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Foresight

What does US-China decoupling mean for emerging markets?

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Schroders

What does US-China decoupling mean for emerging markets?

A decoupling of economic and political ties between the US and China is likely to be one of the most important drivers of financial markets in the emerging world during the next decade. Ever since Donald Trump swept to power by promising to put "America First", policies aimed at clawing back political, economic and military power from China have become popular on both sides of the aisle in Washington. The victory of President-elect Joe Biden is unlikely to change this. And, if anything, a more methodical, consensus-building approach from a Democrat government may ultimately be more effective in driving decoupling. Meanwhile, the global pandemic may also cause companies to reassess the risk of having supply chains concentrated in China.

However, it is not just the US that is pulling away. Policymakers in China have for some time been expressing more overtly a desire to topple the US from number one spot through strategies such as "Made in China 2025" and "Dual Circulation". The former seeks to establish China as a global leader in manufacturing, with a focus on more technology intensive production. Dual circulation incorporates the goal to strengthen the domestic economy, while continuing to grow China's importance internationally. Meanwhile, Beijing's push to re-orientate supply chains around itself through the "Belt and Road Initiative" implies a major shake-up of the world order. US aggression has only accelerated these ambitions. As a result, the recent agreement of the Regional Comprehensive Economic Partnership (RCEP) may be a sign of things to come. This brings together fifteen Asia-Pacific countries to form the largest trade bloc in the world with China at its centre.

We explore the next steps that each side could take if tensions continue to grow, and discuss which other emerging markets might be the winners and losers from differing degrees of decoupling. In the scenario that the status quo is maintained and tariffs remain in place, low-cost manufacturers could relocate to countries such as India and Indonesia. This would give a boost to economic activity and the performance of local markets. Alternatively, in a scenario with further escalation, some reshoring and diversification of supply chains could be favourable for Mexico in particular. In the unlikely scenario of a breakdown in relations, the impact could be more stark, causing the world to split into two markets; one around China and another around the US and the rest of the world. Needless to say, all of this could have significant long-term implications for asset allocation in emerging markets.

Why should investors care?

What decoupling looks like will clearly matter for investors. After all, the opening up of China in the 1990s and its "coupling", or integration with the US and the rest of the world spurred another round of globalisation in the following two decades. During that period world trade almost doubled to around 60% of GDP (figure 1), acting as the catalyst for a period of strong economic growth, low inflation and solid returns from financial markets. However, the boom in global activity came to an end with the global financial crisis (figure 2), since when globalisation has stalled and the performance of emerging market economies and assets has deteriorated (figure 3). The best outcome for the global economy and markets would be that the US and China put aside their differences, triggering another wave of global integration that would boost growth. But this seems unlikely. The conflicting ambitions of the two superpowers raises concerns that policies geared towards unpicking these linkages and "de-globalisation" might have a detrimental impact on returns. This is the scenario whereby decoupling, with a reduction in economic and political links, ultimately leads to lower growth, higher inflation and weaker corporate earnings.

However, the degrees of separation will be important in determining the severity of the economic and market impact. The various measures imposed by the Trump administration, such as trade tariffs and protection of key industries, did contribute to bouts of volatility in financial markets. But it is hard to argue that they significantly altered the direction of travel. Investors can probably live with such frictions. Indeed, China has managed to slightly increase its share of the global export market since the trade war began. However, the longer that tariffs remain in place and political pressure grows, the greater the likelihood that such protectionist measures will begin to alter consumption and supply chain patterns. Regionalisation of supply chains threatens to decrease efficiency and future development, while there would surely be few winners from a technology cold war.

What is the state of play and where might we be heading?

Pressure points have emerged in several interlinked areas in recent years. Trade has perhaps been the most common source of tension between the two sides. Along with disruptions to supply chains during the Covid-19 pandemic, this saw the Trump administration call repeatedly for the reshoring of manufacturing by American companies and the jobs that go with it. In addition, the Whitehouse has accused Chinese companies of stealing intellectual property and US-patented technologies; citing such practices as a threat to national security through alleged links to the Chinese government and military. This has come as geopolitical and even military tensions have fluctuated over Hong Kong Special Administrative Region (SAR), the South China Sea, the Korean peninsula and India. Meanwhile, Washington also appears uncomfortable about Beijing's strategy to increase its global influence through projects such as the Belt and Road Initiative. This plan, announced in 2013, seeks to build international connectivity and cooperation via an infrastructure development strategy, with a target completion date of 2049. There have been further flash-points over financial relations after the Trump administration imposed sanctions on politicians, threatened to kick Chinese companies off US stock markets, and most recently signed an executive order to ban Americans from investment in companies with alleged ties to China's military.

Globalisation boosted EM economic growth and returns from financial markets

Figure 1

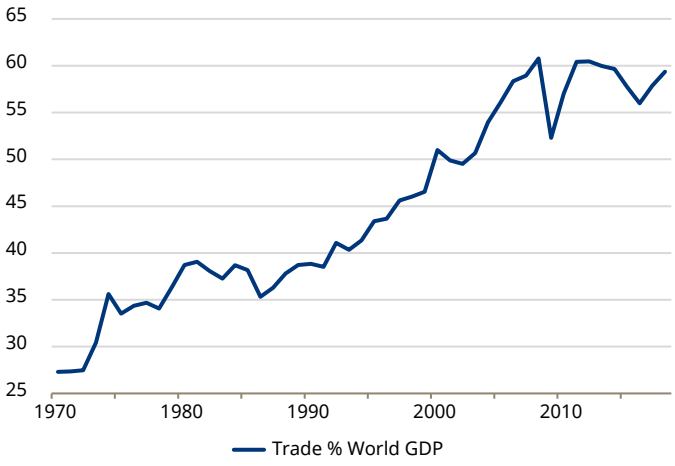
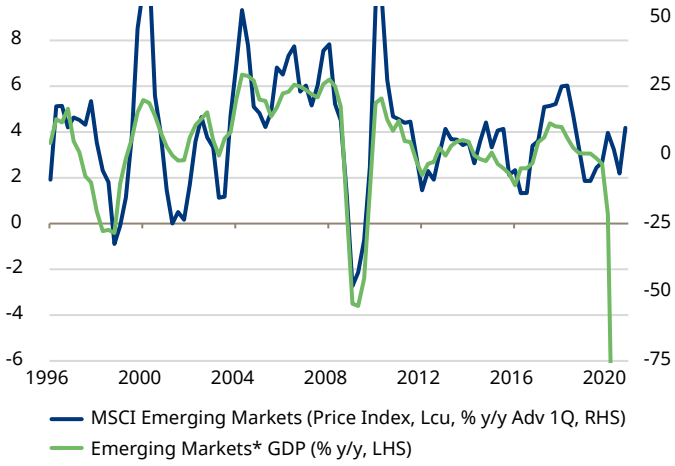


Figure 2

Figure 3



Source: World Bank, Refinitiv Datastream, Schroders Economics Group. 18 November 2020.
*Excluding China at market exchange rates.

