A brief note on "China vs the US", Emerging Markets, Turkey and Argentina

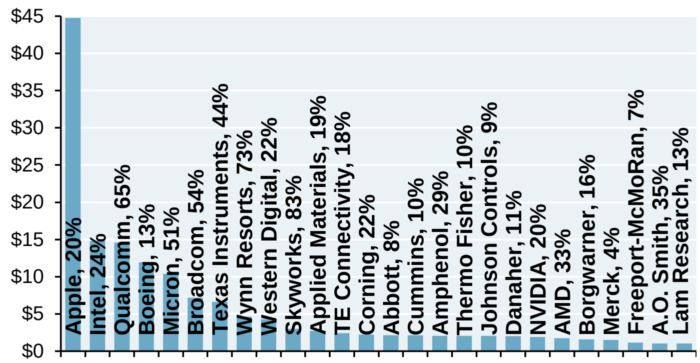
- **While US profits are projected to rise by 20% over the next year and the US capital spending outlook is good, rising US rates, trade tensions, strains in emerging markets and the situation in Italy[1] will limit equity market returns this year to single digits**
- **The US has a lot to lose in a trade war given the high level of US corporate sales in China**
- **Economic linkages between the US & China are much larger than between adversaries of the last 100 years; full-blown trade or military conflict is not inevitable**
- **Don't overgeneralize Turkey/Argentina whose fundamentals are worse than most EM nations**

Chinese handcuffs. The Trump Administration announced on Tuesday that it's moving ahead with 25% tariffs on $50 bn in Chinese imports, and with limits on Chinese investment in US tech industries. Some US officials believe it's easy to gain the upper hand in a trade war when you're the country doing all the importing. In a theoretical world, maybe, but not in the world we live in. Over the last decade, US companies made large investments in their Chinese subsidiaries. In fact, the bilateral US trade deficit with China almost disappears once you include sales of in-country subsidiaries. **In other words, US companies are doing almost the same amount of business in China as Chinese companies are doing in the US, but through their subsidiaries rather than via exports**. The chart on the right shows examples of US corporate sales in China (not all companies disclose sales by country).

The US does a lot of business in China, but through its in-country subsidiaries rather than via exports, US$, billions

Source: Deutsche Bank. April 2018.

Select S&P 500 company sales in China
US$ bn, with % of total company sales



Source: Bloomberg, 2017. Includes co's that report sales from China >$1bn.

The point is that **the US has a lot to lose if China retaliates against US companies doing business in China**. These companies are some of the largest employers and capital spenders in the US, and their shares are widely held in US defined benefit and defined contribution plans. I have written before about all the non-reciprocal trade deals the US agreed to and about Chinese IP infringement/investment restrictions, which are both long-standing issues of contention. Even so, like bamboo Chinese handcuffs, bad trade deals seem easy to get out of until you start pulling on them.

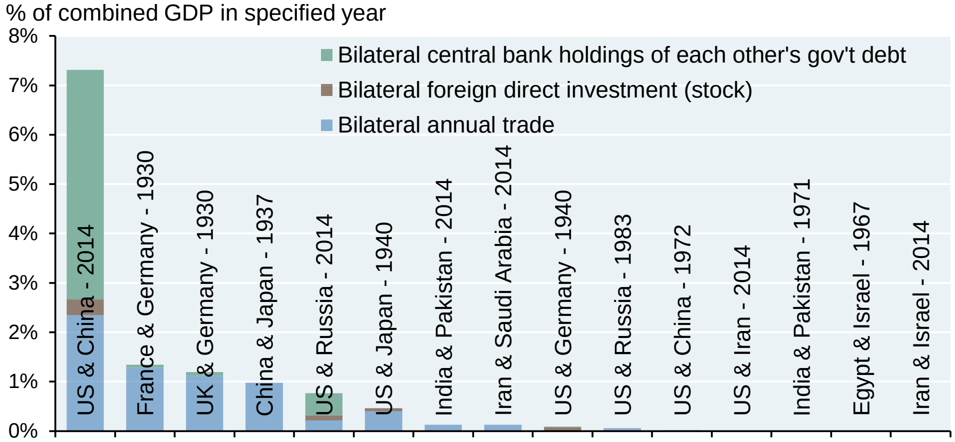
[1] **Italy**. Eurozone firewalls are in better shape than in 2012 given the ability of member states and the ECB to advance funds via ESM and OMT programs. Italy's reliance on foreign capital has also declined: it now runs a ~3% current account surplus, and ~70% of its government debt is held domestically (among the highest rates in the EU). **But**…Italy's trade surplus reflects lingering pain from a collapse in imports and an unemployment rate that's still almost double 2006 levels, as well as longer-term stagnation which began when Italy joined the Eurozone [*click here for some Italy charts*]. That may explain why Italians voted for anti-establishment parties 5SM and NL, whose governing contract calls for re-examining the Stability and Growth Pact and the single currency itself. I don't think this marks the end of Italian membership in the Eurozone (not this year, anyway), but it's enough to keep markets on edge until the next set of elections clarifies whether Italy will formally establish a Plan B to exit the Euro, or not.

