

OP-ED ARTICLE
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OLIVER FRATZSCHER
EM LEADERS



2017 – MOMENTS OF TRUTH FOR AMERICA AND CHINA

“Any American policy must come urgently to grips with the reality of China”, wrote Richard Nixon 50 years ago ... and again a rendez-vous with reality both for America and for China is in our sights. The new relationship between America and China will define global economic and political prospects for 2017 and beyond. American foreign policy has evolved from the objective to integrate China into the family of nations to more recent efforts to contain China’s mighty economic and political power, although China is already struggling to manage its credit bubble and bleeding of foreign reserves.

History will probably record the past quarter century of Chinese growth as most impressive economic transformation. The previous experience of the Asian tigers had illustrated benefits of export-driven growth, and China’s brilliant economic policies realized enormous progress in poverty alleviation with industrialization and urbanization and leapfrogging into a middle-income \$10 trn economy. With the help of an undervalued exchange rate, aggressive industrial policies, and reverse-engineering of foreign technologies, China created a massive export surplus and recycled its earnings into foreign investments and US treasuries. Meanwhile, technological progress and Chinese competition relocated many manufacturing jobs from industrialized countries into China. Today, this process has mostly run its course and will be very difficult to reverse.

The new US administration has many priorities for 2017, aiming to finalize a comprehensive tax reform, to create new infrastructure investments, to address regulatory reforms, and to shift from monetary to fiscal expansion. The success of all these objectives will critically depend on the shape of America’s new trade and industrial policies, most of all on its new trade relationship with China. A constructive relationship would invite new Chinese investments in US infrastructure and continued Chinese purchases of US treasuries would allow a larger fiscal expansion. On the other hand, protracted trade conflicts could undermine these prospects and lead to recessions on both sides of the Pacific. Even in the absence of trade conflicts, both the US and China are facing homemade problems which could soon end the already extended eight-year expansions.

Rational economists prefer collaborative solutions with an optimistic bent. Clearly, US trade policies will become more assertive, just as certain real estate developers are known to have been assertive with their bankers – but probably there will be a deal with the Chinese banker, because it would be too risky to imagine a US chapter-11 in the arena of trade. That deal would likely involve voluntary Chinese export restrictions and additional Chinese investments in US infrastructure projects. But that deal would likely also trigger more Chinese nationalism and assertiveness across Asia given the political needs for the upcoming national congress in late 2017. Chinese political goals may be realized in return for modest US trade concessions.

Assuming this grand bargain between America and China succeeds, then similar deals can be envisaged with other trading partners: Europe’s trade surplus is not even half as big as the Chinese problem; Japan is just one fifth of the problem, and NAFTA with Mexico and Canada combined accounts for only a quarter of the Chinese trade imbalance (chart 1). If the upcoming trade negotiations succeed in a collaborative approach, it would be more likely to attract foreign investment into the US and to support further growth of US exports. An envisaged fiscal expansion and innovative industrial policy might then lead to stronger growth, higher interest rates and a modest appreciation of the US dollar.

However, the imposition of new border adjustment taxes would be destructive because it would raise prices of many US products that rely on imports and would further strengthen the dollar, making US exports less competitive. US jobs would be lost if Brazilian soybeans, Asian cars, and European aircraft replace US exports in a tit-for-tat response. The great danger is that unilateral trade restrictions could start a race to the bottom, which would lead to fights at the WTO, while foreign investment in envisaged US infrastructure projects would become more unlikely.

The first big assumption for 2017 then is the success of **new trade deals**. The second big assumption would be the continuing growth of the **Chinese credit bubble**, as political imperative for the upcoming national congress. However, with prospects of weaker exports there would be additional need to stimulate domestic consumption and real estate investment, combined with renewed capital controls to arrest the bleeding of foreign reserves. Credit creation in China is already at record historical levels today, well beyond the largest US credit creation until 2007 (chart 2), and may reach its limits soon. In the meantime, ample liquidity will likely be forced to remain within China and may propel asset inflation in the year ahead, especially in the financial sector and in domestic industries, while the RMB would be better supported and foreign reserves would stabilize.

