MyStratWeekly
Market views and strategy

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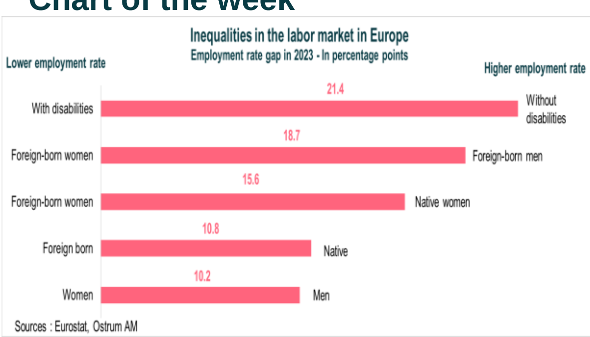
Topic of the week: The Green Energy War Has Begun!

- **China has rapidly become a giant in green technology thanks to its globalized and competitive production chains, as well as strong national and international demand for sustainable technological solutions;**
- **This has raised fears among Americans and Europeans, as the automotive industry is a strategic economic sector;**
- **The new American trade sanctions are expected to have limited economic impact, but with a risk of distortions in the electric battery market;**
- **China is following in the footsteps of Japan in the 1980s by now targeting final demand rather than exports;**
- **The European Union, in trying to protect its manufacturing sector, risks penalizing other specific sectors that export to China;**
- **The emerging countries that have benefited from the redirection of FDI flows to bypass tariffs could be hurt.**

Market review: Market optimism collides with international tensions

- **US inflation eases to 3.4% amid disappointing retail sales;**
- **Chinese data show weak domestic demand;**
- **T-notes outperform Bunds;**
- **Stability in sovereign and credit spreads.**

Chart of the week



Since 2020, the EU has been celebrating the European Month of Diversity every May. The European Commission annually calls on businesses and organizations to work towards diversity and inclusion in the workplace and society by organizing events and activities. In light of this, Eurostat has recently published an infographic on employment inequalities in Europe. There is still much work to be done to reduce these inequalities. For instance, the employment rate for women is 10.2 percentage points lower than that of men. Additionally, the employment rate for foreign-born individuals is 10.8 percentage points lower than that of native-born individuals, and the employment rate for people with disabilities is 21.4 percentage points lower.

Figure of the wee

300

Source : Bloomberg

300-billion-yuan measures taken by the PBoC in support of the real estate sector in the form of loans. Chinese authorities aim to accelerate the resolution of the real estate crisis amid trade tensions.

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Topic of the week

The Green Energy War has Begun!

China has rapidly become a giant in green technology, raising concerns among its European and American partners. While Xi Jinping had just finished his European tour to reassure governments, the Biden administration announced last week an increase in tariffs on three strategic Chinese products: electric vehicles (100%), electric batteries (25%), and semiconductors, as well as on certain solar products (50%). Other increases were also announced on steel and aluminum (25%).

How did China gain the "green" comparative advantage?

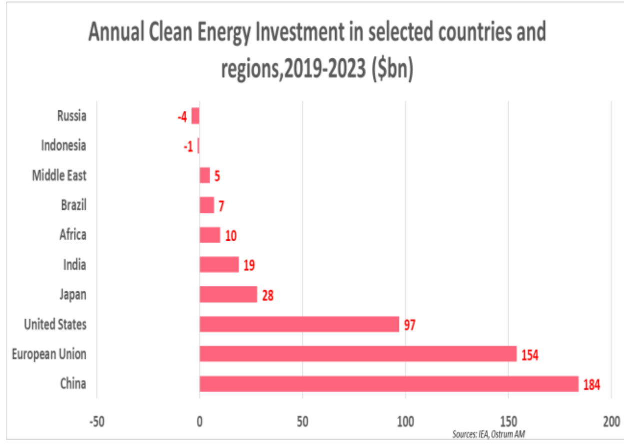
According to Ricardo's theory, countries trade in products in which they have a comparative advantage, contributing to the virtuous operation of global trade. China gained the "green" comparative advantage in sustainable technological solutions, thanks to its proactive industrial policy, but not only that.

Globalized and competitive production chains

If China was able to rapidly become a giant in green technology, it was not solely due to significant government subsidies, amounting to 57 billion dollars between 2016 and 2022. China already had globalized and competitive production chains, notably thanks to its policies to attract foreign direct investment. Consequently, China had an industrial advantage that would have been costly to replicate for other countries.

