Asia: Cutting Through the Noise Series

Issue I – Geopolitics, Protectionism, and Trade **July 2017**

Key Takeaways:

- The US is unlikely to engage in a full-blown trade war as the country's manufacturing-related job losses are largely the by-product of the natural evolution of a developed economy with relatively high-income levels.
- The sheer scale and speed of China's capacity ramp-ups have made the country an obvious target for political rhetoric.
- Supply-side consolidation in China will proceed at a gradual pace in the absence of market-driven mechanisms like bankruptcy.
- Despite the ongoing political posturing, technology is a key structural driver of manufacturing job losses—and old-economy industries in both the US and China are currently experiencing disruptions.
- Industries or companies insulated from regulations and those that embrace change will emerge as the big winners in the current disruptive era.

Asia in the Age of Protectionism

Threats to free trade are deepening worries over the outlook for Asia—but just how vulnerable is the region?

Since the United Kingdom surprised the world by voting to exit the European Union (EU), global equity markets have absorbed a string of unexpected news events, most notably the US election victory of Donald Trump. But despite negative predictions by commentators—amid rising anti-globalization sentiment, protectionist rhetoric, and terrorism concerns—stocks in both developed markets (DMs) and emerging markets (EMs) have generated strong returns over the past 12 months. Still, global markets are far from settled, and investors and pundits are busily trying to gauge the gap between campaign pledges and political reality. As far as Asia is concerned, President Trump's embrace of an "America First" agenda and withdrawal from the Trans-Pacific Partnership (TPP) have raised the specter of growing trade barriers and therefore heightened risks surrounding the region's equities.

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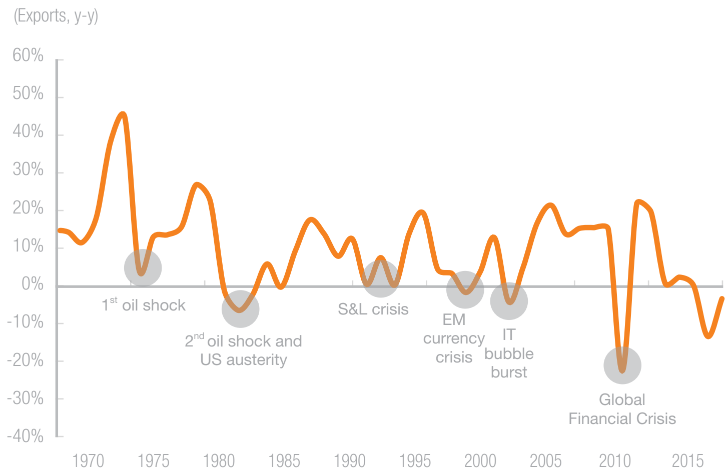
Global Trade Volume Bouncing From Crisis Level

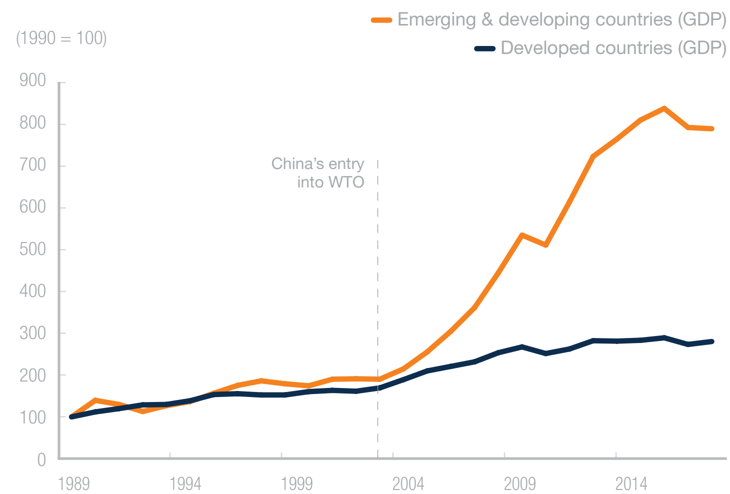
Source: World Trade Organization (2017)



Taking a leaf out of the playbook used by Japan and Korea during their early industrialization stages, China has heavily prioritized growth over profits. Indeed, while many industries and companies in mainland China, particularly those in the old economy, have experienced solid gains, this growth often came at the expense of profits. It is important to note that, in the cases of Japan and Korea, the strategy of establishing market share before targeting profits was supported by sustained economic growth. Japanese and Korean companies expanded capacity at a time when global aggregate demand was stable and supply was disciplined and orderly. On the other hand, since 2009, China has continued to build out large-scale industrial capacity despite a slowdown in global growth.

