BESSEMER TRUST

A Closer Look

Beyond the Deal

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In Brief

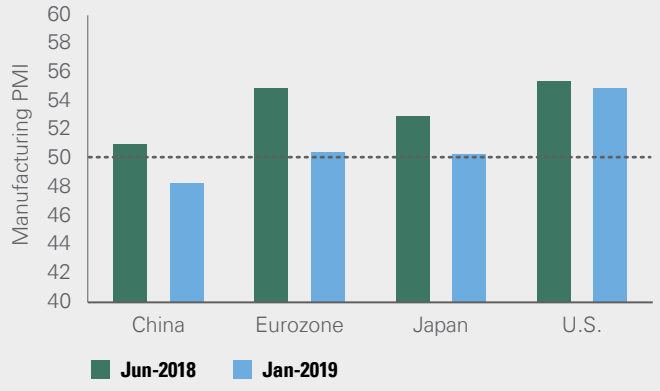
- **Successful trade negotiations between the U.S. and China, averting further tariffs on Chinese exports to the U.S., seem increasingly likely this spring.**
- **While this scenario certainly would be a positive "headline," we see additional trade-related issues as risks that may undermine any sustained investor optimism.**
- **Technology-related tensions are likely to continue, while a shift toward a current-account deficit in China could add pressure for a weaker renminbi.**
- **Meanwhile, broader trade uncertainty seems unlikely to disappear ahead of 2020 elections — limiting upside for risk assets.**

Trade has dominated the market narrative into 2019, with investors trying to gauge whether or not the U.S. and China can reach an agreement to avoid a ratcheting up of tariffs. Indeed, markets have moved in lockstep with each China trade-related headline and unconfirmed piece of speculation — will they or won't they have a deal, and when?

As we head into March, it seems increasingly likely that some sort of deal will be realized. Both U.S. President Trump and Chinese President Xi softened their rhetoric at the start of the year, following an extraordinary equity sell-off in December and economic data that suggested that tariffs and trade uncertainty were having a bigger economic impact, not just in China, but increasingly around the world — including the U.S. (Exhibit 1). More recently, President Trump extended the negotiation deadline and suggested a final summit between the countries' leaders in the U.S., possibly by late March.

Exhibit 1: Business Sentiment Declined as Trade War Heated Up

Key Takeaway: Trade war fears have adversely affected business sentiment in areas most dependent on global trade.



As of January 31, 2019. For PMIs (purchasing manager surveys), a reading above (below) 50 indicates an expansion (contraction) in business activity.

Source: Bloomberg, Markit

In this *A Closer Look*, we preview what we think could be included in an eventual U.S.-China trade deal. Perhaps even more importantly, we look beyond the deal — to its implications and other trade issues that could impact the economy and financial markets in the year and years ahead. While some aspects of the likely deal are clearly positive for the U.S., others could heighten market risks, including the likely lingering tensions between the U.S and China regarding technology and the shift in China's current account toward its first deficit since the early 1990s. While investors may breathe a sigh of relief when Trump and Xi pose for cameras to shake hands and celebrate their deal, we think any outsized positive reaction could present an opportunity to incrementally increase portfolio defenses for the threats we believe lie ahead.

What's the Deal?

The trade agreement is still a work in progress; we will publish our perspectives on the specifics when they are finalized. Even now, though, comments by policymakers, along with the very detailed, long list of U.S. demands released last May, provide a blueprint for what we can expect. In our view, a final agreement is likely to include at least four high-level areas of focus:

1. **Significant Chinese purchases of U.S. goods to narrow the countries' trade imbalance.** (Chinese data estimate the trade surplus with the U.S. was $323 billion last year.) The U.S. has suggested China commit to increasing U.S. import purchases over time by hundreds of billions of dollars, including agriculture, energy, vehicles, and other goods.

2. **More access to China for foreign firms.** The U.S. wants to reduce a variety of restrictions and allow for "non-discriminatory market access and treatment" for foreign firms in China. Financial services and healthcare sectors have been highlighted, though additional industries seem likely to be included.

