



6 May 2020

Markets not ready for a cold war between China and the US

Renewed tensions with China inevitable. Who will be the best president to contain China?
Market have not yet factored in political tensions.

Key points

- Presidential campaign already focusing on Covid-19 crisis
- President Trump can no longer count on a positive economic record
- Time has come for a frontal attack
- Monetisation of debt will lend wings to politicians
- Now is the time to repatriate
- A major turning point in the course of globalisation
- Rising political tensions: China-US cold war
- Reduction in the likelihood of a V-shaped economic recovery

Presidential campaign already focusing on Covid-19 crisis

The US presidential campaign that has begun between Donald Trump and the presumptive Democratic nominee Joe Biden already seems to be focusing on the matter of knowing who will be better placed to “manage” the Chinese issue and fight off China’s ambitions. Joe Biden has fired first, blaming President Trump for displaying weakness towards China in the Covid-19 crisis and in particular for his inability to hold Xi Jing Ping accountable for the spread of the pandemic which is costing the lives of hundreds of thousands of people and which is strangling the economy of the US and other countries, which were forced to impose economically devastating confinement measures on their populations.

The Democratic attacks are clear: presumptive nominee Joe Biden is accusing the presidency of underestimating the magnitude of the risks by ignoring the advice of health experts and failing to adequately prepare the US to face this unprecedented health crisis. The criticism also spotlights Donald Trump’s weakness and his excessive trust in Chinese leader Xi Jing Ping, showing his inability to manage relations with China with the requisite firmness. This criticism will certainly be one of the main thrusts of the Democratic campaign against Donald Trump.

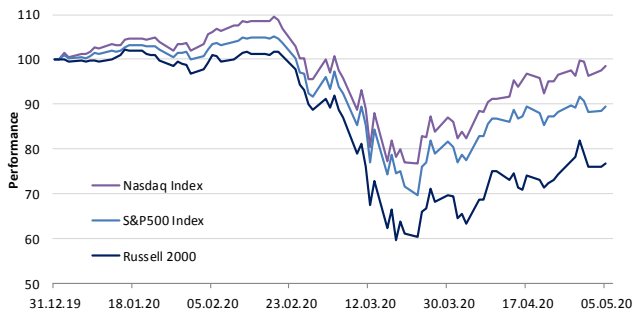
The President’s visible absence of sincere empathy for the thousands of Americans suffering and dying from Covid-19 will be a factor that will be emphasised to highlight how completely disconnected the President is from the reality of people’s life. The presidency’s response to the Democratic attacks is simple and uses the same arguments, accusing Joe Biden of having been rather favourable to China in the past.

President Trump can no longer count on a positive economic record

At the start of 2020, we could have imagined that the favourable economic context might have been enough to ensure Trump’s re-election. Indeed, the US President did not hesitate to claim that the strength of the US economy and his own corporations was entirely due to his economic policies, with the rise in stock market indices in 2019 bearing evidence to the effectiveness of his actions.

Hence, just before the Covid-19 crisis, Trump was prepared to hammer home throughout the election campaign that the stock market hailed the excellence of his management by reaching new heights, evidence that his slogan “America First” was not a mere slogan but a tangible reality marked by four years of his “great” presidency.

S&P500, Nasdaq and Russell small caps performances

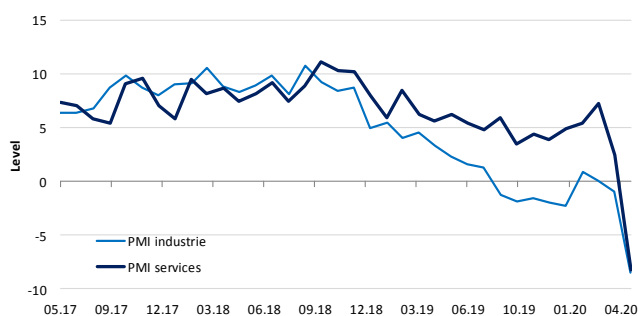


Sources: Bloomberg, BBGI

The stock markets’ collapse has ruined this ideal scenario for Trump, who is now facing a conjunction of events that are difficult to control, i.e. an unprecedented health crisis with a death toll that could reach the unbelievable figure of 150,000 in the US, one of the deepest and fastest financial crashes ever (temporarily mitigated by massive liquidity injections), an oil sector on the verge of bankruptcy, an unprecedented surge in unemployment, a services’ sector even more affected than the industrial sector, and consumers shocked by the magnitude of the crisis and their diminished consumption capacity.

