. We maintain the view that China's US Treasuries holding is not a weapon against the US. This is because any sell-off would backlash China itself, unless it can unload the total holding of USD 1.2tn at once, which is not plausible.
- In the longer term, we expect China to reduce its holding of treasuries, but it will be as a result of its effort to bring down the total FX reserves and not as retaliation against the US.



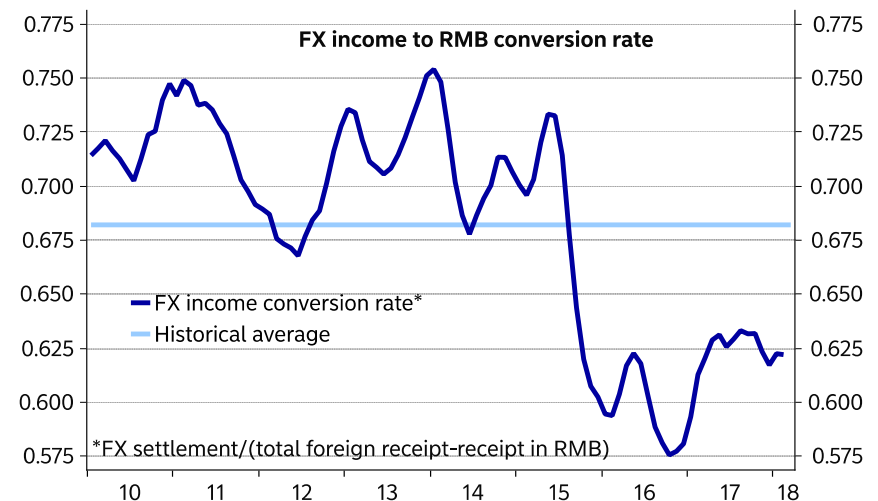
CNY devaluation is not a weapon

The USD will remain a key driver

- The CNY remains closely correlated with the general USD movements, a trend we expect to continue. We still expect medium-term strength in the CNY against the USD, as returned risk-on will weaken the USD.
- Similar to the logics for the FX reserves, Beijing will not likely retaliate by devaluing the CNY, as the cost would outweigh the benefit. A weaker yuan could make exports cheaper but also imports more expensive. Since still a large share of exports is produced using imported parts, it will not be clear-cut win.
- More importantly, any devaluation could spur another round of expectation-fed depreciation and capital outflows, similar to 2015-16. This risk is large as Chinese exporters are betting on the currency to weaken, which explains why they are hesitant to convert FX income to the yuan. Beijing will do just anything to avoid this scenario and not use devaluation as a tool to retaliate the US.



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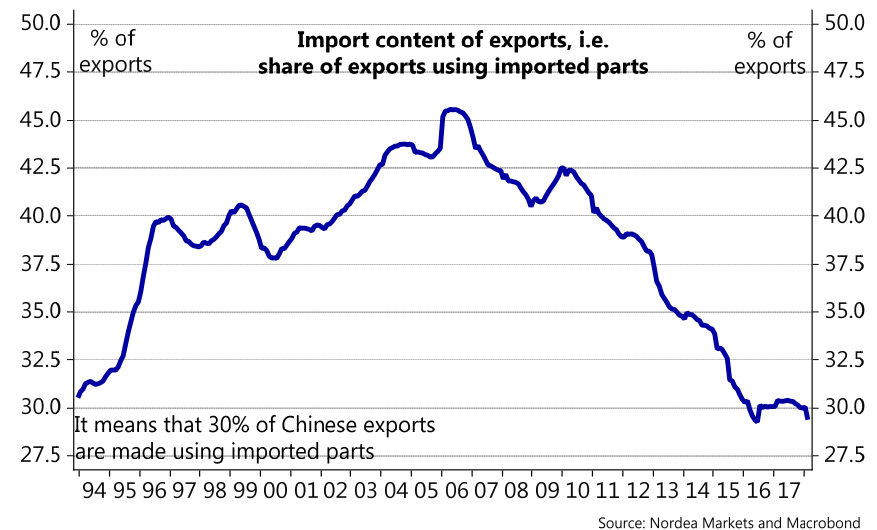
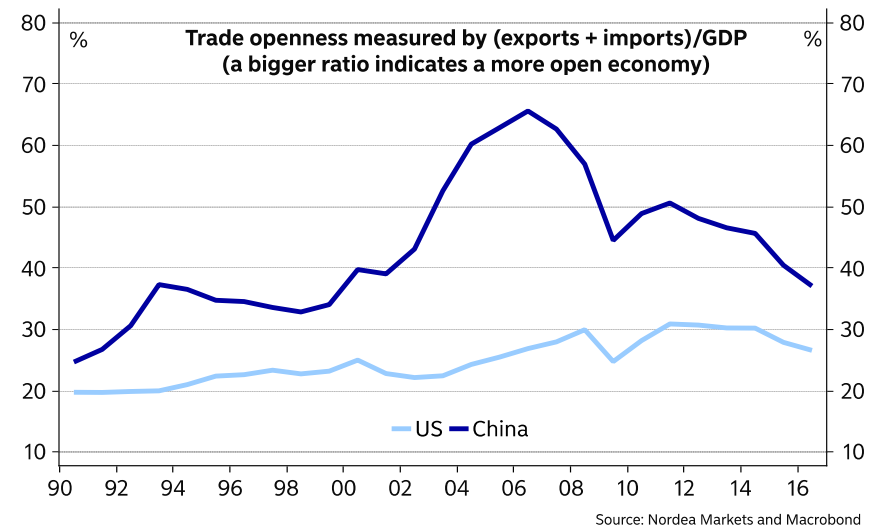


Source: Nordea Markets and Macrobond

China-US rivalry continues

This feeds to protectionism

- One mountain cannot contain two tigers is a Chinese saying that may describe the future rivalry between China and the US.
- China's global status will likely continue rising along with its confidence on its growth model and political system. The level of party control is also about strengthening rather than diminish. It might seek to create new global rules rather than following the existing ones. Furthermore, its rise in the technology ladder could cause some of the currently imported goods to be produced domestically. So its economy could become more closed.
- All these could infuriate China's trading partners, of many already have complaints. The EU and Japan have asked to join the US' WTO case over China's alleged discriminatory technology licensing.
- Ultimately, the risk is that protectionism rises and reverses the last 30 years' effort in globalisation.



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