Trade

It is in the trade arena where there has been the most policy action so far. After the imposition of a succession of tit-for-tat tariffs on goods that began in mid-2018, the US and China eventually agreed the "Phase One" trade deal in January 2020. China agreed to increase protection of intellectual property and technology, open-up its financial sector and significantly raise its purchases from the US of mainly agricultural goods by $200 billion over two years. However, it remains to be seen if the initial deal will hold. As figures 4, 5 and 6 show, China is lagging far behind on the purchases of US goods. And the economic damage caused by the Covid-19 pandemic and subsequent decline in commodity prices may make it hard to meet its targets.

It is possible that some kind of compromise can be found on the purchases of goods. However, discontent with progress on other, less tangible parts of the agreement could easily see the Phase One deal fall apart if US policymakers are not satisfied. Failure of the Phase One deal might see the US further ratchet-up tariffs with reciprocal measures by China. But the fact that tariffs have so far been ineffective in reducing China's bilateral surplus suggests that Washington will focus even more on other areas.

Technology

One such area that might come under even more scrutiny is technology, where direct action to curb the development and growing global influence of Chinese companies was also at the forefront of the Trump administration's protectionist strategy. Telecommunications company Huawei has of course been the prime target of such measures. Suppliers are now banned from providing it with components essential to the manufacture of products such as 5G equipment that use US-patented technologies. The US has also pressured allies to stop using Huawei products on the basis of alleged threats to national security. All of this threatens to make portions of Huawei's business unviable, along with other companies such as TikTok and WeChat that have also been targeted. Looking ahead, the list of companies and sectors that are either barred from using American technology, or lose access to the US market could conceivably broaden to all industries if relations between the two side continue to deteriorate.

Beijing has so far responded to tensions over the use of American technologies by stockpiling inputs and ramping up spending on research and development in order to develop its own products. But the authorities could clearly turn to more aggressive measures. After all, the globalisation of trade in recent decades has seen China move to the centre of global supply chains and become the main assembly hub for many products and companies. So while the Chinese authorities may not be able to stymie the operations of American companies by blocking the use of certain technologies, they could instead bring the supply chains of many foreign companies to a complete standstill.

China is lagging far behind on its Phase One purchases of US goods

Figure 4

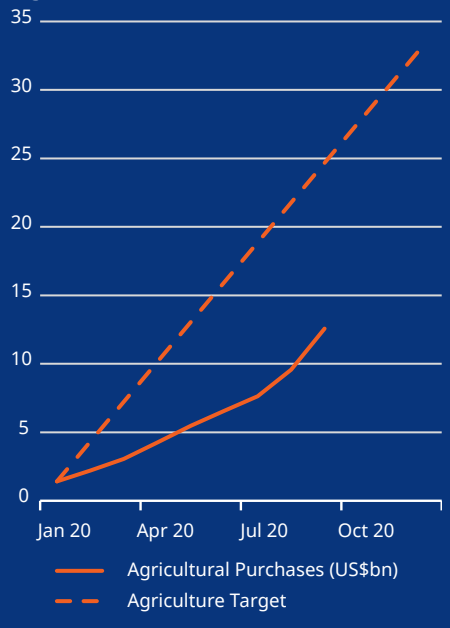


Figure 5

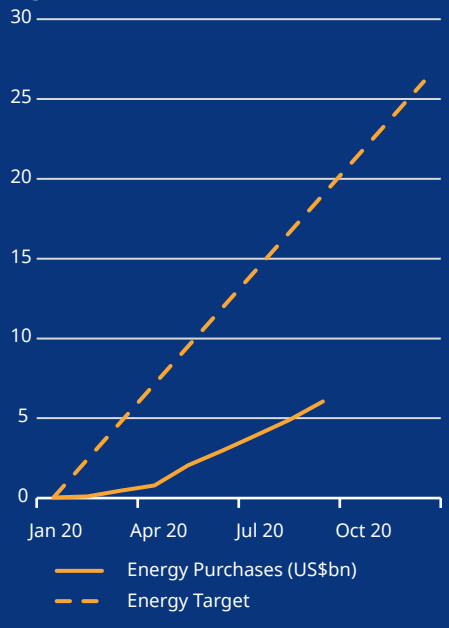
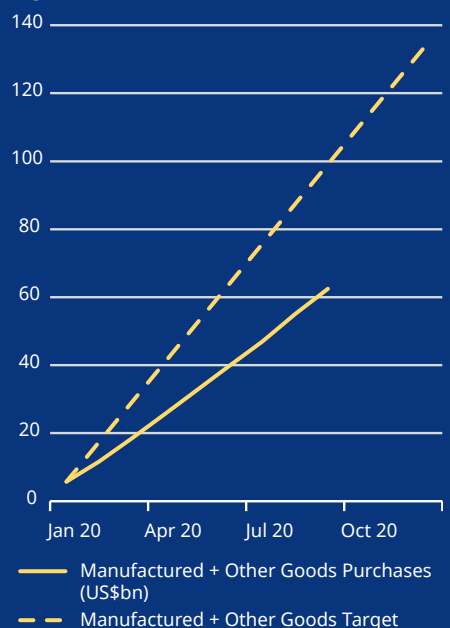


Figure 6



Source: US Census Bureau, Schroders Economics Group. 18 November 2020.

One way in which Beijing has threatened to do this is by drawing up an export control law that would prevent goods manufactured in China by targeted companies from being shipped abroad. For example, there could be a ban on the export of goods produced by telecommunication companies Ericsson and Nokia, or even Apple, in retaliation for curbs on Huawei. Foreign companies could also be added to an unreliable entity list that would effectively ban imports and purchases of goods and services from specified companies. And through its influence on the Chinese business community, the government could also cause damage just by leaning on companies and individuals to stop buying certain goods. South Korean car manufacturers had a taste of such tactics in 2017. Their sales in China collapsed almost overnight during a disagreement over South Korea's installation of the US-made Terminal High Altitude Area Defense (THAAD) system.

Supply chains

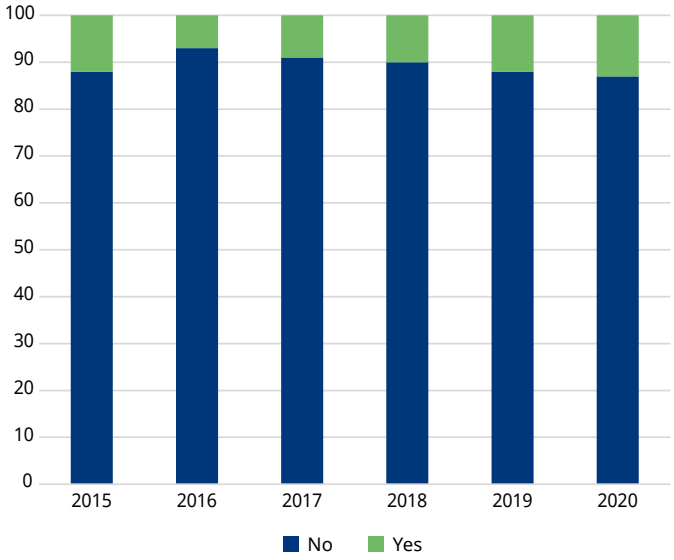
The Trump administration attempted to use incentives to convince American companies to reshore manufacturing production that was previously moved to China. This was driven by concerns about the security of supply chains, along with a desire to bring back industrial jobs. Other countries such as South Korea have also tried to lure companies home with the offer of tax exemptions. This has been prompted in part by a realisation during the Covid-19 crisis that high concentration of production is vulnerable to disruption.