What are the prospects for financial markets in 2017 under these two sanguine assumptions? Three global themes are standing out:

+ first, **volatility** is likely going to increase given the multitude of political and financial risks, and commodities will likely benefit from higher risks: Iran, North Korea, and Venezuela crises could all spark oil prices to rise, while Chinese and US infrastructure spending could support commodities, which would bode well for emerging markets.

+ second, the handover from quantitative easing (QE) to **fiscal expansion** (FE) will likely materialize in the US and possibly also in Europe and Japan. The exit from negative rates by the ECB would mostly benefit the financial sector and support bank stocks, which have reached historic lows across Europe, especially in Italy, where positive election results could trigger a repricing. Positive growth effects should dominate some dampening from higher interest rates and in aggregate would also support emerging markets.

+ third, **relative valuations** in emerging markets versus US equities have reached extreme levels: JP Morgan estimates that US equities are two standard deviations expensive as compared to ten-year averages whereas EM equities are one standard deviation cheap, while earnings revisions have turned positive. GMO projects that real returns over the next seven years for EM will exceed those of US equities by 7% annually, emphasizing mean-reversion rather than trend-extrapolation. This would bode well for undervalued emerging markets with improving growth, especially Russia and Brazil.

How can prospects for emerging markets be compared analytically? Besides qualitative assessments on political and financial risks, four indicators are compared (chart 3):

+ **Equity market valuations** (four measures, ten-year history) are showing that Russia remains by far the most undervalued market, having good momentum after 55% returns in 2016, also Brazil remains two stdev cheap after its 66% run in 2016.

+ **FX valuations** (real effective exchange rates, ten-year history) for EM currencies remain two stdev undervalued whereas the US dollar is currently overvalued by at least two stdev. Mexico and Turkey have the cheapest currencies, reflecting acute political risks, whereas Taiwan and India have somewhat overvalued currencies. China's currency appears to be fairly valued, assuming that capital flows are stabilizing. Brazil and Russia could see some further appreciation of their currencies in 2017.

+ **Real interest rates** have been severely compressed in most emerging markets and are expected to widen as developed markets' rates increase. Real rates still exceed 4% in Mexico and Indonesia, which appear attractive given moderating inflation. A slow increase of real rates across emerging markets is expected in 2017 following the expected Fed rate increases.

+ Momentum of **capital flows** (institutional investors, monthly data) is especially strong in India (5% above index) and Brazil (2% above index) and are especially weak in China (5% below index) reflecting ongoing capital outflows. Further downside can be expected in Turkey and Mexico which currently are neutral to the index although macro and political risks could aggravate in the year ahead.

The toughest call for 2017 will be markets in China. Odds are somewhat positive that markets could rally with excess liquidity and additional capital controls, pressing domestic savings increasingly into real estate and equity markets, where banks could be surprise winners from currently very low valuations. It remains an open question whether any Chinese rally could be sustained when credit growth is moderated next year. On the other hand, strong commodity prices and low valuations bode well for further gains in Russian and Brazilian equity markets.

The sanguine perspective for 2017 is obviously based on two assumptions of constructive US trade relations and continued credit expansion in China. If these assumptions fail to hold, global markets may experience massive corrections even beyond 2009 lows. Pricing of liquidity, credit and market risks might need to reflect these tail risks while America and China hopefully master their moments of truth in the year ahead.

