MyStratWeekly
Market views and strategy

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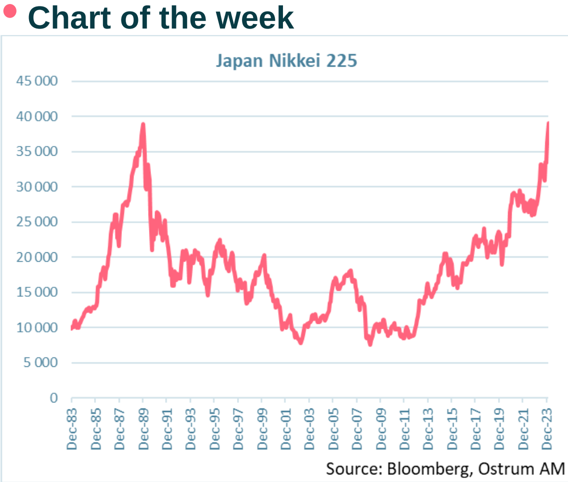
Topic of the week: China has crossed the threshold of sophistication !

- **China is the world's largest manufacturing powerhouse;**
- **However, it is in sophisticated and technological products that China has become competitive;**
- **China gained market share in the automotive sector, including electric vehicles;**
- **This is thanks in particular to the integration of ASEAN in its value chain;**
- **Labor-intensive production chains are moving out of China to ASEAN, while high value-added chains remain in China;**
- **China continues to strengthen its integration into the global value chain by expanding free trade agreements.**

Market review: About-face

- **Central banks ever more cautious about inflation;**
- **Yield curves flatten as T-note hovers about 4.30%;**
- **Nvidia earnings spark new equity strength;**
- **Market environment still supportive of risky assets.**

Chart of the week



Source: Bloomberg, Ostrum AM

The Nikkei 225 index closed on Thursday at 39,098.68 points, up 2.2%. This is a historic record which finally erases the peak of the speculative bubble recorded at the end of 1989.

Japanese growth in the 1980s had generated excessive expectations regarding the value of securities. The bursting of this speculative bubble, stock market but especially real estate, is the trigger for the long period of stagnation which has marked Japan since the mid-1990s.

This stock market signal perhaps validates the end of purgatory for the Japanese economy.

Figure of the week

3.3

Source : Bloomberg

This is the number of Fed rate cuts now anticipated by the markets. These three or four gestures compare to almost seven reductions planned on January 12 by the money markets.

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● Topic of the week

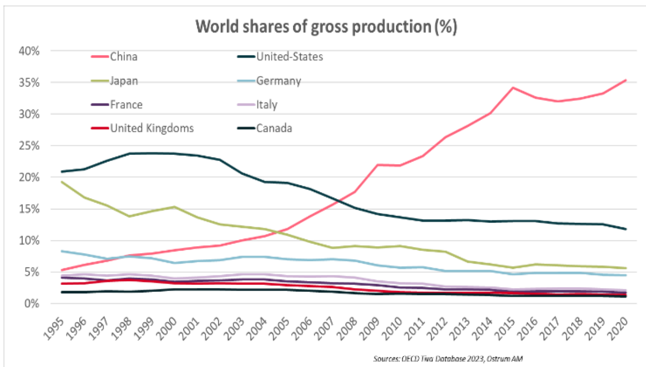
China has crossed the threshold of sophistication !

The United States and the European Union have multiplied hostilities towards China, especially on the products of its “3 new industries”: electric vehicles, batteries, and solar energy. Until 2018, China was a source of deflation for the world, being competitive in low value-added manufacturing goods competing with other emerging countries. China has now emerged as the world’s only industrial superpower and has become more competitive than developed countries like the United States.

The world’s manufacturing superpower…

Despite the efforts of the United States to thwart China’s industrial boom, its dominance in supply chains, as well as its leading position in global manufacturing activity, have not retreated, but have consolidated themselves thanks to the strong will of the Chinese government to strengthen its technological autonomy.

China’s industrial growth is impressive, with a 35% share of global manufacturing output, surpassing the G7 countries, as shown in the chart below.

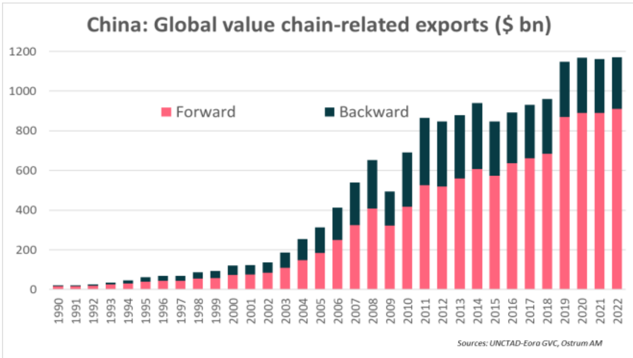


Since 2008, its share in global manufacturing has more than doubled, while that of the G7 countries has fallen. The weight of the United States fell by 3 percentage points. This is a hot topic, especially with the United States, which have invested heavily in its clean energy industry, particularly electric vehicles, in the context of the Inflation Reduction Act and are competing with Chinese products that have become sophisticated and cheaper.

