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# CIO Viewpoint

# US-China talks highlight need for strategic stability

Investment Solutions

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**Until last year, China-US trade and escalating tariffs dominated much economic thinking. Bilateral relations continued to deteriorate through the Covid crisis, and have remained distant under the Biden administration. Neither nation has much domestic political room to be seen to offer concessions but at least the two leaders are talking. We examine the investment outlook for the year ahead.**

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### Key takeaways

- Bilateral relations between China and the US are key to the health of the global economy: the nations' presidents talked last week in an effort to ease tensions
- The Biden administration considers the potential benefits of lowering tariffs to alleviate inflationary pressures
- We expect the US and China to register similar rates of GDP growth next year, at 4.6% and 5% respectively
- Chinese government bonds may act as a hedge in periods of market stress; we keep our overweight position. The renminbi should stay stable against the US dollar.

With hindsight, what began in 2018 as a trade war between the world's two biggest economies has become antagonistic on a range of differences. Relations have worsened on everything from the source of Covid to tensions over Taiwan's independence, military tests and corporate access to one another's markets. This is why there was much attention on a 15 November three-hour video call between Presidents Joe Biden and Xi Jinping. While no breakthrough resulted, last week's discussion suggests that both leaders recognise the importance of addressing their countries' worsening relationship.

At least direct talks can help "to prevent miscommunication," said US National Security Advisor Jake Sullivan after the meeting. Strikingly, Mr Sullivan described the importance of the discussion as helping to "put guardrails around this competition so it doesn't veer off into conflict."

A solution to the trade tariffs looks difficult in the politically sensitive year ahead. Fear of Chinese competition is one of the few topics that unites otherwise polarised US politicians ahead of the mid-term elections next November. The Chinese Communist Party will hold its five-yearly congress in the fourth quarter of 2022. This is expected to confirm President Xi for an unprecedented third five-year term.

## "Disinflationary" tariff cuts

Nevertheless, high US consumer inflation following the economy's re-opening may offer some avenue to ease import tariffs. The Biden administration has called for tariff cuts by underlining their additional costs to American consumers. Treasury Secretary Janet Yellen last month said that lower import tariffs would have a "disinflationary" impact. At the end of October, the US agreed to immediately drop duties on steel and aluminium from the European Union, imposed in 2018, and the EU responded by ending retaliatory tariffs on goods including American whiskey and Harley-Davidson motorcycles.

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US Trade Representative Katherine Tai said on 10 November that there is "traction" on implementing the deal with China "to remove a portion of the tit-for-tat tariffs." Still, Ms Yellen said, the US is waiting to see China meet its commitment to buy an additional USD 200 billion in American goods and services under a February 2020 "Phase One" deal. At the end of September, China said that it had fulfilled 60% of that pledge. Strong consumer demand has meant that despite the additional complication of higher US import tariffs, China has increased its market share. We expect that trend to soften, as US consumers change the focus of their spending away from hard goods for the home and towards services such as travel and eating out.

China is the US's second biggest trade partner after the European Union, and the US is China's largest partner. In 2020, the US and China exchanged goods worth USD 559 billion, compared with USD 557 billion in 2019, and almost USD 659 billion in 2018.

## Political "contest"

Mr Biden characterises competition with China as a "contest" between different types of government. His administration took office calling the US-China relationship as "the biggest geopolitical test of the 21st century" and describing China as the only country with the means "to seriously challenge the stable and open international system."

Bilateral relations between China and the US remain key to the health of the global economy and any tensions merit careful watching. One issue captured much attention in recent weeks. While many nations regularly test their neighbours' borders with military patrols, Taiwan has seen an intense period of Chinese military exercises. Since 1972 the US has officially acknowledged the "One-China" policy on Taiwan, without recognising China's sovereignty over the island.

In addition, the two countries are squabbling over corporate access to one another's stock markets. The US' Securities and Exchange Commission (SEC) has suspended US listings of Chinese companies, pending new disclosure demands, and China plans to ban US companies that hold large volumes of consumer data from its markets. These differences may force Chinese and US firms to de-list, or seek new market homes. In May this year, the US Congressional commission identified 248 Chinese companies listed on US exchanges, including the New York Stock Exchange and the NASDAQ, with a market cap of USD 2.1 trillion. The list includes eight national Chinese state-owned enterprises.

## Convictions and risks

After a rapid slowdown in China's third-quarter output this year, we expect the economy to expand by 5% in 2022. Economically, the Chinese government is working to re-balance the real estate market, faces energy shortages and trying to manage slowing growth with monetary easing and fiscal spending. We see the US economy expanding by 4.6% next year. The last time the two economies recorded matching GDP growth was in the late 1990's.

Recent legislation in China points to a shift in economic priorities away from short-term growth to strategic resilience. The Communist Party is now communicating a set of priorities that include improving citizens' quality of life, wealth redistribution, combatting pollution, greater financial stability, and improved technological autonomy. This is visible in China's chosen technological path. Over the last year Chinese regulations, citing the need to promote "common prosperity," destroyed billions of dollars of market capitalisation from the country's biggest tech firms.

We continue to monitor any risk of excessive leverage in China, tighter regulation on polluting industries or anti-trust and security measures. We do not expect further surprises next year as the country traditionally stimulates the economy ahead of the National Congress of the Communist Party and should benefit from domestic tourism around the Winter Olympics in February.

Turning to financial assets, much of the negative news from China's real estate debt is already reflected in fixed income valuations and so we have increased exposure to some of Asia's dislocated credit, where we see pockets of value. Our fixed income allocation includes an overweight position in Chinese sovereign bonds, which we believe can offer a reasonable hedge in case of market turbulences.

We expect the US dollar to strengthen as global monetary policy becomes less accommodative in response to normalising economic growth. The Chinese economy's balance of payments will support the renminbi, keeping the currency stable against the dollar in the quarters ahead, while outperforming most other major currencies.

While domestic political considerations in both China and the US mean that the bilateral relationship is unlikely to fundamentally alter in 2022, the question is how two systems of government can co-exist while delivering growth, stability and prosperity to their own citizens and the wider international community. There are some positive signs. This month, the COP26 climate summit highlighted an area for cooperation when the two countries agreed a joint pledge to accelerate decarbonisation and the transition to clean energy sources.

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