# CHINA STORY – WILL THE WORLD ECONOMY SUFFER

*March 2019 – by Hervé Chatot, Multi-Asset Fund Manager, La Française AM*

After one year of ongoing trade tensions between the US and China, global growth has weakened and emerging market economies have been impacted by the tightening financial conditions.

Trade policy represents a significant risk to the global outlook in 2019. However, estimating the impact of protectionism is challenging because trade is global, and economies have become highly intertwined.

The greatest risk to the outlook would be a sharp deterioration in Chinese growth which could represent a significant risk-off shock. Given its position in the world economy, the outlook for China will be key.

Global growth is expected to slow this year and should remain mainly driven by US-China trade relations. Growth across countries is less synchronized than it has been in the past. We are beginning to see a divergence between a still robust US economy and weakening European, Chinese and Japanese economies

In a slowing growth environment, the US economy remains ahead of the rest of the world. China is bearing the brunt of the trade war and a more pronounced slowdown of its economy may impact European growth more severely given trade activity between Europe and China.

The key questions concerning the trade war that are still without answer are:

- How bad will it get?
- How long will it last?
- How much damage will be done to the world economy?

That being said, let's take a closer look at the US, China and Europe.

First, the US economy remains quite robust even if the economy will decelerate slightly, as the boost from tax cuts is behind us. The most recent data shows that the US economy is weathering the global slowdown quite well. The economy is already operating at full employment and the services sector remains solid.  We believe that economic fundamentals remain strong and that pessimism surrounding the US economy is misplaced. Moreover, the Fed turned very dovish and called for patience on rising rates this year.

Second, the Chinese economy has weakened in recent months, but policy support provided by the PBoC, including monetary and credit-easing measures (tax and rate cuts), should have positive effects in the coming months and provide for stronger growth in the second part of the year. China has tools to stimulate its economy. We remain confident in the Chinese economy and do not foresee a hard landing in the short term.

In Europe, we remain cautious on the growth outlook. We expect a lower trend rate of growth as downside risks are present (political risks, Brexit, trade war). Activity data remains weak, but seems to show some signs of stabilization. Nevertheless, we do not expect a major downturn at this stage

Globally, we anticipate slower growth, but exclude the risk of a recession. Central banks will remain dovish across the world and financial conditions should ease gradually, which should support growth momentum.

Last, President Trump just announced that he will delay the increase in tariff rates from 10% to 25% on $200bn in imports from China scheduled to take effect March 2.  A potential trade agreement between the US and China is likely later this year which would be positive  We think that the effects of the trade war on both economies will be limited, especially for the US, where trade is a relatively small share of economic activity.

But, an agreement doesn't necessarily mean a "good deal" for others countries.  A big increase in Chinese purchases of US products would create non-US losers due to import substitution. The most exposed countries would include the EU (aircraft and autos) and Japan (autos, machinery, electronics), followed by ASEAN countries.

Finally, the EU-US trade dispute will come back into focus in the coming weeks. There will be discussion concerning potential tariffs on vehicle imports into the US. Higher tariffs on EU automobiles remains a serious threat for European carmakers and the Euro area economy. Germany is the most exposed country. An increase in US tariffs on European cars to 25% could cost Euro area GDP growth between 0.2 to 0.4pp this year.