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Market views and strategy

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Topic of the week: Trade War 2.0: China is Ready for Divorce with the United States

by Zouhoure Bousbih

- China's dependence on foreign trade and the United States has significantly decreased following the trade war 1.0;
- China has diversified its trading partners and massively increased its outbound direct investments, making it less vulnerable to the additional 10% U.S. tariffs;
- Chinese companies have compensated for the loss of American demand by increasing their investments abroad to be closer to their end markets;
- China's retaliatory measures adopt a multidimensional approach beyond tariffs and are creating leverage for a broader deal ;
- The yuan is no longer a weapon to counter U.S. tariffs.

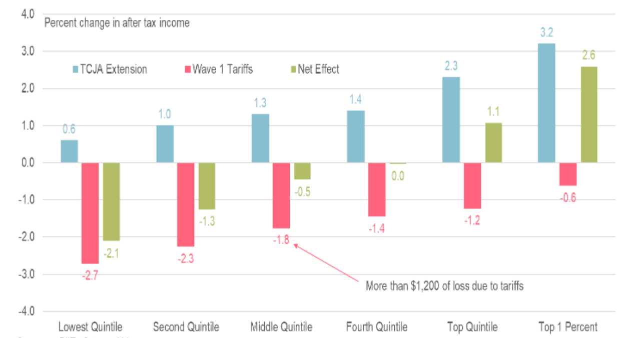
Market review: Trump-proof markets

- U.S. job growth solid despite downward employment revisions to 2024 data;
- The Fed sees neutral rates between 1.75-2.25% range;
- Lower bond yields, flatter curves and widespread narrowing in spreads;
- Equities keep trading higher with a rebound in China Tech stocks.

by Axel Botte

Chart of the week

Impact on the American household of the tariff increases announced on February first on Canada, Mexique and China and Impact on the extention of TCJA



Sources : PIIE, Ostrum AM
TCJA : Tax Cuts and Jobs Act

Contrary to what Donald Trump claims, raising tariffs will be negative for the American economy, particularly for households.

A study by the Peterson Institute for International Economics estimates the impact on income from a 25% increase in tariffs on Mexico and Canada (10% on energy products) and 10% on China. This translates to a loss of after-tax income of more than $1,200 for the median household over the course of a year. Households with the lowest incomes are the most affected.

Furthermore, the extension of the tax cuts desired by Trump (under the Tax Cuts and Jobs Act) will not compensate for the negative impact of tariffs for most households. The net effect will be negative, except for the wealthiest households.

Figure of the week

7

This is the number of members of the ECB's monetary policy council whose terms will expire at the end of the year. It is its largest personnel reshuffle since 2019.

Source: Bloomberg

Topic of the week

Trade War 2.0: China is Ready for Divorce with the United States

On February 1, D. Trump announced the imposition of additional 10% tariffs on Chinese goods, reigniting the trade war he initiated during his first term. In response, China swiftly implemented targeted measures, which are more measured than those of the American administration, foreshadowing an escalation of tensions.

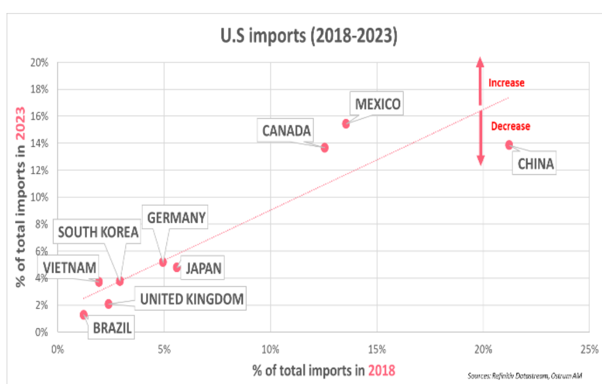
China is becoming less dependent on foreign trade and the United States...

China's reliance on foreign trade for its growth has decreased, as illustrated by the accompanying chart.

Since the 2000s, the share of foreign trade in China's GDP has been halved, dropping from 64% in 2006 to 37% in 2023. This shift reflects a structural transformation of the Chinese economy, which has successfully developed its industrial base.

