

GLOBAL ECONOMY

# Risk of a trade war not over

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Investors should keep a close watch on trade tensions between the US and China in the months ahead as there is still a possibility it could escalate into a trade war and affect key sectors like automotive and steel.

To prepare for that eventuality, fund managers advise investors not to be overly exposed to companies that rely on global trade and to allocate their investments to domestic-related themes instead.

The most prominent risk that will trigger a trade war would be US President Donald Trump's failure to pass his major domestic bills, says Amundi Hong Kong Ltd chief economist for Asia ex-Japan Mo Ji.

"This will be the tipping point. If Trump can't pass his major bills, his administration may turn on China. He might issue a presidential executive order that may trigger a trade war, such as anti-dumping [duties] on specific sectors, including automotive and steel. They could be very tough on the terms, which could cause uncertainty for the international community," she says.

Simon Baptist, chief global economist and managing director of the Economist Intelligence Unit (EIU), says companies in the automotive and steel sectors globally could see higher volatility moving forward as a result of the uncertainty caused by Trump.

"Trump is eventually going to increase trade barriers and certain countries could be targeted, such as China and Mexico. You will probably see trade barriers being imposed for US automotive and steel, which are the sectors supporting the midwestern states. He might do it to make a political point," Baptist says.

After more than 100 days since Trump took office, the lack of real progress in implementing major domestic bills has seen him switching his focus to other plans on his election campaign agenda, such as reshaping US trade policy.

So far, Trump has seen one of two major bills hit a dead end. On March 25, the Republicans in the US House of Representatives withdrew a healthcare bill drafted to repeal and replace the Affordable Care Act, or Obamacare, due to a lack of support within the party.

The healthcare bill, together with the tax reform bill, is high on Trump's priority list. The US dollar weakened against the euro, yen and gold after the withdrawal of the bill. The US stock market also took a dip.

On March 31, he signed two executive orders to review and fight foreign trade "abuses" that have contributed to a US\$500 billion trade deficit. The orders require a study to be done by country and by product, and require officials to develop a better way to collect punitive anti-dumping and anti-subsidy duties on foreign goods.

OCBC Singapore vice-president and senior investment strategist Vasu Menon shares Ji's view, saying a trade war could be triggered if domestic politics do not play out according to Trump's expectations. Global growth would also be threatened.

Other risks, he says, include the FBI's investigation into Russian interference in the US election. "A trade war is a trump card [the president] can use to distract US citizens

from any difficult issues he runs into," he says.

Further tensions could arise between the leaders of the US and China, at least when they face each other at the negotiating table, says Baptist.

He says Trump and Chinese President Xi Jinping are now in a period of consolidating political power within their respective countries.

"Trump, a businessman without any political experience who became president, is trying hard to strengthen his position within the Republican Party. Xi, meanwhile, will be facing the 19th National Congress of the Communist Party of China in the second half of this year," he says.

The national congress is held every five years for the party's top-ranking members to elect the next president of the nation.

Meanwhile, the renminbi, which has been on a weakening trend since 2015, could be another potential risk to triggering a trade war, says Menon.

He says if the renminbi falls to a level much lower than what the markets are expecting, it will leave Trump with no choice but to initiate a trade war with China by imposing trade tariffs.

"We are looking at the renminbi weakening to 7.08 against the US dollar in the next 12 months. But if it has a drastic fall to, say, 7.5 against the US dollar, it might be the tipping point for Trump," Menon says. As at March 28, the renminbi was trading at 6.89 against the US dollar.

Apex Investment Services Bhd regional fund manager Gary Lim says the possibility of the renminbi weakening beyond market expectations could come from the cracks in China's financial system that are causing outflows from the country.

"It could happen. People have been wondering if the turnaround of China's economy is sustainable. There is high leverage and indebtedness within the Chinese corporates and economy. If the Chinese economy goes south and sees rising non-performing loans and more outflows [as a result], I don't think that would be acceptable to the Trump administration."

Should there be a trade war, Lim says equities, in particular Asian equities, would likely see a sell-off, given Asia's position as a supplier of goods to the US consumer and even capital goods for corporates.

"And we will see greater pressure on those countries that are seen as more open economies and highly trade dependent such as China, Hong Kong, South Korea and Taiwan in North Asia. In Asean, it will be Singapore and Malaysia. Export-oriented sectors will also experience greater selling pressure."

## NOT THE BASE CASE SCENARIO

However, as serious as it can be, a full-blown trade war between the US and China is not the base case scenario, says Ji.

While investors should keep a close watch on the risk of a trade war, which could cause turmoil in the global economy, they should not treat it as a base case scenario when it comes to strategising their investments.

"We view the chances of a trade war occurring as low. It is highly possible that China will not manipulate the

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## Consider South Korean banks

Apex Investment Services Bhd regional fund manager Gary Lim likes South Korean banks due to cultural changes in the country, which is one of the investment themes not tied to global trade issues.

In December last year, Park Geun-hye, the ex-president of South Korea, was impeached over a scandal in which she allegedly allowed her close friend Choi Soon-sil to extort money from big firms and channel it into a non-profit organisation she controlled.

In March this year, the Constitutional Court of Korea upheld parliament's impeachment decision, causing Park to lose her immunity against prosecution. She was then summoned by prosecutors to be questioned and could face a jail term.

Lee Jae-yong, the billionaire heir to Samsung, was also arrested as he was accused of bribing Choi, who allegedly colluded with Park, with US\$40 million to gain political favour and consolidate his influence within Samsung.

Lim says this incident shows the changing mindset of the South Koreans, who are more aligned to Western free-market values compared with Asia's controlled economy values.

These changes will benefit South Korean banks, which are now trading very cheaply, some as low as 0.4 times price-to-book value (P/BV).

"Under the country's controlled economy, the government supported big chaebols (large business conglomerates, typically family-owned) like Samsung, Hyundai and LG to grow into the big global companies they are today. To do so, South Korean banks provided loans under pressure and took orders from the government, even if some of the projects didn't make sense. Banks were also required to support these companies when they got into trouble. This was the strange relationship between the South Korean government, banks and chaebols. And this is part of the reason why the banks are trading at 0.4 times P/BV because no one believed their books.

"However, things changed last year. The most significant event was the impeachment of the president and the Samsung chairman being placed under investigation, and possibly facing a jail term. On the company side, you also see big companies such as Hanjin Shipping declaring bankruptcy, which is rare in South Korea. Usually the banks would be asked to bail out and support these companies. All these things point to the fact that the previous way of doing things is no longer deemed acceptable," he says.

Lim says rating agencies are likely to re-rate South Korean banks on the back of more reliable books and improved transparency.

"If you continue to throw good money after bad companies, your books are highly questionable. But if zombie companies are allowed to go bankrupt, it is due to rerating," he says.

More importantly, global trade issues do not affect this investment theme.

"Yes, if a trade war happens, South Korea will be ... affected. But people will soon realise that South Korean banks are doing better and have nothing to do with a trade war. The share prices could rebound faster," he says.

Lim

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- Menon



"We view the chances of a trade war occurring as low. It is highly possible that China will not manipulate the currency as that would hurt the country and global economy."  
- Ji

