



Geopolitics beyond Ukraine

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Key points

- Short-term convergence of economic interests between Beijing and Washington, but pressure around the Taiwan issue is mounting.
- It will probably take a significant slowdown in domestic demand to anchor a deceleration in US inflation, but some supply-side action – e.g., on oil – could help. The negotiations with Iran on a nuclear deal are becoming key on this front.

The geopolitical bandwidth may seem to be saturated by the Ukraine war, but the world's widest fault line remains the rivalry between the US and China. Yet, the economic interest of the two parties may – for a while – converge. Even if no final decision has been made, the Biden administration is looking into terminating the punitive tariff hikes levied on Chinese products under the Trump administration to help in the fight against inflation. Faced with yet another postponement of its much-expected transition to a growth model driven by domestic consumption, being able to count on unimpaired access to the US market would come at the right moment for China, which could foster a more conciliatory attitude towards Washington. Yet, Joe Biden is at the same time exerting more pressure on the Taiwan issue. It's far too early to talk about a "general détente" between the two superpowers. Still, the discussion on the tariffs acts as a nice reminder of an iron law of economics: protectionism is inflationary. This may degrade a bit the level of popular enthusiasm for "deglobalization".

Last week's release of the US inflation print for April seemingly indicated that, although the rise still exceeded market expectations, consumer prices may have started decelerating. Yet, when corrected for the used cars' item, the data suggests inflationary pressure continues to widen to more sectors. The US administration's response – e.g., calling on Congress to support the Clean Energy Act or tweaks to the Affordable Care Act – could easily be drowned in bitter politicking, with the looming mid-term elections pushing for even more polarization. It may be more because of what the Biden administration can no longer do – stimulating demand – that inflation will ultimately slow down, albeit at a cost to economic growth which we think will be substantial in the second half of the year.

Yet, the supply-side component of inflation could respond to US policy, especially if it coordinated with strategic partners, e.g., in this initiative to create an "alliance of oil buyers" to negotiate with Organization of the Petroleum Exporting Countries (OPEC). This however draws attention to the nuclear deal with Iran (Tehran is proposing to double its oil output as a trade-off) which remains politically extremely delicate.

Can de-globalization survive inflation?

During the US presidential election campaign, Biden's attitude towards Beijing was defined within an overall strategy under the title "a foreign policy for the middle class". In practice, that did not seem to differ much from the US approach under Trump: if China, via trade, threatens the livelihood of "middle America" – for instance by taking away well-paid manufacturing jobs – then muscular tariffs are deployed. Still, the interests of the middle-class are manifold. **In a context of full employment and accelerating nominal wages, the middle class may well move away from obsessing over the "destructive nature" of trade with China and focus instead on the favourable impact importing Chinese products can have on domestic prices.** It is therefore not that surprising that **the Biden administration is currently "reviewing" some of the tariff hikes implemented under Trump.**

On May 3rd the Office of the US Trade Representative stated that it would "examine" the first and second batches of 25% levies imposed in China imports worth USD 50bn. Such assessment was always going to happen since the "trade war" moves by the previous administration were implemented under the provisions of Section 310 of the 1974 Trade Act which entail a "review of necessity" after 4 years, for which the opinion of the US industries benefiting from the protection is collected (the consultation process will last until August 22nd). Yet, statements by Biden himself last week – mentioning the review amid a general speech on the need to "do everything in his power" to fight inflation - suggest there is more to it than just a formal assessment, even if he took the precaution of saying that "no final decision has been made".

The impact of custom duties on domestic consumer prices is twofold. First, they can directly lift the prices of imported goods - especially if there is no domestic alternative – and second by protecting domestic producers against foreign competition, they allow them to collect undue profit margins and also lift prices. Assessing these two effects – it's easier for the first than for the second one – is key to a quantification of the overall impact on inflation.

Let's start with the direct effect. **A blogpost from the Peterson Institute estimates the mechanical impact on US consumer prices of lifting the "Trump tariff" to 0.35%** (without considering any margin behaviour). This would be nice in usual times when inflation hovers around 2% but given the magnitude of the US current price predicament, this would not move the dial much. Indeed, for all the political energy invested in the US on the Chinese trade issue, Chinese imports stand for only 2.7% of the goods included in the personal consumption deflator basket, and tariffs at an average of 19.3% are levied on only two third of these products.

