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CIO Insights

Trading Opportunities amidst the Trade War

Unexpected Impacts of China's 2019 "Great Economic Stimulus"

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Summary

- China is responding quietly, but aggressively to President Trump's trade war negotiating strategies. China has amassed a new round of economic stimulus, combining fiscal, monetary and regulatory actions, to strengthen its economy and bolster its bargaining position.

- Though it is impossible to measure the aggregate value of all of China's fiscal moves over the past year precisely, Citi Private Bank estimates that it is the equivalent of half of what China did during the economic crisis of 2008-09.

- The timing, size and likely impact of this "Great Economic Stimulus" is under-appreciated in financial markets. We believe that China's recent policy actions are creating several tactical trading opportunities for investors.

- We would expect Chinese equities to rebound significantly, especially companies focused on their domestic market. We also expect that equities in Asian and other trade-impacted Emerging Markets will benefit from China's actions. Finally, Germany may also get an export-related benefit as corporate investment in upgrading plant and equipment is likely to accelerate. An extension of the negotiations or their resolution will underpin the rebound.

Trade War and the Art of War

There have been many references to Sun Tzu's Art of War in the Western press over the past year, giving credit to Trump for unpredictable negotiating tactics while exposing China's economic and political weaknesses. Another narrative is now being written. That story will be about Chinese preparedness, patience and positioning. China is responding to President Trump's negotiating strategies with several of their own, with a combination of monetary and fiscal stimulus, alongside adjustments to regulatory policy, to bolster its economy in the face of rising risks. We believe that China's recent policy actions are creating several tactical trading opportunities for investors. *"The art of war teaches us to rely not on the likelihood of the enemy not coming, but on our readiness to receive him."*

The State of the Trade War

Given that President Trump and President Xi Jinping are the generals in a trade war, let us consider their circumstances, tactics and current positioning.

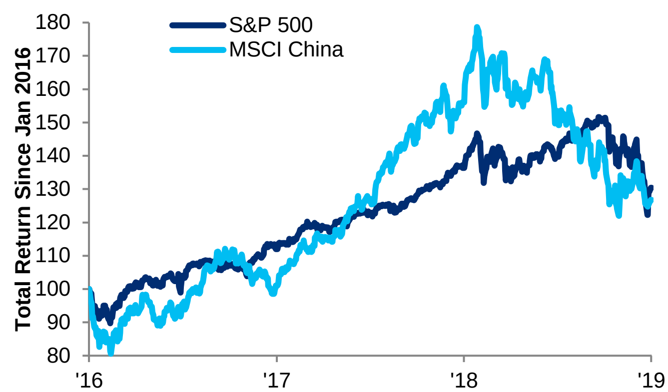
President Trump's team has devised a trade war strategy based on overwhelming force, threatening tariffs on a huge swath of Chinese imports ($250 billion, potentially more) if China does not change its ways. The President has amassed US and international public opinion in his favor, spotlighting longstanding grievances including the imbalance of trade (about $400 billion in goods), the theft of intellectual property, lack of access to Chinese markets and the "future threat" of China becoming the world's largest economy. The US has shown unpredictability in its trade war strategy. It has shown a willingness to inflict harm on the US economy to win, a tendency for the President to contradict his own negotiators and atypical negotiating tactics that include tweeting of how things are going in the negotiations, citing the weakness of China as a reason for China to conclude a deal. The US government has even seen the Justice Department target Huawei as a proxy for China citing security risks associated with the use of its technologies. *"China posts slowest economic numbers since 1990 due to U.S. trade tensions and new policies. Makes so much sense for China to finally do a Real Deal, and stop playing around!"*

At the outset of the trade war in March 2018, China appeared surprised and flat-footed. Its economy was slowing to a 2009 low pace while the US economy was accelerating to a 3% clip. In mid-2018, the Chinese had taken steps to constrain the shadow financing market, restricting capital to private businesses. By the end of 2018 and in the absence of stimulus, much of the data out of China indicated continued economic weakness with growth slowing to a 6.4% rate in the face of further trade sector weakness that could threaten world economic growth. Tim Cook declared that slowing growth in China was responsible for the Q42018 decline in Apple's iPhone sales, while auto sales within China plunged 12.7%.

