On the Minds of Investors

September 2020

Will trade hostilities undermine the investment case for Chinese assets?

On 14 February 2020 the US and China agreed to a trade agreement, known widely as the "phase one trade deal". As part of the deal, China agreed to increase purchases of US goods by USD 200 billion over the next couple of years, helping to defuse an escalating trade conflict between the two nations.

Although welcomed by markets as a first step to prevent further damage to world trade, the phase one deal was quickly overshadowed by the Covid-19 pandemic. However, trade data from the US Bureau of Census, which is tracking China's compliance with the phase one deal, has recently raised concern, with China's additional purchases of US goods standing at only 48% of the year-to-date target by the end of July (**Exhibit 1**).

Demand disruption due to the pandemic and rising political tensions have contributed to China's non-compliance. However, in the midst of a polarised US election campaign, the trade truce could be more fragile than investors would wish, and new trade hostilities are an increasing risk for markets.

EXHIBIT 1: PHASE ONE DEAL TRACKER

US goods exports to China with phase one deal targets for 2020 and 2021

Source: USTR, US Census Bureau, J.P. Morgan Economic Research, Refinitiv Datastream, J.P. Morgan Asset Management. 2020 and 2021 targets are shown for illustrative purposes and we assume a smooth path toward the year-end target. Chart displays only goods exports and for goods not covered by the phase 1 deal we are assuming they remain at similar levels in 2020 and 2021 as they did in 2017. The phase 1 deal outlines an increase in US exports of $200bn over 2020 and 2021. The breakdown is for roughly $160bn additional goods exports and an additional $40bn of services exports. Past performance is not a reliable indicator of current and future results. Data as of 16 September 2020.

AUTHOR

Tilmann Galler
Global Market Strategist

Could a renewed trade conflict undermine the investment case for Chinese assets? When considering this question, we think investors need to look at three aspects: China's trade dependencies, the impact of an economic de-coupling, and structural growth opportunities.

Trade dependencies: A growing domestic economy overshadows possible trade disruption

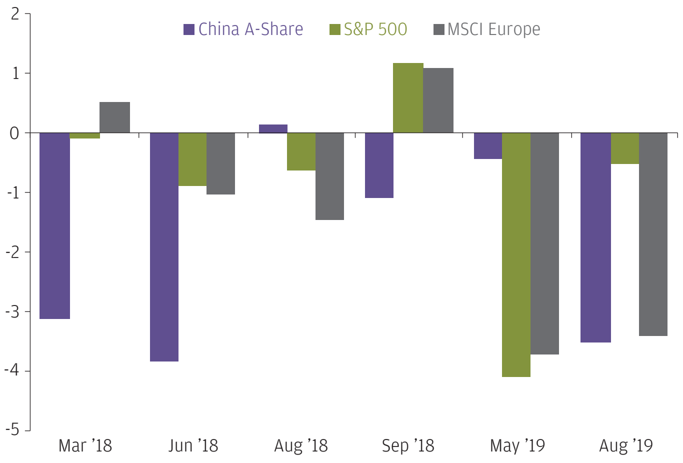
The trade conflict and the implementation of tariffs was a big topic and headline risk for markets in 2018 and 2019. However, when we look at equity market performance following the announcement of new tariffs by the US administration, the reaction appears to have been rather moderate. On the six occasions when the US announced new tariffs, the average drawdown of the local Chinese A-Share market was -2% in the five business days after the announcement, with a maximum drawdown of -3.9% in June 2018 (**Exhibit 2**).

The impact on global markets was also limited. One of the reasons for the lack of market reaction is that China's dependence on global trade is in decline. Between 2010 and 2019, China's share of exported goods and services relative to GDP fell from 28.5% to 18.8%, with the US share falling from 4.7% to 2.9%. China's economy is increasingly driven by domestic consumption, which makes it less prone in total to export shocks, such as the imposition of tariffs.

