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ECONOTE No. 85: The truth at last: HK and instability, The impact of the Trade War, Asian Yield Curves 23/8/2019

Summary

This report is, perhaps, too ambitious to cover three truly big topics in 2 A4 pages, but here it goes. The impact on the **HK economy** of the current political upheaval, on the basis of what happened during SARS and Occupy Central, may not be that serious except that it is happening in a period of steep cyclical downturn. The regional impact of the **US-China trade war** has been exaggerated, even in the case of China. The relatively scarce evidence there is, points much more to expectational factors rather than actual "collapse" of exports. Last but not least the non-issue of **inverted yields curves** (See Fact Box) is put to rest in the case of Asia -there aren't any- except for Hong Kong, and in any case their predictive value is variable. In sum, if there is a culprit for the unease in the markets these three suspects do pass muster, but add the uncertain Fed policies and then there are real reasons to worry.

Investment Conclusions

We focus far more on the next move of the Fed as a factor of support of the equity markets rather than the irrelevancies of the US-China trade war which is, literally, taxing more US consumers and producers rather the Chinese. The strength of the USD, supposedly based on its role as a safe haven will wear thin, if that other major currency manipulator, the US Fed, cutS again interest rates. As for the EU and EUR, we boringly stay with our forecast that the UK will not leave the EU, anyway not without a general election or a referendum, which will postpone that decision for several more months and cause it to fall below the radar out of sheer boredom. Combine together these factors, and we are modestly long on some equities and short on the USD and USD bonds.

Instability in Hong Kong plus the US-China trade war.

There have been three well defined periods of instability in Hong Kong, the SARS epidemic March to June 2013, the Occupy Central 26 Sept to 15 Dec. 2014 and the current Extradition Crisis period from June 2019 to date.In Fig.1 the red columns delineate these periods.**SARS** had a sharp and short lived impact.The GDP growth rate yoy% moved as follows: 4Q.02 4.1, 1Q.03 3.9 , 2Q.03 -0.6, 3Q.03 4.0, 4Q.03 4.7. In the case of **Occupy Central** the movement was shorter and the impact smoother: 3Q.14 3.2 , 4Q.14 2.6, 1Q15 2.4, 2Q.15 3.1. As the **Extradition Crisis** period has not been resolved yet, it is crucial to point out that HK's GDP had been decelerating for nearly a year before the troubles started in June 2019: 1Q.18 4.6, 2Q18 3.6, 3Q18 2.8, 4Q.18 1.2, 1Q.19 0.6, 2Q.19 0.5. Hence it is going to be quite difficult, when all this is over, to filter out and account for separately the, undoubted, impact of the instability from that of the pre-existing cyclical downturn.Anecdotals are helpful, but impossible to seprate from what had been going on for several months before the start of June. The **US-China trade war** has introduced a separate factor of anxiety ripe for wild exaggeration and factually unsubstantiated assertions.**Fact 1** China is the only country that the US has imposed, or threatened to impose, tarrifs on **all** of its exports. NAFTA was renegotiated with Canada and Mexico relatively amicably.The US has imposed selectively **some** tariffs on **some** countries on **some** good, such as on steel exports which included the EU and S.Korea, on solar panels and washing machines and removed preferential treatement of exports from India.Major trading countries such as Japan and Australia have been left relatively untouched, so far, from the current tariff changes but have been subject to continuous threats.Fig 2 shows the ambivalent impact of this "trade war" on the exports growth of major trading economies, and we will comment on this further on.

It is important to point out that a key concern over the US-China trade war was the collateral damage through disruption to supply routes rather than simply reducing exports.But a good number of countries could benefit from the relocation of export facilities from China, thus leading to a zero-sum game outcome of the trade war. **Fact 2**, neither China nor the US are export-driven economies, despite obsessive repetition of that false mantra for China.For the latter, the contribution of net exports growth to GDP growth was negative for 2015, 2016, and 2018.Similar results held for the US.

Fig.1: HK GDP and crises: SARS, Occupy, Extradition, 2002-19 %yoy

Source: Bloomberg

Trade war and inverted yield curves

But much more concretely, there is growing evidence that the expected impact of the trade war (limited as it is!) will have a very modest impact on the growth of the US and of China, but less so for the global economy, the latter under an unlikely scenario of generalized global trade war. A Japanese study estimated the economic impacts of a "full-confrontation" scenario wherein both countries impose 25% additional tariffs on all goods imported from each other for 3 years 2019 onwards. In our calculation, the economic impact for the United States is -0.4% and -0.6% for China. Some Asian countries actually benefit from the trade war. As far as it remains bilateral, the trade war is only an issue for the concerned parties. We also ran the US–world trade war scenario, wherein the US and all other countries impose a 25% additional tariff on all goods. The negative impact on the global economy is 1.7%...(IDE Discussion paper 760, April 2019). Similarly Prof.L.Lau of the Chinese University of Hong Kong concluded that: "China's exports of goods to the US in 2018 were 3.6% of GDP. The total VA attributable to these exports around 66.0% resulting in an estimated maximum loss of 2.4% of GDP if all exports to the US are halted. If, as is more likely, half of the Chinese exports of goods to the US are halted, the maximum loss will be manageable loss of 1.2 % (GDP)" (SCMP, 24 May 2019)