The battlefield changed perceptibly by the end of January 2019. The US stock market had suffered a true meltdown in December 2018 based on fears of an impending global recession due, in some measure, to projections of a worst-case outcome in the trade war. The Democrats took over the House of Representatives and, in their first showdown with the President, proved unyielding to his demand for a border wall in Mexico. This led President Trump to concede defeat by reopening the government as air traffic, a major artery of the US economy, suffered ischemia. In short, he may have been fighting on too many fronts and had shown himself to be a one-dimensional warrior at home. *"The general who loses a battle makes but few calculations beforehand."*

Today, China and the US now appear equally vulnerable to a bad outcome in the trade war. The battlefield is more even and the consequences of a global recession are more readily understood. As a result, we have seen a resurgence in global stock markets that rationally believe that a benign outcome to the trade war is more likely than not. *"If it is to your advantage, make a forward move. If not, stay where you are."*

Figure 1: US and Chinese Equities since Jan 2016



Source: Factset as of February 17, 2019
Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

One can also see the leveling of the playing field in press headlines this weekend. President Trump is considering pushing back the March 1 deadline for a trade agreement with China given the ongoing negotiations and the complexities of the issues at hand. President Xi Jinping is also using the pomp and circumstance of a "Presidential Summit" as a means to delay the tariff deadline with both sides suggesting meeting locations, Sarah Huckabee Sanders offering up said Trump's Mar-a-Lago resort as China proposes the tropical island province of Hainan.

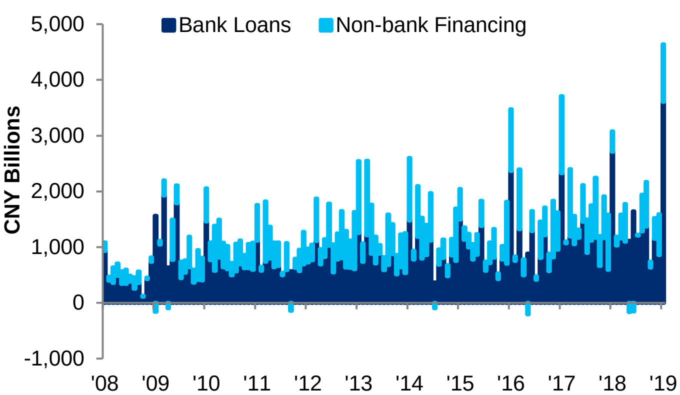
Defense as Offense: A Bolus of Chinese Stimulus

"It is best to keep one's own state intact; to crush the enemy's state is only second best."

As China has assessed its position versus the United States in the trade war, it has taken steps to strengthen its economy. In 2018, the Ministry of Finance began tax cuts and stepped up SOE fiscal support. 2.4 trillion renminbi in local government bonds were issued between July and September, double the amount in the previous quarter. Planned issuance in 2019 has accelerated with CNY 418bn issued in January, more than the entire 4Q.

On Friday, February 15, 2019, new PBOC data showing an increase of more than CNY 4.6 trillion (US$1.05tn) in aggregate financing was made in January, of which 3.6 trillion were in bank loans, the largest monthly figures since this data has been reported.

