Can a trade war cause inflation to spiral out of control?

BY **KUEK SER KWANG ZHE**

The escalating trade tensions between the US and China are beginning to give investors cause for concern as they could lead to inflation spiralling out of control and disrupting the global economy.

There could be serious repercussions if the situation worsens, observe market experts. A long list of products targeted for tariffs could cause prices to soar in domestic markets and fuel supply-side inflation.

"Companies around the world could scale back their capital expenditure (capex) plans amid the tit-for-tat retaliation between the US and China as market uncertainties loom. This could cause a shortage of goods in the market amid an expanding global economic environment in which demand is strong," says Vasu Menon, vice-president and senior investment strategist at OCBC Singapore.

"However, it is still early days and companies are waiting to see how the trade saga between China and the US plays out. Logically, companies may be more reluctant to increase fresh spending until they get a handle on how the conflict pans out."

Joanne Goh Siew Chin, regional equity strategist at DBS Group Research, says purchasing managers' indices around the world have generally declined despite remaining at an expansionary level of above 50 points. "Uncertainties have caused businesses to delay their expansion plans and investment decisions," she adds.

Wang Qinwei, economist for the global asset allocation research team at Amundi Asset Management, is concerned about the drop in companies' capex even though the relevant indicators continue to look positive. "Capex indicators are still at historical highs in the US. Hence, it is not pointing to a deterioration in company investments yet. We are wary that protracted noise of a trade war could dent business confidence and investments," he says.

Wang points to the ISM's March Manufacturing Survey (a survey of more than 300 manufacturing firms conducted by the Institute of Supply Management), which notes that the potential trade tariffs are worrying as they could be one of the reasons for the Prices Paid Index moving higher.

What will happen if the inflation rate, especially in the US, moves higher than expected due to the new tariffs? Gary Lim, regional fund manager at Apex Investment Services Bhd, says there will be a spike in market volatility.

"You will definitely get a negative reaction. Market players are looking at three rate hikes by the US Federal Reserve. It could be four rate hikes [if the inflation rate continues to rise]," he adds.

The US Treasury yield curve, a key indicator of the economic health of the US, would continue to flatten if the Fed hiked rates more aggressively on the back of higher inflation. "This would cause volatility in the market," says Lim.

Investors are already closely monitoring the US Treasury yield curve. According to the *Financial Times*, the yield curve flattened to a 10½-year low on March 28. If it continues to flatten and inverse, there are concerns that the US economy could enter a recession.

As much as fund managers and economists envision presidents Donald Trump and Xi Jinping reaching a consensus on trade deals, tensions between the two countries are rising after a year of peace. At the beginning of the month, Trump raised the potential tariffs on Chinese goods to a total of US$150 billion from US$50 billion in March. Xi retaliated by announcing new tariffs on US exports to China, including steel pipes, fresh food and wine.

INVEST IN SECTORS THAT WILL BENEFIT FROM TARIFFS

Is it time for investors to hold cash and wait on the sidelines? Despite the trade tensions between the two largest economies in the world, investors may not want to take the extreme position of cashing out of the market just yet, says Lim.

He points out that many of the tariffs remain at the proposal stage and may not materialise at the end of the day. Investors who cash out from the market will miss the upside in such a scenario. After all, the outcome of the events is hard to predict. "If you are holding a high level of cash, you can get caught quite badly," he says.

Menon says even if the tariffs are imposed, the US inflation rate may not rise rapidly as the US and China could import comparatively cheap goods from countries unaffected by the tariffs.

Lim's advice to investors is to hedge their positions by allocating part of their investment money to sectors and companies expected to benefit from the trade war tensions and proposed tariffs. One such sector is China's car distributors.

He says the stock prices of Chinese carmakers took a hit when Xi announced on April 10

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Full-blown trade war still unlikely

A full-blown trade war, which could see China and the US impose broad-based tariff hikes on all export goods, has not been projected as a base-case scenario by some market experts.

Wang Qinwei, economist for the global asset allocation research team at Amundi Asset Management, does not see this happening. He says China is already moving in the direction of what US President Donald Trump would like to see. This could be drawn from President Xi Jinping's speech at the Boao Forum for Asia Annual Conference 2018, also known as the "Asian Davos".

"The speech may sound general. But if you look into it, even though it did not mention the US at all, the details are relatively comprehensive and they are responding to Trump's demands," says Wang.

"In Xi's speech, China promised to further open up several markets, including the automotive and financial sectors. It encouraged imports via the plan to host the Import Expo. It will cut tariffs on some products and it has plans for intellectual property (IP) protection.