Commerce Secretary Ross is off to China this week, presumably to nail down promises of increased Chinese imports of US goods[2]. Trade tensions are just one part of the broader Chinese-US relationship; some observers expect **military conflict** between the US and China as well:

- In a 2017 survey by C100[3], 50% of Chinese citizens, 33% of Chinese business leaders and 35% of Chinese policy experts responded that war with the US was "very likely" or "somewhat likely". The percentages were only slightly lower amongst US respondents to the same question
- Harvard's Thucydides's Trap Project found 16 cases over the last 500 years in which a major nation's rise disrupted the dominant state. Twelve of these rivalries ended in war and four did not. The project is directed by political scientist and Presidential advisor Graham Allison, whose recent book is entitled "*Destined for War: Can America and China Escape Thucydides's Trap?*"
- The Chinese state-owned newspaper *Global Times* wrote in 2015 that "if the United States' bottom line is that China has to halt its activities, then a US-China war is inevitable in the South China Sea"

Perhaps, but there's also enormous economic pressure on China and the US to find common ground. Compared to adversaries of the past 100 years, economic linkages between the US and China are much larger. The chart below is something I've been working on for the last few months. The idea is to measure the economic linkages between adversaries of the past and present. To do this, we add the outstanding stock of bilateral foreign direct investment, the amount of bilateral annual trade, and the amount of government bonds owned by the other country's Central Bank. Compare China/US today to Europe and Asia in the 1930's, to US/Russia in the 1980's and to India/Pakistan. I'm not by nature an optimist, but I believe these economic linkages will push the US and China toward compromise and away from a shooting war or a full-blown trade war.

China and the US: much deeper economic linkages than actual and potential adversaries of the last 100 years
% of combined GDP in specified year



Source: JPMAM, UNCTAD, World Bank, UN, US Treasury, Baribieri/Keshk COW Trade data, US Trade Repr. Office, Setser (CFR), Bank of England, St. Louis Fed, Eichengreen (Berkeley), Howson (Princeton), East-West Center, O'Neil (CNA), Ritschl (LSE), Accominotti (LSE), Wilkins (FIU), Villa (CEPII). 2016.

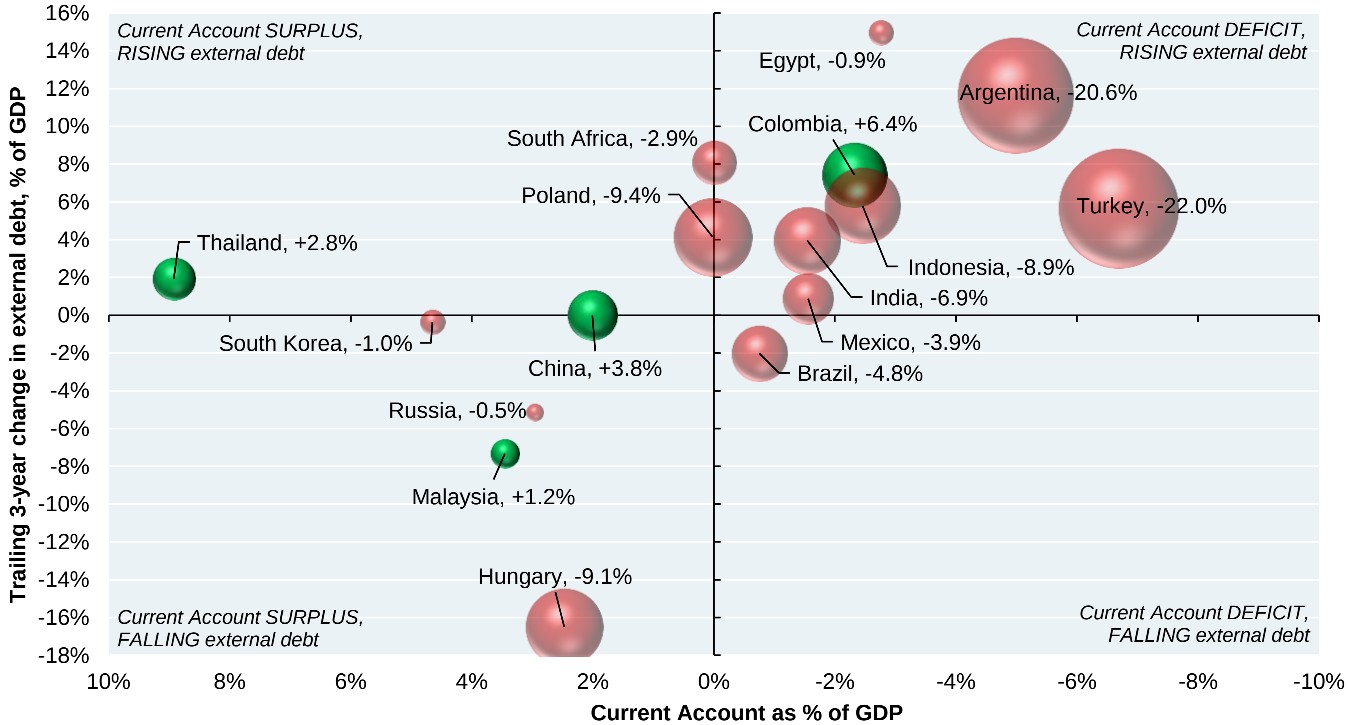
[2] The current framework emphasizes deficit reduction through increased exports of US goods, agriculture and energy with less focus on intellectual property, tech transfer, investment limits and other aspects of the Section 301 investigation. The White House team is divided, with those supporting a focus on narrowing the deficit currently having the upper hand. However, US Trade Rep. Lighthizer continues to emphasize intellectual property protection, an issue I believe will be back on the agenda later this summer.

