Sujet: Les tensions montent entre les USA et la Chine / Tensions between the US and China

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sometimes in a significant way, by rising rate expectations. **Chart 14** highlights this experience. For instance, rising rate expectations in 1975 caused the S&P 500 to correct by 14%. Similarly, in 2004, when rate expectations started to move up, the post tech-bubble rally flattened out.

Our U.S. GDP model is calling for annual economic growth to reach 5-6% in real terms toward the end of this year (**Chart 15**). This means that for the coming quarters, the speed of the recovery could be surprisingly fast.

It is possible that the stock market will, at the beginning, embrace news of strong growth. Nonetheless, if the economic strength persists, then the good news will turn bad for equities. This is mainly because sustained strong growth could cause a chaotic reaction in the Eurodollar market, creating upward pressure on short-rate expectations. A sudden shift in rate expectations could cause some dislocation in the stock market.

Of course, we do not expect this kind of stock-market dislocation to spur a renewed bear market. Nonetheless, it is not impossible to see equity prices shed 10-15% of their value, especially if they climb to significant new highs in the coming months. The shakeout could be very painful and at times look scary. This risk is especially high towards the second half of the year.

3. Escalating Trade Tensions Between The U.S. And China

Protectionist risk is reaching dangerous levels and is a much more serious issue than generally perceived. With the U.S. unemployment rate sticky and stubbornly staying close to 10%, China has become the main target of American attention. There is a bipartisan movement in Congress to pressure the Chinese to revalue their currency, and the mechanism to do so is by branding China a currency manipulator, to be followed by sweeping increases in tariffs levied on Chinese imports.

