China Back in the Crosshairs?

Meghan Shue
Investment Strategist

Highlights

- Sunday marked a key milestone for China's global trade relations, and opens a door to geopolitical risk.
- Also, heading into early 2017, we see Chinese currency risks as heightened.
- Both forces underpin our desire to remain underweight emerging-markets equities; we are aggressively tilted toward U.S. stocks.

Financial markets have focused in recent weeks on geopolitics and policy — from the OPEC meeting in Austria, to the constitutional referendum in Italy, to the ongoing transition of U.S. President-elect Donald Trump's administration. Certainly, the latter has elevated issues related to China; we expect the next couple of months could see China return to the forefront of investors' minds, but perhaps for two less-appreciated reasons. First, China marks the 15-year anniversary of joining the World Trade Organization (WTO); second, Chinese capital controls will face heightened challenges with another page turn of the calendar.

China's 15-Year Anniversary with the WTO

Sunday, December 11, 2016, marked the 15-year anniversary of China's acceptance into the WTO, a global international organization that provides a forum for trade negotiations, administers trade agreements, and handles trade disputes between its 164 member nations. While a 15-year anniversary is customarily commemorated with a gift of crystal, in China's case, this anniversary may generate more discussion around aluminum or steel (the gifts for 10th and 11th anniversaries, respectively).

When China was being considered for membership in the WTO in 2001, one of the concerns raised by members was that unfair trade practices from China would severely disadvantage certain industries in other countries. As a result, Article 15 of China's Protocol of Accession to the WTO made a distinction between market economy status (MES) and non-market economies (NME) in determining how to handle cases of dumping (defined by the WTO in its simplest form as international price discrimination, where the price of a product when sold in the importing country is less than the price of that product in the market of the exporting country).

For a country without MES, which essentially means the economy does not operate on free-market principles, importing countries are entitled to disregard the exporting country's prices and costs to calculate dumping penalties. Instead, they can use external benchmarks, such as prices and/or costs in one or more other countries, as the reference point for what the good in question "should" cost to produce without the influence of government or other non-free-market forces. The U.S. and European Union (EU) have not granted China MES, so they are permitted by the WTO to levy harsher penalties (i.e., duties or tariffs) against cases of Chinese dumping than if China were given MES.

Why do we raise this issue? A clause in Article 15 stipulated that the NME provision would expire 15 years after the date of accession, which is now. This has led China to claim it should automatically be promoted to MES, lessening the burden of WTO-sanctioned anti-dumping penalties, but the U.S. and EU may maintain a right to keep China as an NME until the economy meets specific criteria. In the U.S., the decision is that of the Department of Commerce, which has six requirements for determining a country's status:

1. Currency convertibility;
2. Whether wage rates are determined by free bargaining between labor and management;
3. Allowance of joint ventures or foreign investment;
4. Degree of government ownership or control of the means of production;
5. Degree of government control over the resource allocation, pricing, and output decisions of firms; and
6. Other appropriate factors.

The U.S. has 98 anti-dumping duty orders already in place against China, with the majority in the metals industry (iron and steel) but also miscellaneous manufactured products, including paper clips and wooden bedroom furniture.[1]

President-elect Trump has been anything but shy in his desire to take a more aggressive approach to relations with China, and the decision of whether to maintain China's non-market status could fall to his administration. Wilbur Ross, who was nominated by Trump as commerce secretary, is very familiar with all of these issues. In 2002, Ross purchased assets of bankrupt steel maker LTV Corp., right before President George W. Bush imposed temporary tariffs on all steel imports. According to the Peterson Institute for International Economics, should the U.S. decide not to grant China MES, this could provoke China to initiate WTO litigation, impose its own tariffs in retaliation, or find other less concrete ways of punishing U.S. exporters. We take some degree of comfort in the fact that Ross has acknowledged a trade war is to no one's benefit. It is also a positive that Trump's pick for ambassador to China, Iowa Governor Terry Branstad, has reportedly had a 30-year friendship with Chinese President Xi Jinping, and Branstad's home state is also very much invested in a successful U.S./China agricultural trading relationship.

China's Weaker Currency Foreshadows Stricter Capital Controls

China's currency, the yuan, or renminbi, is the weakest it has been versus the U.S. dollar since May 2008 (Exhibit 1). At face value, this seems to provide more ammunition

Exhibit 1: Chinese Renminbi per U.S. Dollar

As of December 9, 2016.
Source: Bloomberg

[1] U.S. International Trade Commission as of November 29, 2016.

to Trump's claims that China is artificially weakening its currency to make Chinese exports more competitive. In reality, the situation is far more complex.

There is no doubt that China's peg to the U.S. dollar over the years has, practically speaking, made it a currency manipulator (official naming it as such was a campaign threat of both Trump and 2012 Republican nominee Mitt Romney). This changed a bit in December 2015, when the People's Bank of China (PBOC) announced it would begin monitoring the yuan versus a basket of trading partners, a step toward a more laissez-faire approach.