Global Demand Slowing

Source: International Monetary Fund (2017)

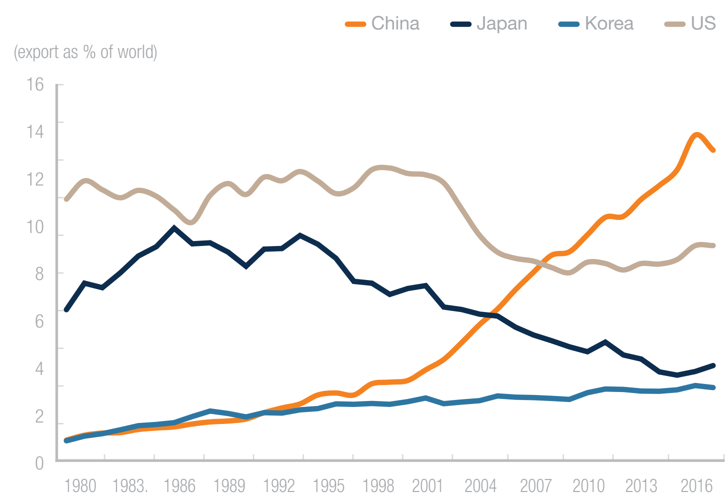


The Ascent of China

Even before the global financial crisis of 2009, trade protectionism and anti-globalization were evident in many parts of the world, driven in part by the remarkable rise of Asian manufacturing. Asia has undoubtedly been one of the greatest beneficiaries of globalization and free trade, with Japan leading the way in the 1970s, and other countries, including Korea in the 1990s, following suit. In 2001, China entered the World Trade Organization (WTO) and took the game to an entirely new level.

China Disturbs World Equilibrium

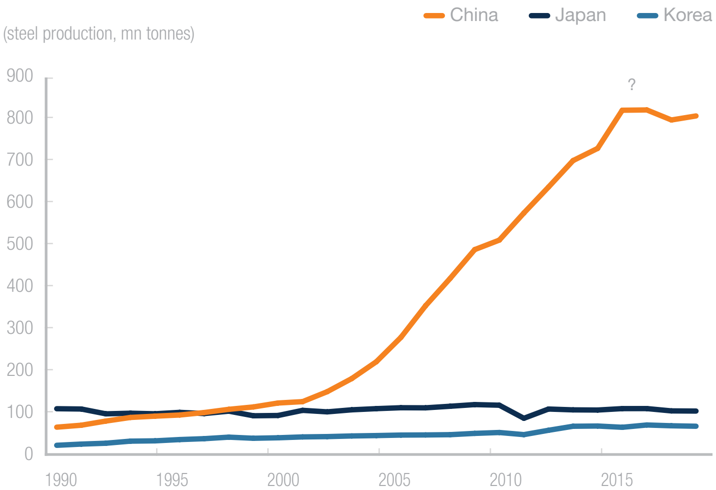
Source: Korea International Trade Association (2017)



After decades of tremendous expansion, China's capacity in most industries now surpasses the available supply of Korea and Japan combined. Thus far, attempts to address structural imbalances arising from China's transformation into the so-called world's factory have been measured, with policy makers attempting to nudge the economy toward equilibrium and shore up the long-term health of the local banking system without dramatically compromising growth and social stability. In other words, China's political focus on jobs and wages is limiting the pace of consolidation, leading to nationalist policies and ongoing trade tensions between the US and China.

But Global Supply Will Not Adjust

Source: World Steel Association (2017)



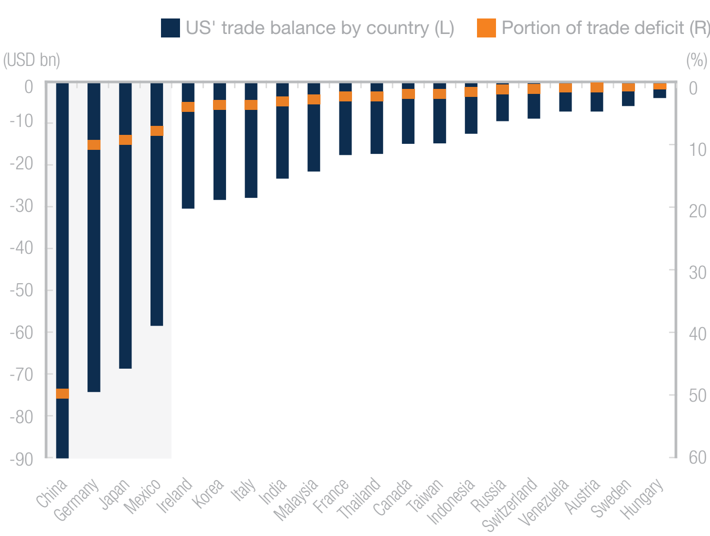
Manufacturing in the US Economy

President Trump has blamed China for the job losses of the American working class. But it is important to note that the US has been showing steady decreases in manufacturing and union activities since the 1950s, well before China entered the WTO and global trade channels. Thus, while China is viewed by some as the culprit behind the US manufacturing decline; it is more accurately the facilitator that has accelerated the process. Our long-held view is that Chinese exporters have a greater impact on low-cost producers from Korea and the rest of Asia than on American factories.