Figure 2: China Aggregate Financing Monthly Flows



Source: PBOC, as of Jan 2019

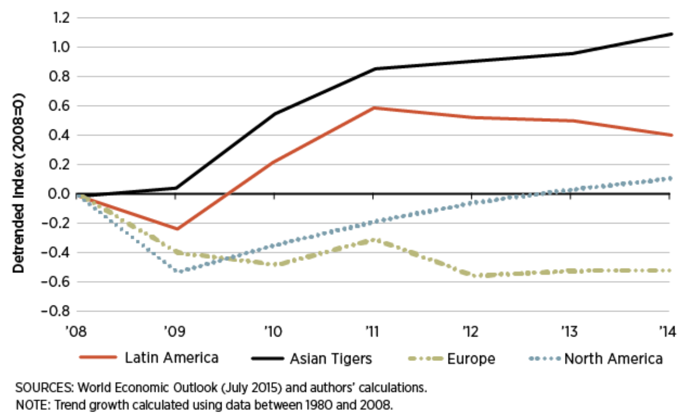
All of this follows five cuts to bank reserve requirements by the central bank to free up more funds for lending to vulnerable smaller firms.

One can expect further cuts in business taxes and fees in 2019, as well as additional central and local government bond issuance to fund key projects and to mitigate credit risk.

Though it is impossible to measure the aggregate value of all of China's fiscal moves over the past year precisely, Citi Private Bank estimates that it is the equivalent of half of what China did during the economic crisis of 2008-09. This is significant and is likely to have material domestic, regional and emerging market spillover benefits. And while there are inherent risks for China, including expanding the amount of unrecoverable debt as well as increasing the likelihood of wasteful spending – both of which China was seeking to reign in – underpinning the sustained growth of the industrial and consumer economies took precedence.

To illustrate the historical effectiveness of China's moves during the Great Recession as a parallel, consider this relative GDP performance illustration by the Federal Reserve Bank of St. Louis, *Recovery from the Great Recession Has Varied Around the World* (October 2015). Note: China and Japan are included in the Asian Tigers. According to the IMF, China represented 12 percent of global output in 2008 and about 50 percent of global growth during the Great Recession.

Figure 3: GDP Growth by Region



Source: Federal Reserve Bank of St. Louis, *Recovery from the Great Recession has Varied around the World, Oct 2015*

Looking back at other periods when China expanded credit (including '13 and '16) their impact was limited to a year or so and followed by tightening. We believe the combination of policies that comprise the current stimulus are broader and likely deeper. Furthermore, we are at an earlier stage of policy impact given the lack of trade war resolution.

The Trading Opportunities

The recent and significant fiscal measures taken by China in the face of the trade war are, in our view, underappreciated by financial markets. China's actions are *not* set against the backdrop of a major worldwide recession, but rather against a backdrop of moderating global growth. Thus, the impact of this stimulus might be greater than expected.

In the event that Trump and Xi set aside the majority of immediate trade issues for future negotiation, developing some areas of agreement by March 1st and a timeline for future negotiations, we would expect Chinese equities to rebound significantly, as they have been more damaged by trade-related valuation declines. This view extends to Chinese companies focused on their domestic market as

China has spent a longer period than the US gripped by fears of a slowdown.

In the event that further tariffs go into effect on March 1st, the Chinese Stimulus provides some cushion to its impact on their economy and lengthens the time China can negotiate. By contrast, absent further fiscal stimulus in the US, the tariffs may more negatively impact the US and the West on a relative basis. Thus, we see Chinese Stimulus as a means toward a negotiated settlement in most scenarios. *"There is no instance of a nation benefitting from prolonged warfare."*

Looking back at Chinese, Asian and Emerging Market equity performance over the past twelve months, we note that trade sensitive equities were most negatively impacted by the US-led trade war. We see the potential for the Chinese stimulus to bolster trade-linked emerging markets equities. Given a benign US interest rate environment and a weakening USD, these effects could be particularly strong assuming that US growth does not decelerate (See details in "Goldilocks or a New Growth Scare"). The Fed's 2015 article provides some insights into regional GDP growth after stimulus:

Figure 4: Aggregate Cumulative GDP Growth (08-14)