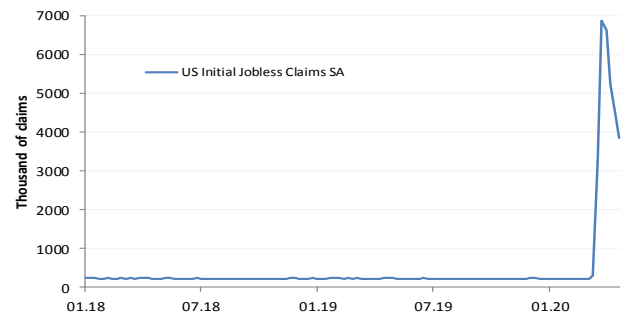
The 100% increase in beef prices over one month and the spectre of rationalising burgers in the land of Mc Donald’s leaves little leeway for President Trump in his presidential campaign. A culprit must be found.

Services PMI – Industry PMI - ISM



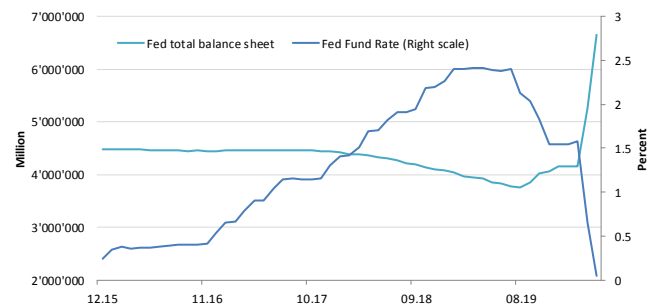
Sources: Bloomberg, BBGI

New jobless claims



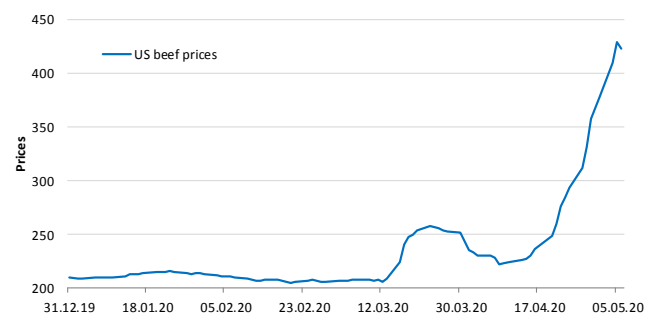
Sources: Bloomberg, BBGI

Fed funds, Fed total balance sheet 2016-2020



Sources : Bloomberg, BBGI

Beef prices in the US 2020



Sources: Bloomberg, BBGI

Time has come for a frontal attack

To counter Biden’s accusations of weakness, Trump’s strategy towards China is likely to harden, which should not be too difficult for a president who thrives on confrontation. Time has thus come for a more frontal attack. The US President is likely to rally his administration during the next few weeks as the lockdown eases to more officially and directly accuse China and possibly demand reparations. President Trump could thus quickly intensify his criticisms towards China and present himself as the defender of all the victims of a pandemic that arose as a result of China’s presumed misconduct and incompetence.

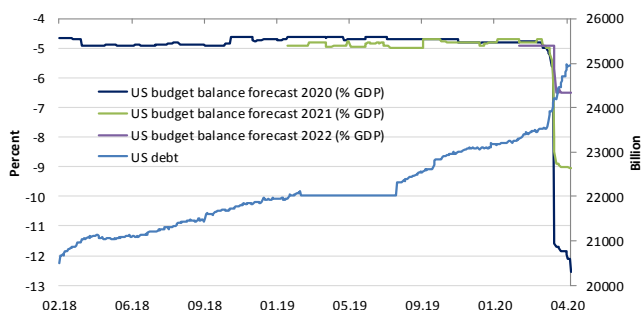
Other Western countries are unlikely to fall into step with this new crusade, although they are likely to rally quite broadly behind the analysis and the criticism of China.

The Covid-10 crisis will undoubtedly also leave a political mark in Europe and in international relations. It may constitute a vector for the US and Europe to become aware of their shared interest in containing China's ambitions together.