Yet, **another [piece of research from the same Peterson Institute](#) is currently making the rounds in the economic press estimating the overall effect (direct plus indirect) of eliminating Trump's trade war tariff to a much meatier 1.3%.** We have our doubts. The second Peterson note relies on the Robinson-Thierfelder model which assumes a strong substitutability of domestic to imported products (i.e., US products could rapidly replace Chinese ones for any change in their relative price). Given the state of the US manufacturing sector and the very different initial product specialization of the two countries, we fail to see how the relaxation of tariffs on goods imported from China could create such a competitive shock on the US industry.

Still, even if the battle around the figures is likely to take centre stage on the political aspects of the issue in the run-up to the mid-term elections, **the Peterson papers act as a timely reminder of an "iron law" of economics: protectionism is inflationary.** True, one may argue that an "excessive" lengthening and internationalization of supply chains has contributed to the current inflationary spike. For any given probability of supply disruption on one segment of the chain, multiplying the number of segments will mechanically raise the overall probability of a price shock at the end of the chain. Still, allowing domestic producers and consumers the possibility to shift from suppliers hit by overheating and price drifts to suppliers faced with capacity under-utilization and price depression can be a powerful way to break inflation spirals. Free trade magnifies this possibility, and it's precisely the lack of openness of the developed economies in the 1970s which made the persistent 2-digit inflation of the time possible.

In the current circumstances, **Chinese products would all the more contribute to capping inflationary pressure in the developed world that China itself is for now largely insulated from the global inflation wave** (consumer prices

rose by only 2.1% over one year in April 2022). While the direct impact of lifting tariffs could be limited, were US domestic inflation to turn persistent, importing more from a low inflation country such as China would help on trend. A key lesson from Exhibit 1 is that the price of Chinese goods imported into the US has remained broadly stable over the last 20 years, where that of goods sourced from the EU – despite the low trend inflation seen there during the period – had increased by 30% between the early 2000s and the beginning of the pandemic.

Exhibit 1 – Price of goods imported from China flat on trend



If you allow your humble servant a digression, this goes beyond China. Japan is another significant contributor to world exports where inflation so far has been remarkably subdued (the recent acceleration to 2% is entirely driven by a base effect on mobile phone contract prices). It will be interesting to see in the coming months if the combination of yen depreciation and lower inflation in Japan triggers a visible rise in the market share of Japanese products in the US.

We also need to look at the current configuration from the Chinese point of view. **The lingering Covid crisis, combined with last year’s crackdown on the real estate market, has – again – postponed the much-expected reshaping of the Chinese economy towards a more self-reliant, consumer-driven model.** Given the current weakness in domestic demand, Beijing may be less keen to accept retaliatory trade tariffs as an unpleasant but ultimately painless consequence of its emergence as a super-power and seek a more conciliatory approach towards the US to magnify the traction from exports. In 2020-2021, China found itself in a unique position, given its capacity to maintain a high level of production, having seemingly dealt swiftly with the pandemic, to take advantage of given the intensity of the global supply-side crisis and the stimulus-fuelled massive demand for manufactured goods in the US. Conversely, **with the prospect of a slowdown in global demand, as economic policy is turning less accommodative in the US and Europe, Beijing may welcome lower tariffs on the US market –** assuming Chinese producers are not so impaired by the sanitary restrictions triggered by the re-emergence of the pandemic that they can actually continue shipping to the US.

Of course, **these economic considerations can be very easily trumped (no pun intended) by the overarching geopolitical rivalry between China and the US.** Biden may be ready to “bury the hatchet” on trade war but he has recently raised the pressure on the Taiwan issue. After the March approval of a USD100mn arms package to Taipei to modernize its missile defence systems, coming just after Chinese incursions in Taiwan’s airspace, Biden has signed into law a Congress bill calling for the World Health Organization to restore Taiwan’s status as an observer (China had pushed for its removal in 2017). This may seem like an obscure issue but given Beijing sensitivity to any move towards the international recognition of Taiwan, it is a significant step. More fundamentally, the US State Department has updated the “factsheet” on Taiwan on its website by removing a key sentence: *“the United States does not support Taiwan independence”*. Since the text still mentions the US *“longstanding One China policy”* the removal of the sentence as such does not indicate a fundamental change of stance since Washington shifted its diplomatic recognition to the People’s Republic of China in 1979, but it is nonetheless a message to Beijing.

The State Department stated separately that “the US One China policy is distinct from Beijing’s One China principle [...] the US takes no position on sovereignty over Taiwan, only that cross-straits are resolved peacefully according to the will abs best interests of the people of Taiwan”. Incidentally, the US “push” on the issue could be construed as signalling that Ukraine is not saturating Washington’s diplomatic bandwidth and that the long-term focus remains firmly on the Pacific.

