Ellerston Capital

Update on the Trade War: A Buying Opportunity Emerging in China

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The last few weeks have seen a flurry of activity on the trade war front, so we thought it prudent to provide investors with an update. For many months now, we have outlined 3 possible scenarios in the trade war: tit for tat tariff escalation, a negotiated outcome and extreme retaliation.

Last week Trump went ahead and imposed tariffs on $200b of additional Chinese goods at a 10% rate, with this rate rising to 25% in January of 2019. Trump has also said that he is ready to go with tariffs on an additional $267b of Chinese goods. This latter amount would effectively imposed tariffs on all imports from China. As such, tit for tat tariff escalation appears to be nearing the latter stages simply because both China and the US are running out of room.

With respect to a negotiated outcome, the low level meetings between Vice Commerce Minister Wang Shouwen and David Malpass did not result in any meaningful advances. Subsequently, Treasury Secretary Mnuchin invited his Chinese counterpart Liu He to Washington for discussions, but this was prior to imposition of the tariffs on the additional $200b. China has subsequently said they will not negotiate with "a gun to their heads" and these talks have been cancelled.

Our view is that a partial negotiated outcome is a possibility. China views the demands the US is making on trade in 3 separate buckets: (1) demands China could agree to in the short term; (2) demands that China could agree to phase in overtime; and (3) demands that are non-negotiable. The following table outlines what falls in each bucket and highlights that the non-negotiables are the demands that threaten China's Made in China 2025 policy.

Figure 1: Trade War Negotiated Outcomes

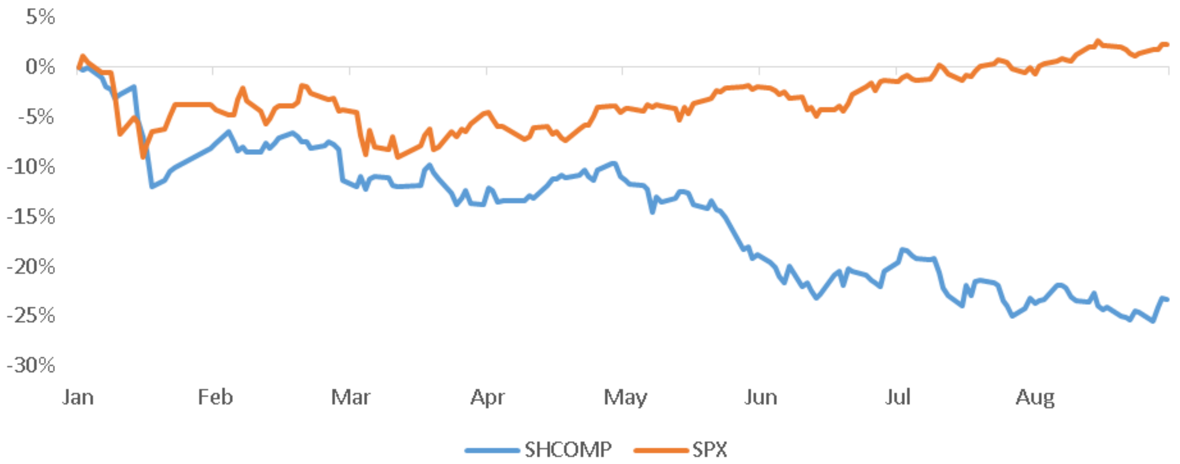
China Could Agree in the Short Term	China Could Agree in the Medium Term	Non-Negotiable
Cut trade deficit by $200b with Chinese purchases of US goods at least $125b of that amount. A cessation of government-sponsored cyber intrusion and cyber theft.	U.S. investors in China to receive fair, effective and non-discriminatory market access and treatment, particularly for agriculture and services. China to reduce tariffs on all products in non-critical sectors to levels that are no higher than the levels of the US' corresponding tariffs.	China to immediately cease providing subsidies and government support that fuels excess capacity in industries targeted by the Made in China 2025 plan.

If the trade issues cannot be negotiated in a timely manner and tit for tat tariff escalation becomes exhausted, the situation could descend into the use of unconventional, extreme retaliation tactics including the Chinese selling US Treasuries, China imposing travel/study restrictions, increased regulation for US companies in China and backlash against American products. This is the least unlikely outcome of the scenarios outlined above and obviously the most negative.

A Buying Opportunity in China

The Shanghai and Hong Kong markets have sold off sharply on trade war concerns. As shown below, since the January 2018 highs, the Shanghai Composite Index is down over 23%, underperforming the S&P 500 by over 25%.

Figure 2: Shanghai Composite vs S&P 500 (January 24 to August 21)



Source: Bloomberg

However, the macroeconomic impacts of the trade war on the Chinese economy are expected to be manageable with a hard landing very unlikely. For equity investors, the earnings impact of the trade war on many domestic demand focused stocks in China is negligible. There is a misperception that since China is an exporting economy that there is a high representation of exporters in Chinese indices. But this is not true at all. The table below shows that the Top 20 stocks in the MSCI China (over 60% of the benchmark) does not include even one exporting company. The first exporter in the MSCI China Index is Shenzhou, which is the 27th largest weight at only 56 basis points.

Figure 3: Top 20 Weights in MSCI China

Rank	Name	Weight	Rank	Name	Weight
1	Tencent	14.9%	11	JD.com	1.2%
2	Alibaba Group	11.9%	12	NetEase	1.0%
3	China Construction Bank	5.2%	13	China Life Insurance	1.0%
4	Baidu	4.0%	14	PetroChina Co	1.0%
5	China Mobile	3.7%	15	Ctrip.com	1.0%
6	Ping An Insurance	3.3%	16	China Merchants Bank	0.9%
7	ICBC	3.1%	17	Agricultural Bank of China	0.9%
8	Bank of China	2.2%	18	Yum China	0.8%
9	CNOOC	2.0%	19	China Overseas Land & Investment	0.8%
10	China Petroleum & Chemical	1.6%	20	Country Garden	0.7%
Top 10		**51.9%**	**Top 20**		**61.3%**

Source: MSCI and Bloomberg

Despite the lack of representation of exporters in Chinese indices, markets have plunged on trade war concerns. In other words, a lot of babies have been thrown out with the trade war bath water. Valuations in China and Hong Kong are now looking very attractive. The forward PE of the Shanghai Composite index and the Hang Seng Index are only ~10x versus the S&P 500 at over 16x and the ASX 200 at 15x.

The other point to highlight is that China has made it clear that they will support the economy via fiscal and monetary stimulus if the impact of the trade war is greater than expected. This is likely to include increased spending on infrastructure, tax cuts to boost personal consumption and additional cuts in the reserve requirement ratio (RRR) for banks.

Finally, Premier Li has recently confirmed that the Chinese yuan (CNY) will not be used as a weapon in the trade war. Given the CNY's recent depreciation, this gives foreign investors comfort that equity gains will not be wiped out by further FX losses.

Conclusion

There has been some reprieve in the trade war following the announcement of tariffs on $200b of Chinese goods. This may prove to be short lived and tensions could ratchet up again after the mid-term elections, or it may be the start of a de-escalation which could result in a negotiated outcome between Presidents Trump and Xi. In any case, China has made it clear they will support the domestic economy via monetary and fiscal stimulus and significant value has emerged in high quality, domestic demand stocks in China.

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