Bridgewater®
Daily Observations
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The US-China Tit-for-Tat and the Market's Reactions in Numbers and Gauges

As you know we like to quantify and then make gauges for just about everything that we are interested in following. In some cases they are for things that are normally not quantitatively expressed, such as our "populism gauge" that shows the degrees of populism around the world over time and in different countries or our "conflict gauge" that shows the degrees and types of conflict over time, by type and by location. Because we are especially interested in watching the evolution of the US-China conflict, several months ago we created a tit-for-tat gauge to capture the nature and severity of the exchanges of harmful actions (thus far just trade tariffs) between the US and China. We are particularly interested in seeing each action taken and each response to that action. As explained before, we believe that this conflict is about more than trade and that it could take different forms, though that hasn't happened yet. For your reference, our updated gauge is shown below.

United States and China Tit-for-Tat Gauge (USD, Bln)

On Monday, the Trump administration announced another round of tariffs and China responded with more tariffs of its own. What isn't yet clear in the exchanges (though we have our theories) is:

1) Whether the Trump administration's steps are intended as leverage to reach accommodation under the existing global trading system, or whether the administration is on a path to fundamentally change the system (which risks disrupting existing supply chains and broadening the conflict).
2) Whether these tit-for-tat dynamics trigger new types of significant tit-for-tats (e.g., capital wars, sanctions, etc.).

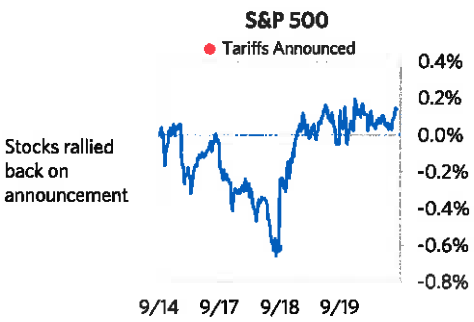
Give Feedback

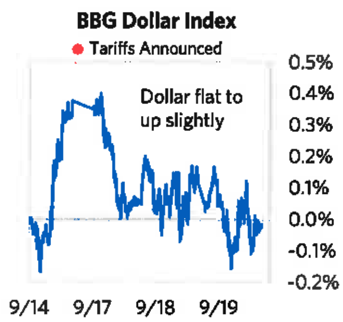
Thus far, negotiations by the Trump administration have mostly been limited to changes within the system, as opposed to attempts to more fundamentally change the system in a way that will really hurt efficiencies. The tentative agreement with Mexico and negotiations with the EU are consistent with seeking modifications rather than deep, fundamental changes. It is not yet clear how instructive these prior outcomes are for China, where the power balance isn't as uneven and where global economic and geopolitical rivalry is greater. The trade dispute is just one part of a complex, multi-dimensional relationship, with some goals that overlap and others that conflict. There are also exogenous factors at play, such as the US's upcoming midterm elections. That muddies the waters. Below, we review the recent actions and why we still think the key questions of the path we're on remain unanswered.

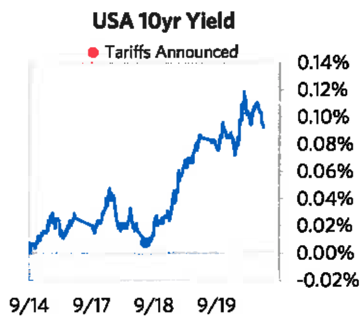
- On Monday, as expected, the Trump administration imposed tariffs of 10% on another $200 billion of Chinese imports (under Section 301 of the Trade Act of 1974). The magnitude, structure, and timing are instructive as to potential constraints at play.
    - The 10% tariff was lower than the 25% originally floated by the Trump administration. This likely reflects some political concerns, particularly ahead of the important midterm elections.
    - The 10% tariffs are scheduled to rise to 25% on January 1, if no progress is made in resolving the US allegations of unfair trade practices. This both reduces the impact on businesses and consumers prior to the midterm elections, as well as on the all-important holiday shopping season, and also provides a window and incentive for negotiations.
    - Several carve-outs of sensitive consumer goods, including Apple phones and baby products, reflect concern over both the message to and the protection of the American consumer.
    - Further, reflective of pressure from agricultural interests, the administration stated that if China takes retaliatory action against US farmers or other industries, "we will immediately pursue phase three, which is tariffs on approximately $267 billion of additional imports."
- Consistent with their past pattern, the Chinese response was measured and commensurate. China imposed tariffs of 5-10% on an additional $60 billion of US imports after initially communicating that tariffs could be as high as 25% on some products.
- Market reaction was muted, largely because the announcement was mostly as expected.