…But now in high value-added products!

From assembler to producer in the global value chain

Chinese authorities' efforts to promote manufacturing modernization and support openness have strengthened China’s status in global supply chains. The chart below shows the type of Chinese exports involved in the global value chain process.

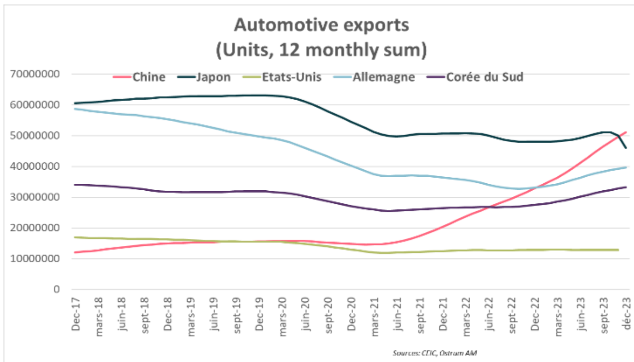


Backward participation refers to exports that participate downstream in the global value chain process are exports from China that use inputs from other countries. For example, China buys components from South Korea for its exports. These, after peaking in 2014, have declined, especially since 2019. On the other hand, forward participation refers to the exports involved upstream in the global value chain, that is those which are used in other production chains in other countries and are used in the final assembly process, have significantly increased after 2019.

The trend has therefore clearly reversed after the Covid-19 crisis, indicating that China has become a larger exporter in the front end of supply of global value chains. These exports are now entering the production lines of other countries in the final assembly process.

China gains market share in more sophisticated and technologic products.

China has clearly become the final assembler in products with high added value and technology, such as automobiles. The graph below shows vehicle exports by the main manufacturing countries.



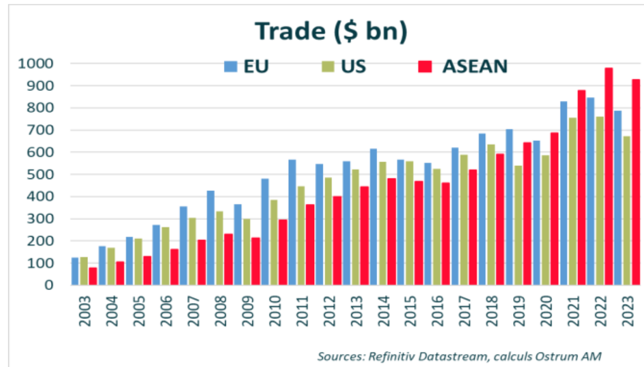
In 2021, China exported an average of 1 million vehicles. In just two and a half years, China has surpassed Germany, South Korea and Japan by a fourfold increase in vehicle exports. Last year, China overtook Japan (4.42 million vehicles), exporting 5.1 million vehicles. The rapid growth of the automotive sector in recent years is linked to massive investments in electric vehicles.

After the Covid-19 crisis, the Chinese authorities sought other growth drivers to replace the housing sector in crisis and contributing ¼ of GDP. China has chosen to replace investment in the real estate sector, by its clean energy industry, especially in the "3 new industries": electric vehicles, batteries, and solar energy. 890 billion dollars have been invested, the equivalent of the global investments in fossil fuels and the GDP of Switzerland and Turkey!

Without these investments, Chinese growth would have been 3% instead of the official 5.2%, according to the CREA (Centre for Research on Energy and Clean Air). The Chinese authorities would then have missed their 5% growth target, amid a real estate crisis and demographic decline, reviving fears related to the country's economic outlook. Economic policy, including monetary support for the manufacturing sector, has delivered rapid results on Chinese growth.

China at the heart of Asia's value chain

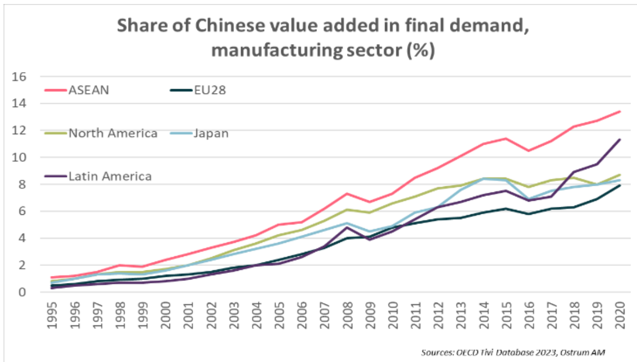
The 10 ASEAN member states have become China's main trading partners, overtaking the European Union since 2020, as the following graph shows.



