

Mitch on the Markets

The Global Economy's Biggest X Factor in 2019



By Mitch Zacks
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Equity markets received some relief in late January, when the Federal Reserve decidedly shifted tone on interest rate increases for 2019. Fed Chairman Jerome Powell said that “the case for raising rates has weakened somewhat,”¹ adding that the Fed is increasingly concerned about the effects of policy-related headwinds from trade disputes, Brexit, and the potential for future U.S. government shutdowns. Markets cheered the news.

The temporary lifting of interest rate uncertainty was a positive for stocks. But I would argue that the most important story in the global economy – and its biggest uncertainty – still looms. The story is US-China trade relations, but I’d argue that it goes much deeper. To understand the full scope of China’s impact on the global economy today, one must think about trade, the Belt and Road initiative, the race to 5G technology, and growth trends.

It’s a layered and complex set of factors, and its collective impact on the direction of the global economy is paramount. Below, I’ll take a look at the four biggest China factors I see today.

Trade

Trade negotiators are taking a break this week with the Chinese Lunar New Year, which gives market watchers a good opportunity to assess progress and get the lay of the land. In short, though trade negotiators have been hard at work and both sides appear eager to reach a deal, the final terms remain elusive, and there’s only one month left to go.

Lead U.S. negotiator, Robert Lighthizer, is focused on structural issues and enforcement. He is seeking to force China into significant changes to protectionist industrial policies that hurt U.S. competitors, while also eliminating forced technology transfers. Mr. Lighthizer has indicated that the two sides have made “headway,” but no details have been divulged.

At issue within the White House is what will be seen as a victory in trade talks. While Mr. Lighthizer is focused on

structural issues more meaningful to long-term macroeconomic trends, President Trump appears to be more focused on the trade deficit. The two sides are currently in a trade ‘truce’ where tariffs will not be lifted until March 1, at which time tariffs on \$200 billion of Chinese goods could increase to 25% from 10%.²

China’s Growth Slowdown

China’s GDP growth rate has hit its lowest level in three decades, owing to fewer exports, the fiscal constraints associated with huge debt buildups, and constraints on private businesses. Imports are also falling, which is hurting major export industries across Europe and the U.S. Oxford Economics estimates that exports to China from large developed economies including the U.S. and other Asian countries fell nearly 10% last year from 2017.³

China’s slowing growth begs a larger question about the trade dispute with the U.S.: *What happens if accommodations offered by the Chinese have an impact that leads to slower rates of long-term growth?* It’s somewhat of a catch-22 – big concessions for China would be good for the U.S. but potentially bad for the global economy. It is all the more reason that investors keep a very close eye on what the final trade deal looks like, and what it means across different industries.

The Race for 5G Technology

5G is the next generation of internet connectivity and speed, and there’s a global race between China and the U.S. to lead the rollout. 5G technology will make it easier to connect items like cars and appliances to the internet, but it will also render networks more vulnerable to cyberattacks and espionage. At the center of this controversy is a company many readers have likely heard of by now – Huawei.

The United States has recently charged Huawei with stealing technology, improperly using Chinese government subsidies to grow, and of violating US sanctions on Iran. These recent charges are the latest levied against the Chinese government or Chinese companies, accused of stealing intellectual property from U.S. firms through a combination of cyberattacks, traditional espionage and other means. U.S. officials have warned that these activities represent a preeminent national and economic security threat.⁴

Since Huawei is a de facto Chinese state-run company, governments across the world are now worried that Huawei’s involvement in 5G projects represents a threat to national security. The full-scale rollout of 5G technology is slated to occur in the next year or two, and in our view it is critical that the US take the lead – though time will tell.

Belt and Road

China is able to play its “Belt and Road” initiative as a large-scale infrastructure

project meant to create more trade routes and boost economic activity across the developed world. But there may be ulterior motives in play here as well.

The U.S.-China Economic and Security Review Commission said China's efforts to build bridges and digital networks in Asia, Africa, the Middle East and Europe have given its government an excuse to maintain a military presence there. The Commission added that China may be using the initiative to "encourage and validate authoritarian actors abroad," while also forcing technology standards that could threaten U.S. businesses and markets access across the world. Perhaps the United States' best counter to Belt and Road would be to invest more in global infrastructure as well, or at least re-explore trade agreements with Asian nations so as to maintain formidable influence in the region.⁵

Bottom Line for Investors

The global economic chess match between the U.S. and China spans far wider than just trade, and in our view the U.S. is "fighting the good fight" with a strong leader at the helm in Robert Lighthizer. For market watchers, the next two months could prove critical in shaping the global economy for years to come, and the door is wide open both for positive and negative surprises. Investors should prepare for both.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

¹ CNBC, January 30, 2019.

<https://www.cnbc.com/2019/01/30/fed-chair-jerome-powell-says-the-case-for-raising-interest-rates-has-weakened.html>

² The Wall Street Journal, January 29, 2019.

<https://www.wsj.com/articles/u-s-authorities-unveil-sweeping-set-of-actions-against-chinas-huawei-11548711284?mod=djem10point>

³ The Wall Street Journal, January 31, 2019.

<https://www.wsj.com/articles/china-slowdown-causes-recoils-in-growth-around-the-globe-11548932400>

⁴ The Wall Street Journal, January 29, 2019.

<https://www.wsj.com/articles/u-s-authorities-unveil-sweeping-set-of-actions-against-chinas-huawei-11548711284?mod=djem10point>

⁵ Reuters, November 13, 2018.

<https://www.reuters.com/article/us-usa-china-roads/u-s-should-create-fund-to-counter-chinas-belt-and-road-push-commission-idUSKCN1NJ0E1>

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