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Investments

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G2 Polarization – Eyeing China's Response to US Tech Containment

Key Takeaways

- The second US presidential election debate took a far different course than the first. Both candidates were sure to cite Chinese, Russian and other foreign factors as material threats for the US. We see US election uncertainty dragging on investor sentiment, following the routine but temporary pattern of election years we discussed in last week's CIO Bulletin.
- Whether the coming election unifies Congress and the Executive branch under one party or leaves it divided remains highly unpredictable in our view. For US fiscal policy, we see significant constraints on major tax and spending policy changes compared to the elections of 2016 and 2020, regardless of who wins.
- This week, we reexamine China's challenges which are impacting global markets. Rather than stimulate weak demand, China has chosen to invest in its own supply chains, focusing on their future security. This follows US steps to limit technology transfers.

Potential Portfolio Implications

- The world is waiting on the US election to understand its foreign policy course which will take a very different turn under Harris or Trump. G2 polarization – a division of alliances around the US and China – seems to be significantly steering Chinese economic policy.
- China's concern with security and self-sufficiency is likely driving a less robust domestic stimulus approach. This allows deflationary dynamics to fester. In contrast, tight fiscal policy is far off from the US political agenda.
- Among the greater US domestic tax uncertainties, the halving of the US estate tax exemption in 2026 under current law may provide a good motivation for planning.

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US Polarization – Except on Deficit Spending

After a second presidential debate, news coverage of the US election is set to heat up further in coming weeks. The temperature is set to "boil." As the world watches anxiously, Tuesday's debate showed apocalyptic language has been normalized.

In matters such as foreign policy and regulation, the differences between candidates Harris and Trump shouldn't be minimized. Yet for investors, we believe it is important to understand legislative constraints on certain US policies. These will likely narrow the differences in economic outcomes compared with the two sides' campaign vision statements. A lack of enthusiasm to constrain the US fiscal stance is also quite bipartisan, despite a big contrast in how the two parties deliver large US budget deficits.

First, let's repeat the background conditions and key constraining factors that exist now compared to four and eight years ago. Following those two elections, conditions allowed for big fiscal changes including a sharp cut in the US corporate tax rate from 35% to 21% and a massive fiscal response to COVID (please see our July 27th CIO Bulletin).

Today's electoral/policy backdrop

- Even after the Harris/Trump debate, current US presidential polling shows a close race. The much larger number of Senate Democrats facing re-election in November than Republicans (roughly 3 to 1) suggests a higher probability of a Republican "red sweep" if Trump wins the presidency than if Harris wins for Democrats. One prediction market shows an 80% chance of a Republican Senate win. However, polling data also suggests a solid chance that the closely divided House of Representatives swings to Democrats. **In short, we see the chance of a divided government of some sort (with either house of Congress or the Presidency differing in party) at slightly above 50%.** A divided government would be forced to compromise on US fiscal issues that demand attention, limiting the scope for aspirational changes. Compromise, they must.[1]
- US personal income tax rates will increase at the end of calendar 2025 automatically (see **FIGURE 1**). This is because of "sunset provisions" used to scale back the projected cost of tax cuts in 2017. It will take an act of Congress to prevent various increases. Either divided or unified, we expect Congressional action to prevent the bulk of the tax increases from taking place by end 2025. US politicians have very faint market pressure to tighten fiscal policy and no political constituents demanding tax increases (see **FIGURE 2-3**). Only a "red sweep" could deliver on proposals for new tax cuts, but with limited timing and scope in our view.
- It would take an act of Congress to raise corporate taxes, dividend income taxes or put new wealth taxes into place. Using so-called "reconciliation procedures," a unified government could approve such changes without a filibuster-proof super-majority of 60 Senate votes. Yet since the chance of a Democrat "blue sweep" seems quite low even if Harris wins the Presidency (see above), we see the probability of any new forms of taxation or radically higher tax rates as low.

[1] The last bi-partisan compromise to extend tax rates from sunset provisions took place with a 2 am vote by the Senate on January 1, 2013, technically after the "cliff" had been breached but before the tax rate changes took effect.