3. **Stronger technology "guardrails."** The U.S. would like China to stop providing subsidies and other forms of government support to certain sectors (notably technology-related sectors identified in the "Made in China 2025" industrial policy; see our October 2018 *Quarterly Investment Perspective, "The Chinese Dream"*). In addition, the U.S. wants China to strengthen intellectual property protection and enforcement and pledge that it will not retaliate if the U.S. restricts investment from China in designated U.S. technology-related sectors. Technology is one of the largest sticking points, as China believes its longer-term economic policies are a sovereign right. That said, we could see China at least compromising in some areas here as part of a final deal — especially reducing subsidies and improving intellectual property rights.

4. **Rules around cyber engagement.** The U.S. wants China to cease government-sponsored cyber hacking and/or cyber theft. One challenge will be proving a cyber intrusion is state sponsored versus executed by a private entity. That said, we believe the two countries will seek to find some middle ground to ensure an overall deal can be achieved.

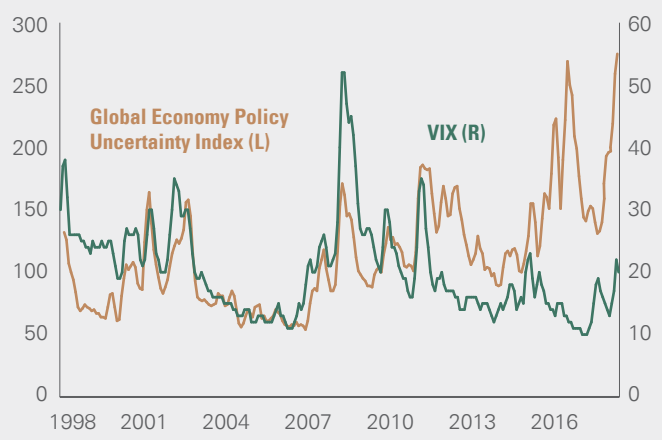
Assuming a deal is struck this spring, the simple fact that agreement was reached on so many key topics would likely be celebrated — we would not be surprised to see equities rally on hopes of a deal and then immediately after its confirmation. Already, Chinese equities have gained some 25% year to date, in part as fears of additional tariffs have receded.

Beyond the Deal

The details of the deal will matter a lot in terms of the duration and magnitude of any trade-related equity rally. One such detail is enforcement. U.S. officials have repeatedly said they need to have reassurance that the Chinese implement whatever is agreed upon. Indeed, there has been speculation that suddenly increased tariffs could follow any evidence of Chinese "cheating." The U.S. has suggested such reviews could take place as often as every three months. To us, the frequency of enforcement is a major qualifier. If a U.S. company is considering new

Exhibit 2: Global Economic Policy Uncertainty and VIX Index (Three-Month Rolling Average)

Key Takeaway: We could potentially see a rise in U.S. equity volatility or decline in uncertainty in the coming months to bring these two variables more in line with each other.

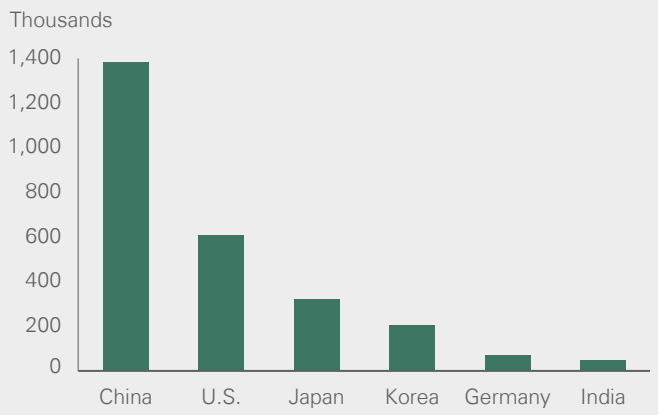


As of January 31, 2019.

Source: Baker, Bloom & Davis, Bloomberg, CBOE

Exhibit 3: Total Patent Applications Filed by Country in 2017

Key Takeaway: China's patent applications were more than double those of the U.S. and other major developed markets.



As of 2017.

Source: World Intellectual Property Organization

longer-term investments in China or has a business that is sensitive to Chinese trade, the risk of increased tariffs every quarter would likely factor into such investment decisions. Put another way, both businesses and investors like clarity and certainty. If higher tariffs remain a risk on a regular basis, that degree of uncertainty will likely hinder business and investor sentiment. One can see this relationship over time in a Global Policy Uncertainty Index and a measure of U.S. equity volatility, the VIX Index. As seen in Exhibit 2, the VIX is currently low relative to uncertainty. We would expect the coming months will likely see either more certainty reflected in a reduction of this index level as it converges with the VIX index, or persisting uncertainty triggering another bout of volatility (with a higher VIX and equity weakness), similar to what occurred at the start and then end of 2018.

