



Does China Really Want a Deal?

RICK VILLARS, CFA

Much of the daily trade war commentary purports to know the Chinese position with certainty. News editors and producers demand this to get impactful quotes, and in the case of government representatives they are communicating negotiating postures. But the truth of it is they are all guessing. We do not profess to have any insider insight into the thinking of Chinese officials. But we do believe that a reasonable case can be built for the idea that China is not as keen to do a deal as some would have us believe.

The Long Game

As the trade war ebbs and flows, I am reminded of a fact-finding trip to China for a previous firm. We were considering opening an Asian office and I was charged with assessing the viability of such an endeavor. The Chinese message was quite consistent. "Business in China is about the long game. Americans are in too big of a hurry. Relationships take time to build and short-term to the Chinese was looking out 5-10 years." They often reminded me that their culture was 5000 years old and ours was only a bit over 200. The daily tweet or market prognostication leads me to wonder if, once again, we Americans are playing a short game, while the Chinese are playing their more traditional long game.

One version of that long game has to do with the upcoming U.S. election. Clearly, our current administration is more adversarial with the Chinese than any in the past. So in the long run it is to their benefit if President Trump is not re-elected? It is also widely believed that his getting a Chinese trade deal would increase his election chances significantly. At the same time, Chairman Xi is firmly in power with little fear of losing it. A strategy of denying the U.S. president of a key win for his campaign may be a viable one for his Chinese counterpart. While most aspiring U.S. politicians agree that the trading relationship needs to be more fair, a successor administration may be more willing to play the long game to get there. It does not take much imagination watching the chess match of these negotiations to envision the Chinese negotiators following this strategy.

Make _____ Great Again

The Trump administration ran on the slogan "Make America Great Again", while at the same time Chairman Xi was three years into his program called the "Chinese Dream", which has grown into the "Great Revival of the Chinese Nation". Xi predecessors were inward focused, but Xi sees China's role in the world in a very different light. He believes his country should be a world leader with influence outside its borders. The Belt and

Road Initiative is one pillar of that vision. Chinese leadership in technology and innovation is another, with national champions competing on a global stage. The "Made in China 2025" initiative is focused on moving up the value-added chain and having homegrown innovation. The third pillar is a strong military with a target to modernize it by 2035, followed by a fourth called "Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era", which has actually been made a part of the constitution. It is apparent that Xi sees himself as a transformational leader and seeks to leave a powerful legacy with China as one of the top world leaders. He clearly is as committed to making his country great again as President Trump is to his vision of the U.S.

If the current trade negotiations were just about buying more soybeans from farmers, letting the currency float, and companies manufacturing goods elsewhere, a deal might be more doable. But the hawks in the Trump administration are asking for fundamental reform of Chinese laws and trade practices that could hinder Chairman Xi's vision of greater influence on the world stage. Vice President Pence has laid out fundamental changes to intellectual property laws, open markets, transparency, etc. requiring changes in Chinese law. If a trading partner gave the U.S. an ultimatum to change our laws, what do you think the reaction would be? National security hawks also want the "Made in China" and military modernization initiatives muzzled in the process with sanctions to continue as long as these paths are pursued. From a Chinese perspective, this probably feels much like the current super power trying to keep a rising power down.

Give an Inch, Take a Mile

Recently, I read an article detailing market opening changes that the Chinese have made. Joint venture equity caps in the auto sector are to be phased out on commercial car producers by 2020 and on passenger vehicle makers by 2022. The 50% cap on electric vehicle production was removed in 2018, and tariffs on imported vehicles were reduced to 15% in July. There are also a host of changes intended to further open the financial sector which will go into effect by 2020. BNP Paribas and Deutsche Bank were just granted licenses to lead underwriting activities in China. While we in the U.S. see these changes as long overdue, it is logical that the Chinese see them as incremental changes in the direction that the U.S. is requesting. Yet they probably don't feel like they are getting much credit for the direction that reform is headed. It is not my

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intention to judge whether they are moving fast or far enough. I'm just trying to put myself in their shoes and consider how they might feel about negotiations that do not give credit for movement in the right direction.

Saving Face

The concept of Mianzi (face) in Chinese culture is important and complex. One of the worst things that can happen in Chinese culture is to “lose” face. For the Chinese, causing someone to lose face on purpose can make an enemy for life and is at the root of many conflicts. By coming on so strong, doing it in a public way via Twitter, and by not being consistent, President Trump is flirting dangerously with this cultural taboo. One day he calls Xi a friend and great leader, then the next day a liar and an enemy. While this may have been an effective negotiating tactic used to beat subcontractors into submission, it may be adding to the antipathy of these negotiations. In fact, it may be that not giving in to U.S. demands may be seen by Chinese trade negotiators as the only way they can save face. Chairman Xi has a vested interest in appearing strong in the face of a foreign threat.