Strong demand for green technologies

The growing demand for sustainable technological solutions at both the national and international levels has also driven the development of green technology in China. The post-Covid recovery and the energy crisis stemming from the war in Ukraine have been strong catalysts in accelerating investments in green energy. The graph below illustrates the annual amount of investments in green energy for a selection of countries and regions.



Between 2019 and 2023, China invested $184 billion annually in green energy, surpassing the European Union ($154 billion) and the United States ($97 billion).

Considerable competitive advantage in electric vehicles

China clearly holds a competitive advantage in the electric vehicle sector. The country has seen the emergence of 200 electric car brands, enabling it to sell its sophisticated and low-cost electric vehicles worldwide. Chinese electric vehicle manufacturers also produce their own electric batteries, unlike their European and American counterparts. China boasts the largest refining capacities for critical materials required for manufacturing electric batteries. This has allowed Chinese manufacturers to save costs compared to their European and American competitors.

Why is this problematic?

China's sophisticated and low-cost green technology could quickly help its European and American partners achieve their climate objectives. However, the concentration of green technology in the hands of China has raised economic and national security concerns.

The automobile is a strategic economic sector

This year, Chinese electric vehicle sales accounted for 25% of total vehicle sales in Europe. The

automobile is a strategic economic sector on both sides of the Atlantic.
In the United States, the sector employs 9.7 million people and represents 5% of the GDP. In Europe, its weight is 7% of the GDP and employs 13 million people. During his recent European tour, Xi Jinping tried to reassure governments. China proposes to build factories in Europe to create jobs. Thus, after Spain and Portugal last month, China is now preparing to open an electric vehicle production plant in France.

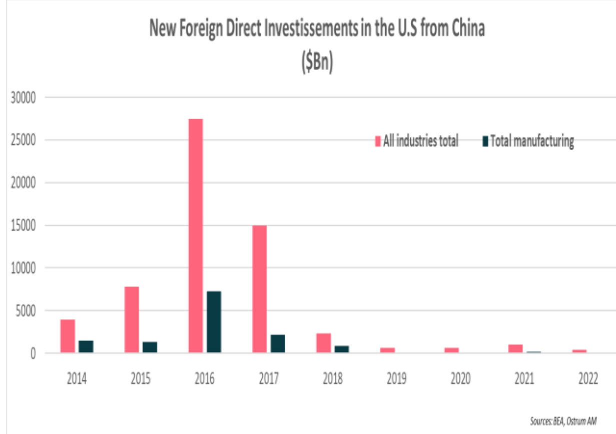
By 2030, electric vehicle sales will account for two-thirds of global vehicle sales according to the Rocky Mountain Institute, hence the strategic importance of the sector for Europeans and Americans.

I.R.A., the largest investment program in American history, is at risk of failing!

The Inflation Reduction Act, I.R.A., is an American law enacted on August 16, 2022, marking one of the largest investments in the American economy, energy security, and climate that the U.S. Congress has ever made. This takes the form of tax credits to encourage American companies to invest in green energy to enable them to be competitive in this emerging sector.

The I.R.A. will soon celebrate its two-year existence. 280 green energy projects were identified in the first year for a total of $282 billion (out of the $500 billion planned) and are expected to create 175,000 jobs. While these are long-term projects, the construction of new facilities has already been reflected in the U.S. economic figures through the accelerated investment in structures since April 2022, also linked to the CHIPS and Science Act, two other economic programs to support semiconductor research and production.

The I.R.A. is also a protectionist policy as the subsidies clearly favor American companies by reducing their costs. In this sense, it aligns with D. Trump's "America First" approach, which had triggered protectionist responses against Europe and China. It is also a mean to counter China's presence in the American market. The graph below shows the new foreign direct investments from China to the United States.



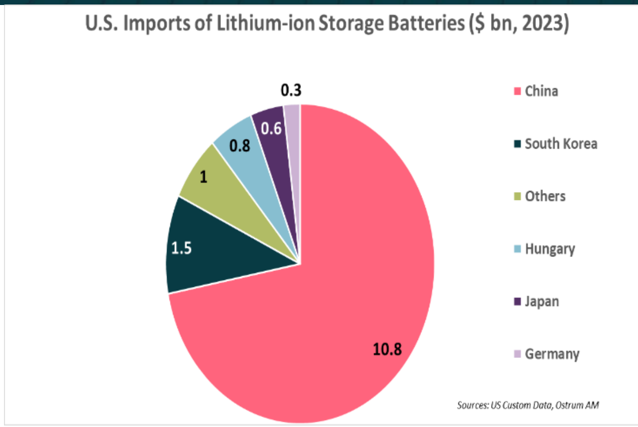
Since 2018, the start of the American trade war against China, new foreign direct investments from China to the United States have significantly decreased. The Biden administration, therefore, does not view China's dominance in these new strategic sectors, in which it has heavily invested, favorably.