[3] The **C100** is an organization of prominent Chinese Americans founded by IM Pei and Yo Yo Ma to promote political participation of Chinese Americans and encourage constructive relationships between the US and China.

The EM selloff: Turkey and Argentina are getting hit for a reason

After outperforming developed equity markets by 20% in 2016-2017, EM is underperforming by 2.5% so far this year. Investor fears are focused on the impact of rising US interest rates and the rising US dollar on EM external debt, and on rising oil prices. A closer look shows that the market reaction has been orderly so far, with Argentina and Turkey leading the way down. The chart shows each country's current account (x-axis), the recent change in its external borrowing (y-axis) and the return on a blended portfolio of its equity and fixed income markets (the larger the red bubble, the worse the returns have been). This outcome looks sensible given weaker Argentine and Turkish fundamentals. The rising dollar and rising US rates will be a challenge for EM, but most will probably not face balance of payments crises. I would not make wholesale EM portfolio reallocations to other regions at this stage.

Argentine and Turkish markets are getting hit for a reason
Bubble size indicates magnitude of YTD return on blended portfolio of EM equities, EM cash and EM bonds by country. Green bubble for positive returns, red bubble for negative returns.



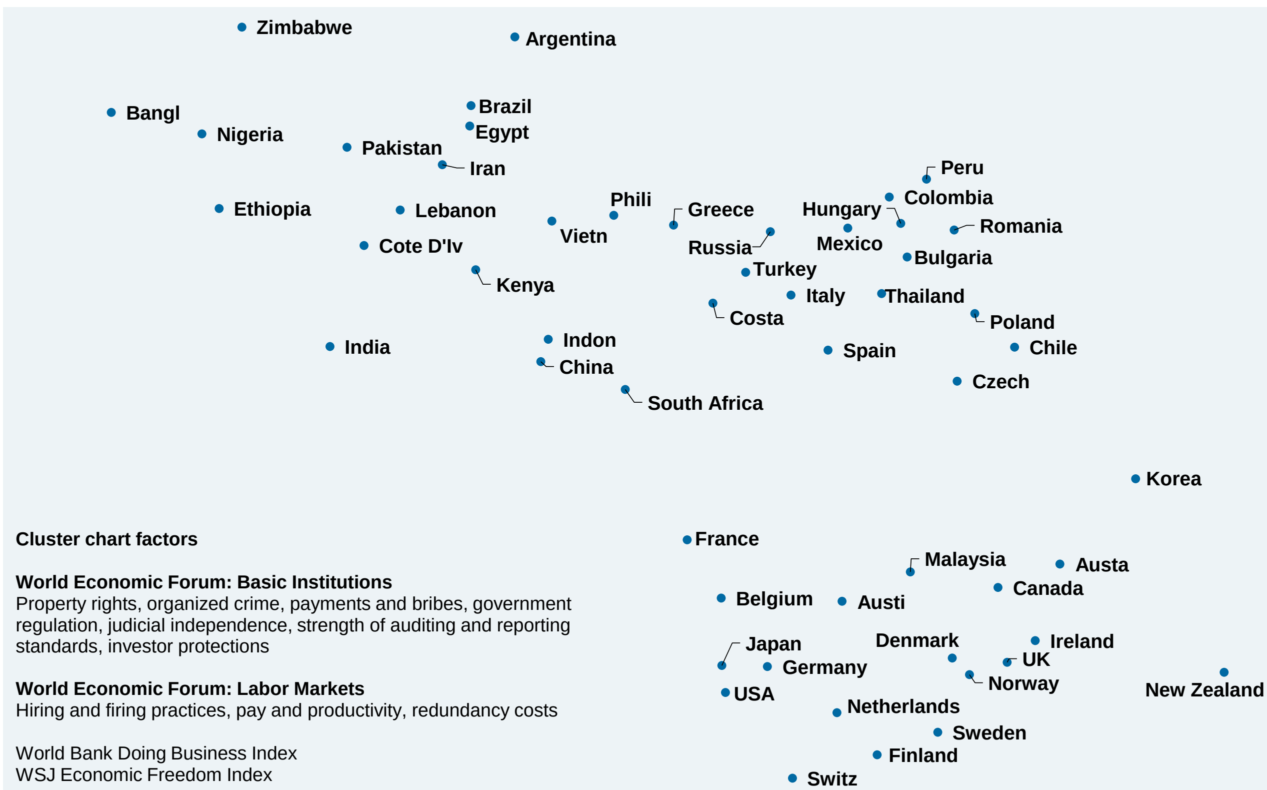
Source: JP Morgan Global Index Research, JPMAM, Bloomberg, IIF, Haver. May 24, 2018 or most recent data available. Blended portfolio composed 50% of MSCI EM equity, and 50% split evenly among JPM ELMI Plus (T-Bills), JPM EMBI Global Diversified (external hard currency debt) and JPM GBI-EM Global Diversified (term debt in local currency). Includes countries with more than 5% index weights in any of the blended portfolio indices, plus Hungary, Egypt, and Argentina. Excludes countries with very large current account surpluses (Singapore and Taiwan).

On Turkey (0.9% of the MSCI EM Index), President Erdogan lost a battle with markets when he finally agreed to higher interest rates to defend the lira. The big risk: the inadequacy of Turkish international reserves to cover its short term external debt, particularly since some reserves could evaporate if it looks like capital controls will be imposed. There's also $80 bn in Spanish bank exposure to Turkish borrowers. Turkey looks like an unstable EM economy of the 1980's and 1990's, and is a country whose problems should not be over-generalized. This goes double for **Argentina**, which I discuss on the next page.