FIGURE 1: Summary of estimated key federal tax rates for calendar 2025 vs 2026

Married Filing Jointly Brackets		
Taxable Income	**Current**	**Tax Cuts Expire**
$0-$24,000	10%	10%
$24,001-$97,000	12%	15%
$97,001-$196,000	22%	25%
$196,001-$206,000	22%	28%
$206,001-$299,000	24%	28%
$299,001-$393,000	24%	33%
$393,001-$499,000	32%	33%
$499,001-$533,000	35%	33%
$533,001-$602,000	35%	35%
$602,001-$749,000	35%	39.6%
Above $749,001	37%	39.6%

Standard Deduction	
Current	**Tax Cuts Expire**
$27,700	$12,700

Corporate Tax Rate	
Current	**Tax Cuts Expire**
21%	21%

State and Local Tax Deduction	
Current	**Tax Cuts Expire**
$10,000	Full deductibility

Source: Haver Analytics and CGWI as of September 12, 2024. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

FIGURE 2: Federal interest payments as % of revenue and average interest rate

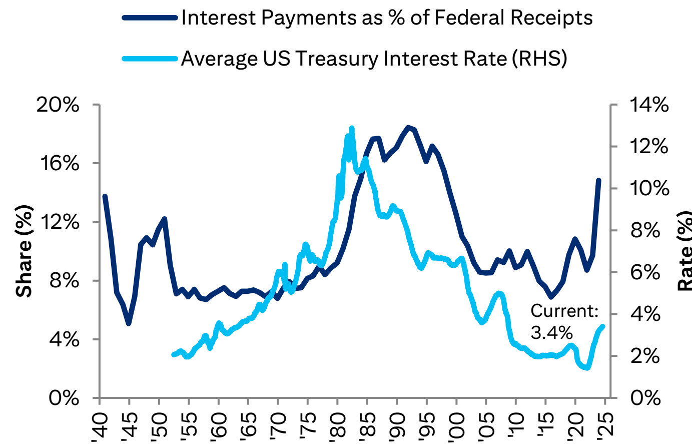
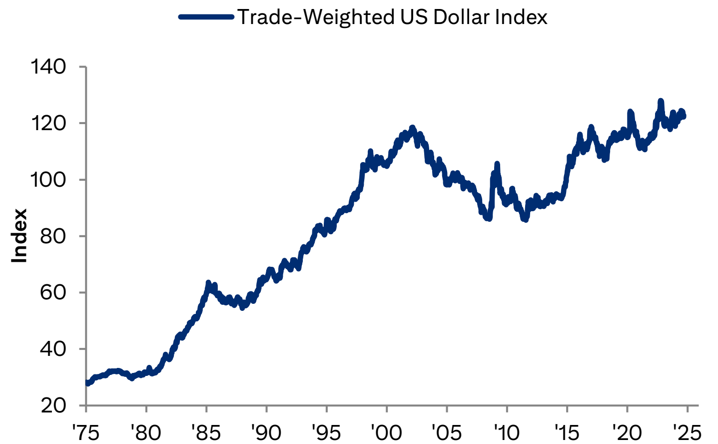


FIGURE 3: How does the US compare to others? US nominal trade-weighted dollar index



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Why do we expect the US to avoid a late 2025 "fiscal cliff?" Both US parties have expanded federal spending programs either passively or actively over the decades, particularly programs to support the healthcare needs of an ever-larger share of the population. With Federal Reserve interest rate cuts coming and a very strong US dollar as a starting point, the pressure to "absorb pain" is absent. And once feared as a "ticking time bomb," China's holdings of US Treasuries have diminished to less than 3% of US borrowing (see **FIGURE 4**).