Will these new trade sanctions change anything?

Limited economic impact but distortions expected

The Chinese exports affected by the increase in American customs tariffs represent only $18 billion out of a Chinese GDP of $18.5 trillion! In other words, the economic impact on China is limited. The customs tariffs implemented by D. Trump, especially those for Chinese electric vehicles at 27.5%, had already significantly reduced Chinese imports into the United States.

For the United States, imports of electric vehicles and solar panels from China accounted for only 3% of total American imports in 2023, so the impact is limited for these two products. However, the United States imported $13.1 billion worth of batteries, accounting for 70% of the total American imports of electric batteries! The dependence on China is even more pronounced in lithium storage batteries, as shown in the graph below.

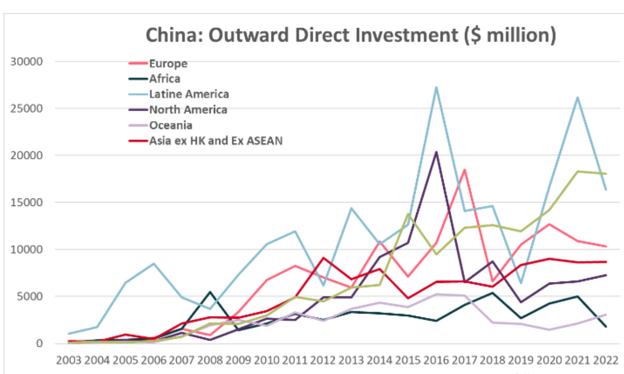


China accounts for 72% of American imports of lithium storage batteries. This new tariff increase could therefore be disruptive. Indeed, the United States does not have existing production sites for graphite, a key material in the construction of electric batteries. While $34 billion of investment was made in the manufacturing of electric batteries in 2023, this is still far from sufficient.

China follows in the footsteps of Japan in the 1980s

American trade sanctions against China have already contributed to reshaping supply chains and global trade. This has resulted in a redirection of foreign direct investment (FDI) flows, including those from China.

China has shifted its commercial strategy by now targeting final demand rather than exports, like the approach taken by Japan in the 1980s. Japanese companies had directly established themselves on America to bypass the increase in customs tariffs on their vehicles. The graph below shows China outward direct investment (ODI) by region.



In 2022, the ASEAN was the main recipient of Chinese outward foreign direct investment (FDI), accounting for 11.4% of total outward FDI flows. It is also worth noting that Chinese outward FDI flows to Latin America accelerated in 2019, primarily reflecting flows to the Cayman Islands and the British Virgin Islands at 90%. The share of outward FDI flows to Europe, North America, and Oceania has significantly decreased over the past five years. Outward FDI flows serve to accelerate the integration of the ASEAN with China. Customs tariffs between the countries in the region and China are very low or even non-existent, enabling the intensification of trade and facilitating foreign direct investment.

Another interest of China in the ASEAN is the quest for critical materials for its green transition. Consequently, outward FDI flows from China to Indonesia have been substantial, increasing by 144% over the past five years. Indonesia is a major producer of nickel and cobalt. While China controls 50% of the refining capacities for these metals, as well as for copper and lithium, it remains heavily dependent on imports. Therefore, China accounts for 70% of global lithium demand, 79% for copper, 80% for nickel, and 95% for cobalt. Aware of its high vulnerability, China secures its supplies by investing in countries abundant in these metals.

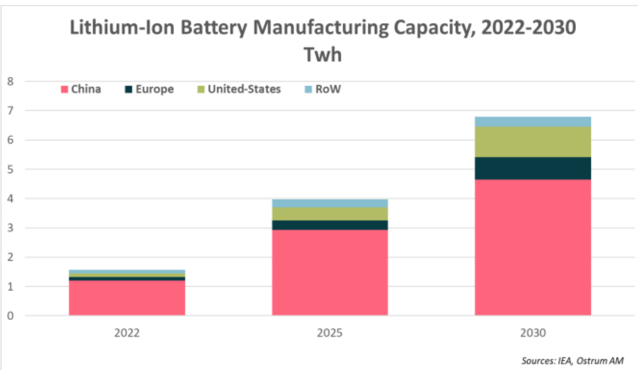
And Europe in all this?