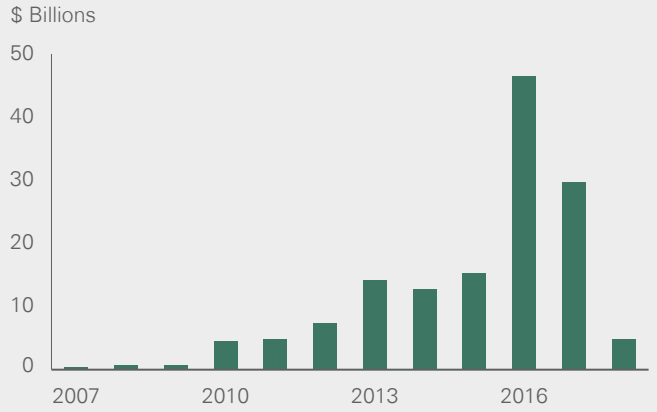
There are at least two other major aspects of the trade deal we would highlight as risks to global equities over the coming quarters: technology conflicts and capital flows. Below we explore each issue and related risks for financial markets.

Technology cold war. No matter what is established on technology within the trade agreement, this topic will not go away any time soon. Both major U.S. political parties have voiced concerns about China's technology ambitions — not just because of the economic benefits of technology to China, but also the risk that China could use greater technology capabilities for military and geostrategic goals. Washington broadly, not just the current administration, seems to support efforts to prevent such a reality from unfolding.

China, meanwhile, sees technological innovation as essential for longer-term economic and even social stability. As we noted in "The Chinese Dream," China's political structure requires that leaders maintain sufficient economic growth to maintain social stability (i.e., happy citizens). With China now seeing its labor force declining, and with more limited means to support growth via capital (the government is cognizant of its already massive debt overhang), future economic growth will depend relatively more on using technology to boost productivity. Especially following the release of the government's industrial policy, "Made in China 2025," both the public and private sector have been trying to move full steam ahead. In 2017, Chinese firms applied for nearly 1,400 patents — more than double the number of patents applied for by U.S. firms that year (Exhibit 3). The same year, China received roughly $135 billion in foreign direct investment with a growing share of that capital going toward high-tech manufacturing firms.

Exhibit 4: China Foreign Direct Investment (FDI) to the U.S.

Key Takeaway: China's FDI declined notably in 2018 versus the 2016 and 2017 inflows to the U.S.



As of January 2019.

Source: Rhodium Group

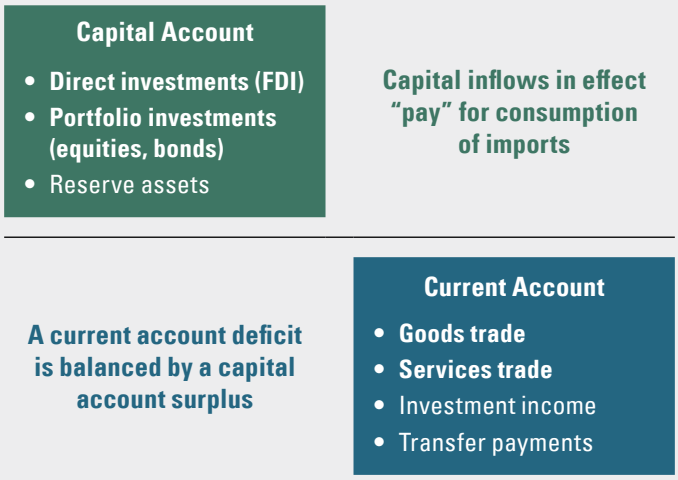
Still, China is fighting an increasingly uphill battle, especially against the U.S. Last year, the U.S. Department of Commerce increased the number of Chinese firms on an "export control" list — meant to limit trade relations between those firms and U.S. companies; the administration has hinted that the list could grow further. In addition, legislative action last autumn broadened the mandate of the Committee on Foreign Investment in the U.S. (CFIUS). This cross-agency body reviews potential foreign proposals for possible security risks and can deny investments (see our August 17, 2018, *Investment Insights,* "Still Open for Business?"). What can be a cumbersome and costly process has had a chilling effect on Chinese capital coming to the U.S., especially in the technology sector. In 2018, Chinese foreign direct investment into the U.S. fell to less than $5 billion, down sharply from $46 billion in 2016 (Exhibit 4).