Region	2008-09	2009-14
Africa	-2%	53%
Asia (excl. Tigers, Japan, China)	4%	54%
Asian Tigers (plus Japan and China)	5%	48%
Eastern Europe	-21%	38%
Europe (excl. Eastern Europe)	-10%	10%
Latin America	-8%	42%
Middle East	-11%	48%
North America	-3%	22%
Oceana	-6%	47%

Source: Federal Reserve Bank of St. Louis, *Recovery from the Great Recession has varied around the World, Oct 2015*
Note: China and Japan are included among the Asia Tigers to separate them from the smaller economies in Asia. The "Asian Tigers" are Hong Kong, Singapore, South Korea, and Taiwan.

While there is a risk that the US will shift its trade battle to Europe at some point, the Chinese Stimulus may also directly help Germany, one of two country markets we have left overweight in Europe given the strong linkages to Chinese growth (please see January Quadrant for discussion).

Finally, given our highest probability view that US macro policy overall will need to shift toward sustaining the expansion, the likely combination of low US rates and Chinese stimulus could extend the global equity recovery after an already generous rally.

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Asset Allocation Definitions

Asset classes	Benchmarked against
Global equities	MSCI All Country World Index, which represents 48 developed and emerging equity markets. Index components are weighted by market capitalization.
Global bonds	Bloomberg Barclays Capital Multiverse (Hedged) Index, which contains the government -related portion of the Multiverse Index, and accounts for approximately 14% of the larger index.
Hedge funds	HFRX Global Hedge Fund Index, which is designed to be representative of the overall composition of the hedge fund universe. It comprises all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage and relative value arbitrage. The strategies are asset-weighted based on the distribution of assets in the hedge fund industry.
Commodities	Dow Jones-UBS Commodity Index, which is composed of futures contracts on physical commodities traded on US exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). The major commodity sectors are represented including energy, petroleum, precious metals, industrial metals, grains, livestock, softs, agriculture and ex-energy. The Thomson Reuters / Core Commodity Index is designed to provide timely and accurate representation of a long-only, broadly diversified investment in commodities through a transparent and disciplined calculation methodology.
Cash	Three-month LIBOR, which is the interest rates that banks charge each other in the international inter-bank market for three-month loans (usually denominated in Eurodollars).

Equities	
Developed market large cap	MSCI World Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the equity market performance of the large cap stocks in 23 developed markets. Large cap is defined as stocks representing roughly 70% of each market's capitalization.
All Country Ex US	MSCI All Country ex US, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the equity market performance of the large cap stocks in all countries excluding the US.
US	Standard & Poor's 500 Index, which is a capitalization-weighted index that includes a representative sample of 500 leading companies in leading industries of the US economy. Although the S&P 500 focuses on the large cap segment of the market, with over 80% coverage of US equities, it is also an ideal proxy for the total market.
Europe ex UK	MSCI Europe ex UK Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in each of Europe's developed markets, except for the UK
UK	MSCI UK Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in the UK
Japan	MSCI Japan Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in Japan.
Asia Pacific ex Japan	MSCI Asia Pacific ex Japan Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the performance of large cap stocks in Australia, Hong Kong, New Zealand and Singapore.
Developed market small and mid-cap (SMID)	MSCI World Small Cap Index, which is a capitalization-weighted index that measures small cap stock performance in 23 developed equity markets.
Emerging market	MSCI Emerging Markets Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure equity market performance of 22 emerging markets.