EXHIBIT 2: MARKET IMPACT OF TRADE HOSTILITIES

Five-day equity market performance during trade hostilities

% price return



Source: Bloomberg, MSCI, Standard & Poor's, J.P. Morgan Asset Management. Time periods show the price change in the 5 trading days after a notable trade escalation. Past performance is not a reliable indicator of current and future results. Data as of 16 September 2020.

Nevertheless, vulnerabilities still exist at the sector level. For example, computer hardware, cell phones and telecommunication equipment, which make up the largest Chinese exports to the US, represent 9% of China's domestic A-Share market, as represented by the CSI 300 Index. So, any further deterioration in trade relations could have a negative effect on these sectors.

The biggest threat to the Chinese economy is not to be found in its exports to the US, however. Instead, China's most crucial trade dependency is its imports of US semiconductors, which by volume make up the third largest imported good from the US. Most of China's technology industry, including its 5G, mobile internet and artificial intelligence companies, depend on US microchip technology. A full ban on technology exports to China by the US administration could be very disruptive for the Chinese economy and therefore would also likely cause significant disruption to equity markets. A US technology export ban is therefore probably the worst case in a rising trade conflict scenario.

Whether the current US administration is willing to risk a full escalation of trade tensions before the election in November, risking turmoil in capital markets, is at least questionable. Although surveys show that an increasing number of Americans have an unfavorable view of China regardless of their political preference, recent polls also show that China is a low priority with voters, far behind economic, health, and social issues.

Economic de-coupling: Assessing the risks and opportunities

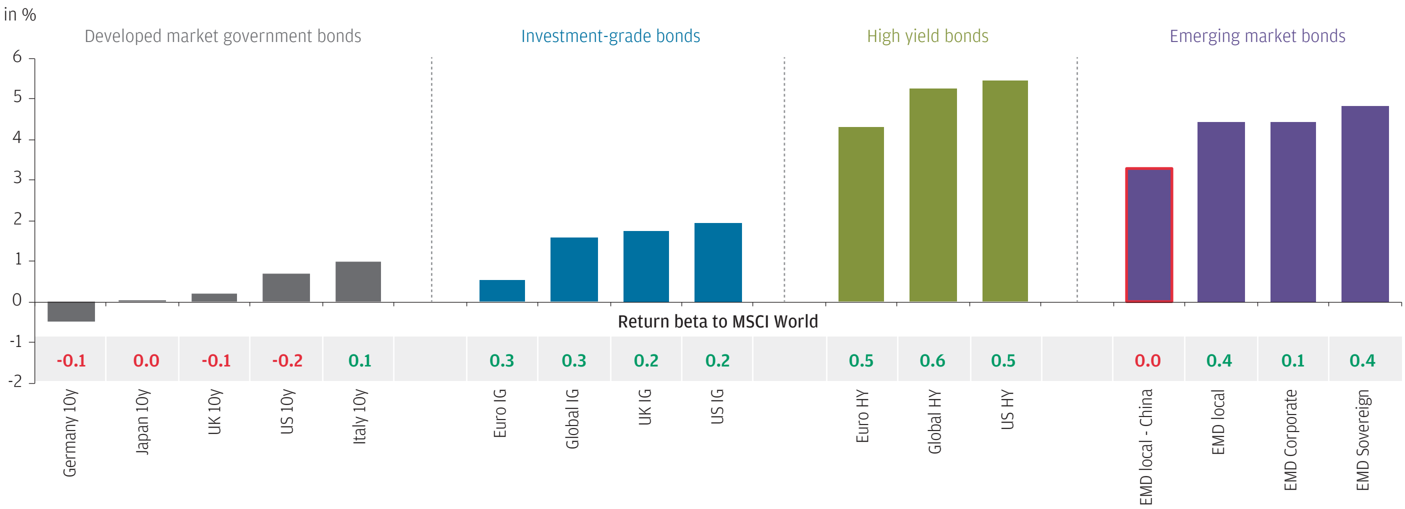
Despite rising trade tensions with the US, and Beijing's push to be more self-reliant and de-couple from global value chains, investors should not overlook the investment opportunities presented by local Chinese assets, which look attractive relative to the rest of the world in the aftermath of the Covid-19 pandemic (**Exhibit 3**).