However, despite the desire of governments to bring home manufacturing there has so far been little evidence of it happening. For example, a survey conducted by the US-China Business Council shows (figure 7) that the overwhelming majority of respondents had not moved nor planned to move production out of China. Indeed, few of those that said they would relocate expected to move facilities back to the US.

There are several possible reasons for the lack of enthusiasm from companies to move factories back to the US. An obvious one is that the Trump administration's policies have been erratic, and firms may simply have been waiting to see what the lie of the land will be after the election. In this respect, a more methodical Biden administration that tries to build long term multi-lateral alliances against China may have more success in convincing firms to relocate facilities. Another obvious reason is that it would be expensive and time consuming to relocate factories. Estimates by Bank of America suggest that it would cost around $1 trillion and take five-years for all non-Chinese firms to relocate production elsewhere. And reshoring production would probably also entail higher costs in the long-term. After all, the driving force behind moving production to China in the first place was to take advantage of cheap and productive labour. Firms would also face higher labour costs that would ultimately damage their competitiveness in the global market. With the exception of companies that are able to increase the automation of their production lines as they reshore to the US, which would not create many jobs.

Figure 7: The trade war has not yet convinced many US companies to leave China

Has your company moved or does it plan to move any operations out of China? (%)

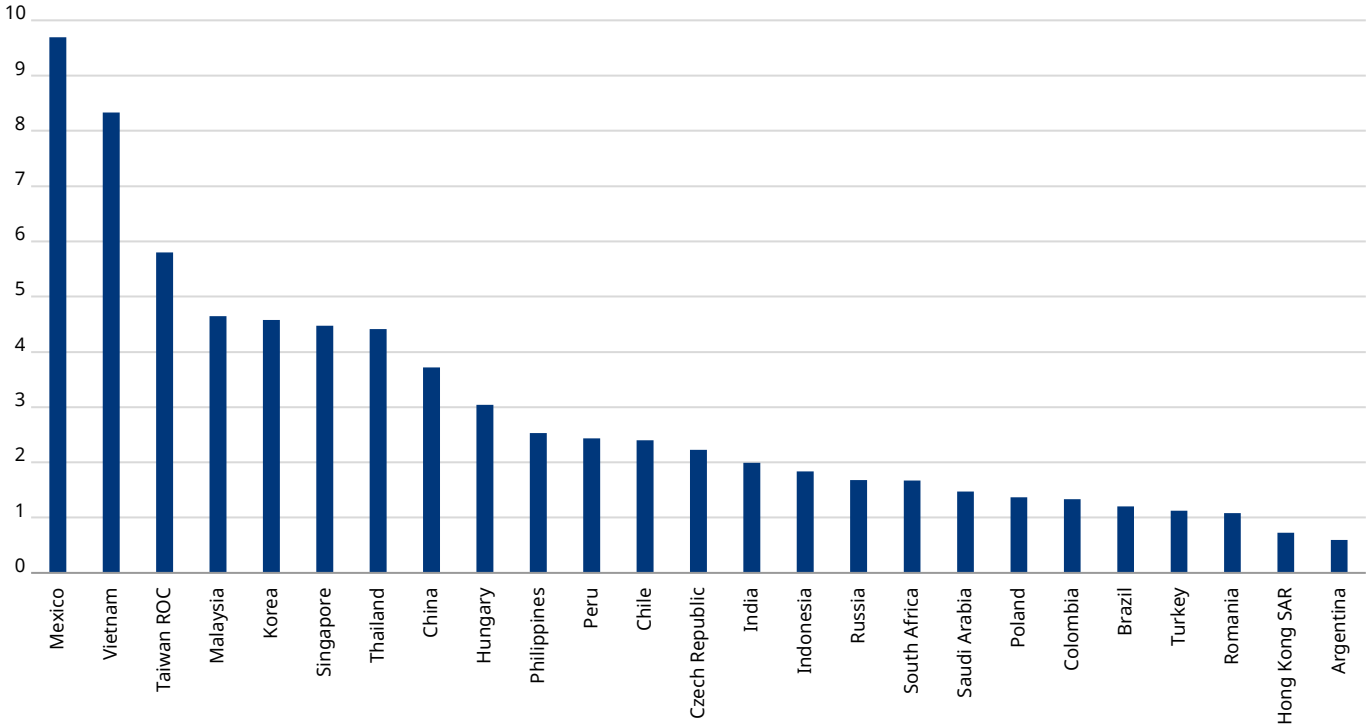


Source: US-China Business Council, Schroders Economics Group. 18 November 2020.

Looking ahead, there is clearly a risk that the US government will simply demand that companies move at least part of their production out of China in order to ensure secure supplies of goods. This would probably start in key industries such as healthcare and technology, but could clearly broaden to more sectors over time. However, relocating to the US may not be an attractive proposition for many firms. So this could be good news for emerging markets that could easily expand existing trade relationships with the US, and where wage costs are relatively low. For example, Mexico, along with several markets across Asia, already derive a significant amount of GDP growth from the value-added in goods that the US imports (figure 8). It is often the case, particularly for Asian markets, that this value-added is gained through supply chains that deliver inputs for assembly in China. A greater push towards supply chain diversification could see assembly plants moved to other countries. And such industrialisation could raise the potential GDP growth rates of those emerging market economies that benefit.

Figure 8: Trade with the US is an important driver of growth in Mexico and Asia

Value–Added in US Imports as a % of Local GDP (2015)



Source: OECD TiVA, Schroders Economics Group. 18 November 2020.

The authorities in China have so far been tight-lipped on the issue of supply chain relocation, perhaps because there has not been much movement. Moreover, the government probably has designs on shedding some low-end manufacturing to other countries through its Belt and Road Initiative and the RCEP trade deal. This could be replaced with its own higher-value manufacturing, which would help to re-orientate the shape of China's economy as well as raise domestic incomes and consumption. In this respect, if a break-up of existing supply chains forced Beijing to further ramp-up investment in high-value manufacturing, US policies could conceivably backfire. Because these could help China to arrest the structural slowdown in its economy that threatens to leave it stuck in the middle-income trap.