In the short-term, it seems the economic interests of the US and China are converging – Washington’s sensitivity to inflation meets Beijing’s interest for unimpaired demand from the US – but the geopolitical rivalry remains acute. Tension is likely to re-emerge once these immediate concerns recede.

Has US inflation peaked?

Exploring whether US inflation has peaked is likely to become a fixture of Macrocast. Both headline and core inflation for April exceeded market expectations, but at least the index decelerated relative to March. Still, there are unfortunately signs that price pressure continues to widen. Used cars – which stand for only 5% of the basket for core – have been the bane of US inflation watchers since the exit from the worst of the pandemic given the wild gyrations in their price (the year-on-year changed peaked at a whopping 45% in June 2021. Excluding this item from the calculation, no deceleration appears, be it in year-on-year terms or on a three-month annualized basis (we look at the two frequencies to filter the impact of base effects) as Exhibits 2 and 3 illustrate.

Exhibit 2 – It’s rolling over, but not quite...

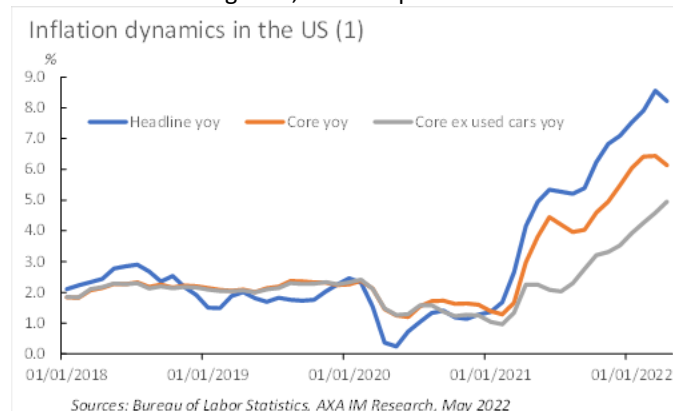
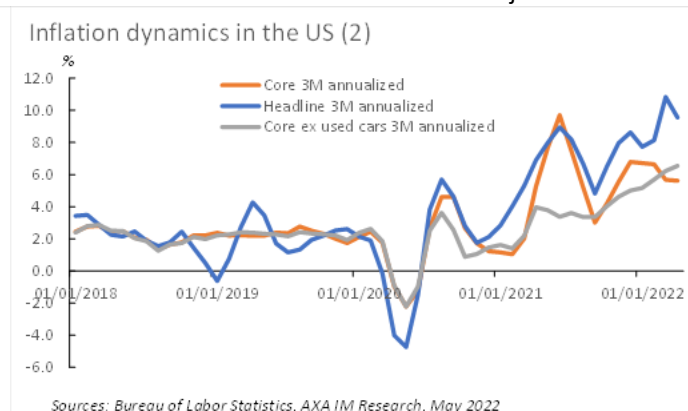


Exhibit 3 – Deceleration still owes to much on just one item



Rents continue their steady – and probably “sticky” – acceleration, reaching 4.8% year-on-year from 4.4% in March, the fastest pace since the mid-1980s. The rise in the price of medical services is also an area of concern, hitting 3.5% from 2.9% in March. **Biden’s focus on inflation is unlikely to go away soon since the spike is particularly acute for politically sensitive items.** For now, his policies – beyond the openness to reverse tariffs which we have discussed in the previous section – seem to focus on areas where he is unlikely to gain support from Republicans. He called on Congress to pass the Clean Energy and vehicle tax credits, as well as fixing what he called “glitches” in the Affordable Care Act and allowing Medicare to negotiate drug prices, all issues on which Republicans – and some moderate Democrats – are likely to mount a stubborn resistance.

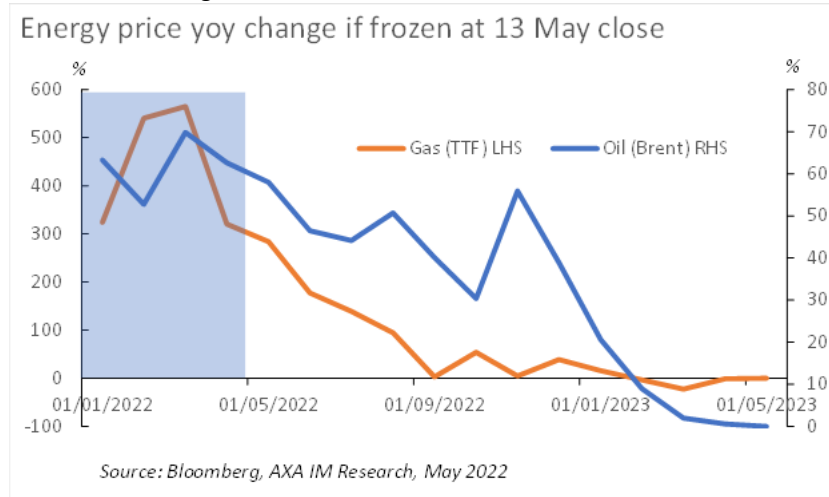
In a way, resolving inflation in the US may come less from what the Biden administration will do than precisely what it won’t. Indeed, at least the “demand-side” component of the current inflation spike can be alleviated by allowing the fiscal stimulus from the last few years to “die down” without adding more fuel to the fire, which would be further helped by the Fed tightening. At the risk of repeating ourselves, we don’t think a “painless disinflation” is possible in the current American configuration. We think inflation in the US will significantly decelerate in the second half of this year... but so will economic activity.