The Market Reactions

The market action was broadly favorable as the tariff announcement was pretty much as expected, the Chinese response was a bit more muted than expected, and questions about whether Vice Premier Liu He will accept the invitation to have talks in Washington with Treasury Secretary Mnuchin and whether or not Trump will follow through with his threat to add to tariffs in response to the Chinese retaliation remain open. Below are some pictures of the market action (indexed to last Friday's open). The US 10-year bond action is notable, as it wouldn't be entirely surprising to see the trade war slip into a capital war, though we wouldn't draw the conclusion that we are going there yet.







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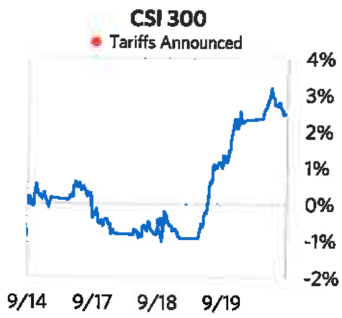
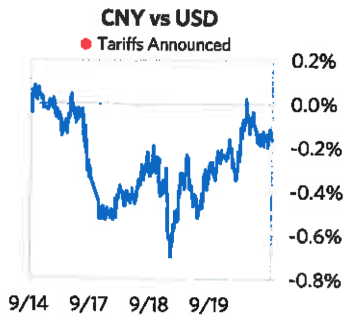
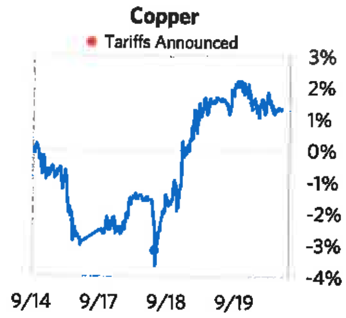


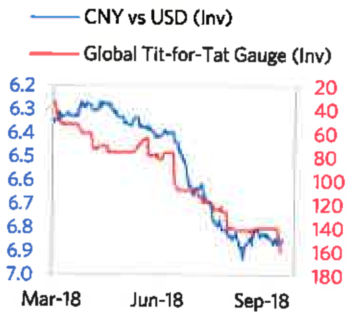


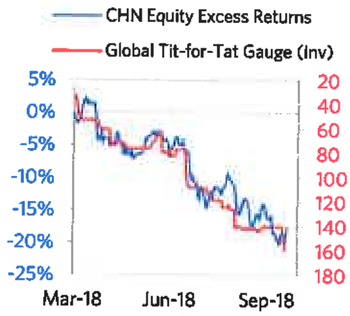


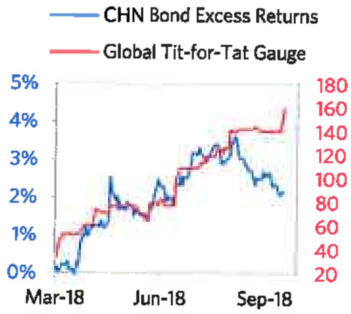
China-sensitive commodities rallied over the following day

Over the Course of the Year, Chinese Markets Have Shown a Large and Broad-Based Sensitivity to Shifts in Trade Sentiment

While there are a number of dynamics influencing Chinese markets, trade tensions have been a particularly important influence, with the stock, bond, and currency markets all showing meaningful sensitivity to developments in trade policy sentiment. The charts below show the movement of China's stocks, bonds, and currency during the period of the most acute rise in trade tensions this year as measured by our global tit-for-tat gauge.







The impact has also been broad-based across Chinese equity sectors, in contrast to the US market, where the impact has been concentrated in sectors that are more directly affected by tariffs and sensitive to global (especially Chinese) demand.