In 2023, trade between China and ASEAN reached more than $900 billion, tripling from 2009. We can note the decrease of trade with the United States by 11% compared to 2021, corresponding to the peak of trade with China during the Covid-19 crisis.

The rapid increase in China's trade with ASEAN is facilitated by the reduction of tariffs between the two regional blocs, allowing the acceleration of the integration of ASEAN in its supply chain. ASEAN tariffs on Chinese products have dropped from 12.8% to 0.6%, while China has almost eliminated all tariffs on ASEAN products sold on its soil. The free trade agreement, signed in November 2020, the Comprehensive Regional Economic Partnership, also lowered tariffs for member countries, contributing to the transformation of the region's supply chains.

China has built a new dependence on its products in ASEAN countries that import an increasing share of its intermediate goods. The graph below shows China's share of value added in final manufacturing demand.



It can be noticed that dependence on China is also beginning to be built in Latin America, whose share of Chinese value added in final demand is more than 11% in 2020, converging towards that of ASEAN.

Some labour-intensive industries are moving production out of China as the country improves its industrial structure and moves up the value chains. For example, some Chinese and several international companies have relocated production from China to Southeast and South Asia, such as Vietnam, Thailand, Malaysia, and India. The chart below shows manufacturing wages in these countries relative to China between 2009 and 2022.

Wages in the region fell relative to China between 2009 and 2022. This reflects the sharp rise in Chinese wages over the period. However, countries like Malaysia, whose average wage in the manufacturing sector accounted for 120% of China's wage 13 years ago, have become competitive, like the Philippines and Sri Lanka, whose wage is the lowest in relative terms. It is therefore also an economic reason that explains the transfer of part of the production chains to Southeast and South Asia. High value-added production chains remain in China.

Conclusion

China has become competitive in sophisticated products with high technological value, making it indispensable in the production processes of other countries. China currently has the best battery manufacturing technology in the world, as well as other materials and accessories that foreign electric vehicle manufacturers need. As the United States and Europe turn to protectionism, the Chinese authorities are increasing free trade agreements to strengthen China's integration in the global value chain through the Belt and Road Initiative but also by encouraging its companies to settle in other countries, such as Mexico, Thailand, and Europe. China's role in global value chains is expected to continue to grow, increasing the world's dependence.

Zouhoure Bousbih

Market review

About-face

Central bankers, more cautious in the face of inflation, are revising their communication. Risky assets seem to ignore the rise in interest rates.

Communication from Central Banks has turned more hawkish again since the publication of US inflation in January. The minutes of the latest meetings of the Fed and the ECB indeed reflect the caution of central bankers in the face of residual inflation risks. The decrease in inflation observed since the 2022 peak is mainly due to the normalization of global supply chains and the fall in energy prices. Monetary policy only weighs on demand, but policymakers are helpless in the face of repeated supply shocks. The credibility of central banks would once again be attacked in the event of renewed price slippage. The financial markets are revising upwards the trajectory of key policy rates. The flattening of the yield curves is accompanied by a slight decrease in expected inflation in the long term. Risky assets continue to resist the rise in long-term rates (T-note yields at 4.33%). The stellar performance of equities in 2024 can still be explained by the run-up in US technology stocks. Nvidia's results quickly erased the caution from the start of the week. Western indices gained between 1 and 2% over the past week. The Nikkei (+16% this year) is riding the downward wave of the yen (150) and erases the historic peak of 1989.

The speech of the members of the FOMC (repeated this week by Lisa Cook, Christopher Waller, Philip Jefferson, Patrick Harker) contrasts with the commitment, even the eagerness, to cut interest rates which had prevailed since October of last year. This newfound prudence is not incompatible with a slowdown in the pace of contraction of the Federal Reserve's balance sheet from March. A halving of the QT pace would give the US Treasury room for maneuver while continuing the monetary tightening effort. The money market now includes a rate trajectory close to the median of FOMC projections (the 'dot plot'). The assumption of a monetary status quo even appears in the prices of options on short-term rate futures. On a cyclical level, existing home sales are recovering gradually as indicated by the improvement in mortgage loan demand at the end of the year. This should get the Fed's attention given the importance of shelter in inflation. In the euro area, activity surveys continue to rebound seen since the start of the fall with the exception of the German manufacturing sector, down 3 points to 42.3 in February. Germany's economic weakness is accompanied by excess inflation which could harden the hawkish posture of Isabel Schnabel or Joachim Nagel within the ECB Governing Council. The situation in Germany, opposite to that of Italy for instance, may cause some inertia in the ECB's policymaking.