Following the opening of the USD 15 trillion local renminbi bond market to foreigners, yield starved international bond investors now have the opportunity to invest in government bonds with yields north of 3%. As well as providing access to higher yields, local renminbi bonds have a relatively low correlation to developed market bonds and zero return beta to global equities, helping investors to enhance diversification and target enhanced risk-adjusted returns.

In the past 12 years, monthly return correlations between renminbi bonds and global developed market bonds have been 0.06, compared to a correlation range of 0.43 to 0.72 between developed market bonds themselves. Just like with past performance, there is of course no guarantee that past correlations will be repeated. However, with China's early success in containing the Covid-19 pandemic knocking its economic cycle out of sync with the rest of the world, and with the Chinese central bank providing a less expansionary central bank policy response compared to developed economies, we would expect correlations to remain low for the time being.

EXHIBIT 3: RELATIVE ATTRACTIVENESS OF CHINA BONDS

Fixed income yields



Source: Bloomberg, Bloomberg Barclays, J.P. Morgan Economic Research, Refinitiv Datastream, J.P. Morgan Asset Management. Beta to MSCI World is calculated using monthly total returns since 2008. Indices used are as follows: Euro IG: Bloomberg Barclays Euro-Aggregate - Corporate; Global IG: Bloomberg Barclays Global Aggregate - Corporate; UK IG: Bloomberg Barclays Sterling Aggregate - Corporate; US IG: Bloomberg Barclays US Corporate Investment Grade; Euro HY: Bloomberg Barclays Euro High Yield; Global HY: Bloomberg Barclays Global High Yield Corporate; US HY: Bloomberg Barclays US Corporate High Yield; EMD Corporate: CEMBI Broad Diversified; EMD local: GBI-EM Global Diversified: EMD local - China: GBI-EM China: EMD Sovereign: EMBI Global Diversified. Past performance is not a reliable indicator of current and future results. Data as of 16 September 2020.

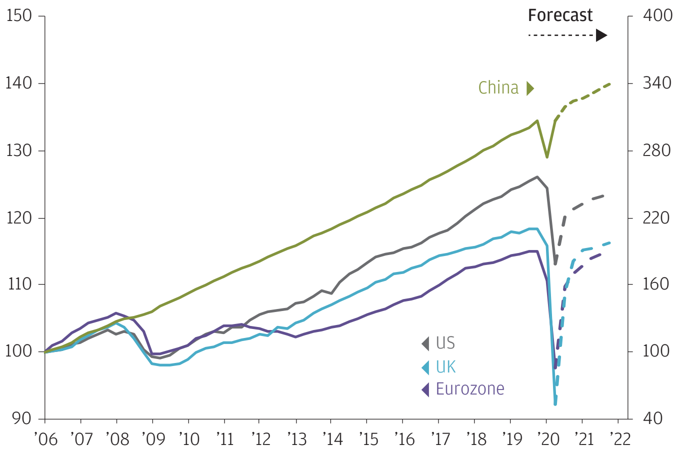
Structural growth opportunities: Chinese equities

After a period of strong outperformance investors might look at Chinese equities with a certain amount of skepticism, especially against a background of rising trade tensions and valuations. But in the short term the economic tailwind for the equity market is strong, particularly for domestic-oriented businesses.

China's containment of the pandemic should enable its economy to recover faster than the rest of the world, and this relative advantage is likely to persist unless a medical solution to Covid-19 is found, which itself is still hard to predict (**Exhibit 4a**). However, the factor that makes the case for domestic China A-shares even more compelling is, counterintuitively, the fact that economic stimulus measures have been much smaller this round than in the past two downturns (**Exhibit 4b**). Therefore, we should not expect a massive stimulus-driven Chinese expansion to lead to stronger demand for imports from Asia and the rest of the world, making local Chinese investments relatively more attractive.