Europeans had already begun to question their ties with China, as seen in the sanctions against Huawei, citing national security concerns. The European Union is also preparing to increase its customs tariffs on Chinese electric vehicles to 25-35% from the current 10%, following the anti-subsidy investigation announced in September 2023 by the European Commission on Chinese electric vehicles exported to its territory. Reactions have been mixed, reflecting the ambivalence between its trade relations with China and its strong dependence on Chinese green technology.

The EU is China's largest market, accounting for 40% of its exports of electric vehicles. The EU's institutional and political stability makes it a prime destination for Chinese investments. Like the United States, China's dominance in the electric vehicle sector threatens European economic interests, particularly those of Germany, renowned for its historic vehicle brands.

However, the European Union has ambitious climate goals. The EU aims for at least 30 million zero-emission vehicles to be on European roads by 2030, representing 12% of the current car fleet. This is part of the goal of achieving net-zero carbon emissions by 2050. Given the high production costs and prices of electric vehicles, making them unaffordable for many Europeans, the EU will have no choice but to rely on Chinese imports if it sticks to its 2030 target.

The vulnerability of the EU lies in its lack of capacity in electric battery production, as shown in the graph below.



According to projections by the International Energy Agency, China will maintain its dominant position, with manufacturing capacity expected to multiply by 5 by 2030. The EU is also heavily dependent on rare earths from China. Strained by the energy crisis linked to the war in Ukraine, which has reduced visibility for manufacturing projects in the private and public sectors, the EU must find a balance between climate goals, economic growth, and national security. China has indicated that it could target other sectors such as food, wine, or planes as retaliation. The EU, in seeking to protect its manufacturing sector, also risks penalizing other sectors with significant exposure to China.

Conclusion

Striking a balance between climate, economic, and national security goals is challenging and reflects the ambivalence of trade relations with China and strong dependence on its green technology. The question now is about the risk of escalation. The Chinese Ministry of Commerce has indicated that China will take firm measures to defend its rights and interests. The EU, in seeking to protect its manufacturing sector, risks penalizing other specific sectors with significant exposure to China. The US administration has pressured Mexico to increase its customs tariffs on certain Chinese products. D. Trump, a candidate for the White House, has indicated a 200% increase in customs tariffs on Chinese electric vehicles produced in Mexico. Emerging countries that have benefited from the redirection of foreign direct investment flows due to trade sanctions are at risk of economic penalties. There is also a risk of trade sanctions on other countries that would gain a competitive advantage over the United States, such as Indonesia and Saudi Arabia, which are heavily investing in AI.

Zouhoure Bousbih

Market review

Market optimism collides with international tensions

The deteriorating international climate with the return of protectionism does not dampen market optimism.

The current international relations are becoming increasingly strained, both in terms of trade and geopolitics. The Biden Administration has raised customs barriers in response to Chinese dumping of cheap goods in export markets. Vladimir Putin's visit to Beijing, amidst military cooperation between the two countries, seems to overshadow the meager gains from Xi Jinping's recent trip to Europe. China's overcapacity poses an existential threat to industry in Western economies and explains the disparities in inflation and domestic demand between major economic regions. In China, the People's Bank of China and government authorities are coordinating for yet another real estate support plan, while calm prevails in the global financial markets. Financial market volatility remains low in spread products and stock markets. Bond yields are below 4.50% for the T-note and 2.50% for the Bund. The US greenback is weakening slightly in favor of the euro and Australian and New Zealand dollars, whilst the Bank of Japan continues to struggle to stabilize the yen.

In the United States, economic data is somewhat softer since the beginning of the second quarter. Retail sales moderated in April (-0.3% excluding volatile items, the so-called control group series) after two months of strong growth. Despite a decrease in goods inflation (except for gasoline prices), housing costs and overall service prices continue to increase rapidly. Inflation stood at 3.4% in April (CPI). Another area of concern is residential construction, as homebuilder confidence is dwindling (NAHB dipped to 45 in May) and housing starts are slowing down. The persistent imbalance in the housing market poses a significant risk of further increasing the cost of living. The Fed reluctantly admitted it as the pace of the reduction of its MBS portfolio remained unchanged at $35 billion per month, unlike Treasuries. In the UK, next week's inflation release could pave the way for a rate cut despite wage increases of around 6% per year. In China, retail sales experienced a setback (+2.3% in April), while residential investment contracted by almost 10% per year. Public intervention to offset this purchasing deficit is estimated at 300 billion CNY.