Even so, it seems unlikely that Beijing would stand by and watch a slow dismantling of its manufacturing sector. China still relies on transfers of skills and technologies to drive its development, while an exodus of foreign manufacturers would leave a sizeable hole in the economy and labour market. Accordingly, the authorities might threaten to add companies that intend to relocate to the unreliable entity list and impose export controls on their products. In other words, companies that move elsewhere might lose access to the Chinese market.

We think that companies would be more likely to seek diversification through the use of regional supply chains rather than abandon production in China altogether. There will undoubtedly be concern about being barred from the potentially lucrative Chinese market, or the risk of export controls until new factories can be built elsewhere. And there are real world success stories of regionalised supply chains, such as motor vehicle production. It has largely been split into three regional supply chains in Asia, Europe and North America. This regionalisation of production does not appear to have had much of a detrimental impact on the efficiency of vehicle manufacturing, technological transfers or consumer prices. Indeed, as figure 11 shows, new vehicle prices in countries such as the UK have increased at a slower rate than headline inflation during the past two decades. And regionalisation brings other benefits such as shorter transportation distances as the global economy is decarbonised.

Decoupling could even help China escape the middle-income trap if it triggers rapid investment in high tech sectors

Figure 9

Real GDP Growth (%,1980–2019)

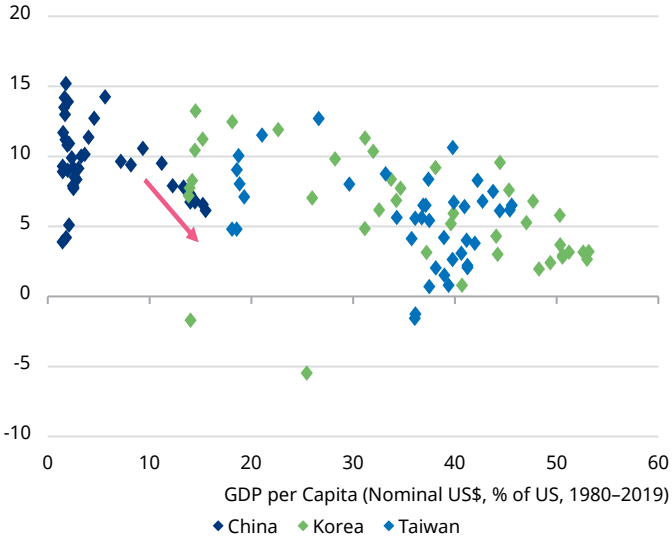
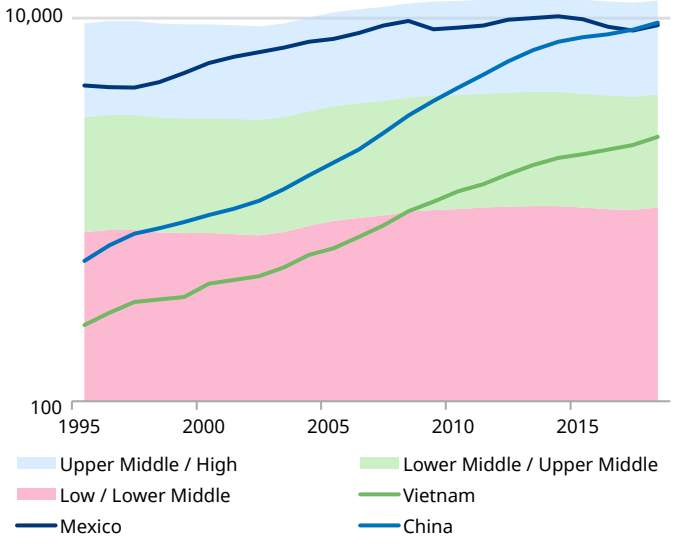


Figure 10

GNI per Capita (Log US$)

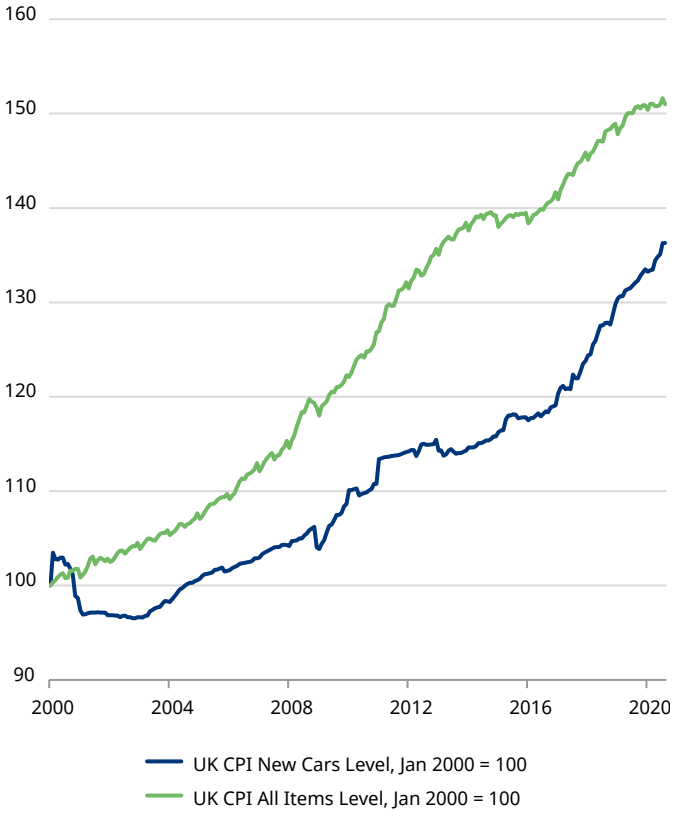


Source: World Bank and IMF, Schroders Economics Group. 18 November 2020.

However, not all industries are well-suited to a regionalisation of supply chains. In many cases, operating several production facilities would simply decrease the efficiency of production and increase costs. What's more, if a regionalisation of supply chains was accompanied by continued curbs on the sharing of intellectual property and capital flows, then it could slow the advancement of new industries. And this would weigh on future economic growth. Moreover, a technology cold war that led to completely discrete streams of technologies and standards, along with reduced competition, would give existing companies greater pricing power. The upshot is that the further the world travels down the road of supply chain regionalisation and divergence, the greater the negative impact on economic growth and inflation.

Any significant changes to global supply chains would also be likely to have major ramifications for long-term asset allocation in emerging markets. After all, export-led industrialisation has tended to be an anchor for the performance of assets; given that manufacturing exporters tend to enjoy lower real interest rates, tighter credit spreads on hard currency debt and deliver better, less volatile returns over the long-run. The economic explanations for this are obvious. Export-led growth models tend to generate multi-year current account surpluses, resulting in a higher domestic savings and investment rate, while allowing the accumulation of large amounts of foreign currency. Being "cash-rich" makes foreign currency less expensive to borrow; hence tight spreads. Without the need to attract foreign capital in order to fund investment and external deficits, interest rates can be structurally lower. Exchange rates therefore tend to be less volatile. Accordingly, if emerging markets such as Brazil, India, Indonesia, Mexico, South Africa or Turkey could transition into more stable, manufacturing export-led economies, their financial markets would be likely to outperform substantially in the long run.