The optimal size of US government is a grand and subjective question. Financing government budget deficits absorbs scarce savings. These might find more productive uses in the economy to invest in productive capacity. **But left to choose, historically Republicans have preferred larger tax cuts and smaller spending cuts over deficit reduction whereas Democrats have preferred smaller tax hikes and larger spending increases over deficit reduction.**

Growth is imperative for national debt sustainability

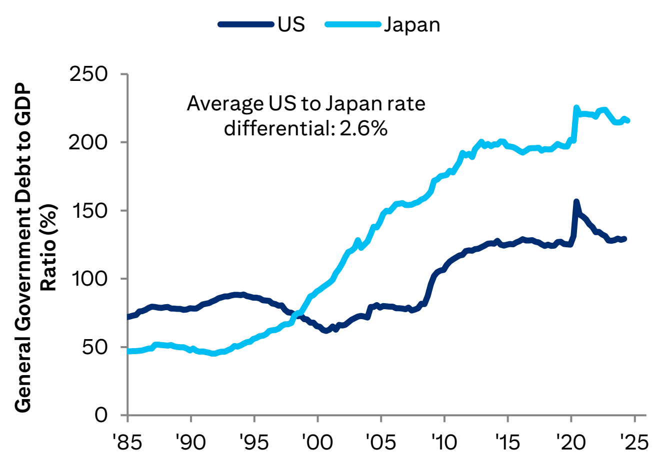
We routinely get questions over when US debt will collapse markets and the economy (please see our February 18th CIO Bulletin). At 5% US Treasury yields last year, many saw room for yields only to rise further. Conversely, low yields and low deficits don't ensure economic success.

As a best example of this, Japan's budget deficits in the past four decades differed little from the US's (both averaged near 4.5% of GDP). Japan's interest rates have been dramatically lower than the US's, by roughly 3 percentage points over the same forty years. Despite the lower yield "advantage" for Japan, its debt to GDP ratio has risen to about double that of the US over the same period as a result of weak nominal growth (see **FIGURE 5**).

In short, economic growth is imperative for macro-level debt sustainability. Reducing US deficits – if such a policy ever becomes a reality – should be gradual and long-term structural in nature, to coexist with economic growth. These are questions China faces in its longer-term economic outlook.

FIGURE 4: China's holdings of US Treasuries as % of total

FIGURE 5: Japan's debt to GDP ratio doubled vs US despite an interest rate averaging almost three percentage points lower than the US



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Understanding China's View of "Success"

Understanding China's economic policy and market outlook became fraught beginning around 2021. After initial successes in containing the COVID pandemic and attracting greater confidence from global investors, China took a variety of steps that trampled on its perceived "national champions" in the technology sector and among many industries attractive to domestic and foreign investors. After decades of rapid growth in property investment, China demanded changes that burst its property bubble, and recovery is still elusive.

Yet China's economy remains the world's first or second largest depending on the form of measurement. While its financial linkages to the world remain very limited relative to its size, its impact on global trade and corporate profits remains enormous (see **FIGURE 6-7**). With this in mind, we address several key questions from regional and global clients on China's outlook below.

FIGURE 6: China's share of global exports (%)

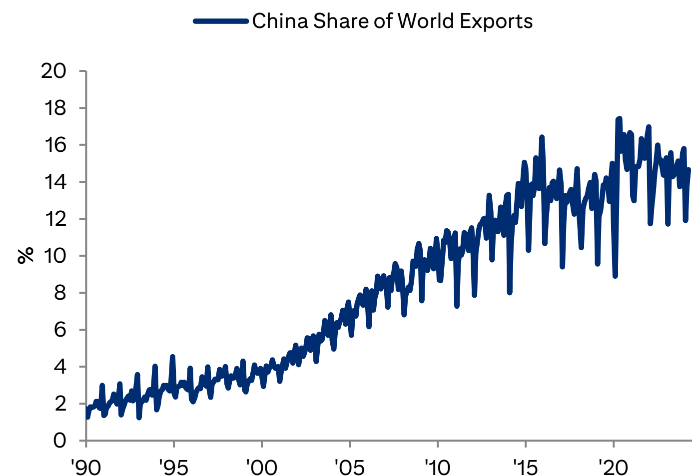


FIGURE 7: China's export price index Y/Y%

Source: Haver Analytics as of September 11, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Will China's central government restore consumer confidence and local demand growth?

We see China's economy needing two things to begin a more robust recovery, but neither seems to be in the cards.

