THE US-CHINA TRADE WAR

How Did We Get Here and What's at Stake?

The US-China "trade war" has attracted a significant amount of attention among investors for the last couple of months, with a staggering amount of information published on the topic. The relationship between the US and China is very complicated, so for our purposes, we will focus on the issue of the trade deficit.

GENERAL US-CHINA RELATIONSHIP

Before we can discuss the issue of the trade deficit, it is important for investors to first understand the type of relationship the US has with China, as it is the background for everything that is happening.

China knows that the pace at which its economy has been growing for the last 20 years is mostly owed to US consumers, and at this point, the Chinese still need Americans to continue buying and for the US economy to stay strong.

At the same time, the US —and especially the US dollar — is the largest obstacle in China's way to becoming the dominant world superpower it aspires to be.

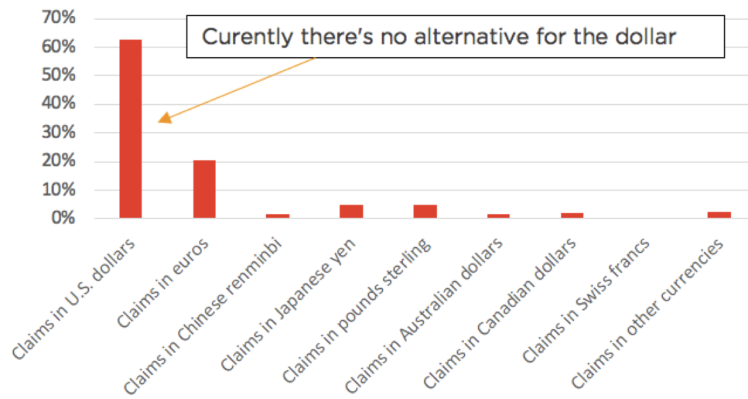
For the last couple of years, China has actively been targeting the dollar as a world reserve currency. China had conversations with central banks about holding the yuan as part of their reserves and suggested an alternative to the US dollar in the shape of a multi-currency solution.

What we believe finally caused the US to react is the launch of local future contracts for oil priced in yuan in March 2018. Prior to the launch, China tried to build international cooperation in the oil industry to start trading these futures. The idea is to shift the volume of trade from the US dollar to the Chinese yuan while also lowering the need for China to hold dollars for oil purchases, but what's more important is it will give China the ability to print yuan for oil. China intends to launch additional futures contracts on other major commodities.

This could have significant and severe consequences for the US economy. Suddenly the US deficit will matter a lot more than it does today. (There are also positives that, in the long run, could be very good developments for the US economy.)

Currently, as seen in the table below, the dollar dominates the reserve holdings of central banks:

RESERVES BY CURENCIES Q1 2018



Source: IMF, OFW

TRADE FRICTIONS - NOT A SURPRISE

To start, we need to remember that before being elected, President Trump promised he would confront China about their questionable trade and currency practices.

In addition, the President's trade advisor, Peter Navarro, has written a number of books including: *Confronting the Dragon, The Coming China Wars, Crouching Tiger and Death by China*, giving us a clear indication of his views on China's threat to the US.

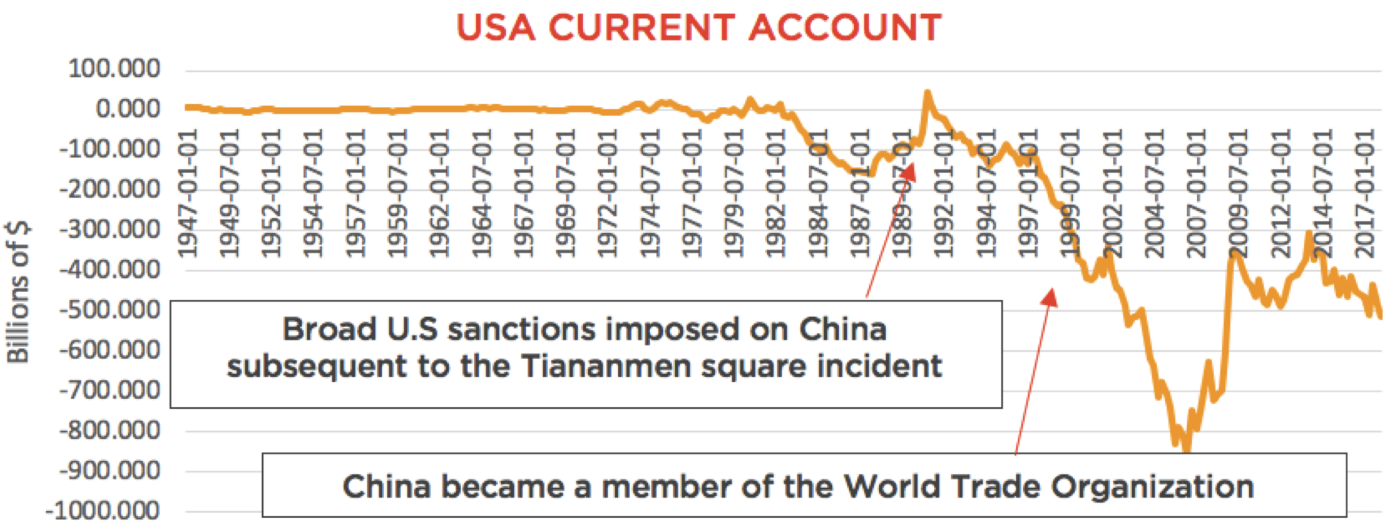
WHAT DOES IT MEAN FOR CHINA?