Figure 11: Regionalisation of supply chains has not had an adverse effect on car prices



Source: Refinitiv Datastream, Schroders Economics Group. 18 November 2020.

Assets would perform well in any EM that are able to transition towards export-led growth models

Figure 12

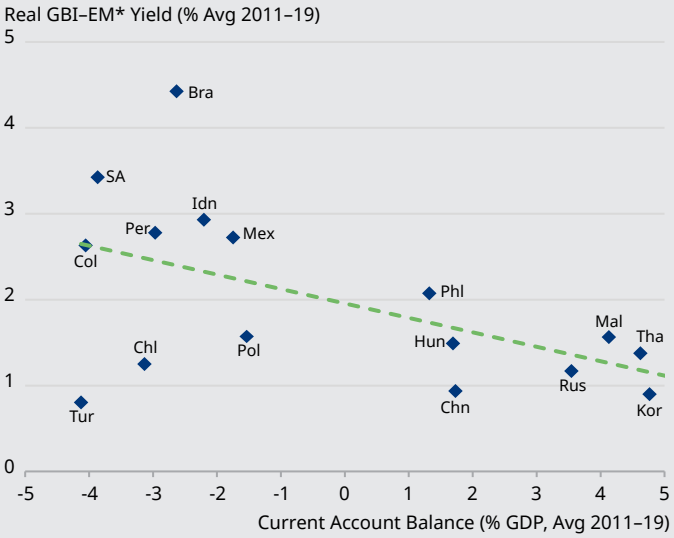


Figure 13: Credit spreads

Figure 14: EM FX volatility

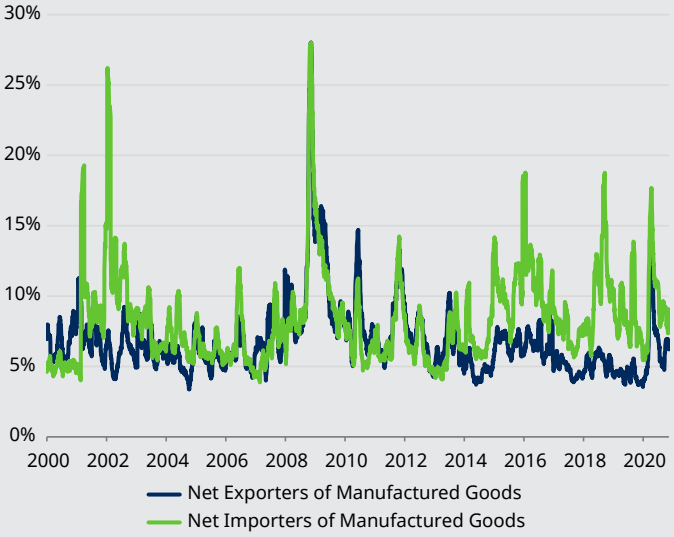
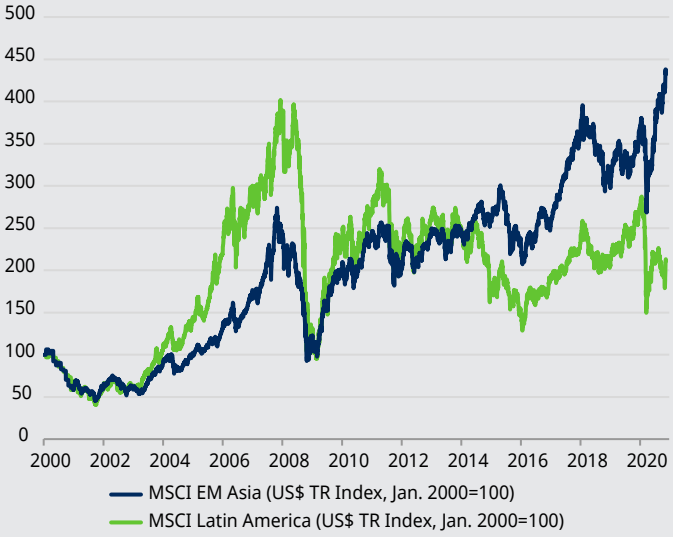


Figure 15: Emerging market equities



Source: Refinitiv Datastream, JP Morgan, Schroders Economics Group. 18 November 2020.
*Deflated by CPI

Financial

Finally, there have also been flash-points regarding financial relations between the US and China. The US government has sanctioned some individuals over events in Hong Kong SAR. And it has threatened to force Chinese companies to delist from US stock markets if they refuse to allow a full audit of their accounts. The Trump administration also sought to deter state-linked pension funds from investing in China, and signed an executive order to ban Americans from investing in 31 companies that are alleged to have links to China's military. Again, Beijing has not explicitly responded to these measures, and they are frankly not very meaningful. Financial sanctions against individuals do not tend to be very effective, while Chinese companies could just move their listings elsewhere. But China has taken several small steps to placate US concerns about access to onshore financial markets, including a partial opening up of its domestic bond market to foreign investors. The government has also issued a US dollar denominated bond to US investors for the first time.

Meanwhile many large US financial institutions, keen to tap into China's long-term potential, have been quietly setting up major onshore operations.

However, there is clearly scope for much more damaging policies if relations between the US and China deteriorate further. For example, the Trump administration has imposed financial sanctions on countries such as Russia, Iran and Venezuela, including a ban on purchases of the latter's sovereign debt by US investors. In addition, US companies could be barred from investing in China, US banks could be ordered to leave Hong Kong SAR or Chinese banks could be barred from using the dollar for transactions. China could respond by expanding its own payments systems, which might also help to broaden the use of the renminbi. And there has long been speculation that it could dump its holding of US Treasury bonds. Such measures would cause major disruptions to the global economy and financial markets if they were to ever happen.

There are clearly many permutations to all of this. But the short point is that the further the world pulls apart, the greater the likelihood that economic growth will be slower in the long term, inflation higher and the performance of assets poorer. It is useful to consider three different scenarios when thinking about the possible economic and market impact of all of this, and to identify the possible winners and losers.

Scenario 1 – Continuation of current policies, but no escalation

In this relatively good scenario, the incoming Biden administration leaves current policies in place but does not pursue a more aggressive strategy. In aggregate, a continuation of existing policies would probably not have much of a negative impact on the performance of the global economy or its markets.

In the short term, Chinese exporters would continue to circumvent tariffs by shipping goods to the US through third parties, or absorbing some of the additional costs into their margins. However, in the longer run, tariffs would encourage foreign manufacturers to relocate production, particularly of relatively low-value goods where producers were already facing rising labour costs in China.