United States Stock Sectors	Betas to a $10 Bln Move in the Tit-for-Tat Gauge
Energy	-0.94%
Materials	-0.83%
Industrials	-0.60%
Financials	-0.47%
Information Technology	-0.27%
Total Market	-0.24%
Telecommunication Services	-0.22%
Healthcare	-0.17%
Consumer Discretionary	0.11%
Consumer Staples	0.22%
Utilities	0.99%

China Stock Sectors	Betas to a $10 Bln Move in the Tit-for-Tat Gauge
Telecommunication Services	-2.01%
Information Technology	-1.93%
Materials	-1.56%
Healthcare	-1.40%
Consumer Staples	-1.36%
Consumer Discretionary	-1.31%
Total Market	-1.17%
Energy	-1.14%
Industrials	-1.13%
Financials	-0.66%
Utilities	-0.42%

Give Feedback

The tables below show the recent market action and betas of markets to our tit-for-tat gauge shown earlier. The effects on US markets and even on those of Mexico and Canada have been smaller than the effects on China, Asian markets, or Europe.

Market Sensitivity to a $10 Bln Move in the Tit-for-Tat Gauge

Chinese stocks look very sensitive to trade conflict → China

Euroland also showing some sensitivity → Euroland

Canada showing more moderate sensitivity → Canada

Equities	Beta
Hong Kong	-1.24%
China	-1.17%
Philippines	-1.13%
Poland	-0.97%
South Africa	-0.94%
Malaysia	-0.87%
Singapore	-0.75%
Hungary	-0.66%
Thailand	-0.66%
Russia	-0.58%
Korea	-0.56%
Portugal	-0.56%
Japan	-0.52%
Norway	-0.48%
New Zealand	-0.47%
Taiwan	-0.46%
Germany	-0.42%
Brazil	-0.41%
Ireland	-0.39%
Netherlands	-0.37%
Chile	-0.37%
United Kingdom	-0.36%
Peru	-0.34%
France	-0.33%
Euroland	-0.28%
Spain	-0.28%
Switzerland	-0.28%
United States	-0.25%
Belgium	-0.20%
Canada	-0.19%
Czech Republic	-0.13%
India	0.01%
Saudi Arabia	0.02%
Australia	0.03%
Colombia	0.04%
Bulgaria	0.17%
Italy	0.19%
Turkey	0.25%
Indonesia	0.26%
Mexico	0.35%
Greece	0.40%

Nominal Bonds	Beta
Canada	0.28%
Australia	0.22%
United Kingdom	0.20%
Euroland	0.20%
China	0.18%
United States	0.18%
Switzerland	0.16%
Japan	-0.01%

EM Spreads	Beta
Malaysia	-0.10%
Hungary	-0.07%
South Africa	-0.06%
Poland	-0.06%
Philippines	-0.05%
Indonesia	-0.05%
Saudi Arabia	-0.04%
Korea	-0.03%
China	-0.03%
Singapore	-0.01%
Hong Kong	-0.01%
Czech Republic	0.00%
Thailand	0.00%
Turkey	0.01%
Russia	0.01%
India	0.02%
Peru	0.03%
Colombia	0.03%
Chile	0.04%
Mexico	0.08%
Brazil	0.14%

Developed FX	Beta
Canada	-0.34%
Euroland	-0.22%
Norway	-0.21%
United Kingdom	-0.20%
New Zealand	-0.06%
United States	0.08%
Japan	0.16%

EM FX	Beta
Korea	-0.45%
Turkey	-0.34%
Thailand	-0.31%
Czech Republic	-0.30%
Bulgaria	-0.23%
Poland	-0.23%
China	-0.23%
Taiwan	-0.21%
Hungary	-0.21%
Singapore	-0.19%
Colombia	-0.12%
Russia	-0.09%
Indonesia	-0.04%
Hong Kong	-0.01%
Saudi Arabia	0.00%
Malaysia	0.02%
Philippines	0.04%
South Africa	0.04%
Peru	0.06%
India	0.11%
Chile	0.30%
Brazil	0.54%
Mexico	0.59%

China ← Chinese FX also sensitive

China-sensitive commodities have shown weakness over the last year → Oil, Iron

Commodities	Beta
Oil	-1.32%
Copper	-1.20%
Aluminum	-0.99%
Iron	-0.64%
Silver	-0.37%
Gold	-0.12%
Soybeans	0.00%

