THE FRAGILE AND THE RESILIENT

"The most obdurate wills are those most prone to break".

Creon to Antigone.

In 2017, markets freed from a deflationary straightjacket overcame every setback. From the market peak on the 22nd January 2018, you could echo Creon ("the most obdurate wills are those most prone to break") by reflecting that Donald Trump's statements on international trade and the Middle East led markets to stumble. Investor optimism gave way to doubt, uncertainty, and even concern. Among the nagging questions are: uncertainty about free trade, concern over the situation in Syria, the forthcoming renewal of the nuclear agreement with Iran, and finally doubts about the longevity of the growth cycle. Grappling with untimely trade statements and aggressive geopolitical posturing, as well as with sometimes contradictory economic statistics, markets saw a resurgence of volatility and feared that Donald Trump might commit an irreparable error.

Far from wanting to ignore the risks, we should try to temper them by showing that a trade war is unlikely. The probability of escalation in the Middle East is moderate and the idea of economic slowdown is premature. Corporate earnings growth in 2018 remains promising, and concern about rising long-term interest rates is for very limited for now.

I. The trade concern: The China-US trade relationship.

It is indisputable that China, behind its posturing in favour of free trade, distorts the competition rules through government subsidies, protects its market with finicky regulations, encourages the formation of large industrial groups in numerous sectors, and does not hesitate to bail out its companies in distress. The country thus mocks free-market orthodoxy. It is certain that the United States can complain about a $370 billion bilateral trade deficit with China, because it buys $500 billion worth of goods from them and sells just $130 billion to them.

But tariffs cannot be the right answer. The US trade deficit is the result of a shortfall in savings, over¬consumption, and a lack of competitiveness among its industrial companies. Raising taxes would not create more jobs in the United

States, because the economy is close to full employment. Raising taxes would instead reduce the purchasing power of US consumers or encourage them to buy those goods elsewhere, and this would not bring down the overall US trade deficit. Raising taxes would reduce the competitiveness of US firms which rely on imports of cheap components - it is well known that 60% of US imports are components.

Historically, trade wars have brought no benefits: the notorious US Smoot-Hawley Tariff Act of 1930 led indirectly to a 60% decline in US exports. The ECB estimates that in the event of a 10% tax on all products imported by Americans and reprisals on all products exported by Americans, US GDP growth, as of the first year, would be reduced by 2.5 percentage points, i.e. it would fall to 0.5%, and global growth would shed 1 percentage point. At the end of the 1980s, the then-wealthy Japan, with its record trade surplus, barely reacted to US taxes, but that was because, politically, it was in a relationship of servility to the Americans. The situation with China bears no resemblance to that.

Following on from our note earlier this month, "Protectionist threats and risks for the markets", we will try to explain why in a standoff with China, the United States would not necessarily gain the upper hand. China has a massive capacity for reprisal. Fortunately, the consultation period on this issue will continue for two months and US companies can express their reservations up to the 22nd May. In a world becoming increasingly globalised, in which firms are intertwined, it would be difficult to break away from this process.

- It is wrong to say that things have got worse. In 2008, the Chinese trade surplus, as a percentage of GDP, was 10%, while at the end of 2017 it was $422 billion, or 3.4% of GDP. At the time the Chinese currency was undervalued, where now it is no longer so.
- The best way to reduce the US trade deficit would be to reduce US consumption, but that would risk putting an end to the growth cycle, and the United States, by cutting taxes, has chosen the opposite route.
- The four weapons available to the Chinese are, in decreasing order of probability of use:

- The agricultural weapon: Although the US has a large trade deficit in manufacturing, it has a large surplus in agriculture. China's threat to tax US soya beans would reduce US sales to China, which last year amounted to $14 billion, and would delight the Brazilians and Argentines, who could thus dispose of their stocks for better prices. US farmers have until June to know whether they are going to plant soya beans or maize (corn), but Chinese reprisals would reduce their revenues, thereby affecting the prosperity of the Midwest states which traditionally vote Republican, and this would not be good for Donald Trump in the upcoming mid-term elections in November. According to the Peterson Institute, the curtailment of soya bean exports could cost up to 20% of jobs in some Missouri counties.
- The industrial weapon: The United States plans to tax a whole series of products, but the Chinese can easily counter-attack and hurt US companies such as GM, who sell more cars in China than in the United States. Or Boeing, or Caterpillar. Better still, tech companies such as Qualcomm or Texas Instruments, who generate a large proportion of their revenues in China. Hence the current vulnerability of these companies on the stock market, and their rebound potential if a trade war does not break out.
- The Treasuries weapon: The Chinese are the leading holders of US Treasuries, to the tune of around $1,200 billion. A sell-off, or even a mere sell signal, could push US long-term yields above 3%, and hence make US debt more expensive and undermine the country's growth. However, this weapon is a double-edged sword, because a Treasuries sell-off would reduce the value of China's foreign exchange reserves and result in an appreciation of the yuan, which is not necessarily what the Chinese authorities want.
- The monetary weapon: The yuan is not convertible, so its exchange rate is set by the Chinese authorities, who could easily devalue their currency by an amount equivalent to the tax added to their goods, to neutralise its impact. This is a possibility in which we do not really see happening, and which the central bank governor, Yi Gang, seems to rule out. It would be a last-ditch weapon, because the