Risky assets have proven resilient to the revision of the policy rate path. Stocks are trending upwards, with the caution at the start of the week being swept away by Nvidia's strong earnings release. The semiconductor stock has become a barometer for the US market. The extreme concentration of equity market performance coupled with reduced volatility raises fears of complacency regarding the asset class. The rebound initiated in October may only be hanging by a thread. The S&P 500 is trading above the 5000 threshold as the Euro Stoxx 50 sails towards 4900 points. We have seen an upturn in chemicals and a further rebound in bank equities. The Japanese Nikkei index made a new historical high some 35 years after the financial bubble burst. The flipside of a strong Nikkei is the chronic yen weakness.

On the fixed income markets, the T-note yield oscillated around 4.30%at the end of last week. The upshift in the short-term rate outlook contributed to the yield curve flattening and weighed on long-term breakeven inflation rates (-2 bps to 251 bps). The widening in MBS spreads clashes with the climate that is resolutely favorable to risky assets. Demand for life insurance products in the United States is helping to alleviate the upward pressure on long-term rates. In the euro area, the Bund yield briefly touched 2.50% before falling back to about 2.40%. The Schatz yield rose to 2.88%. This rise in the risk-free rate tightens swap spreads but appears to have no impact on sovereign spreads, especially as primary market activity has slowed down. Italian BTP trades at 145 bps against Bunds. Credit spreads continue to tighten. The level of spreads against swaps fell to around 83 bp. High yield remains very well oriented. The iTraxx XO is now just over the 300 bp mark.

Axel Botte

Main market indicators

G4 Government Bonds	26-Feb-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.88%	+7	+25	+48
EUR Bunds 10y	2.38%	-3	+8	+36
EUR Bunds 2s10s	-50.4bp	-10	-17	-12
USD Treasuries 2y	4.68%	+4	+33	+43
USD Treasuries 10y	4.23%	-4	+10	+36
USD Treasuries 2s10s	-45.2bp	-9	-24	-8
GBP Gilt 10y	4.11%	0	+14	+57
JPY JGB 10y	0.69%	-5	-12	-18
€ Sovereign Spreads (10y)	**26-Feb-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
France	47bp	-1	-3	-7
Italy	144bp	-4	-11	-22
Spain	89bp	-1	-3	-7
Inflation Break-evens (10y)	**26-Feb-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR 10y Inflation Swap	2.16%	-3	+4	+3
USD 10y Inflation Swap	2.49%	-4	0	+7
GBP 10y Inflation Swap	3.58%	0	+3	+4
EUR Credit Indices	**26-Feb-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR Corporate Credit OAS	118bp	-7	-16	-20
EUR Agencies OAS	62bp	-2	-6	-8
EUR Securitized - Covered OAS	69bp	-2	-7	-10
EUR Pan-European High Yield OAS	345bp	-8	-20	-54
EUR/USD CDS Indices 5y	**26-Feb-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
iTraxx IG	55bp	-1	-3	-4
iTraxx Crossover	304bp	-6	-11	-9
CDX IG	52bp	-1	-3	-5
CDX High Yield	339bp	-8	-11	-17
Emerging Markets	**26-Feb-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
JPM EMBI Global Div. Spread	374bp	-9	-29	-10
Currencies	**26-Feb-24**	**1wk (%)**	**1m (%)**	**2024 (%)**
EUR/USD	$1.086	0.742	0.055	-1.6
GBP/USD	$1.269	0.778	-0.087	-0.3
USD/JPY	JPY 151	-0.272	-1.588	-6.3
Commodity Futures	**26-Feb-24**	**-1wk ($)**	**-1m ($)**	**2024 (%)**
Crude Brent	$81.2	-$2.4	-$1.8	5.5
Gold	$2 034.1	$16.9	$15.6	-1.4
Equity Market Indices	**26-Feb-24**	**-1wk (%)**	**-1m (%)**	**2024 (%)**
S&P 500	5 089	1.17	4.04	6.7
EuroStoxx 50	4 863	2.11	4.92	7.6
CAC 40	7 937	2.17	3.97	5.2
Nikkei 225	39 234	1.94	9.74	17.2
Shanghai Composite	2 977	2.28	2.30	0.1
VIX - Implied Volatility Index	14.06	-1.26	6.03	12.9

Source: Bloomberg, Ostrum AM

Additional notes

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