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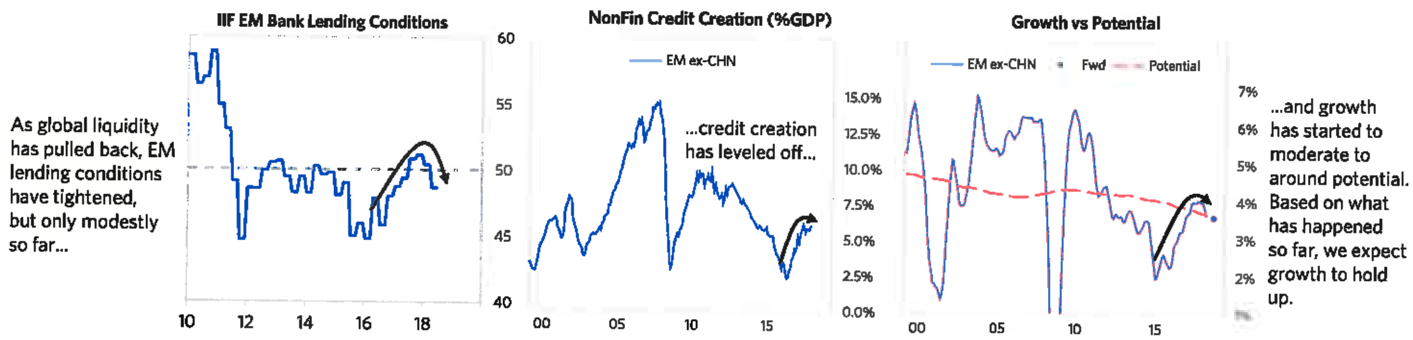
Thus far the sizes of the market reactions have been larger than the actual developments warrant, which might be due to emotional sentiment shifts playing an exaggerated role or because extrapolations of where this conflict will go are being made. Clearly, these new political-fundamental influences are playing a bigger role than they used to.

The Recent IIF Survey Shows EM Lending Conditions Are Tightening, but So Far the Deterioration for Most Is Modest and the Negative Impacts Look Manageable

Billy Prince | David Trinh *| Stuart Webber*

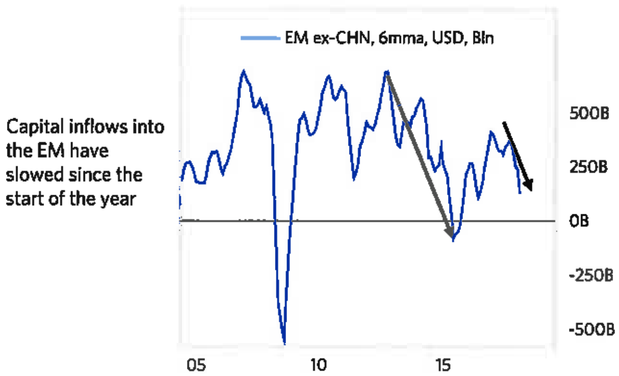
While the pullback in global liquidity is flowing through to a tightening in lending conditions across the emerging world, the deterioration so far has been modest outside of the most severe pockets of distress. The market-based tightening in most of these economies has been milder since the start of the year than in past cases, and this market action is consistent with the recently released Institute of International Finance (IIF) banking survey, which provides a holistic picture of EM banks' sources and uses through the second quarter. The shift in credit conditions is an important dynamic to monitor, as a pullback in lending has the potential to create a self-reinforcing vicious cycle, whereby capital pullback drives down asset prices, interest rates rise, and the growth rates that were dependent on the prior interest rates and inflow of capital slow. This in turn causes more capital to be withdrawn. This dynamic occurred most recently across the emerging world in 2013-2015. Today—unlike the 2013-2015 period and other more significant examples (such as the early '80s and late '90s)—most of these economies are much less susceptible to the pullback in foreign capital, and as a result are seeing more subdued pressure on assets, interest rates, and growth. But even so, the pullback in capital is driving a modest shift toward tighter domestic policy and credit conditions, and is exerting a negative pressure on growth. In the near term, this pressure is only enough to moderate growth from above to roughly at potential in the less exposed economies, but a continued pullback in liquidity could create a more meaningful drag moving forward.



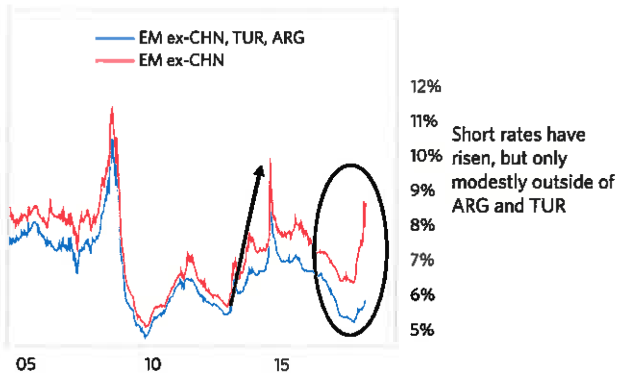
The Withdrawal of Foreign Capital and Modestly Tightening Domestic Policy Are Flowing Through to Deteriorating Credit Conditions