Role Reversal

China has historically been seen as a bad actor on the world stage with unfair trade and human rights as black marks. But in this trade conflict, the U.S. has taken the role of aggressor, which allows China to position itself as the aggrieved party and to project blame for a global slowdown on the U.S. This image is then reinforced when the U.S. opens trade disputes with other countries or takes an opposing position on things like climate change or Iran. Chinese officials may view their position in this dispute as the underdog standing up to the bully and are enjoying not being the bad guy for a change. Of course, that may change, depending on how the Hong Kong situation plays out. However, if they end up being the authoritarian in that case, it is unlikely that will make trade negotiations easier.

Job, Jobs, Jobs

For most of China's economic rise since reform, conventional wisdom has been that the Communist Party needs to create jobs to keep workers happy in order to stay in power. Now unemployment is low and the workforce is shrinking, while the consumer class has taken hold of the national conversation. Chinese urban employment shrunk in the second quarter, but the unemployment rate continued to improve reaching 3.6%, slightly better than the 3.7% rate in the U.S. A fully employed declining workforce, which is estimated to have peaked in 2015, and a rising middle class, which Alibaba claims has reached 300 million, shifts the national conversation to a different band on the quality of life spectrum. In

some cities, job openings exceed job seekers. If jobs are our gauge of how bad the Chinese public is being hurt, it may be off the mark.

Twist Their Arm Until It Hurts

We keep hearing how China wants a deal because they are really hurting. Admittedly, there is plenty of data to indicate that the Chinese economy is slowing. But their Citi Economic Surprise index turned positive in August, indicating that, on balance, economic data has been better than expected over the last three months. Retail sales in July were 7.6% higher than last July. That is twice as fast as the 3.5% rate in the U.S. Year to date retail sales in 2019 have grown faster than in 2018. Some of their retail giants are also reporting robust sales. Alibaba reported sales growth of 42% in their latest quarter, ahead of expectations. JD.com reported 23% sales growth and Anta Sports a 45% jump. That compares favorably to Amazon's 19% sales growth. Despite a drop in exports to the U.S., overall year to date exports in Yuan have grown by 6.5%, while U.S. exports have been shrinking. The U.S. is China's largest export destination, so new tariffs are bound to have a bigger impact on total exports, but to date their trade flows have not fallen off a cliff and a weakening Yuan will cushion the blow somewhat. Pain may be in the offing, but so far it is difficult to describe the Chinese economic situation as hurting.

Chinese growth is currently expected to slow to around +6%, the slowest in 20 years. But does that mean they are hurting? Or are they just reaching the stage in development when high growth rates moderate? For example, economic growth slowed in both Taiwan and South Korea at about the same level of purchasing power parity GDP per capita. In the 10 years before reaching a similar level, Taiwan averaged 8.2% GDP growth, but afterwards 6.7%. Similarly, Korea averaged 9.3% before and 5.8% afterwards. One could contend that slowing Chinese growth is as much about their economy reaching the next stage of maturity as it is about the trade war.

Patriotism

The Chinese government may be authoritarian, but the Chinese people are still proud of their country, their culture, and their accomplishments. Chairman Xi's “Chinese Dream” plays well as a rallying cry for the masses. By assuming the aggressor role, the U.S. may not be winning the hearts and minds of the general population. Huawei is an example of a Chinese corporate champion that is under fire from the U.S. But recent data shows that Chinese consumers have accelerated purchases of Huawei smartphones at the expense of Apple. In years past Chinese consumers have been quick to boycott Japanese goods when unhappy about Japanese politics. While good data on how the Chinese people view their government is not available, anecdotal evidence would imply

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that there is a level of patriotism there. There is a reasonable expectation that they will blame the U.S. for a slower economy and not their leaders.

In contrast, if there are boycotts of Chinese products in the U.S., they have not been publicized much. When consumers start seeing price increases from their local Walmart to the Apple store, it is not clear who they will blame. Recent surveys indicate the typical view of the U.S. public is that outlook for the economy is getting worse. Pressure from the President's base may also turn problematic. Farmers understand the reasons for trying to bring the Chinese to the negotiating table, but that does not pay the bills. At the same time, manufacturing employment growth has dipped below total employment growth in the past few

months. In an extended trade war it is not clear which leader will have the public support in the long-term.

Let's Make a Deal

Clearly, this trade war is having global effects and ending it would be in everyone's economic interest. The above comments are not meant to imply judgement about what should happen. We also do not claim to know more about what the Chinese government or its people are thinking than our peers. But we do think that a prognostication purporting that a deal is imminent because "we are doing better than China" is not evidence-based. There is just as much data to support a view that China is not as motivated as might generally be believed, as there is to espouse a view that they want a deal.

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