Monetisation of debt will lend wings to politicians

We are also seeing the emergence of a new paradigm on a political, economic and financial level, which may create the conditions for a change in attitude of Western governments towards China's ambitions. The major government debt monetisation project that lies ahead will free governments to some extent of the burden of managing budget deficits. Due to the situation, the Covid-19 crisis clearly demands unprecedented economic support and financial aid, which will lead to budget deficits and rising debt.

US budget and debt forecasts



Sources: Bloomberg, BBGI

Since a few weeks ago, the financing of countries by central banks is no longer taboo, for the moment and probably still for a few years to come. The need for financing from China may thus turn out less indispensable in this context and enable Western economies to distance themselves somewhat from China. Indeed, no more need to hand over companies to China or to rely on its financing.

The monetisation of debt opens the door to new capacity for government action, to nationalisations if necessary, and to massive government aid under certain conditions.

Now is the time to repatriate

On an economic level, Donald Trump has the opportunity to go back on the offensive with more acceptable and reasonable arguments to encourage certain factories to relocate to the US, especially for US companies that had been tempted to give China a try.

The trade war is back and is once again the central argument of the presidential campaign. The Trump administration is likely to develop an arsenal of tax regulations and proposals with the aim of repatriating as many segments in the value chain from China to the US, especially those that seem essential, strategic and indispensable to ensuring the country's independence. An increase in tariffs is likely to be the first decision, once it is "politically correct" to implement it, i.e. as soon as the US economy is back on its feet.

President Trump will have to blame the unprecedented collapse of the US economy and the surge in unemployment of more than 30 million Americans on China. He will certainly not hesitate to simplify and muddle concepts by claiming that the rise in tariffs is a just punishment for China for the victims it indirectly caused in the US by failing to control the spread of Covid-19.

Major turning point in the course of globalisation

Covid-19 may mark a major turning point in the course of globalisation, which may have reached its peak. A natural trend of rebalancing supply sources and reducing the dependency of Western companies on China is thus one of the most likely consequences of this crisis. This probably does not mean the end of globalisation, but it does point to a gradual transformation of production chains as well as a likely return to a somewhat more local and more diversified production. Already before the Covid-19 crisis, Trump wanted to repatriate to the US some of the production that had moved away in the previous decades. The trade war initiated with China in 2018 had temporarily halted in 2019 with a truce that was favourable to both parties, but the current situation is perfectly conducive to resuming hostilities.

In the broad majority of other industrialised countries, multinational companies are expected to follow the same trend. Their new relocation strategies will undoubtedly come with a less scathing and logically more moderate political discourse than in the US. However, the Covid-19 crisis will also leave significant political marks. The budget measures that have been decided will further inflate deficits and increase sovereign debt levels, while national governments will undoubtedly ask for compensation from the companies that have been helped or saved. National preference will logically appear as a just policy in such a context.

Rising political tensions: China-US cold war

The Covid-19 crisis will thus certainly revive tensions between the two superpowers that are China and the US. By becoming a central topic in the presidential campaign very soon, risks of a frontal confrontation and its consequences will likely have an impact on the investment climate. Indeed, if Covid-19 initially appeared like a phenomenon whose direct effects would be limited and potentially temporary, the confinement measures imposed and their economic and social impact have been such that they have raised new concerns about the conditions for returning to a “normal” economic and social situation in the world.

Renewed tensions between China and the US would clearly weaken prospects of a quick recovery of global economic activity and threaten the current rebound of risky assets. The election of Joe Biden would not be any more favourable in the current context to the extent that the latter has already announced his intention of taking a firm position with regard to China.

It is in no way certain that China will now be able or willing to fulfil its commitments to purchase as agreed close to \$200 billion in US products. China will be tempted to renegotiate the terms of the initial agreement, but regardless, the cold war is likely to resume between the two countries.

At this time, both countries are trying to blame the other for their incompetence and their responsibility in the management and development of the Covid-19 crisis to derive benefits on the domestic front. Rising tensions between the two superpowers will only have a negative impact on future economic prospects, at a time when the world is sinking into an unprecedented crisis that would call for better communication and cooperation between countries to optimise chances of coming out on top of this crisis.

Financial markets do not seem willing to be moved by the return of uncertainty and the possible impact of the new paradigm on a geopolitical level. They are not yet worried about the risks of failure of an economic model supported by government debt monetisation. A return of inflation is not at all impossible in such a context. Before that, however, we have to consider that the likelihood of a V-shaped economic recovery will fade with the resurgence of trade tensions in the next few weeks.

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