Recent months have seen scrutiny of Chinese technology intensify, in part as 5G technologies begin to roll out (5G refers to fifth-generation telecom capabilities that can enable a more seamless "Internet of Things"). Huawei Technologies Co., the world's largest telecommunications equipment manufacturer

Balance of Payments Refresher

The balance of payments refers to a country's current account and capital account. These two accounts need to equal zero in order for the currency to be stable: Put in simple terms, whatever a country buys or sells in terms of goods and services to the rest of the world must equal what it sells or receives in financial assets. The current account includes the trade balance (net purchases and sales of goods and services), while the capital account includes portfolio flows (equities, bonds, etc.) and foreign direct investments (Exhibit 5). If a country has a current account *deficit* of $100 billion (suggesting that it imports more than it exports), it will have to run a capital account *surplus* of $100 billion (net foreign capital inflows) — this "balances" the country's payments.

Exhibit 5: Economics Refresher — Balance of Payments



The United States tends to run current-account deficits — much of what this consumer-driven society buys is produced overseas. However, the deficit is offset by large net capital inflows. Foreigners buy U.S. assets such as equities and bonds, as well as make direct investments in U.S. companies.

Trends in the U.S. current-account deficit are heavily influenced by the business cycle and exchange rates. In an economic expansion, the U.S. current-account (including trade) deficit tends to widen, as U.S. consumers have more disposable income and buy more. In a recession, with less consumption, imports tend to fall faster than exports, narrowing the deficit. Meanwhile, exchange rates impact the cost of exported and imported goods but also the value of U.S. financial assets to foreign holders. A very strong dollar can lead to a wider current-account deficit by making U.S. exports more expensive overseas and imports more attractive (see our July 2014 *Quarterly Investment Perspective,* "Common 'Cents' — All About the Dollar").

There is another economic equation that sheds light on the trade balance part of the balance of payments: Savings – investment = Exports – imports. In other words, a trade balance should reflect the flow of investments into or out of a country. A country with a trade deficit is apt to also be a country where savings are low relative to investments. Going back to the U.S. recession scenario, if Americans are worried about the economy, they will likely want to increase savings and consume less. That should be reflected in a narrowing trade deficit. Importantly, given today's policy rhetoric around China, trends in trade and current account balances have much less to do with trade policy and tariff rates than they do with the economic cycle and currencies.

and second-largest smartphone maker, is a leading player in 5G and provides the best example of the U.S.' more aggressive approach toward China.

About a year ago, U.S. security officials testified to Congress that firms such as Huawei could present security risks by embedding their products into U.S. telecommunication networks, possibly in an effort to spy for the Chinese government. (Huawei has denied these allegations.) Around the same time, both AT&T and Verizon stopped distributing many Huawei products. U.S. officials have subsequently accused Huawei of stealing trade secrets and of wire fraud, the latter allegedly violating U.S. sanctions against Iran. Comments from the White House suggest that the U.S. is considering banning Huawei's telecom equipment from being sold in the U.S. altogether. Further, U.S. officials have met with a number of allies, urging these countries as well to avoid doing business with the Chinese company.

Whatever develops with Huawei specifically, this broader U.S.-China "tech cold war" seems increasingly likely to last, potentially leading to regionalization of supply chains. In an effort to keep countries safe from cyber intrusion and technology theft, firms would likely shift suppliers to known allies, even if faced with relatively higher costs and less efficiency. There would be clear country- and company-specific winners and losers, albeit not overnight. Many U.S. companies trying to tap a growing Chinese consumer base could find themselves having to focus energies elsewhere, especially if a technology polarization made it harder for U.S. firms to do business in China. According to a recent JPMorgan survey, while an increasing number of companies are evaluating shifts in their supply chains, most plan to absorb additional costs or pass them through to consumers.