In contrast, for Mexico and Canada—two countries currently given a one-month reprieve from the potential imposition of additional 25% tariffs by the American administration—foreign trade remains dominant, accounting for nearly 70% of their GDP. The decline observed in Mexico is partly due to the significant appreciation of the peso (+15% in real effective exchange rate) over this period, which has penalized its exports.

Since the imposition of the first American trade sanctions in 2018, trade between China and the United States has significantly decreased, particularly for products targeted by previous tariffs such as auto parts, solar panels, and semiconductors.

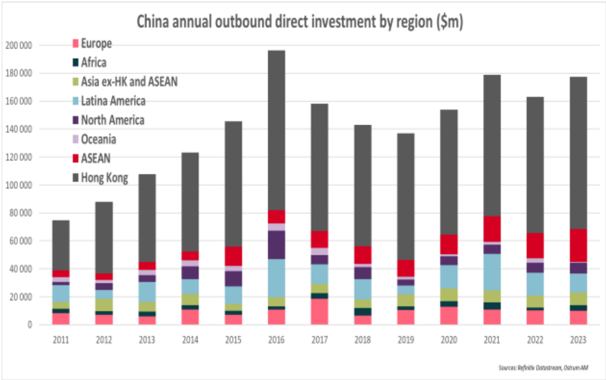


Indeed, China's share of U.S. imports fell from over 21% in 2018 to 13.85% in 2023, representing a reduction of more than 7%. Conversely, the shares of other countries, such as Mexico (+1.87%) and Vietnam (+1.77%), have increased, reflecting the intensification of their trade with China to circumvent American tariffs.

… By replacing them with outbound direct investments from Chinese companies.

Previous U.S. tariffs forced China to seek other opportunities. Thus, Chinese companies, like their Japanese counterparts in the 1980s, have relocated part of their production chain abroad to be closer to their end markets.

This has resulted in a significant increase in foreign direct investments (FDI) from Chinese companies abroad, as shown in the accompanying chart.



Outbound FDI flows have remained particularly high since 2016, prior to U.S. trade sanctions. In 2023, they reached $177 billion, close to the historical levels of 2016. Excluding Hong Kong, ASEAN countries have become the primary destination for Chinese companies' FDIs. The absence of Chinese tariffs (or very low ones) allows for commercial and financial integration between ASEAN countries and China, serving as an offshore manufacturing base for Chinese companies.

China's retaliatory measures are multidimensional beyond tariffs

China immediately reacted to D. Trump's new tariffs by announcing measures that will take effect on February 10. Its approach is now multidimensional beyond tariffs, thereby creating a broader negotiating leverage with the U.S. administration.

As in 2018, China targets D. Trump's electorate.

In response to the implementation of an additional 10% U.S. tariff on its products, the Ministry of Commerce announced an additional 15% tariff on U.S. coal and LNG, and 10% on oil, agricultural equipment, and automobiles.
According to Brookings, the tariffs imposed by China target 80 American manufactured and energy products, threatening approximately 400,000 to 700,000 jobs. Most of jobs in the targeted industries are in counties that voted for Trump in 2024, particularly in industrial regions and the Southeast, suggesting that these communities may suffer a greater impact than those that voted for K. Harris. In July 2018, China imposed 25% tariffs on American soybean imports in response to Trump's initial tariffs, leading to a 50% drop in exports to China! Despite diversifying towards the European Union, Mexico, and other Asian markets, American farmers have not been able to fully compensate for the loss of Chinese demand.

The control of rare earth exports as a preventive measure against potential U.S. export controls on technologies.

A tightening of export controls on rare earths and certain materials like tungsten, used in the electronics, aerospace, and defense industries, has also been implemented. On December 3, 2024, China announced that it had banned the export of gallium, germanium, and antimony to the United States. These rare minerals are crucial in the manufacturing process of semiconductors, military equipment, and for general industrial use. This new measure by

Chinese authorities expands existing restrictions that had been in place since July 2023 on gallium and germanium, and since October 2023 on graphite (see our MyStratWeekly from December 9, 2024: Rare Earths: China Opens a New Front in the Technological War). The aim of the export controls on rare earths is to create distortions in supply chains impacting production lines.