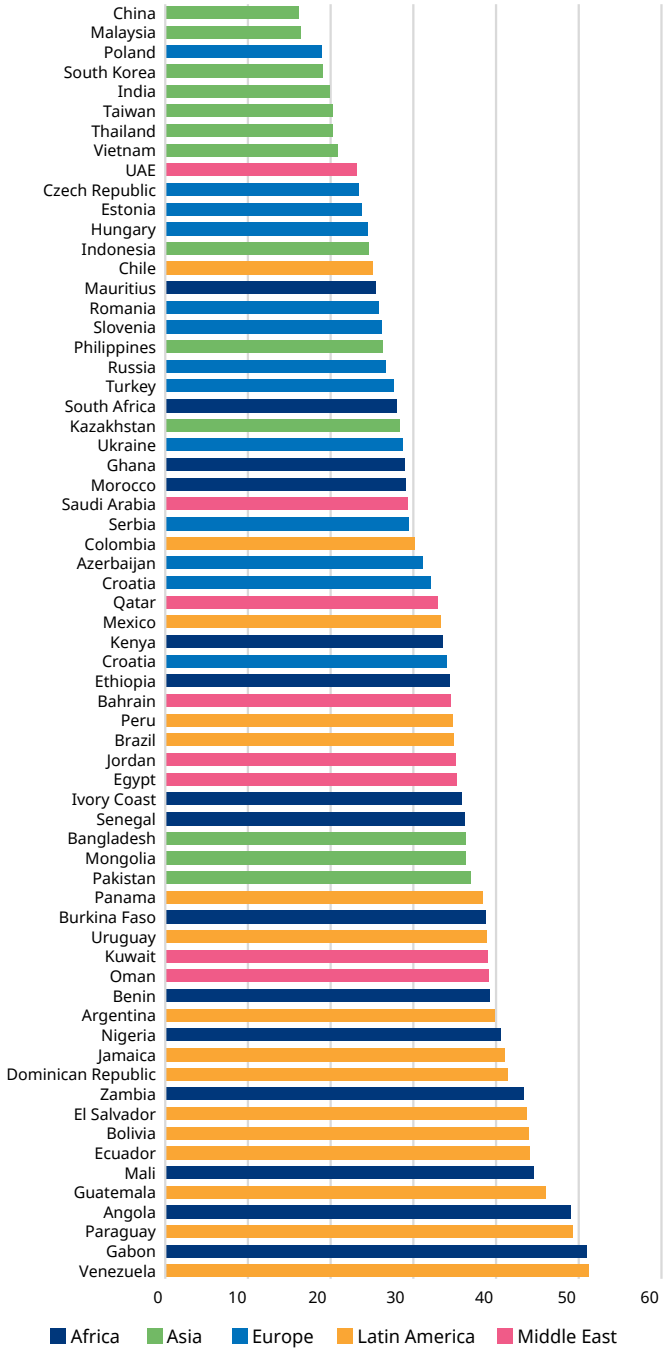
In order to assess emerging markets in our investment universe (that is the markets that make up the MSCI Emerging Markets and Frontier Markets equity indices and the JP Morgan EMBI Global US dollar-denominated and GBI-EM local government bond indices) we have ranked markets (figure 16) according to their overall scores in several global business environment surveys. These are the World Bank's "Doing Business" survey, DHL's Global Connectedness Index, the World Economic Forum's Global Competitiveness Report, and Transparency International's Corruption Perception Rank. This is to gauge the relative attractiveness of business environments across various emerging markets. We have also attempted to rank these markets according to the relative attractiveness of their labour markets. This is not easy, as labour market statistics in many emerging countries tend to be poor. Without easily available and comparable wage data for manufacturing, we have tried to proxy labour costs by comparing income levels, measured as nominal US dollar GDP per capita as a share of that in the US. Meanwhile, we also have ranked markets according to the International Labour Organisation's (ILO) estimates of growth in real output per worker, in order to gauge productivity growth. Again, it would be preferable to compare productivity in manufacturing, or ideally unit labour costs. Finally, we also ranked countries according to the ILO's projections for the size of the working age (15-64) labour force in 2025. This is because companies are likely to prefer markets that have large amounts of readily-available workers.

In figure 16, we have plotted the average rank of the 65 emerging markets across the 7 indicators. What becomes clear from this analysis is that the vast majority of attractive destinations for the relocation of low-cost manufacturing are in Asia or Europe. A combination of poor business environments and governance, coupled with unproductive work forces, means that most African and Latin American markets do not score well on a relative basis.

Attractive business environments mean that several of those markets such as South Korea, Taiwan and Poland are already relatively developed. And as can be seen in our scorecard in figure 17, this is already reflected in high income levels which probably rule them out when it comes to relocating low-cost manufacturing. By stripping these higher income markets out, emerging markets that have a similar or lower income level to China and compare relatively well in terms of other factors include: Malaysia, India, Thailand, Vietnam, Indonesia, the Philippines and Turkey.

Figure 16: EM in Asia and Europe offer the most attractive business environments

Average rank of EMs across 7 business and labour market indicators



Source: World Bank "Doing Business" 2020, DHL "Global Connectedness Index" 2017, World Economic Forum "Global Competitiveness Index" 2019, Transparency International "Corruption Perception Rank" 2019, IMF, ILO Refinitiv Datastream, Schroders Economics Group. 18 November 2020.

Of course, these different markets have contrasting strengths and weaknesses, which would play a role in determining the kind of industry they might attract. For example, many companies would surely find India's relatively large and low-cost working age population appealing when considering where to relocate manufacturing bases. India does score relatively poorly when it comes to its business environment. However, the Covid crisis has forced the Modi government to start pushing through reforms to areas such as the labour market and agriculture, which could eventually improve operating conditions for companies. What's more, given that it has joined the US in banning Chinese companies such as TikTok, it might expect to be rewarded with an influx of investment from the US in the longer term.

It is a similar story for Indonesia, which ranks well on the basis of its relatively large, young population that command low incomes. And like India, the Covid crisis has forced the government to revive long overdue structural reforms with the recently approved Omnibus Law.

If they were successful in attracting a significant influx of manufacturers, there could be substantially positive economic impacts. In the short-term, economic growth would be boosted by capital inflows to fund investment and the construction of factories and infrastructure. In the longer-term, an increase in manufactured exports would lift productivity and thus potential GDP growth. This would likely lead to an improvement in external balances, a decline in structural interest rates and better exchange rate dynamics. All of this would be supportive of the performance of local financial markets.

Malaysia, Thailand and Vietnam also rank well in our scorecard and these markets have already established themselves as exporting economies. The main drawbacks for them are perceptions of corruption and, particularly in the case of Malaysia, relatively high incomes. However, they could still be attractive destinations, especially if the Biden administration encourages companies to leave China by resurrecting the Trans-Pacific Partnership (TPP). This sought to create a trade agreement that included the US, Malaysia and Vietnam, until the Trump administration pulled out of it in January 2017. (Thailand and the Philippines also showed early interest in TPP although we not signatories).

Companies looking to diversify their supply chains out of Asia, however, might turn to Europe. Given that income levels are now high in Central Eastern Europe (Czech Republic, Hungary, Poland and Romania), companies could turn increasingly to Turkey where labour market dynamics and business environment are relatively attractive. The major drawbacks come from political risk and low productivity. However, Turkey's economy and markets would clearly benefit from any structural improvement in its external position if it were to ever materialise.