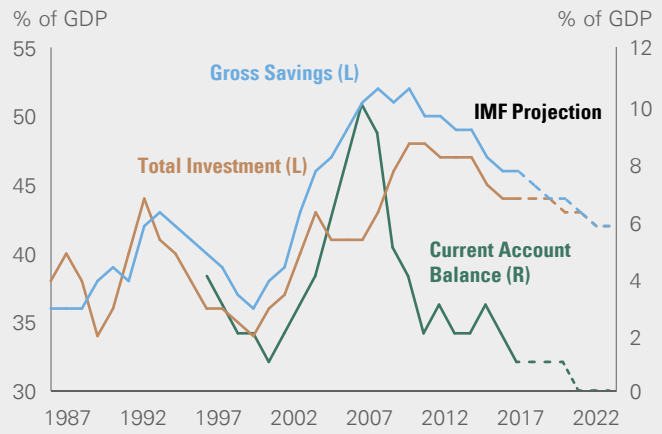
Current account turning point. At first glance, reducing the bilateral trade imbalance appears to be one of the easier U.S. demands for the Chinese to meet. They just need to source relatively more of the imports they buy from the U.S. instead of other countries (soybeans from the Midwest rather than Brazil, for instance) and potentially import more overall. That said, the shift in China's trade balance has broader implications for global markets.

Even before the U.S.-China trade war, China's economy was seeing its current-account surplus steadily shrink. The government's push to balance the economy, making it less reliant on exports and relatively more driven by domestic consumption, has worked. Consumption has become a growing driver of the broader economy, and savings have fallen, the latter also a result of the aging population (Exhibit 6). As of the end of 2018, China's current-account surplus was just under 0.5% of GDP, down from more than 10% of GDP in 2007. The potential for China to import more as part of the U.S.-China trade deal would only speed China's transition to current-account deficit.

To think through implications of this tectonic shift for China, one should go back to balance-of-payments basics. If China is no longer a net exporter to the world (that is, it is importing more), it needs to offset that by attracting net capital inflows (i.e., a capital account surplus). While the likely size of the current-account deficit and hence needed capital inflows should be modest for the foreseeable future, it still will mark an inflection point from the past.

Exhibit 6: China Current Account Balance

Key Takeaway: China's current account surplus has shrunk as the economy has transitioned from manufacturing to consumption.

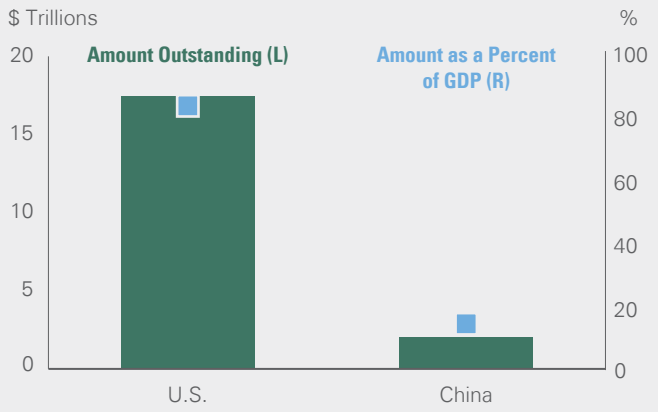


As of October 2018.

Source: Bloomberg, International Monetary Fund

Exhibit 7: U.S. and China Government Bonds Outstanding

Key Takeaway: China has been working to further open its bond market to foreign investors, but it faces challenges related to policy restrictions and low liquidity.



As of September 30, 2018 for U.S. and December 31, 2018 for China. U.S. includes outstanding Treasuries. China includes government bonds.

Source: Bloomberg, Federal Reserve, J.P. Morgan, U.S. Bureau of Economic Analysis

Can China attract sufficient capital inflows in this new economic reality? It is certainly trying to. In January, China's commerce minister said that the country would reduce restrictions on foreign investment (a piece of the ongoing U.S.-China trade negotiations). According to Chinese officials, FDI to China in 2018 was $135 billion, down about 8% from 2017.

Beyond direct investments, China has been trying to further open its stock and bond markets to foreign investors. Last summer, MSCI, a global research firm and equity index provider, started including domestic Chinese equities (so-called A shares) in key indices; this year it is raising the China weighting in its emerging market index from a current 5% to 20%.

Meanwhile, China's government bond market has become the third largest in the world with more than $2 trillion in bonds outstanding, but it remains under-represented in key bond indices due to policy restrictions and lack of liquidity (Exhibit 7). Like equities, this is evolving: In January, Bloomberg announced it would start phasing in Chinese renminbi-denominated government bonds to the Bloomberg Barclays Global Aggregate Index starting this April. (For now, central banks account for the bulk of foreign ownership of Chinese government debt outside of China.)