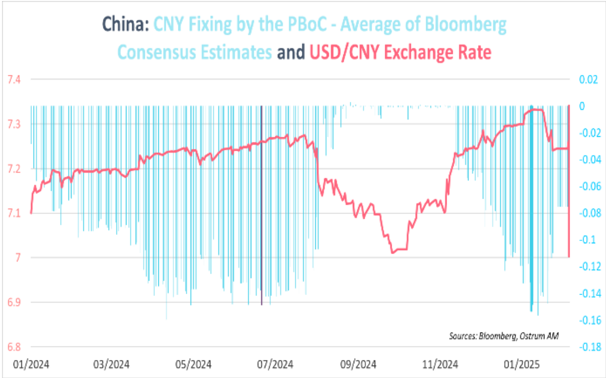
Investigations for violations of antitrust laws in response to the TikTok ban.

China has also launched an investigation into several American companies, such as Google, for antitrust violations, as well as adding American companies to its blacklist. This echoes Washington's "Entity List," which prohibits commercial ties between American and Chinese companies (allies included). China has targeted companies with significant financial interests on its soil.

The Yuan is No Longer a Weapon Against U.S. Tariffs

Market operators awaited with anxiety the reopening of Chinese financial markets, which had been closed for the Lunar New Year. In particular, the central parity rate of the yuan against the dollar set by the PBOC attracted significant attention. Indeed, market participants feared a devaluation of the Chinese currency in response to the new U.S. tariffs.

China no longer needs to devalue its currency as it did in 2018 to counter American tariffs, as it has become the world's manufacturing powerhouse (accounting for 35% of global manufacturing output) that is essential in production chains around the world due to its high-tech intermediate goods. The message from the PBOC, by keeping the yuan's central rate unchanged at 7.17, is clear: the priority is to stabilize the yuan in order to prevent capital outflows from the country.



Conclusion

China is better prepared for a divorce than the United States itself. Its economy's dependence on foreign trade has significantly decreased, as has its reliance on the United States. China has compensated by diversifying its trading partners and massively increasing its foreign direct investments. These factors allow it to be better prepared for an escalation of trade tensions. Its response to American tariffs is multidimensional, creating a broader negotiating leverage. "An eye for an eye, and the world will end up blind," Gandhi said. No one has an interest in escalating tensions that would severely impact the global economy.

Zouhoure Bousbih

Market review

Trump-proof markets

Financial markets appear insulated from the erratic communications emanating from Donald Trump. Yield curve flattening has led to a broad-based narrowing in spreads. Despite the Fed's status quo stance and the Bank of Japan’s restrictive policy, monetary easing remains the prevailing trend globally. The sharp rise in gold prices, however, sends a solitary note of concern.

The Fed faces increasing complexity in interpreting labor market data. The unemployment rate dropped to 4% in January, and the projected decline in immigration flows is expected to lower the threshold for job creation, needed to keep unemployment unchanged although it will weigh on activity. A freeze on public hiring, coupled with potential layoffs, will likely reduce employment levels in the coming months. Nevertheless, labor shortages are poised to reignite wage pressures. The inflationary impact of tariffs on Chinese goods remains uncertain. Dallas Fed President Lorie Logan asserts that the neutral interest rate has already been reached, as Trump advocates for a loosening of fiscal policy. The monetary status quo anticipated through June reflects these uncertainties.

In the euro area, sluggish growth and tightening credit conditions overshadow inflation inertia, which stood at 2.5% in January. The ECB is expected to continue easing toward a revised neutral rate of 1.75-2.25%. Meanwhile, the Bank of England has lowered its rate by 25 bps to 4.25%, with two votes in favor of a 50-bp cut. The downward revision of growth forecasts outweighs the projected inflation increase to 3.5% by 2025. Catherine Mann has shifted her stance, highlighting the upside risk to mortgage rates under the current rate policy.

