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ASIA MACRO STRATEGY

China-US Trade War: A Quiver Full of Arrows

Report | 4 October 2019

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The market's expectations of a mini-trade deal between the Unites States (US) and China in October was spoiled by the spectre of US President Donald Trump's financial warfare on China.

Newswire Bloomberg reported that the Trump administration is planning to constrain China's financial development in three ways:

- Delisting China's American Depositary Receipts (ADRs) from US stock exchanges.
- Limiting US portfolio holdings of Chinese assets (equities and bonds) through government pension funds.
- Constraining Chinese companies in global stock indices managed by US firms.

Although there is no official confirmation on this news, the US Treasury Department has said that there were no plans to block Chinese listing 'at this time'.

The statement has only added to the fear of investors that, even though the trade disputes may eventually be resolved, a decoupling of US and China may remain well and alive for the long-run. The next level of confrontation may extend beyond the technology sector to include the financial sector.

Trade War Morphs Into Financial Confrontation

The potential impact on China's financial development could be profound if the above measures were implemented fully and abruptly.

As of end-September 2019, China ADR stocks amounted to $1.2trn or 7% of US's market cap. Of the top large-cap ADR stocks, according to J. P. Morgan research, US investors make up 38% of ownership on average. US investor exposure to technology and info-communication companies is even higher.

From the perspective of the US, portfolio investment in Chinese assets (in both mainland China and Hong Kong markets) has remained modest. The investment amounts to about $375bn in equities (4.2% of US's offshore equity holdings) and a mere $20bn in bonds (0.6% of their international exposure).

Long-Term Offshore Securities Holdings of US Investors

	Stock		Bonds		Total	
	US$ bn	% of total	US$ bn	% of total	US$ bn	% of total
Mainland China	191	2.2%	12	0.4%	203	1.7%
Hong Kong SAR	181	2.0%	7	0.2%	189	1.6%
Total	**373**	**4.2%**	**19**	**0.6%**	**392**	**3.3%**

Source: J.P. Morgan

However, the US government pension is world's largest with assets under management reaching $15.6trn in 2018. Asset allocation details are absent but a modest 1-2% China exposure is worth $150-$300bn which matters significantly to the Chinese markets (for example, this may compare to MSCI China float-adjusted market capitalisation of about $1.7trn).

Constraining Chinese stocks in global indices would also be a big blow to China at a time when Beijing is determined to open up the domestic financial markets further. The latter is evident by the recent removal of Qualified Foreign Institutional Investor (QFII) and RMB Qualified Foreign Institutional Investor (RQFII) quotas to encourage more global inflows.

Indeed, similar headwind has emerged recently. The Financial Times Stock Exchange Index (FTSE) surprisingly held off its decision on September 27 to include Chinese bonds into their global index this year (against earlier positive moves to do so by Bloomberg/Barclays and J.P. Morgan in their respective global bond indices).

Reality Check

In our view, these measures seem like long-term strategic considerations as part of US' isolation strategy of China, rather than imminent de-coupling measures.

The proper procedure should be for US to tighten standards and regulations on Chinese listing in future rather than abruptly banning a country's listing right.

Unless tensions escalate and conditions are met for US to declare a national emergency (and evoke the International Emergency Economic Power Act, IEEPA), direct financial restrictions on China and banning China's access to US financial markets represent extreme measures.

The best-case scenario, however, is that this may be a typical negotiation tactic of Trump to up the ante and increase pressure on China in the run-up to 7-8 October trade talks in Washington.

Overall, we expect equities will stay under pressure and are likely to move sideways in the coming weeks unless trade news turns more constructive with additional concessions from both sides.

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