"On IP protection, it is not only mentioned in Xi's speech but also included in the National People's Congress report. In fact, China is planning to fully restructure its State Intellectual Property Office."

However, this does not mean Xi is giving in to Trump, says Wang. The initiative to open up markets and enhance IP protection will be made largely because China is ready to open its markets to foreign players as Chinese companies are becoming more competitive. The automotive sector is an example of this.

China is also opening up its financial markets to address the country's high debt levels. "The Chinese companies themselves need the IP protection. They are spending more money on R&D, with the total amount as a share of gross domestic product almost reaching that of Western European countries. The number of new patents filed by the Chinese is the highest globally," says Wang.

He adds that Xi is committed to addressing these issues and would not want his plans to be complicated by the US. The Chinese president, who is expected to stay in power for more than two terms, is in a good position to push all these reforms through. In addition, key figures in the country such as Yi Gang (governor of the People's Bank of China), Liu He (China's vice-premier in charge of the country's economy) and Guo

Inflation still a concern, but not due to trade war

A trade war is not the only factor that could cause inflation to rise going forward. Gary Lim, regional fund manager at Apex Investment Services Bhd, is more concerned about the supply-side reforms that China is undertaking to reduce the supply of steel, coal and aluminium, among others.

"If you look at the steel sector, China produces about 50% of the world's steel. So, let's say it plans to reduce supply by 10% to 15%. This translates into a 5% to 10% cut globally. That is very meaningful," he says.

Lim also warns about rising oil prices that could feed into a higher inflation rate. "We are not sure if oil prices will surpass US$100 per barrel. It could happen," he says.

On April 20, *The Economist Espresso* — a new morning briefing from the editors of *The Economist* magazine — reported that the Trump administration is looking forward to imposing new sanctions on Iran, which could send oil prices higher. Brent crude oil was then trading at about US$74 per barrel, the highest since the second half of 2015.

The *Economist Espresso* also said there had been talk that the Saudis want oil prices to reach US$80 to US$100 per barrel.

However, Lim is not worried about this happening in the short term. "Inflation will definitely pick up as we have gone past the deflationary period, when the markets were so worried a few years back. Inflation is good as long as it is growing at a reasonable rate," he says.

He adds that a higher-than-expected increase in US inflation may prompt the US Federal Reserve to hike interest rates more aggressively. "While this could create market volatility in the short term, the growth of the US and global economy are expected to remain intact."

Vasu Menon, vice-president and senior investment strategist at OCBC Singapore, agrees. He compares the US inflation rate to the historical 12-month year-on-year performance of the S&P 500 index.

Menon says when the inflation rate is between 1% and 3%, the median return of the S&P 500 is 11.4%. But when inflation rises to 3% to 5%, the median return is 6.8%.

"Inflation in many parts of the world is running below 2%. And even if it picks up to 3%, it should not be too problematic for bond and equity markets," he says.

"However, if we see a sharp increase in inflation because of widespread tariffs, this could force central banks to tighten their policies, which will not be good news for investors."

US inflation and equity market performance

US INFLATION RATE (%)	MEDIAN (%)	AVERAGE (%)	% OF TIMES THE INDEX IS POSITIVE
-15 to -10	-10.30	-13.10	28
-10 to -7	-10.90	-11.70	22
-7 to -5	-1.70	-0.80	44
-5 to -3	0.70	0.90	50
-3 to -1	6.80	5.30	57
-1 to 0	15.00	14.40	60
0 to 1	7.30	8.60	64
1 to 3	11.40	10.70	76
3 to 5	6.80	7.20	63
5 to 7	2.70	4.00	53
7 to 10	3.00	5.70	62
10 to 15	3.90	1.40	59
> 15	-2.00	0.80	46

that the country would cut car import tariffs and ease restrictions on foreign ownership in the car industry. That means foreign companies could have more say in the Chinese automotive market and the competition between foreign and Chinese car manufacturers is expected to heighten.

What investors can do in such a situation is to allocate some of their money to Chinese car distributors to hedge their positions, says Lim. "[Chinese] car manufacturers will be affected when the market opens up. But the distributors are less affected or could even benefit from [the lower import tariffs]. The distributors also import foreign cars, especially high-end ones such as Porsche, Mercedes-Benz and BMW. In a way, investors are hedging their positions."

Investors can also deploy some of their money to countries and stocks that are more domestically driven and are less affected by global trade flows. For instance, the news of peace talks between South and North Korea could create investment opportunities in South Korea's infrastructure sector.