As part of negations to reduce the US trade deficit with China, President Trump imposed 25% tariffs on $34 billion of Chinese imports in July and on an additional $16 billion last month. Recently, the President imposed additional tariffs on $200 billion of Chinese imports, a step that escalates the situation.

What most investors fail to understand is that China's amazing growth has been largely financed by the huge $4.7 trillion trade surplus with the US between 1990 and 2017.

This cumulative trade surplus increases each year, and that Chinese annual trade surplus (the counterpoint to our own trade deficit with China) continues to be a major growth-driver for them.

OMNIA FAMILY WEALTH



Source: US Census Bureau, OFW

CHINA'S ECONOMIC MODEL

China's economy grew and transformed significantly in the last 20 years, but their economy is still very fragile. As it is still driven primarily by exports, it reminds us of Japan's economy and exports boom in 1989. We know how that ended. China's economic model is built on three main elements: debt, exports and investments. There's a tight relationship between its debt and imports as explained later.

HOW DOES CHINA KEEP ITS CURRENCY LOW VERSUS THE US DOLLAR?

China's main growth engine is exporting goods, and for that reason, they have done everything they can to keep their exports cheap and competitive (mainly through currency manipulation). As exporters sold their merchandise in the US and got paid in dollars, they had to convert these dollars to local currency to pay employees and other local services. Doing so would have caused a significant appreciation in the yuan against the dollar, ultimately making their merchandise less competitive in the global marketplace. The solution was for China to "take" these dollars and give the exporters freshly printed yuan in return. With those dollars, China then purchased US Treasuries (thus explaining China's significant holding of US Treasuries).

WHY CHINA DESPERATELY NEEDS TO KEEP THIS LEVEL OF EXPORTS TO THE US

China's growth model is at a dangerous point. China created large excess capacity in many industries through large amounts of debt and global demand for its exports is not likely to be able absorb all of this excess capacity. Also, there could not be much help from internal consumption. China's consumption as a percentage of GDP is just 39 percent compared to the average consumption in the rest of the world at 58 percent and about 75 percent in the US. These are the two main reasons why China cannot withstand significant taxes on $200 billion (or worse $500 billion) of exports to the US.

One aspect of China's hopeful solution to this problem is its "One Belt, One Road" project, which is intended to absorb much of this excess capacity (like cement and steel) and help China continue growing through global exports, but this initiative has its own problems.

HOW CAN CHINA RETALIATE?

China can try to retaliate in several ways. It can impose tariffs on US imports to China, it can devalue its currency (effectively offsetting the impact of US tariffs), it can disrupt US companies by withholding licenses or launching tax, anti-monopoly, or other investigations, or it can use North Korea.

IMPOSING TARIFFS

The US imported $505 billion of goods from China in 2017 while China imported $129 billion of goods from the US, causing a trade deficit of $375 billion for the US. Such a gap makes the tariffs strategy ineffective and dangerous for China.

CURRENCY DEVALUATION

This might actually be a problem for China. China's currency has started depreciating without the help of the People's Bank of China (PBOC). China's massive debt stands the risk of continued currency depreciation, capital flight and drop in its foreign currency reserves. On June 24, when the yuan fell to a six-month low against the dollar, the PBOC intervened to stop the decline.

TARGETING US COMPANIES IN CHINA

This is not something new. China has been targeting US companies for years. One of the main reasons Google abandoned its search business in China was government meddling. Also, the US can make it hard for Chinese companies to do business in the US. Many Chinese companies trade on US exchanges.

NORTH KOREA

Using North Korea as a bargaining chip will not be in China's favor as it looks to become a respected global leader.

CHINA'S NUCLEAR OPTION

China's selling of its holdings in US Treasuries is referred to in the media as the "nuclear option." The thought behind it is that China would throw treasuries in to the open market, causing the price of Treasuries to drop and yields to rise significantly, creating chaos in the markets and hurting the US economy.

A move like that is more of a "suicide option" than a "nuclear option." It could cause a dramatic appreciation in the US dollar, which will severely hurt China's exports and economy. It could also crush the economies of other countries that import Chinese goods. We also have to remember that China held $1.18 trillion in Treasuries as of January 2018. That's just about 5.6% of the $21 trillion in total US Treasury debt. If China does sell off all of its Treasuries, other buyers including US investors such as government pension funds, states, bond mutual funds and so on will come in, or the Fed could always simply buy them by printing money.

WHAT CAN GO WRONG?

Imports from China are a major contributor to the low-inflation environment the US has enjoyed for the last 20 years. Whether through tariffs or an overall rebalancing of global trade relations, imports to the US could become more expensive. These upward price pressures, and the resulting rise in inflation, could eventually lead to higher interest rates and even a recession.

China can also retaliate "irrationally" and halt exports of essential products/parts that many US industries rely on. In such a case, important supply chains could break and really hurt both economies. China will have to use additional monetary and fiscal measures to support its economy.

While it seems the US has the upper hand in the "trade war" with China, we have to remember this is just one episode in a larger, complicated relationship. Yes, China carries a significant amount of debt, but, so does the US. The difference is the US doesn't really have anything to show for it other than highly valued financial assets. China, on the other hand, has built massive new infrastructure projects that will support its fast growth for many years to come.

For investors, it is important to understand the overall picture of the relationship between the countries, interests and motivations as this unfolds and could impact world growth and markets.