U.S. Treasury yields fell back below 4.50% last week amid a significant flattening movement. The unchanged quarterly refunding of Treasury securities for the February-April period has reassured investors, contributing to the outperformance of T-notes against swaps. The Fed's status quo likely aims to curb inflation expectations. In contrast, the short-term structure of real rates remains steep. The German Bund approaches 2.30%, with spreads tightening across all euro bond markets. Swap spreads remain under pressure, benefiting agency debt and covered bonds, with the 10-year swap spread remaining in negative territory at -2 bps. The acceleration of quantitative tightening in January, which saw a €9 billion reduction in German debt holdings, coupled with global quantitative tightening and a lower deposit rate, is tightening swap spreads.

On the sovereign debt front, budget uncertainty in France has eased following the adoption of a budget for 2025 and a lower-than-expected state deficit of 5.4% for 2024. The French OAT has tightened by 10 bpsthis year, bolstered by the generally favorable risk environment. Credit markets remain relatively stable, with average spreads against swaps fluctuating between 80 and 90 bpss. High yield bonds, now more expensive, are no longer outpacing investment-grade securities. Concurrently, equity markets remain well-supported, with a rebound in Chinese technology stocks symbolizing a shift in sentiment towards American giants heavily invested in AI. The banking and basic materials sectors are leading the charge in Europe, while defensive sectors such as consumer staples and utilities have not participated in the rally.

Axel Botte

Main market indicators

G4 Government Bonds	11-Feb-25	1wk (bp)	1m (bp)	2025 (bp)
EUR Bunds 2y	2.04%	-1	-25	-4
EUR Bunds 10y	2.39%	-1	-21	+2
EUR Bunds 2s10s	34.4 bp	+0	+4	+6
USD Treasuries 2y	4.28%	+6	-10	+4
USD Treasuries 10y	4.51%	+0	-25	-6
USD Treasuries 2s10s	23.2 bp	-6	-14	-9
GBP Gilt 10y	4.46%	-3	-38	-11
JPY JGB 10y	1.32%	+7	-3	-5
€ Sovereign Spreads (10y)	**11-Feb-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
France	77 bp	+6	+3	-6
Italy	109 bp	-1	0	-6
Spain	63 bp	+1	+2	-7
Inflation Break-evens (10y)	**11-Feb-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
EUR 10y Inflation Swap	2%	0	-7	+7
USD 10y Inflation Swap	2.59%	0	-1	+13
GBP 10y Inflation Swap	3.58%	-3	-10	+5
EUR Credit Indices	**11-Feb-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
EUR Corporate Credit OAS	92 bp	-2	-9	-10
EUR Agencies OAS	54 bp	-1	-7	-8
EUR Securitized - Covered OAS	49 bp	-2	-7	-8
EUR Pan-European High Yield OAS	310 bp	-11	-10	-8
EUR/USD CDS Indices 5y	**11-Feb-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
iTraxx IG	53 bp	-1	-6	-4
iTraxx Crossover	289 bp	-2	-31	-25
CDX IG	48 bp	0	-4	-2
CDX High Yield	297 bp	-2	-28	-15
Emerging Markets	**11-Feb-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
JPM EMBI Global Div. Spread	315 bp	-3	-5	-11
Currencies	**11-Feb-25**	**1wk (%)**	**1m (%)**	**2025 (%)**
EUR/USD	$1.030	-0.704	0.842	-0.4
GBP/USD	$1.234	-1.146	1.364	-1.4
USD/JPY	JPY 152	1.527	3.541	3.6
Commodity Futures	**11-Feb-25**	**-1wk ($)**	**-1m ($)**	**2025 (%)**
Crude Brent	$76.6	$0.4	-$2.3	3.1
Gold	$2 913.0	$69.0	$252.1	11.0
Equity Market Indices	**11-Feb-25**	**-1wk (%)**	**-1m (%)**	**2025 (%)**
S&P 500	6 066	1.20	4.11	3.1
EuroStoxx 50	5 358	2.69	7.66	9.4
CAC 40	8 006	1.93	7.74	8.5
Nikkei 225	38 801	0.73	-0.99	-2.7
Shanghai Composite	3 318	2.08	4.72	-1.0
VIX - Implied Volatility Index	15.81	-15.09	-19.09	-8.9

Source: Bloomberg, Ostrum AM

Additional notes

Ostrum Asset Management

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