South Korean newspapers recently reported that the country may consider negotiating a peace treaty with North Korea. This could lead to the unification of the two countries. North Korean Supreme Leader Kim Jong-Un was expected to meet South Korean President Moon Jae-In on April 27.

If peace talks are successful, investors can expect new infrastructure projects to start in North Korea, which will benefit South Korea's infrastructure companies. "This investment theme is largely domestically driven and has less to do with global trade flows," says Lim.

DBS' Goh says investors could look at the consumer sector in countries such as India and Indonesia, where the demand for consumer goods is also largely domestically driven. E

Shuqing (chairman of the China Banking Regulatory Commission) are also all pro-reform.

Vasu Menon, vice-president and senior investment strategist at OCBC Singapore, says Trump is not punishing China but putting pressure on the country, partly to address its trade imbalance. And China knows that this is not sustainable.

"Imposing tariffs is not his main goal. It is more of a negotiation weapon to force an agreement in favour of the US," says Menon.

He adds that the upcoming key developments on the US front are the response from the domestic constituents in the country to the impact of the tariffs that have been imposed and those being proposed. That is because some of the proposed tariffs are still under the public consultation period and US companies have up to May 22 to raise any objections. "Meanwhile, a public hearing on the issue will take place on May 15," he says.

Wang adds that if a full-blown trade war materialises, it could cause the prices of goods to increase and interest rates — especially in the US — to rise faster than expected in the short term.

"If that happens, household purchasing power will go down, thus reducing the total imports of both countries. Global demand and trade flows will take a hit. Company earnings will be impacted, workers' wages will go down and the unemployment rate will climb," says Wang.

"As a result, the inflation rate will fall in the longer term, instead of rising, as the global economy enters a downward spiral. Central banks globally will then be expected to cut interest rates to get their country's economy back on track."

The key risk of a full-blown trade war is only a miscalculation, says Menon. "This happens when emotions, rather than rationality, take control of the decision-making process when the US or China pushes too far with trade measures," he adds.

"Xi is one of the strongest leaders China has seen in a long time and while he is a pragmatist, he is not someone Trump or the US can push around."

Wang concurs. "The key risk is a miscalculation. It is like bargaining in the market. You put the highest price and I put the lowest. We want to strike something in the middle. However, if they miscalculate the threshold they could reach, such as bargaining too much or misreading certain signals, what could be triggered is hard to say. We are closely monitoring the situation," he says.

HNWI population growth expected to accelerate

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Although it has traditionally had a client base of older HNWIs, the banking group has been working to attract Malaysia's newly affluent business owners.

Thanks to Southeast Asia's growth story over the last 10 years, new millionaires have been minted at a very high rate across the region, says Lim. The Capgemini Asia-Pacific Wealth Report 2017, released last November, shows that Asia-Pacific led the world in terms of HNWI population in 2016.

"These new millionaires came into their wealth through business success. They are relatively young business owners in their forties and are now looking to diversify their net worth away from their businesses," says Lim.

However, the report found that Malaysia's HNWI population growth rate for 2015/16 was among the lowest in the region. "This comes down to currency depreciation. Given that the ringgit is now strengthening, I expect the HNWI population growth rate in Malaysia to accelerate soon," says Lim.

OCBC Bank Malaysia's high-net-worth clientele largely fall into three groups — those who are very confident of managing their net worth and investments alone, those who want active control over their assets and investments but still desire the advice and opinions of a wealth adviser, and those who are almost completely dependent on the expertise of OCBC's wealth management team.

"I would say that 90% of our clientele fall in the middle of this spectrum. I do see a small shift towards greater independence, although considering the amount of money involved at this level, clients will always prefer face-to-face interaction," says Lim.

As part of its strategy to capture a greater share of the private wealth market, the bank introduced its Premier Private Client (PPC) service early last month. This end-to-end advisory service is for clients with at least RM3 million under management. While the bank has been serving this segment for a long time, this is its first standalone offering.

"The PPC proposition is that we are able to assist high-net-worth clients with their personal, familial and business banking needs. PPC clients have access to a team of specialists dedicated to servicing clients across all three categories," says Lim.

"PPC also provides services that help clients maintain their lifestyles and keep their families secure. There is a range of wealth management solutions to take advantage of, including insurance services, investment advisory and management, as well as various legacy planning and trust services. For businesses, our range of services include cash management, trade facilities and business lending. All these services are available to the client under one roof."

What sets PPC apart from other services in the market is that it works seamlessly across the group's retail banking, commercial banking, asset management, wealth planning and insurance divisions. "All these divisions have the combined objective of servicing the client. The seamlessness is not common among many banks, but it is very much a theme for us with PPC," says Lim. E