By contrast, the operations of Chinese technology companies would be severely hampered once stockpiles of inputs have been exhausted, leading to slower growth in the near term. The government might try to circumvent US sanctions by breaking up and rebranding technology companies, while simultaneously increasing public spending to replace lost growth. However, Beijing would also continue to drive rapid research and development spending in the technology sector to develop home-grown products. This is unlikely to be sufficient to fully offset other long-term drags on growth such as a shrinking working-age population. However, it should result in the eventual achievement of productivity gains, as Chinese companies develop technologies to allow manufacturing to climb further up the value-added ladder. That would help to cushion the structural slowdown in GDP growth and support the performance of onshore equities, particularly in the technology sector. Despite losing some low-end manufactured exports, relative productivity gains and still-fast GDP growth support gradual, long-term renminbi appreciation.

Figure 17: Average rank of EM across different indicators

		World Bank Ease of Doing Business Rank	DHL Global Connectedness Rank	Global Competitiveness Rank	Corruption Perception Rank	US$ GDP per Capita % US	Growth in Real Output per Worker	2025 Working Age Labour Force % China	Avg
1	China	10	25	5	25	46	1	1	16.1
2	Malaysia	2	2	4		45	26	24	16.4
3	Poland	14	11	12	9	53	10	23	18.9
4	South Korea	1	4	2	8	63	36	19	19.0
5	India	26	35	35	25	9	7	2	19.9
6	Taiwan	4	8	1	5	62	32	30	20.3
7	Thailand	7	9	13	39	36	25	13	20.3
8	Vietnam	30	12	34	36	20	3	11	20.9
9	UAE	5	1	3	2	64	47	40	23.1
10	Czech Republic	15	3	8	10	58	27	43	23.4
11	Estonia	6	10	7	1	60	18	64	23.7
12	Hungary	19	5	17	20	55	8	47	24.4
13	Indonesia	32	50	19	30	24	14	3	24.6
14	Chile	23	16	9	4	48	44	32	25.1
15	Mauritius	3	13	21	14	43	19	65	25.4
16	Romania	21	28	20	20	49	5	38	25.9
17	Slovenia	13	7	10	7	61	23	62	26.1
18	Philippines	43	17	31	46	18	17	12	26.3
19	Russia	9	19	14	57	44	37	7	26.7
20	Turkey	11	29	28	33	39	39	14	27.6
21	South Africa	39	21	27	20	28	43	18	28.0
22	Kazakhstan	8	30	24	46	42	16	32	28.3
23	Ukraine	27	26	43	53	19	11	22	28.7
24	Ghana	50	27	54	25	14	6	27	29.0
25	Morocco	20	34	39	25	16	41	29	29.1
26	Saudi Arabia	25	15	11	12	56	60	26	29.3
27	Serbia	17	20	38	33	38	12	48	29.4
28	Colombia	28	40	25	36	30	35	17	30.1
29	Azerbaijan	12	36	26	53	25	21	45	31.1
30	Croatia	18	24	30	17	50	28	58	32.1
31	Qatar	36	14	6	6	65	49	55	33.0
32	Mexico	24	31	18	55	40	55	10	33.3

	World Bank Ease of Doing Business Rank	DHL Global Connectedness Rank	Global Competitiveness Rank	Corruption Perception Rank	US$ GDP per Capita % US	Growth in Real Output per Worker	2025 Working Age Labour Force % China	Avg
33 Kenya	22	49	46	57	12	33	16	33.6
34 Croatia	33	38	29	10	47	28	53	34.0
35 Ethiopia	61	59	61	36	3	12	9	34.4
36 Bahrain	16	6	15	24	59	61	61	34.6
37 Peru	35	32	32	39	33	51	21	34.7
38 Brazil	52	23	37	42	34	52	4	34.9
39 Jordan	34	33	36	16	26	50	51	35.1
40 Egypt	48	46	45	42	21	30	15	35.3
41 Ivory Coast	47	51	57	42	15	8	31	35.9
42 Senegal	51	52	55	18	7	24	46	36.1
43 Bangladesh	62	62	51	61	10	2	6	36.3
44 Mongolia	37	39	49	42	23	4	60	36.3
45 Pakistan	46	57	53	50	6	42	5	37.0
46 Panama	41	18	33	39	51	31	56	38.4
47 Burkina Faso	60	60	63	30	1	21	36	38.7
48 Uruguay	45	43	23	2	54	48	57	38.9
49 Kuwait	38	22	16	30	57	56	54	39.0
50 Oman	29	44	22	14	52	63	50	39.1
51 Benin	58	65	60	25	5	20	42	39.3
52 Argentina	54	42	42	18	41	62	20	39.9
53 Nigeria	56	37	56	61	13	53	8	40.6
54 Jamaica	31	45	41	23	31	57	59	41.0
55 Dominican Republic	49	48	40	57	37	15	44	41.4
56 Zambia	40	61	59	46	4	58	35	43.3
57 El Salvador	42	55	50	46	22	40	51	43.7
58 Bolivia	59	54	52	51	17	34	41	44.0
59 Ecuador	55	47	44	35	32	59	37	44.1
60 Mali	57	64	62	55	2	38	34	44.6
61 Guatemala	44	58	48	61	27	45	39	46.0
62 Angola	64	53	65	61	11	64	25	49.0
63 Paraguay	53	56	47	57	29	54	49	49.3
64 Gabon	63	41	58	51	35	46	63	51.0
65 Venezuela	65	63	64	65	8	65	28	51.1

Source: World Bank "Doing Business" 2020, DHL "Global Connectedness Index" 2017, World Economic Forum "Global Competitiveness Index" 2019, Transparency International "Corruption Perception Rank" 2019, IMF, ILO Refinitiv Datastream, Schroders Economics Group. 18 November 2020.

If China were to gradually transition to higher value-added manufacturing it too may seek to offload some of its own lower value manufacturing to markets that it has established close links with through the Belt and Road Initiative. For example, China has spent a lot of time and effort investing in East African markets such as Ethiopia, where there is an abundance of cheap labour. Expansion of its manufacturing base would help to soothe strains in the external accounts and allow spreads on hard currency bonds to narrow if it were to happen.

Scenario 2 – Further escalation across the board

There is clearly a good chance, however, that US-China tensions will continue to grow, leading to a greater decoupling and at a faster pace. In a more abrasive scenario, the US imposes more punitive trade tariffs on Chinese goods, and outright bans on certain products. Meanwhile, strategic industries such as semiconductors are ordered to reshore manufacturing plants from Asia, as restrictions on the supply of US-patented goods to China are broadened to more sectors. Beijing responds by imposing export controls on key sectors such as telecommunication and other technologies that cut-off the supply of products to companies such as Apple. Some American companies that relocate operations are barred from accessing the Chinese market by being added to the unreliable entity list. Concerns about long-term supply chain security, balanced with a desire to retain access to Chinese markets, lead to a regionalisation of supply chains in other sectors.