EXHIBIT 4A: CHINA'S RECOVERY - EARLIER AND FASTER

China vs. developed markets, real GDP
Index level, rebased to 100 at 1Q 2006



Source: BEA, Eurostat, National Bureau of Statistics of China, ONS, J.P. Morgan Economic Research, J.P. Morgan Asset Management. Forecasts are from J.P. Morgan Securities Research. Past performance is not a reliable indicator of current and future results. Data as of 16 September 2020.

EXHIBIT 4B: LESS STIMULUS COMPARED TO PRIOR DOWNTURNS

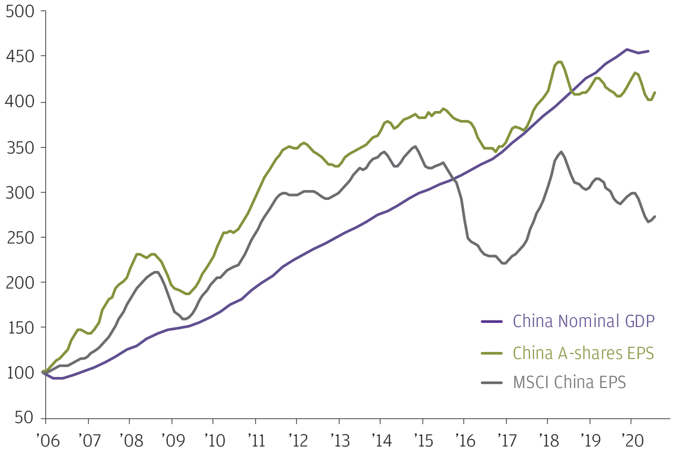
China M1 money supply and import growth
% change year on year

Source: China Customs, IMF, PBoC, Refinitiv Datastream, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 16 September 2020.

In the long-term, China's transition from the workshop of the world into the largest domestic market in the world still demands that Chinese equities are given a significant strategic representation in globally-diversified investment portfolios. And with corporate earnings growth in the China A-Share market providing a better representation of nominal Chinese GDP growth over the last 10 years than the MSCI China, investors may continue to look to domestic stocks for their Chinese exposure (**Exhibit 5**).

EXHIBIT 5: DOMESTIC EQUITY MARKET EARNINGS – A BETTER PROXY OF GDP GROWTH

China nominal GDP and equity market earnings
12 month forward EPS, GDP; Index level, rebased to 100 at start of 2006



Source: Bloomberg, IBES, National Bureau of Statistics of China, Refinitiv Datastream, J.P. Morgan Asset Management. Fwd EPS is next twelve months' earnings estimates in USD. China nominal GDP is in USD. Shenzhen and Shanghai include all listed A-share stocks and is combined using a market-cap weighted average. Past performance is not a reliable indicator of current and future results. Data as of 16 September 2020.

Summary

A trade conflict between the world's largest economies is disruptive to established value chains and will certainly be negative for global growth. So, investors should rightly pay attention to any further escalation in tensions.

However, it would in our view be a mistake to single out China as the clear underdog in such a conflict and therefore shun investments into the local markets. As we have shown, the direct impact of the trade tensions on the Chinese economy is limited. Even if there is a further de-coupling between China and the US, the case for local investment in China may strengthen because of the diversification benefits provided by Chinese assets.

Equity investors should find comfort and confidence in the fact that in the past 10 years, Chinese A-share earnings have reflected the strong growth in China's GDP. In contrast, a less cooperative international trade backdrop in the coming years could see non-Chinese companies lose out on some of their own profits from China's economic expansion.

The Market Insights program provides comprehensive data and commentary on global markets without reference to products. Designed as a tool to help clients understand the markets and support investment decision-making, the program explores the implications of current economic data and changing market conditions. For the purposes of MiFID II, the JPM Market Insights and Portfolio Insights programs are marketing communications and are not in scope for any MiFID II / MiFIR requirements specifically related to investment research. Furthermore, the J.P. Morgan Asset Management Market Insights and Portfolio Insights programs, as non-independent research, have not been prepared in accordance with legal requirements designed to promote the independence of investment research, nor are they subject to any prohibition on dealing ahead of the dissemination of investment research.

LV–JPM52929 | 09/20 | 0903c02a829f9287

J.P.Morgan
Asset Management