Chinese are anxious to consolidate the image of a stable yuan and above all do not want to exacerbate capital outflows. Lastly, devaluing the yuan would require further purchases of US Treasury Bills, which the Chinese are not necessarily prepared to do.

To sum up, the trade war will probably remain largely verbal. The Chinese will make some concessions regarding the deregulation of financial services, the opening of their markets, equity investment thresholds for foreign groups in joint-ventures in China, patent protection and a reduction of the subsidies to certain state- owned enterprises, and Donald Trump will have something to boast about. As regards the NAFTA agreement, which is nearly 25 years old, and the US deficit of more than $60 billion with Mexico, some adaptations in certain industries such as the automotive sector, should make it possible to extend the agreement.

II. Geopolitical concerns over Syria and Iran: "The worst is not always certain". Calderon.

- After seven years of war, more than 350,000 dead and 10 million people displaced out of a population of 22 million, Syria is a scene of a conflict between the great powers, Russia, the United States, France and the United Kingdom. It is also the theatre of action for regional powers: Turkey against the Kurds, Iran, directly via the Pasdaran or indirectly via Hezbollah, not to mention small Islamist groups. With Assad's use of chemical weapons, the red line laid down by the Americans has been crossed. Trump, wanting to distinguish himself from Obama, who was considered overcautious in similar circumstances, has promised to intervene, but Putin has undertaken to respond. It is hard at this stage to discern which of the two will come to his senses.
- The Iranian nuclear agreement signed under the Obama presidency in July 2015 provided for a freeze on nuclear development by the Iranians in return for a lifting of US sanctions, hence the prospect of increased foreign direct investment. Rohani expected $50 billion per year. But nothing is going as planned. Firstly, Trump, wanting to destroy Obama's legacy and honour an election promise, would like to break this agreement. Secondly, the Iranian population, disappointed by the

absence of economic improvement, the 30% fall in the value of the currency over the last six months, inflation still above 10% which is eroding their purchasing power, a high unemployment rate and costly military interventions abroad, is ultimately having doubts concerning the line adopted by the moderate Rohani. The situation is not new, but what has changed are the appointments of Mike Pompeo as secretary of state and John Bolton as national security adviser. Both are hardliners hostile to Iran. The former is a neo-conservative, close to the Tea Party movement, while the latter famously spoke in favour of military strikes against Iran and North Korea. Is it possible that, in Trump's mind, these appointments, intended to stoke fear prior to negotiations, will allow him to enter the arena in a position of strength? Or should we consider that John Bolton, the third head of this State Department in just over one year, will not be around for long? Should we deduce from these appointments that the agreement will be broken at the 90-day deadline, on the 12th May? Many fear this outcome, and markets would suffer the consequences, but it is by no means a done deal. The Iranians have not definitively abandoned uranium enrichment, and though they have agreed to reduce the number of centrifuges, that could change quickly. Tearing up the agreement before Trump's forthcoming meeting with the North Korean president on a similar issue would be clumsy, and would push Iran slightly closer to the Russian camp for military security and the Chinese camp for economic assistance. In return for a renewal of the agreement, Iran could agree to rein in the development of ballistic missiles. Between global hostility to Russia and the regional conflict with Iran, it may be felt that the US Congress will, as it is entitled to do, force its viewpoint on Donald Trump and prefer to renew the agreement with Iran in order to avoid seeing Russia strengthen its presence in the region. John Bolton and Mike Pompeo are both advocates of a hard line against Russia, and they may possibly consider it preferable to step up economic sanctions, because they would hit Russia harder than military skirmishing. This year, Russian GDP growth will probably not exceed 1.7%, and lower interest rates would be problematic because the depreciation of the rouble would cause a resurgence of inflation, depleting foreign

investments.