At the global level, the various measures would probably result in a decline in trade volumes and result in weaker economic growth in emerging markets. Slower economic growth would be a general drag on corporate earnings, while those of companies in both the US and China that are targeted would be severely reduced. In the longer term, companies would face higher costs of production as they are forced to operate less efficient supply chains; and this would ultimately feed through to higher prices, inflation and interest rates. Lower US dollar liquidity as trade volumes decline would cause spreads on emerging market hard currency corporate and sovereign bonds to widen, and emerging currencies to generally weaken against the US dollar.

That being said, some markets would stand to benefit from a forced reshoring and diversification of supply chains. Perhaps most obviously, in the instance of the reshoring of manufacturing to North America, there would probably be significant spill-over to Mexico. Wages in Mexico are relatively low and companies enjoy tariff-free access to the US market through the United States-Mexico-Canada Agreement (USMCA) trade deal. Because of this, it would probably only be companies that are able to automate production that would return to the US, bringing very few jobs with them. Mexico is already a significant manufacturing hub that could easily expand operations. The economy would clearly benefit from any expansion of higher value manufacturing; that might raise its paltry level of potential growth from about 2% currently, while driving an improvement in its balance of payments. But while this would be likely to provide a good prop to the long-term performance of Mexican assets, it might not be good for the global economy. As our scorecard shows, Mexico ranks relatively badly when compared to other markets in terms of its business environment and productivity. In the long-run, such concerns would probably contribute to higher consumer prices.

Meanwhile, as an ally of the US, with cheap labour and a large domestic market, India would probably still benefit from some forced diversification of supply chains away from Asia. However, other export-dependent markets further east, such as South Korea and Taiwan would be likely to suffer if foreign manufacturers began to pull out of the region and restrict the use of their technologies.

A broader clampdown on the access of Chinese companies to US-patented goods would deliver a sizeable shock to economic growth in China in the short term. And the loss of technology and skill transfers would be a major barrier to longer term development. Like in our first scenario, the Chinese government would be likely to drive major investment in research and development in key industries. But faced with a more significant economic shock, it would also be more likely to turn back to old drivers of growth such as heavy public investment in infrastructure or rapid activity in the real estate sector. That might deliver a temporary shot in the arm for growth. But it would also exacerbate the misallocation of capital, high debt levels and overcapacity, ultimately leading to slower long-term economic growth: all of which would be negative for the relative performance of local financial markets and the renminbi.

Scenario 3 – Complete break-off of all US-China relations

An unlikely, but not incomprehensible scenario could see relations between the US and China break down completely, causing the world to split into two markets; one around China and another around the US and the rest of the world.

In the short term, the global economy would benefit from a construction boom and companies relocating, supporting commodity prices and those emerging economies that export them. However, the bigger picture would surely be that "de-globalisation" and subsequent declines in capital and technological flows would cause the long-term outlook for emerging market growth to deteriorate markedly. Companies would gain greater pricing power from a reduction in competition, allowing them to expand margins and pass on the costs of less efficient production, fuelling higher inflation. That would ultimately lead to structurally higher global interest rates which would choke-off real growth, while also causing the spreads on EM hard currency bonds to widen more significantly and currencies to be weaker.

On a relative basis, Mexico would continue to benefit from reshoring, supporting the performance of its economy and markets. But a greater reshoring by European companies would also spill over into markets such a Turkey. By contrast, the reshoring from Asia of all foreign manufacturing that relies on foreign technology would leave US-allies in the region stuck in the middle. South Korea, for example, would be unable to replace lost demand by tapping into China's domestic market. Financial markets in such countries would underperform substantially.

China would be likely to re-orientate its own supply chains in relatively undeveloped allies built through the Belt and Road Initiative. Trade with these partners would be denominated in renminbi, but a cessation of trade with the US would cause the renminbi to weaken sharply against the US dollar. Financial decoupling would force China to dump its holdings of US Treasuries, instead moving into other reserve assets such as gold.

Figure 18: Overview of different scenarios

	Scenario 1	Scenario 2	Scenario 3
Impact on	No escalation	Broad escalation and some reshoring/diversification of supply chains	All relations broken off
World	No material change	Slower growth, higher inflation, structurally higher interest rates	Much slower growth, higher inflation
China	Short-term hit to tech sector, but large R&D drives self-sufficiency. Decent growth dynamics and productivity gains support the performance of Chinese markets and long-term renminbi appreciation.	Additional policies against China deliver a sizeable near-term growth shock, leading to greater public investment in order to support demand. Increased public investment exacerbates concerns about misallocation of capital and causes long-term economic outlook to deteriorate.	China pumps domestic investment to offset loss of manufacturing, causing greater concerns about debt and misallocation of capital. Loss of technological transfers etc negative for long-term growth and earnings. Financial sanctions mean that foreign investors lose access to Chinese markets
EM	Permanent tariffs encourage low-cost manufacturers to relocate to markets such as India and Indonesia, supporting structural improvement in potential growth and external balances.	Mexico gains from reshoring of important high-tech US industries, leading to improved macro fundamentals. Export-led EM in Asia suffer from loss of some high tech manufacturing.	Most Belt and Road countries side with China, those in Europe and the Americas side with the US. Exodus of foreign manufacturers from China benefits EM such as India and Mexico, but also others such as Turkey.
Markets	Global markets largely unaffected Improved economic outlook supports long-term performance of India.	EM spreads wider, interest rates higher and currencies weaker against the US-Dollar. Mexico, India outperform, SE Asia underperform. Some short-term benefit for commodity prices as supply chain diversification drives construction activity	More negative impact on EM equities, spreads, rates and currencies. Markets in those EMs that attract manufacturers outperform on a relative basis, SE Asia underperform. Reserve assets such as gold benefit from Chinese demand. Commodities get short-term boost from construction activity

Source: Schroders Economics Group. 18 November 2020.

It’s not about picking the path, but knowing where each path leads to

Global uncertainty has not been this high for decades and it is hard to gauge which direction relations between the US and China will take. Much will depend on the approach taken by President-elect Biden and his counterpart President Xi Jinping. In the near-term, we may see either side test the others tolerance. But while long term strategic competition between these two superpowers appears inevitable, it seems unlikely that the situation will deteriorate to the point of a total breakdown in relations. We would therefore place only a low probability on our third, hugely detrimental scenario. Instead, we see a much greater chance that either of our first two scenarios – or some variation on them – play out and would place an even probability on them. It could simply be the case that the impact of the pandemic will cause companies to choose to reduce the concentration of their supply chains and diversify away from China, regardless of geopolitics. Either way, the key point is that the more the world pulls apart, the greater the risk of downward pressure on economic activity and the performance of financial markets. For investors in emerging markets, understanding these potential developments and their implications will be key over the next decade. Knowing who the winners and losers might be is an integral piece of the puzzle.

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