1. **Massive policy rate cuts toward zero (the level of policy rates in much of the developed world during the past two recessions):** This would help remove any financing cost constraints to existing investment projects (such as mortgages and new infrastructure) and government policies (such as the local government property-buying scheme). The risk of such a policy is it could destabilize the currency and hurt bank margins, which authorities fear will destabilize the financial system. Ideally, this systemic risk can be mitigated with deposit insurance and government guarantees on banks. But Chinese authorities have little experience with deposit insurance and loathe to increase government guarantees on banks. They prefer to help by keeping a healthy profit margin for banks even as economic growth is constrained.
2. **Substantial fiscal stimulus**: In essence, a tangible recovery for China's economy would be more likely if it followed past steps from developed governments like the US and EU with a policy of monetary-financed deficits, welfare spending and subsidies worth at least 2% of GDP. A policy of income support for new parents would cost dramatically less than government infrastructure spending. In our view, compensating businesses for hiring new college graduates would be helpful. Replenishing public elderly care and healthcare programs would likely support confidence, but the Chinese government appears to see technology and global competitiveness as more important economic objectives. The current emphasis on investing in infrastructure or high-tech industries is unlikely to produce a widespread, positive demand impact, and is hence ineffective so far.

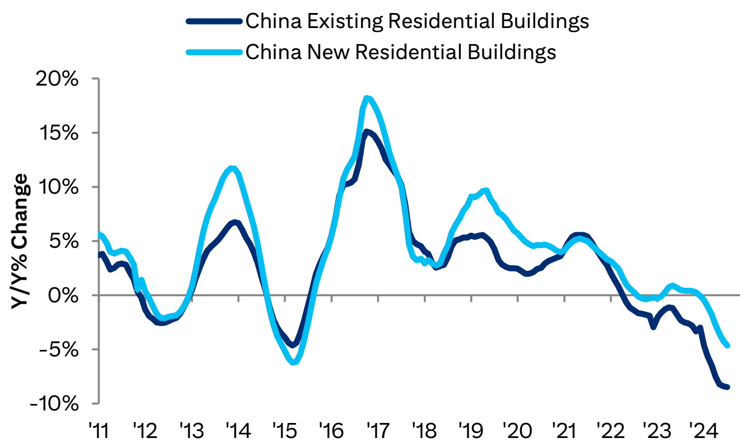
Notably, China's population shrank in 2023 by 2 million, and is on track to shrink by 100 million in the coming 15 years[2]. This will drag demand massively, but also reduce the pressure to create jobs. Substantially subsidizing childbirth could slow down this decline but not reverse it. This has become a policy priority, but it has ranked low compared to security, tech self-sufficiency, and financial stability concerns amid US "containment" policies centered, for now, around high-tech exports to China.

[2] Source: United Nations "World Population Prospects 2024"

Will China continue to take insufficiently small steps to move past its property bubble?

China's property-related policies remain focused on preventing a large-scale financial crisis, rather than to restore real estate sector stability. As a result, we cannot expect a quick solution. However, there are signs that the market is adjusting. Property prices were previously not allowed to fall, as price stability was a local government (LG) goal, with the intention to avoid social unrest and banking instability. But since spring 2024, more and more LGs are allowing prices to fall. For example, Beijing property prices have fallen 25% since the 2021 peak. Nationwide, we estimate the average decline is 30% or more. This type of price adjustment brings us much closer to a market equilibrium than the official data that showed only an 8% drop (see **FIGURE 8**).

FIGURE 8: China residential property prices Y/Y%



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The missing piece of the puzzle is demand. And clearly, at the current price, housing demand is still not recovering (top 100 developer sales fell 27% over the year through August[3]). The government launched a program for LGs to buy excess inventory for affordable housing, but the financing cost is not low enough and developers are unwilling to sell at the price that LGs are offering. We believe this program needs to be adjusted to create real additional demand.

Ultimately, households need to come back to the market. This would require restoring employment and income expectations, which would require restoring business confidence.

Would a re-elected Trump take even stronger tariff steps and other trade restrictions?