- Regional activism: The debate has shifted from nuclear proliferation to the proliferation of ballistic missiles in the region. And on this point, the Saudis, the Americans and the Israelis share the same determination to check this penetration, to intercept the missiles sent by the Houthis and punish Syria for its use of chemical weapons. One positive point is the imminent elections in Iraq, which are expected to mark a distancing from Iran.

III. Concern about an economic slowdown is exaggerated: resilience.

In the last two months, both the confidence indicators and manufacturing production indicators point to a growth dip in OECD countries and in China. Is this a signal that the peak of the cycle is behind us? Is it a temporary contraction, attributable mainly to harsh weather conditions in the northern hemisphere? We lean towards the second hypothesis, believing in the resilience of growth and an extension of the cycle, and are reassured by prospects of corporate earnings growth of between 8% in Europe and 10% in the United States this year. In other words, current hesitations on the stock markets should fade and give way to a slight rise in the markets.

- In the United States, consumption and credit growth, manufacturing production indicators and investment growth, household confidence indicators and activity indicators all converge to suggest a contraction in growth in the first quarter. But the tax cuts are providing stimulus just when the economy is moving closer to full employment. Setting aside the protectionist threat, the only possible fear would be a shock on long-term interest rates due to the combination of a restrictive monetary policy, i.e. three interest-rate hikes this year, and an expansionary fiscal policy which, according to estimates by Congress, will bring the deficit up to $800 billion in 2018 and around $1,000 billion in 2019. So far, nothing is anticipated by the market, because 10-year interest rates have not crossed the 3% mark and a further flattening of the 2-/10-year curve is expected.

- In China, car sales were stable in January, rising only 2.4%, and industrial production rose only 6% year on year. And in March, the Caixin business indicator

for medium-sized companies underscores a slowdown, as does the PMI indicator for industrial production.

- In Europe, quieter economic activity was noticeable in the first quarter and the figures for industrial production in February were not great. However the appreciation of the Euro and bad weather conditions party explain this. There is no reason to worry about a temporary slowdown, and if it were to continue, the ECB could extend quantitative easing beyond the 30th of September.
- In Japan, a slowdown in consumption and a contraction in machinery orders were observed in the first quarter, and the Bank of Japan has pointed to a deteriorating business environment, probably as a consequence of the yen's appreciation, but a rebound in both consumption and investment is expected as of the second quarter.

Conclusion:

Could we say, like Baudelaire: "Soon, we shall plunge into the cold darkness/ Farewell, vivid brightness of our short-lived summers "? We don't think so. But what are stock markets going to do? Paradoxically, an upturn could come through the "fragile" rather than the "resilient" aspect. This will be possible if protectionism does not materialize and if the geopolitical crisis is contained. Conversely, resilient growth goes hand-in-hand with high expectations regarding corporate earnings, and the slightest disappointments will be punished.

- From the trade viewpoint, rather than erect barriers, it would be better for the Americans to endeavour to open up markets, and for the Europeans to reflect on the impact of the agreements that China, within the framework of the Silk Road, is negotiating with Eastern European countries. If a trade war is averted, then export-sensitive US cyclical stocks will regain favour with the markets.
- From the geopolitical viewpoint, sanctioning Russia economically is less risky than allowing the situation to turn ugly in Syria. That pushes down the Russian stock market and the rouble, and therefore prevents the central bank from lowering its interest rates, discouraging foreign investment and holding back growth, which was previously expected to be 1.7% this year. For investors, two of

the possible insurance policies against Middle East crises are buying gold and oil.

- In this note, we have not gone back over the old refrain of a pickup in inflation, because there is still no convincing view of this scenario. In light of a situation of near-full employment in the United States, Germany, the United Kingdom and Japan, wage growth would make sense and would cause a rise in long-term interest rates which would be negative for markets. However as many of the jobs created are probably unstable, part-time or self-employed, this growth is proving slow to materialize. The impact of the rises in oil prices and in the prices of other commodities which began last year is starting to wear off. The latest figures published by China point to a fall in inflation, because the PPI (Producer Price Index) for March only increased by 3.1% year on year, well below from the 7.8% posted in February 2017, while core inflation slipped back to 2.1%. In the United States, core inflation in March was only 2.1% and wage growth was 2.6% or 3.3% depending on whether or not the figure is based on constant weekly working hours.