Chart 1
US Trade Deficit (2015): \$736 bn or 4% of GDP

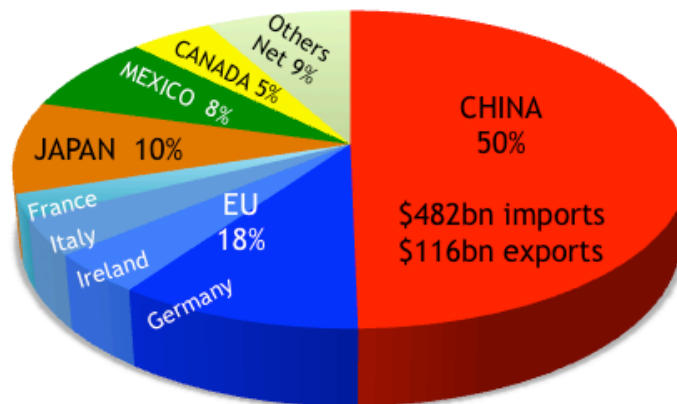
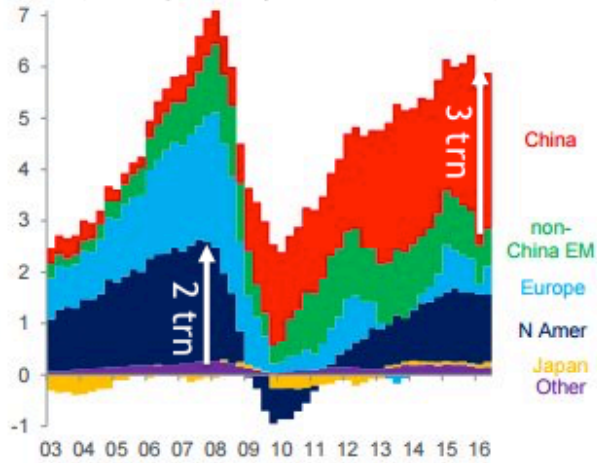


Chart 2
Private Sector Credit Creation
US versus Chinese bubbles
(rolling four quarters, US\$ trn)

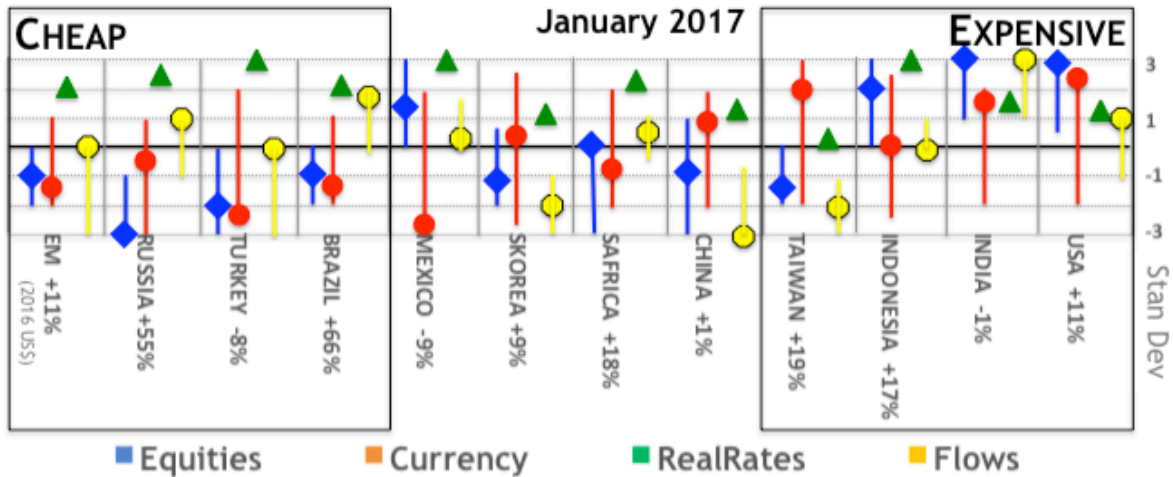


Chinese Bank Loans:
doubled since 2010 > 170% GDP
total social financing > 210% GDP

Sources: BIS, Citi Research

Chart 3

Valuations in Emerging Markets



Sources: Bloomberg, JP Morgan, Morgan Stanley, EM Leaders