CHART 13
Distribution Of Equity Returns *Vis-À-Vis* Growth

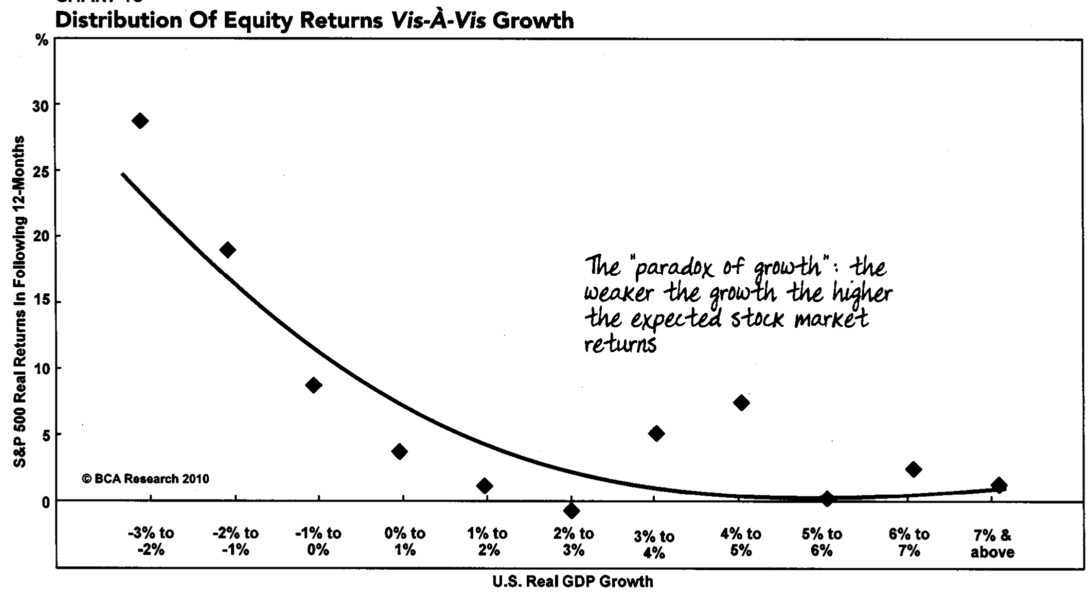


CHART 14
Major Bear Markets: A Historical Perspective

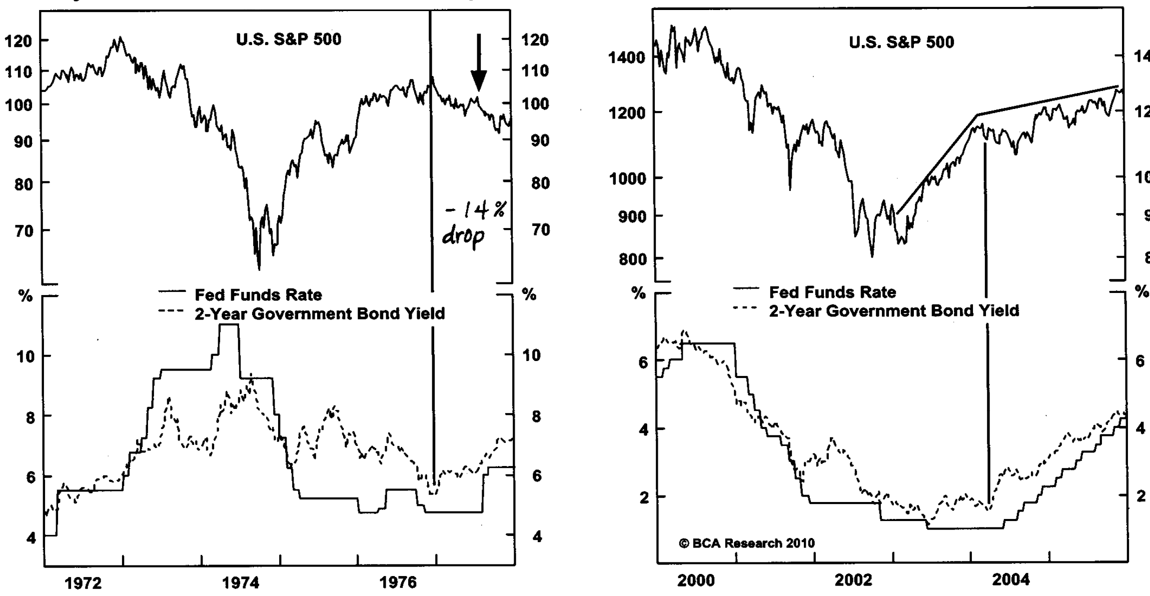
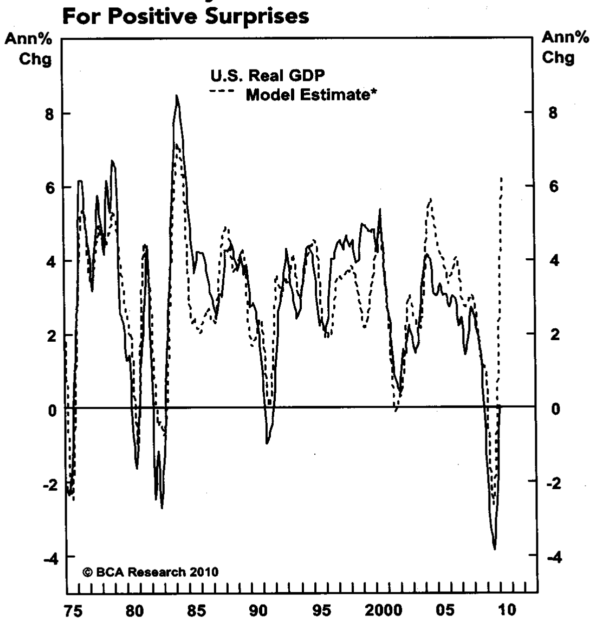


CHART 15
U.S. Economy Still On Track For Positive Surprises

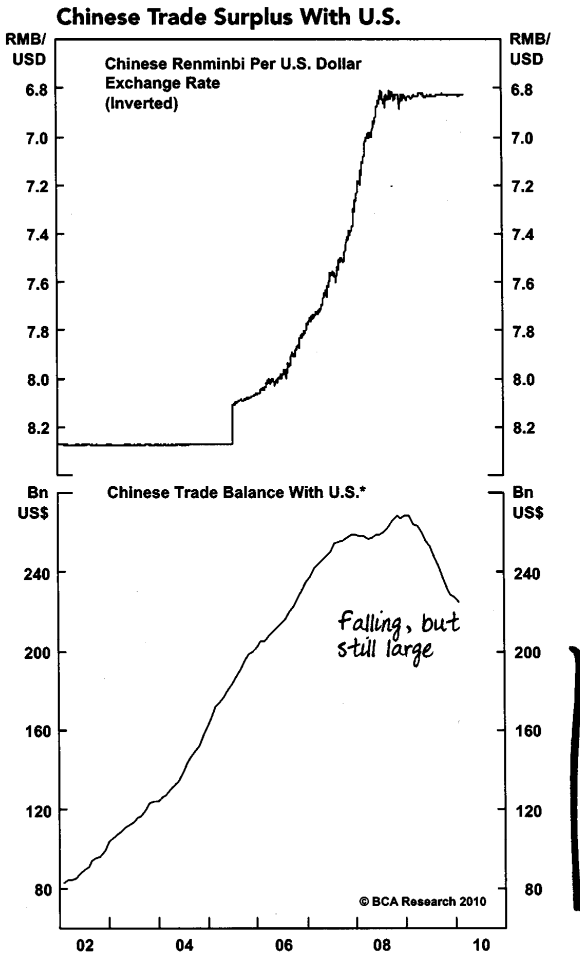


* Based on the ratio of industrial production to new U.I. claims, the annual change in corporate BAA spreads, manufacturing and the ratio of the NASDAQ to the Dow Jones Industrial Average.

The Chinese currency has long been a contentious issue standing in the way of cordial U.S.- China trade relations. The dispute dates as far back as early 2002, when the U.S. first pushed for Chinese revaluation. Beijing has managed to dodge the bullet by orchestrating slow and steady currency appreciation (**Chart 16**) combined with periodic buying sprees of U.S. made products geared towards calming anti-China sentiment. This time, however, trade tensions may not be easily managed by both sides.

Beijing has become overly confident in dealing with economic disputes. A combination of nationalism, newly-gained confidence and self-righteousness among the Chinese population has created enormous political pressure on the Chinese government, forcing leaders to act tough on U.S. demands. The Chinese Premier's recent tough rhetoric and unyielding stance on currency policy highlights

CHART 16
Chinese Trade Surplus With U.S.