The scrutiny on China is due to the sheer size of its trade surplus and the unprecedented speed of its emergence. However, other exporting nations, such as Taiwan, have much greater foreign exchange reserves and trade surpluses relative to their respective gross domestic product (GDP) levels. Rising tensions between the US and its trading partners, China in particular, are likely to persist in the coming years against a backdrop of deepening populism and anti-trade sentiment caused by stagnant growth and widening income inequality.

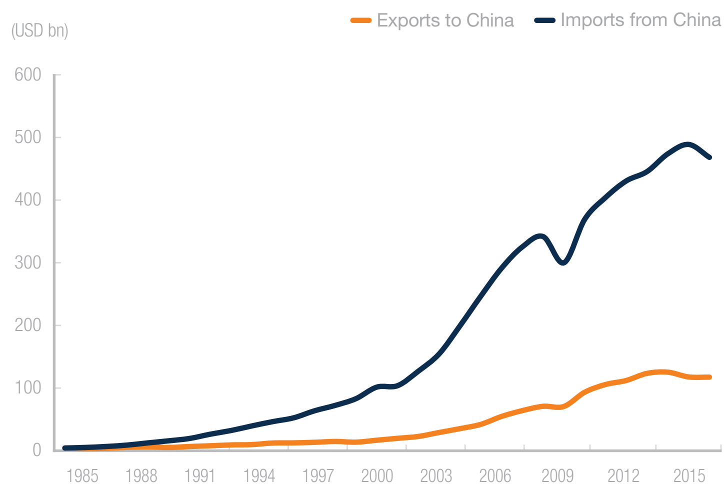
Trump's Trade War "Hit List"

Source: Thomson Reuters, Mirae Asset Daewoo Research (2017)



Bilateral US-China Trade Flows

Source: US Census (2017)



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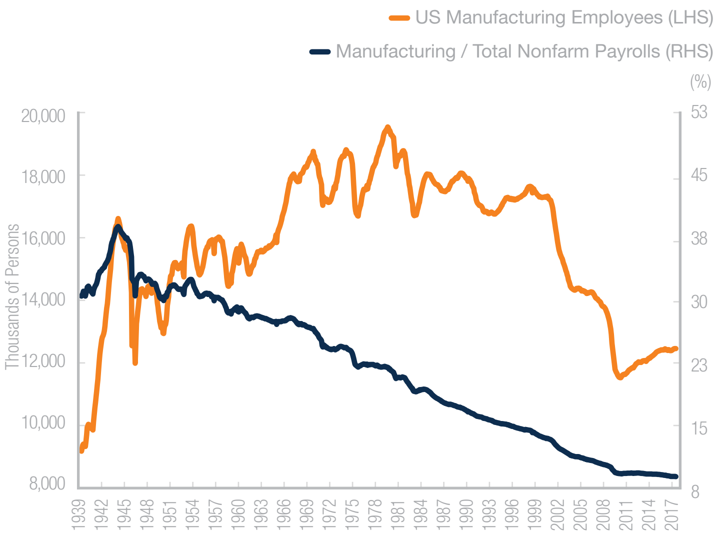
The Decline of US Manufacturing

Source: Federal Reserve Economic Data (2017)



Technology: A Gift and a Curse

On top of the current policy issues, job losses stemming from technological developments are on the rise. While this has traditionally been a DM concern, automation and robotics adoption rates have recently started to increase rapidly all around the world—even in China—amid slowing growth and the rise of advanced technologies (e.g., artificial intelligence). Meanwhile, policies geared to stop or slow the contribution of technology to productivity or the bottom line will mean lower efficiency and diminished profits. For both the US and China, trade protectionism in such an environment is not only counterproductive, but could ultimately lead to higher costs and thus cost-push inflation. In an era of rising trade barriers and nationalism, industries or companies insulated from profit-hindering regulations and inefficiencies will excel. In our view, embracing technology to reinvent existing business models offers an effective way for industry players to emerge as winners under the current circumstances.

A Shifting Landscape

Amid increasingly protectionist rhetoric from the US, we see one potential silver lining: There may be an opportunity for China to assume leadership within Asia, first economically and, later, politically. With the TPP in disarray, China's promotion of the Regional Comprehensive Economic Partnership (RCEP) may set off a paradigm shift in which globalization is replaced by "regionalization." This possible step-change in the global landscape would highlight the rising impact of EMs in the context of world trade.

From Globalization to Regionalization?

Source: Mirae Asset Daewoo (2017)

Regional Comprehensive Economic Partnership (RCEP)	GDP 2015 (USD bn)
China	11,007.70
Japan	4,383.10
India	2,095.40
South Korea	1,377.90
Australia	1,339.10
Indonesia	861.9
Thailand	395.2
Malaysia	296.3
Singapore	292.8
Philippines	292.5
Vietnam	193.6
New Zealand	173.8
Myanmar	62.6
Cambodia	18.1
Brunei	12.9
Laos	12.4
Total	**22,815.30**

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