Over the past three years the yuan is 13% weaker versus the U.S. dollar. However, during that same time, the U.S. dollar has strengthened 24% versus a trade-weighted basket, so the relative value for the pair is as much or more a result of a stronger U.S. dollar than it is an intentional weakening of the renminbi.

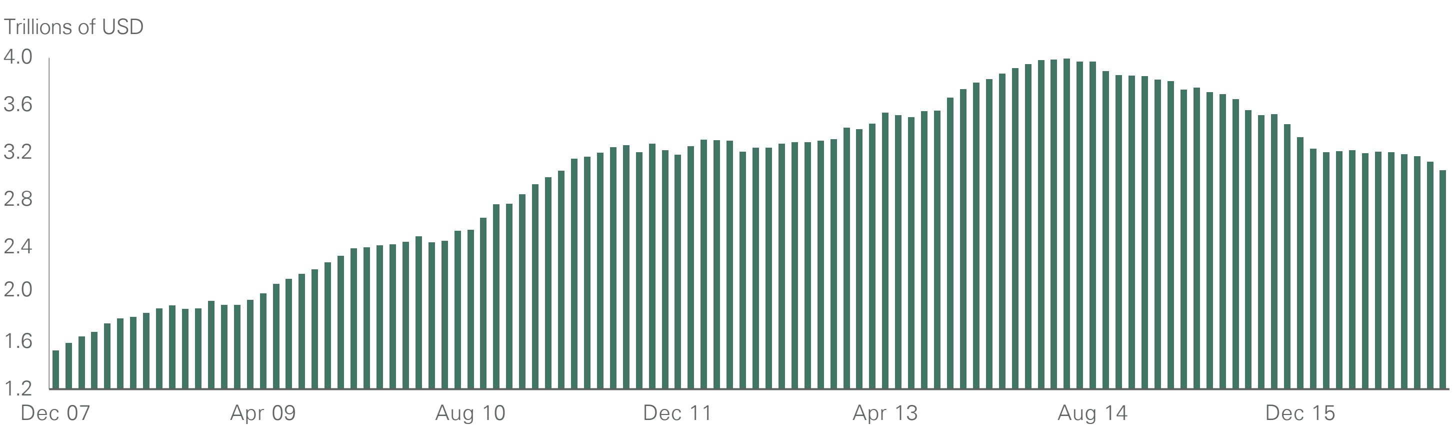
In fact, the PBOC has been working to slow the weakening of its currency as companies and investors sell the yuan out of fear that a slowing Chinese economy will lead to further capital flight or, worse, a one-off devaluation by Chinese authorities. To support its currency, the PBOC has been selling U.S. dollar reserves and buying back renminbi, and as a result, China's foreign-exchange reserves have fallen in each of the past five months (Exhibit 2).

We will be monitoring Chinese reserves especially closely in January and February. China has recently imposed a new round of capital controls on Chinese firms, further restricting loans or other investments overseas. This is on top of an existing quota of $50,000 worth of renminbi that individuals are permitted to exchange each year. As the calendar turns to a new year, individuals could feel an urgency to make that exchange as soon as possible, before the rules are changed again or the yuan falls further. In January 2016, Chinese foreign-exchange reserves fell by close to $100 billion. Global stocks fell over 6% that month.

Positioning

It is with these risks in mind that we remain comfortable with our neutral positioning to equities versus strategic benchmarks and our underweight exposure to emerging-market stocks in particular. Our base case is that China will actively try to maintain a stable economic environment into its 19th National Congress of the Communist Party this fall. However, even without trade friction or a Chinese currency-related scare, we believe the rising U.S. yield/stronger-dollar trend will create a headwind for emerging markets in general.

Exhibit 2: China Monthly Foreign Exchange Reserves



As of November 30, 2016.

Source: Bloomberg

Our Recent Insights

Helpful Tips for Year-End Tax Planning and Charitable Giving — Wealth Planning Insights (November 2016)

2016 Elections: First Thoughts — Investment Insights (November 2016, Video Available)

A Tale of Two Tails — Quarterly Investment Perspective (Fourth Quarter 2016, Video Available)

Personal Umbrella Liability Policy: A Must Have Insurance — A Closer Look (October 2016, Video Available)

2016 Elections: Five Questions — A Closer Look (September 2016)

What We Believe — Investment Insights (August 2016)

To view these and other recent insights, please visit www.bessemer.com.

About Bessemer Trust

Privately owned and independent, Bessemer Trust is a multifamily office that has served individuals and families of substantial wealth for more than 100 years. Through comprehensive investment management, wealth planning, and family office services, we help clients achieve peace of mind for generations.

ATLANTA • BOSTON • CHICAGO • DALLAS • DENVER • GRAND CAYMAN • GREENWICH
HOUSTON • LONDON • LOS ANGELES • MIAMI • NAPLES • NEW YORK • PALM BEACH • SAN FRANCISCO
SEATTLE • WASHINGTON, D.C. • WILMINGTON • WOODBRIDGE

Visit us at bessemer.com