Bonds	
Developed sovereign	Citi World Government Bond Index (WGBI), which consists of the major global investment grade government bond markets and is composed of sovereign debt, denominated in the domestic currency. To join the WGBI, the market must satisfy size, credit and barriers-to-entry requirements. In order to ensure that the WGBI remains an investment grade benchmark, a minimum credit quality of BBB–/Baa3 by either S&P or Moody's is imposed. The index is rebalanced monthly.
Emerging sovereign	Citi Emerging Market Sovereign Bond Index (ESBI), which includes Brady bonds and US dollar -denominated emerging market sovereign debt issued in the global, Yankee and Eurodollar markets, excluding loans. It is composed of debt in Africa, Asia, Europe and Latin America. We classify an emerging market as a sovereign with a maximum foreign debt rating of BBB+/Baa1 by S&P or Moody's. Defaulted issues are excluded.
Supranationals	Citi World Broad Investment Grade Index (WBIG)—Government Related, which is a subsector of the WBIG. The index includes fixed rate investment grade agency, supranational and regional government debt, denominated in the domestic currency. The index is rebalanced monthly.
Corporate investment grade	Citi World Broad Investment Grade Index (WBIG)—Corporate, which is a subsector of the WBIG. The index includes fixed rate global investment grade corporate debt within the finance, industrial and utility sectors, denominated in the domestic currency. The index is rebalanced monthly.

Corporate high yield	Bloomberg Barclays Global High Yield Corporate Index. Provides a broad-based measure of the global high yield fixed income markets. It is also a component of the Multiverse Index and the Global Aggregate Index.
Securitized	Citi World Broad Investment Grade Index (WBIG)—Securitized, which is a subsector of the WBIG. The index includes global investment grade collateralized debt denominated in the domestic currency, including mortgage -backed securities, covered bonds (Pfandbriefe) and asset-backed securities. The index is rebalanced monthly. Moody's Baa Corporate Bond Index is an investment bond index that tracks the performance of all bonds given a Baa rating by Moody's Investors Service. BAML US Corporate index (Bank of America Merrill Lynch) tracks the performance of US dollar denominated investment grade rated corporate debt publically issued in the US domestic market.

Other miscellaneous definitions	
Asset Backed Securities (ABS)	A security whose income payments and hence value are derived from and collateralized (or "backed") by a specified pool of underlying assets such as consumer credit card debt or auto loans.
Commercial Mortgage Backed Securities (CMBS)	Commercial mortgage-backed securities (CMBS) are a type of mortgage-backed security that is secured by mortgages on commercial properties, instead of residential real estate.
High Yield Corporate Bonds (HY)	High yield corporate bonds are bonds with a credit rating less than BBB- (S&P) or Baa3 (Moody’s), and are debt securities issued by a corporation and sold to investors. The backing for the bond is usually the payment ability of the company, which is typically money to be earned from future operations.
Investment Grade Corporate Bonds (IG)	Investment grade corporate bonds are bonds with a credit rating equal to or above BBB- (S&P) or Baa3 (Moody’s), and are debt securities issued by a corporation and sold to investors. The backing for the bond is usually the payment ability of the company, which is typically money to be earned from future operations.

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Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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Past performance is no guarantee of future results.

International investing entails greater risk, as well as greater potential rewards compared to US investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economics.

Investing in smaller companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity.

Factors affecting commodities generally, index components composed of futures contracts on nickel or copper, which are industrial metals, may be subject to a number of additional factors specific to industrial metals that might cause price volatility. These include changes in the level of industrial activity using industrial metals (including the availability of substitutes such as manmade or synthetic substitutes); disruptions in the supply chain, from mining to storage to smelting or refining; adjustments to inventory; variations in production costs, including storage, labor and energy costs; costs associated with regulatory compliance, including environmental regulations; and changes in industrial, government and consumer demand, both in individual consuming nations and internationally. Index components concentrated in futures contracts on agricultural products, including grains, may be subject to a number of additional factors specific to agricultural products that might cause price volatility. These include weather conditions, including floods, drought and freezing conditions; changes in government policies; planting decisions; and changes in demand for agricultural products, both with end users and as inputs into various industries.

The information contained herein is not intended to be an exhaustive discussion of the strategies or concepts mentioned herein or tax or legal advice. Readers interested in the strategies or concepts should consult their tax, legal, or other advisors, as appropriate.

Diversification does not guarantee a profit or protect against loss. Different asset classes present different risks.