If global investors view Chinese assets as attractive, and the Chinese government continues to develop its markets, there may be sufficient net capital inflows to offset the likely widening trade deficit. Indeed, a number of investment firms have recently upgraded their view on Chinese equities and the renminbi (RMB) in light of a possible trade deal and intensified efforts by the Chinese to attract foreign capital, while short-term investors have increased allocations to Chinese assets (through late February, the renminbi has gained nearly 3% against the dollar).

The risk is that these capital inflows may not last and prove insufficient to fund a widening current-account deficit. In that case, for most economies, a weaker currency would likely ensue to stabilize the balance-of-payments ship. That's not as simple in China, where domestic and foreign investors alike are used to a tightly controlled currency regime.

Exhibit 8: U.S. Dollar vs. the Chinese Renminbi (RMB)

Key Takeaway: Investors believe China wants to cap the USD/RMB exchange rate below 7.0.

As of February 26, 2019.

Source: Bloomberg

Currency Policy: Careful What You Wish For

As U.S.-Chinese trade negotiations continue, it appears that one tenet of the deal will be China's pledge to preserve a stable renminbi, or at least not act in a way to purposefully devalue its currency in an effort to have an unfair trade advantage. This is good news for U.S. firms where exchange rates are a material input for business decisions and global competitiveness. However, as with most things in life, there is no free lunch. A stable or stronger renminbi, specifically against the dollar, could come with costs that potentially could hurt the U.S.

Currencies trade as pairs — so if the dollar is generally strengthening, RMB is weakening, perhaps because U.S. interest rates are rising or U.S. markets are attracting sizable capital inflows. The renminbi could also weaken versus the dollar if a substantial amount of capital were leaving China — maybe because citizens find a loophole in the country's capital-account controls or foreign investors decide there are better opportunities for their money and sell renminbi-denominated assets they have.

In both of these instances, the renminbi would have devalued but not because China's government wished it so and took steps toward that goal. The Group of 20 policymakers, appreciating these nuances of global markets, agreed in early 2013 on "best practices" for currencies that included avoiding competitive devaluations but encouraged market-driven exchange rates and would have allowed for RMB weakness in this scenario.

Unfortunately today, if the renminbi were to weaken for the same reasons rather than because of an explicit government-led devaluation, Washington might feel pressure from vocal impacted U.S. businesses to enforce the new trade agreement and punish China. What can China do to prevent such an occurrence — how can it ensure a stable or stronger currency when market trends are leaning the other way?

Two simple words: sell Treasurys. China is one of the largest holders of U.S. government debt as part of its $3-plus trillion in central bank reserves. If the renminbi is too strong, China's central bank can intervene in currency markets, selling the currency and buying U.S. dollars in the process. Those dollars are usually held in the safe, liquid, interest-bearing form of U.S. Treasurys. Likewise, if the renminbi threatens to raise America's ire by weakening too much, China's central bank can again step into the market, buying renminbi to support its value — and selling those Treasurys in the process.

In theory, China has a lot of Treasurys it could sell: around $1.3 trillion as of late 2018. Most investors assume China would never sell too much too quickly, as it could trigger a bigger wave of selling in the bond market and hurt the value of the remaining bonds in China's reserves. Indeed, worries about a fall in China's reserves in late 2015 and early 2016 not only impacted bond markets but also triggered contagion to global equity markets. The possibility alone of China's Treasury stockpile suddenly changing contributed to Chinese equities falling around 20% and S&P 500 falling 11% over a six-week period.

For now, an abrupt change in China's U.S. bond holdings seems unlikely. However, the potential for a sustained reduction in Chinese Treasury reserves will become a bigger risk if this part of the trade deal is strictly enforced and if the U.S. sees a prolonged period of U.S. dollar strength. Especially at a time when the supply of U.S. bonds is growing significantly, losing this important Treasury buyer could result in higher borrowing costs for U.S. businesses and households, quite possibly with spillover to equities.

The push for a stable or stronger renminbi would also encourage more investors to position for the same one-way currency trend — a concentration of positions all tilting in the same direction would leave markets vulnerable to any shock that forces a sudden unwind, similar to what unfolded in the 1997–1998 Asian crisis as regional currencies that had been thought to be permanently fixed to the dollar devalued sharply as central bank reserve adequacy was questioned. It is somewhat ironic that Washington today wants the renminbi held steady; for much of the last decade, policymakers from both parties were pushing China to allow for more market-based flexibility in the renminbi. Intervention was seen as the greater evil — now it is being welcomed as a necessary tool.