In financial markets, the barbell investment strategy combining cash holdings with exposure to stocks and credit seems a consensus call. The assets under management of US money market funds exceed $6 trillion and can be reallocated to Treasuries if the US economy slowed further. The more accommodative stance of the Fed could justify a more constructive position on long-term rates. According to our models, the fair value of the T-note subject to our scenario of 3 Fed rate cuts is at 4.35%. The consensus steepening trade does not seem to be adding value so far. In the euro area, the Bund is trading around its equilibrium at 2.50%. Swap spreads are trading close to the year's lows, indicating relative cheapness for the Bund against swap rates. Demand at bond issuance remains solid (EU 30-Yr bonds for instance) but may partly explain the narrowing in the T-note spread to Bunds to around 190 basis points. The Bank of England is waiting for confirmation of disinflation, but the accommodative bias is palpable. The Gilt is expected to fare well against this backdrop.

Sovereign and credit spreads are remarkably stable. Credit fund inflows support valuations that may appear expensive below 80 basis points against the swap on euro IG. The compression trade resumes on euro high yield, with the iTraxx Crossover reaching 290 basis points.

The risk-on environment has already erased the weakness of the first half of April in equity markets. Implied volatility hovers around 13%. The S&P 500 is trading around 5 300 points, and the Euro Stoxx 50 at 5 050. In European equities, performance differentials between equity styles are reduced, with financials dominating the market since the beginning of the month, but other cyclical or defensive sectors are also performing well.

As for the foreign exchange market, the dollar-yen exchange rate remains the most volatile pair despite the Bank of Japan's efforts to stabilize it. The Japanese 10-year bond yield approaches 1%, accelerating in tandem with the currency's weakness.

Axel Botte

Main market indicators

G4 Government Bonds	21-May-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.98%	0	-2	+58
EUR Bunds 10y	2.52%	-3	+2	+49
EUR Bunds 2s10s	-47.1bp	-3	+3	-9
USD Treasuries 2y	4.83%	+1	-16	+58
USD Treasuries 10y	4.43%	-1	-20	+55
USD Treasuries 2s10s	-40.3bp	-3	-3	-3
GBP Gilt 10y	4.15%	-3	-9	+61
JPY JGB 10y	0.98%	+3	+6	-25
€ Sovereign Spreads (10y)	**21-May-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
France	47bp	-2	+0	-7
Italy	130bp	-4	-3	-37
Spain	76bp	-2	-1	-20
Inflation Break-evens (10y)	**21-May-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR 10y Inflation Swap	2.24%	-1	-3	+11
USD 10y Inflation Swap	2.58%	+1	-4	+16
GBP 10y Inflation Swap	3.74%	+4	0	+21
EUR Credit Indices	**21-May-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR Corporate Credit OAS	110bp	-1	-6	-28
EUR Agencies OAS	57bp	+0	-4	-13
EUR Securitized - Covered OAS	60bp	-1	-6	-18
EUR Pan-European High Yield OAS	343bp	-7	-36	-56
EUR/USD CDS Indices 5y	**21-May-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
iTraxx IG	51bp	-2	-7	-8
iTraxx Crossover	288bp	-12	-37	-25
CDX IG	49bp	-2	-6	-8
CDX High Yield	326bp	-12	-34	-31
Emerging Markets	**21-May-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
JPM EMBI Global Div. Spread	363bp	-5	+20	-21
Currencies	**21-May-24**	**1wk (%)**	**1m (%)**	**2024 (%)**
EUR/USD	$1.087	0.490	2.037	-1.5
GBP/USD	$1.272	1.032	3.012	-0.1
USD/JPY	JPY 156	0.192	-0.814	-9.7
Commodity Futures	**21-May-24**	**-1wk ($)**	**-1m ($)**	**2024 (%)**
Crude Brent	$83.2	$0.8	-$3.3	8.8
Gold	$2 416.3	$58.2	$89.0	17.1
Equity Market Indices	**21-May-24**	**-1wk (%)**	**-1m (%)**	**2024 (%)**
S&P 500	5 308	1.66	6.86	11.3
EuroStoxx 50	5 035	-0.90	2.37	11.4
CAC 40	8 099	-1.55	0.95	7.4
Nikkei 225	38 947	1.54	5.07	16.4
Shanghai Composite	3 158	0.39	3.02	6.2
VIX - Implied Volatility Index	12.47	-7.08	-33.35	0.2

Source: Bloomberg, Ostrum AM

Additional notes

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