As central banks have removed accommodation, the pace of global capital inflows into the emerging world has slowed meaningfully and is now close to zero. As the chart on the right shows, this pullback has in turn flowed through to a modest pickup in short rates, largely due to central banks tightening to defend their currencies. So far, however, the average increase in rates has been modest (roughly +0.5%) relative to past cases of capital pullback, consistent with (1) the slowdown in capital inflows being more moderate and (2) the decreased sensitivity to such a slowdown this time around.

Foreign Investment ex-FDI

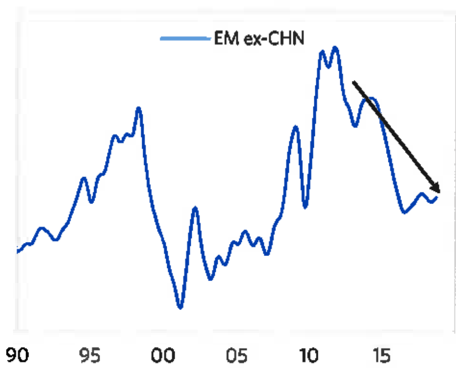


Short Rates

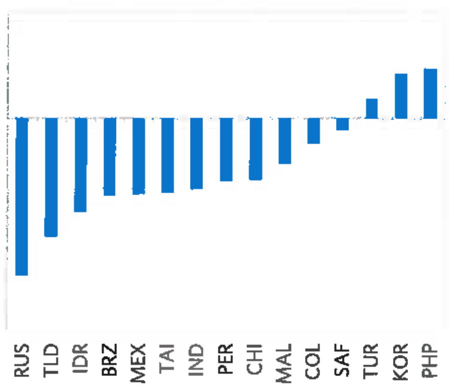


The chart below on the left gives a sense of the global sensitivity to dollar liquidity, which measures both the amount of dollar financing that's required to fill external imbalances plus the need to roll outstanding dollar debts. As you can see, over the past five years, the emerging world's sensitivity to dollar liquidity has declined from secular highs and is now closer to its historical average. On the right, you can see that sensitivity has decreased notably across almost every economy throughout the emerging world.

Dollar Sensitivity Index



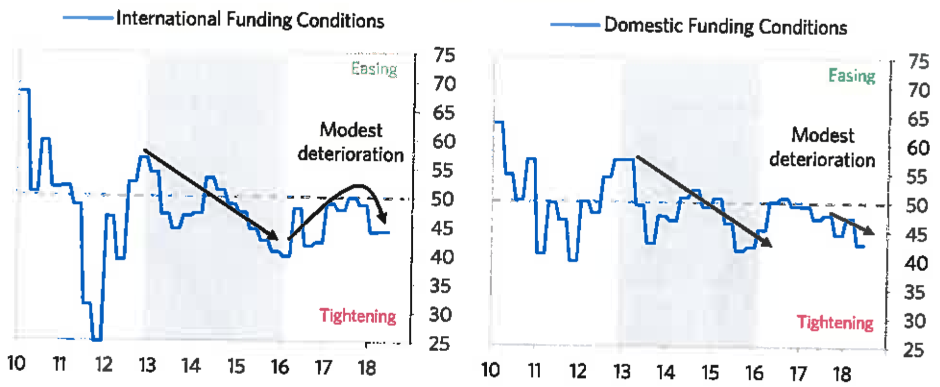
Dollar Sensitivity Change by Country



Give Feedback

This modest deterioration in credit conditions is reflected in the most recent IIF survey results, which corroborate the outright tightening across both international and domestic credit conditions. However, compared to the recent periods of distress in 2013-2015, highlighted below, the tightening of international and domestic funding conditions today is far more moderate.