Fact Box: Asian yield curves, local currency govies, 20 Aug.2019

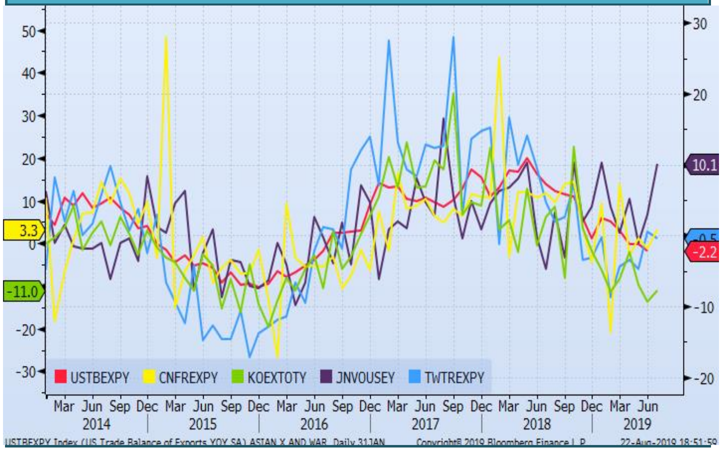
Country	Yield details, bps	Slope, bps
China	3.025-2.65	0.37
Hong Kong	N/A	-0.1 (N.B. USD peg)
Taiwan	0.63-0.47	0.16
S.Korea	1.23-1.13	0.10
India	6.56-5.83	0.73
Singapore	1.78-1.63	0.15
Thailand	1.50-1.41	0.09
Indonesia	7.19-6.29	0.90
Philippines	2.68-1.99	0.69

We use here the 10Y-2Y slope for all countries except for the Philippines: 15Y-5Y.Shorter durations were not generally available

Source: Bloomberg

Finally we turn to the **inverted yield curve** syndrome, one more symptom of the "US-centricity" in the field of financial comments. The evidence that inverted yield curves are good forecasters of US recessions is far from convincing especially as some of the "forecasts" proved right two years after the curve inverted! Furthermore the post- 2008 period has now cast doubt on the fixed income market historic expectational behavior as markets have adjusted to near zero rates and with trillions USDs of fixed income paper with negative yields. Try to interpret a negative, inverted yield curve! Furthermore what works for the US may be utterly irrelevant for the smaller and relatively illiquid Asian fixed income markets. No one has yet suggested that inverted yield curves forecast recessions in Asia, but it is a useful antidote to take at the time that a recession in the US is supposed to trigger a global recession The lessons of 2008-9 have not been learned yet, when the collapse of the US financial system did not trigger the collapse of the financial markets in Hong Kong, China, Taiwan,India, Singapore, S.Korea Japan and Australia among others.

Fig.2: US and Asian exports, 2014-2019 %yoy



Source: Bloomberg. All total exports. except Japan (mauve) exports to the US.

Pulling all the threads

Fig. 2 shows that the exports performance of major Asians and of the US is far from pointing to an exports recession.It is important to note that all exports had peaked by 2017, a year before the trade war broke out.Japan's exports to the US have bottomed, while the total exports of the Asians, China (yellow) and Taiwan (blue) are on a recovery path, but not for S.Korean exports (green).Only the culplrit of it ot all, the US, is registering still a deceleration in exports growth.Bar the figures from Japan, the rest of the exports reflect the sum of total of exports to the world and not just to the US.And herein lies the crux of our argument.The US-China spat has not dragged the rest of the world in imposing tariffs in everyone else, just because the US does threaten action.Hence, despite the evidence that a generalised trade war would knock off full precentage points off global growth, a trade war between two non-export dependent economies will have little direct impact on each other and even less collateral damage .As for Hong Kong, the current political events could not have happened at a worse "economic time" as the economy was already decelerating quite sharply.Blame attribution wlil tax later on investigators, including Econotes, in sharing the economic costs between the cycles and the protesters.Last but not least, on the topic of the inverted yield curves, the least said the better, especially for Asia.

We stay with modest equity bullishness, but stay bears for the medium terms on the USD as the Fed will cut again and, hence, bears on the massively overpriced bonds.As we stick to our Brexit (will not happen) view, we remain bullish on the FT100, GBP and, of course, the EUR.The UK not leaving will give a huge moral boost to the much maligned EU bar one thing, the reluctant Brits will continue to be part of Europe !

Andrew Freris (writing completed on 22 August 2019)