With **Argentina** dominating EM headlines again, let's remember what country we are talking about here and not overgeneralize its problems. As shown above, Argentina spent the last 3 years borrowing an enormous amount of money; it has defaulted on its international debt 7 times since its independence in 1816; and spent most of the last decade in investment purgatory (it was jettisoned from the MSCI EM Equity index into the MSCI Frontier Equity Index alongside countries like Lebanon and Kenya).

Our cluster model illustrates how risky Argentina is for investors. In the chart, the closer countries are to each other, the more similar they are with respect to competitiveness, regulation, investor protections, labor markets and ease of doing business. **Like Bangladesh and Zimbabwe, Argentina lies at the outer edge of this known universe, far from other EM countries like China, Peru, Indonesia and Mexico and Vietnam, and lightyears away from the developed world.** Only in a world of financial repression by central banks could a country like this issue an oversubscribed 100-year bond.

An investor's view of the world: Argentina occupies the fringe
Cluster chart of country competitiveness and business conditions; proximity indicates similarity



Sources: World Economic Forum, World Bank, WSJ. JPMAM, 2018. Multilateral country distances optimized to track relative country factor differentials.

The price of Argentina's 100-year bond issued a year ago is down 16% from its December peak. There are echoes here from 2001, when Argentina issued new debt just a few months before defaulting on it. My wife ran JP Morgan's EM Capital Markets division back then, and led the syndicate that originated that particular set of doomed Argentine bonds. As a buy-side EM investor at the time, I gave her plenty of grief about it. However, she has since retired, so if you bought the 100-year Argentine bond issued last year, you're on your own.

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Acronyms
ECB European Central Bank; **EM** Emerging Markets; **ESM** European Stability Mechanism; **5SM** 5-Star Movement; **OMT** Outright Monetary Transactions; **NL** Lega Nord

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