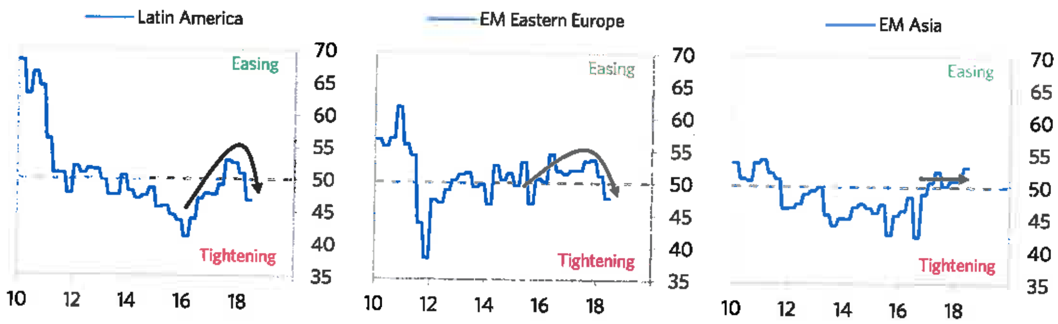
IIF EM Lending Conditions



Conditions Are Deteriorating across Most of the Emerging World, Particularly in Latin America and Eastern Europe

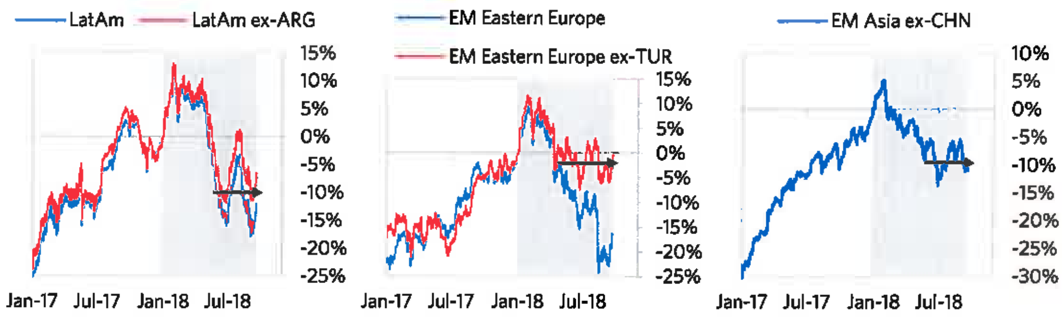
Consistent with the fairly broad-based pullback in global capital, the deterioration in lending conditions has been reasonably similar across major EM regions. The most recent IIF data release shows continued tightening in aggregate lending conditions, particularly in Latin America and Eastern Europe (which, between the two of them, include Argentina and Turkey). In EM Asia, where China has been easing policy in recent months, conditions have remained more stable.

IIF Aggregate Lending Conditions by Region



Given that the IIF survey runs through the second quarter of 2018, one timely way of sizing the impact felt by emerging market economies since then is to look at equity market returns in foreign currency terms, which to some extent captures a combination of external pressure on the currency (e.g., from continued pullback in foreign capital) and domestic pressure on growth (e.g., from tightening in liquidity due to a foreign pullback and domestic policy response). Aside from the idiosyncratic stresses experienced in Argentina and Turkey, the equity returns across these regional aggregates over the third quarter have been mostly flat, suggesting fairly limited deterioration over the past few months since the IIF survey was conducted.

Equity Excess Returns (USD)



Looking below the aggregate level, we see a similar story playing out across most individual countries in the emerging world. As you can see, equities in foreign currency have sold off and domestic short rates have risen significantly in only a few places, while most have remained largely stable. Across the EM, performance has been much stronger than what we have seen in past cases of broad EM contagion because of stronger underlying conditions, as we discussed in more depth in our August 23 *Observations*.

Emerging Market Susceptibility and Response

		Since January	
Country	**Susceptibility**	**Market Action (Equity Returns, USD)**	**Policy Response**
Argentina	Very High	-68%	Tightened
Turkey	Very High	-62%	Tightened
Chile	Med	-16%	No Change
South Africa	Med	-28%	Modest Easing
Indonesia	Med	-21%	Tightened
Brazil	Med	-22%	No Change
Hungary	Med/Low	-15%	No Change
Poland	Med/Low	-15%	No Change
Malaysia	Med/Low	-2%	No Change
Czech Republic	Med/Low	7%	Modest Tightening
Taiwan	Med/Low	1%	No Change
Mexico	Med/Low	5%	Modest Tightening
India	Med/Low	-10%	Modest Tightening
Philippines	Low	-22%	Modest Tightening
Peru	Low	-2%	No Change
Thailand	Low	0%	No Change
South Korea	Low	-12%	No Change
Russia	Low	1%	Modest Tightening

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