# The Dissolution Of Chimerica

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The economies of the US and China are by far the world's largest. Each year since 2002 they have contributed between half and two thirds of global GDP growth. Such has been their importance and dependence that the composite phrase "Chimerica" emerged to describe both the integration of supply chains and corporate profitability, and also their cultural and educational connections (Xi Jinping's own daughter attended Harvard). Yet today, the single most important question confronting investors may be: is the foundation on which this Chimerica pillar rested now crumbling?

Gavekal has expressed a range of views on the way the US-China trade war will likely play out

This is a question that we have tackled from many angles. Anatole has said that investors should focus on President Trump's well-worn negotiating tactic to ask for the moon, yet compromise at the last moment to somewhere just beyond the other party's comfort zone. Those of us living in Asia have been more cautious, pointing out that Washington has a broader strategic goal than just redressing US-China trade imbalances. Arthur has argued that Washington wants to disentangle the supply chains that made many US firms reliant on Chinese manufacturing capacity, and so neuter China as a strategic rival (see **An Irresistible Trade Policy Meets Immovable Interests**).

The reality is that President Trump seems set on taking China down a peg and that can't be good for global growth

It is worth noting that Trump declared in an August 21 speech: "China was on the way to being bigger than us in a very short period of time. That's not going to happen anymore." This was quite a statement, for if US policy is to stop China growing, the prospects for global growth must have dimmed. Perhaps even more importantly, Trump's statement underlines why the markets' hopes for a near term lull in US-China tensions may be overly rosy.

The optimistic scenario is that "free traders" in the US administration like Larry Kudlow, Steven Mnuchin, David Malpass and Jared Kushner work behind the scenes so that a "beautiful deal" can be struck when Trump and Xi sit down at the G20 meeting in late November. In contrast, there are many challenges to this upbeat scenario that include:

### Checking The Boxes

Our short take on the latest news

| Fact | Consensus belief | Our reaction |
|---|---|---|
| **US composite PMI rose to 53.4** in Sep, from 54.7 in Aug | N/A; mfg rose to 55.6, from 54.7; services fell to 52.9, from 54.8 | US growth remains resilient, but rising input cost should hurt margins |
| **Eurozone composite PMI fell to 54.2** in Sep, from 54.5 in Aug | Below 54.5 exp.; manufacturing fell to 53.3, from 54.6; services rose to 54.7, from 54.4 | Domestic demand offsets weak exports but slowing job growth shows further downside risks |
| **UK public sector net borrowing ex bks rose to £6.8bn** in Aug, from -£3.1bn in Jul | Above £3.4bn | Disappointing but follows strong surplus in Jul; repairing govt finances still on track |
| **Thailand trade deficit widened to US$0.59bn** in Aug, from US$0.52bn in Jul | Below US$1.2bn surplus exp; export growth slowed to 6.7%, imports accelerated to 22.8% | Weakest export growth since Feb 2017 contraction; stronger THB & global trade war to blame |

1) Beijing seems disinclined to pursue high level talks with anyone other than Trump himself after getting burnt this spring following the dialogue between Treasury Secretary Mnuchin and Vice Premier Liu He.

2) Washington and Beijing seem to have no ongoing high-level dialogue on trade, as reinforced by reports this weekend that China is downgrading the forthcoming delegation it will send to the US.

It may be tough to negotiate a deal as each side seems to think it holds the whip hand in the negotiation...

However, the greatest obstacle to a "beautiful deal" being struck may be the lingering perception that each country has of the other. In Washington, the consensus seems to be that China is in deep economic trouble, as decades of debt binging leaves it vulnerable to US pressure that could collapse its house of cards. The view in Beijing is that the US is more politically divided than ever, leaving it incapable of pushing through policies that may cause pain for the US voter. In other words, while China can "chi-ku", or "eat bitterness", the US is quite incapable of handling any kind of pain, for any measure of time.

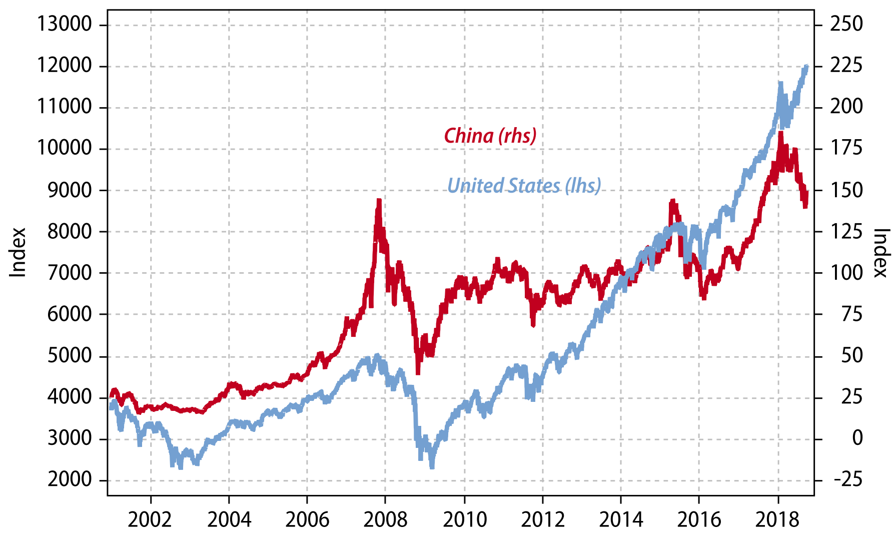
Such beliefs about the other may be a reason to fade reports of a breakthrough in the talks. Indeed, parties who come to the table convinced that the other side is weak, and convinced they hold all the cards, are unlikely to bend over backwards to find a workable compromise. And if both sides are convinced that the other is weaker than is actually the case, then the parties are more likely to talk at each other, than to each other.

...US stocks' outperformance over the summer may reinforce the Trump administration's view that China is vulnerable to an economic collapse

In that respect, this summer's divergence between US and Chinese stock market performance may be a poor omen for compromise. In Washington, a falling Chinese stock market will have re-enforced the view that China's economy is on a cliff edge. The reality, however, is that a -20% drop in equity values does not spark calls for changed economic policies in China, yet such a fall in the US would likely result in less hawkish monetary policy. By the same token, if the Republican Party scores badly in the November 6 midterm election, Beijing may become more convinced that the US is politically divided and Trump will struggle to deliver on his economic agenda.

**Headed in different directions**

MSCI China vs MSCI US: mid & large cap total return in US$

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