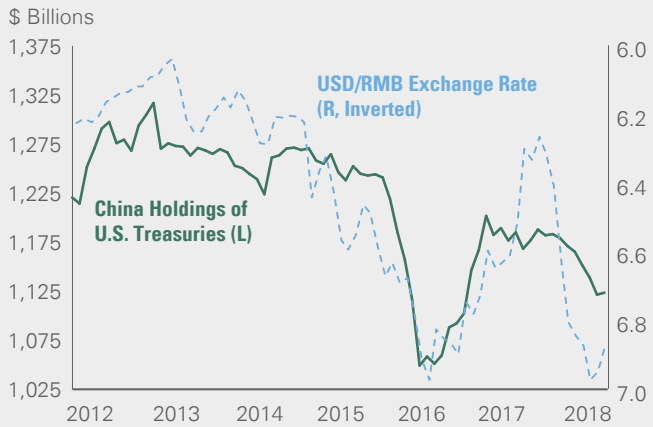
It's easy to agree that countries shouldn't manipulate their currencies to take advantage of their neighbors. However, identifying what is truly bad behavior, and dealing with the potential consequences of a perceived one-way currency regime, may prove a much bigger challenge than policymakers currently appreciate.

Indeed, in recent years, when China has taken steps to make the currency more market-driven, largely following U.S.-led requests, or has allowed the renminbi to weaken a bit faster than had been the case previously, investors have panicked. They have interpreted small RMB losses as a precursor to something much bigger, and something that could reflect broader financial and economic problems. In both of these recent cases, RMB weakness triggered broad investor selling of risk assets globally — currencies, credit, commodities, and equities.

Since then, conventional market wisdom is that (rightly or wrongly) China wants to keep the renminbi from weakening beyond 7.0 against the dollar (Exhibit 8) and prevent its reserves from falling below $3 trillion (reserves stood at $3.09 trillion as of end-January). Without sufficient capital inflows to offset a current-account deficit, we believe one of these two goals would have to be missed. China would either need to weaken its currency, or more likely (given pressure from the U.S. not to use the renminbi to benefit local exporters), it will need to draw down its reserves (and use those reserves to intervene to support RMB). Even before this current-account shift, China has been reducing its U.S. Treasury holdings. So far, it has not had a noticeable impact on U.S. debt markets, in part as there have been sufficient offsetting local buyers of U.S. debt. However, if Chinese selling were to accelerate, especially if suddenly and in a way that pushed up U.S. yields, we would not be surprised to see at least a short-term bout of contagion into global risk assets, such as equities, on worries that higher U.S. borrowing costs could undermine growth (Exhibit 9).

Exhibit 9: China's U.S. Treasury Holdings versus the U.S. Dollar/RMB Exchange Rate

Key Takeaway: In recent years, China has reduced its U.S. Treasury holdings to defend against renminbi depreciation beyond its target range.



As of December 31, 2018.

Source: Bloomberg, U.S. Treasury

Final Thoughts

The increasingly likely prospects for a trade agreement between the U.S. and China are good news for many U.S. businesses. This note does not suggest otherwise. Avoiding additional tariffs means avoiding an economic force that could slow growth and push up prices.

However, we believe relief over this agreement needs to be balanced. Trade rhetoric is not going away — around China and more generally (global autos) — especially into 2020 elections, where the topic is popular among the president's supporters (and others). Further, the trade deal, in our view, will not solve the technology-related tensions between the U.S. (and its allies) and China, as well as what those tensions could produce in terms of altered economic and business alliances. Finally, the trade deal could exacerbate China's transformation to a current-account-deficit country, with a number of possible spillovers to global currency and bond markets.

As investors, we always try to see different sides of an issue and think about second- and third-order effects of events, especially when it concerns something as important as relations between the world's two-largest economies.

We continue to believe that medium-term risks around trade, central bank policy, and politics across a number of countries may limit upside for equities — particularly against a backdrop of slowing global growth. While we do not see a global recession as imminent, our bias is to use any additional substantial equity strength to consider further incremental de-risking steps within portfolios.

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