Most likely yes. But the tariff regime is unlikely to be 60%+ across the board on China out of concern to minimize disruptions to the US farming and retail markets. But significant increases in tariffs for many product groups are still likely.

The key is how China might respond. Direct responses could include countervailing tariffs (particularly agriculture), export limitations on rare earths and tighter regulatory action against US companies in China. These are likely to have limited impact on markets outside the directly affected industries/companies. However, allowing the CNY to depreciate could have wider consequences similar to the 2015 global growth scare. If it were the case, markets that directly compete with China or export to China would likely be most impacted. This would include Korea, Taiwan and

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[3] Source: Bloomberg and China Real Estate Information Corp. as of August 31, 2024.

many in Southeast Asia. If this is done at the same time as potential equalization tariffs on all US trading partners away from China, it could be a more notable negative for global growth. It would create safe-haven demand for the USD and US Treasuries and would be disruptive to markets. Yet apart from the fainter possibility of a US-led global trade shock, it is notable that exporters in Asia have shifted supply chains away from China to access the US market. This is likely to diminish the impact of another US/China "tariff war" similar to 2018.

Conclusions

China's economy may now be performing worse than official data suggest. Survey data suggest that industrial production is slower than the reported 5%. Deep property declines and weak manufacturing suggest fixed investment might be negative, rather than the 2% pace reported. Retail sales growth at 2.7% also seems high compared to the unemployment rate and confidence measures. This could also mean that we're closer to action from officials. Real GDP growth of 4.7% Y/Y in 2Q shows weak momentum with more action needed to restore growth to meet the 5% target.

But it is important to understand why China has taken the policy steps that it has over the past few years. It's been a reaction to perceived domestic social threats to stability and external concerns about security. A side effect of China's priority shifts is US and broader western disapproval of China's direction. This has clearly accelerated as China became more assertive in foreign policy. In terms of polarization, it appears the US may not accept a compromise that the Chinese government is willing to make as sufficient to de-escalate.

With the above understanding, it is easy to see why China had chosen industrial capacity building as a way to both ensure self-sufficiency and to counteract western containment (see **FIGURE 9**). This does nothing to alleviate deflationary pressure in China's economy, which it is exporting (if marginally) to the world.

FIGURE 9: China fixed investment in equipment and instruments Y/Y%

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Medium grade	Baa	BBB	BBB
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Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
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Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

An investment in alternative investments can be highly illiquid, is speculative and not suitable for all investors. Investing in alternative investments is for experienced and sophisticated investors who are willing to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks may include:

- loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices;

- lack of liquidity in that there may be no secondary market for the fund and none is expected to develop;
- volatility of returns;
- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- absence of information regarding valuations and pricing;
- complex tax structures and delays in tax reporting;
- less regulation and higher fees than mutual funds; and
- manager risk.

Individual funds will have specific risks related to their investment programs that will vary from fund to fund.

Asset allocation does not assure a profit or protect against a loss in declining financial markets.

Diversification does not guarantee a profit or protect against loss. Different asset classes present different risks.

The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

Past performance is no guarantee of future results.

International investing entails greater risk, as well as greater potential rewards compared to US investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economics.

Investing in smaller companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity.

Factors affecting commodities generally, index components composed of futures contracts on nickel or copper, which are industrial metals, may be subject to a number of additional factors specific to industrial metals that might cause price volatility. These include changes in the level of industrial activity using industrial metals (including the availability of substitutes such as manmade or synthetic substitutes); disruptions in the supply chain, from mining to storage to smelting or refining; adjustments to inventory; variations in production costs, including storage, labor and energy costs; costs associated with regulatory compliance, including environmental regulations; and changes in industrial, government and consumer demand, both in individual consuming nations and internationally. Index components concentrated in futures contracts on agricultural products, including grains, may be subject to a number of additional factors specific to agricultural products that might cause price volatility. These include weather conditions, including floods, drought and freezing conditions; changes in government policies; planting decisions; and changes in demand for agricultural products, both with end users and as inputs into various industries.

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