* Shown as a 12-month rolling total. Source: U.S. Department of Commerce.

Beijing's new assertiveness. Meanwhile, Chinese officials are fully aware of how the U.S. forced the Japanese to revalue the yen after the bubble burst in the early 1990s, pushing the Japanese economy into decades of stagnation. Beijing has vowed not to be pressured into a major revaluation.

China may have miscalculated the depth of American anger over trade. China's export machine is primed to race away again in response to recovering global demand and a highly competitive exchange rate, while American businesses are still suffering. Very high unemployment has bred deepening discontent toward politicians who desperately need a scapegoat. China is a perfect target: It is a nominally communist regime, has a large trade surplus with the U.S. and has recently made a series of blunders in dealing with high-profile commercial disputes such as Google's China operations.

It is difficult to predict how trade frictions will evolve, but Treasury Secretary Timothy Geithner is not a protectionist, and he will most likely resist congressional pressure to name China a currency manipulator. He understands that everyone will lose big should a trade war break out. In the meantime, the Chinese side may also yield some ground by announcing a series of high-profile Chinese purchases of U.S. goods to quell the brewing anti-China sentiment.

In the end, cooler heads will likely prevail, but investors should be aware that the protectionist risk is always lurking. Any miscalculation on both sides could prompt some unanticipated and highly undesirable developments that would be very disruptive for the world economy and financial markets.

CHINA WATCH

30th Mar. 2010

CAPITAL ECONOMICS

China set for a well-timed trade deficit

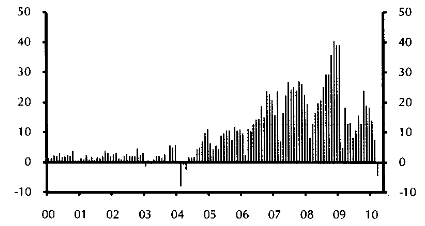
- ***A deficit would weaken the argument that China manipulates its currency…***
- ***…but the trade surplus, and frictions with the US, will soon rise again***
- ***Pro-currency reform academics join the MPC but power over policy lies elsewhere***

The timing of China's first monthly trade deficit in six years, if confirmed by March's data, is almost too good to be true.

The data are due on 10th April, just a few days before the US Treasury is set to give its twice-yearly verdict on whether China manipulates its currency. The Treasury is under growing pressure to say that China does, but it would then have to explain why it had changed its mind after 27 consecutive reports in which it concluded the opposite.

One approach might be to argue that China's exchange rate interventions favour its exporters more now than in the past. But a first monthly trade deficit for China since 2004 would make that argument sound rather hollow. (See Chart 1.)

CHART 1: CHINA GOODS TRADE SURPLUS ($BN)



Source – Thomson Datastream. Note – March 2010 is CE forecast

Hence, if a deficit is confirmed – and with the prime minister saying last week that an $8bn deficit was recorded in the first third of the month and the commerce minister forecasting a deficit for all of March, this is looking likely – **the chances of the US Treasury labelling China a currency manipulator in April will dwindle.**

What happened to reverse the surplus? Continued import strength may have played a role, but the main explanation is probably that manufacturers struggled to fill export orders when migrant workers were slow to return after the Chinese New Year holiday in mid-February.

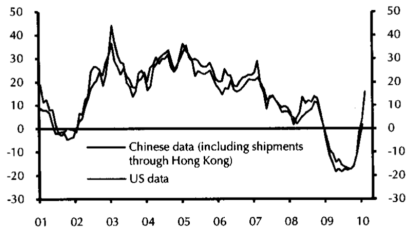
In fact, it is not too difficult to project a March deficit from February's data based on the usual pattern of a post-Chinese New Year rebound that is normally weaker for exports than imports. On the last three occasions prior to the global downturn that the holiday fell in February (2002, 2005 and 2007), exports rose an average 21% m/m in March and imports 37% m/m. If repeated, the deficit would be $4.5bn this month (compared with the $7.6bn surplus in February).

Whatever the explanation, the deficit is unlikely to last for long. A similar exercise suggests another small deficit may be recorded in April, but that surpluses will return thereafter. Indeed, the seasonal strength of exports in the second half of the year and a gradual winding down of import demand growth as both stimulus-linked investment and commodity stockpiling slow means that the surplus will probably rebound quickly.

This suggests that the medium-term policy implications of a small deficit lasting one or two months are not that great. The chances of a significant one-off revaluation, for example, were already pretty thin. Furthermore, pressure on China from its trading partners will not ease for long, whatever the Treasury decides this month. (See our *China Economics Update*, "A pivotal moment for relations with the US?" 18th March.)

A final point on the trade numbers: the convenient timing of the deficit might lead some to question whether the data can be trusted. We think they can – China's trade data are probably the most reliable of its high-profile statistics and are easily checked against those from trade partners. (See Chart 2.)

CHART 2: CHINA EXPORTS TO THE US ($, 3M % Y/Y)



Source – Thomson Datastream