Oil and gas manoeuvres in the dark

Still, the “supply-driven” components of inflation can be addressed, at least partly, by the US government policy, especially if it is coordinated with strategic partners. We were intrigued by a Reuters paper according to which the US decision in late March to release one million barrels per day from its own strategic reserves to stabilize the oil market – three times the previous record for such moves – was made without prior discussions with other governments within the International Energy Agency, which had been set up in the 1970s to precisely coordinate action across oil consumers against the cartelization of production by OPEC. Mario Draghi’s announcement last week – after a conversation with Joe Biden - of an initiative to organize in common the purchase of oil and obtain a rise in production from OPEC may be seen as a “correction” of the initially unilateral move.

Iran is clearly trying to take advantage of the current geopolitical situation and is proposing a trade-off between a deal on its nuclear capacity – which had been scuppered by the Trump administration - and a significant increase in its oil output. The head of Iran’s national oil company stated last week that his country has the capacity to double its production – currently roughly 1 million barrels a day. Josep Borrell, who heads the EU diplomacy, stated on Friday that a “final deal is within reach”, following the trip of European Union (EU)’s envoy Mora to Teheran which had gone “better than expected”. Nothing can be finalized however without the support of the US, and Congress has set out to constrain Biden’s capacity to manoeuvre here. On 5 May, a majority in the Senate – including 16 Democrats – voted a non-binding resolution stating that any nuclear agreement with Tehran should address Iran’s support to terrorist organizations in the Middle East and that sanctions could not be lifted in any case on members of the Revolutionary Guard. Down the road, if a deal was struck with Iran, Biden could always veto any Congressional vote blocking it, and his opponents would have trouble gathering the 2/3 majority needed to overcome this, but these domestic political hurdles matter when trying to gauge the chances of a deal and hence the possibility to see more oil flowing on the market.

Exhibit 4 – Looking into future base effects



Ultimately, it may well be that any proper decline in oil prices will depend more on the intensity of the slowdown in economic activity which we expect for the West and the continuation of Covid-induced demand restraint in China than on any political manoeuvring between producer and consumer countries. The most prudent course of action when building assumptions for energy prices for the remainder of 2022 is to extrapolate the recent stabilization of oil and gas prices (volatility remains huge by historical standards but less so than at the beginning of the Ukraine war). We provide in Exhibit 4 an illustration of how the year-and-year change for oil and gas would look like over the next 12 months in this case. For gas, because of the base effects (prices rose significantly last year already) the year-on-year change would get to zero by the end of the summer. For oil however, the contribution to the year-on-year change in consumer prices would continue to be significant – albeit moderating somewhat – until late into the autumn.

Of course, assuming a stabilization of gas prices from the current levels is risky given the ever so present possibility Russia “turns the tap off” its supply to the EU. So far however, Moscow has restricted itself to “half measures” which have not dried up supply – reflecting the country’s own dependence on these financial resources.

Incidentally, **the decision by Russia to stop exporting electricity to Finland to retaliate against the country’s decision to join North Atlantic Treaty Organization (NATO) illustrates this country’s strong position rather than highlight the EU’s overall vulnerability.** Finland can manage without imports of Russian electricity – 10% of its consumption – because (i) it has just added to its nuclear capacity with the European Pressurized Reactor (EPR) Olkiluoto plan which has started producing in March (on which we have already commented when discussing the economics of the energy transition) and (ii) it can import electricity from Sweden – which has also developed a strong nuclear programme. 40% of Swedish electricity comes from nuclear power. Habitual readers of Macrocast are probably by now used to your humble servant’s strong conviction that nuclear power must be a key component of any viable transition to a net zero economy, and that it can also contribute to the EU’s security.

Country/Region	What we focused on last week	What we will focus on in next weeks
	<ul style="list-style-type: none"> CPI inflation (Apr) dipped to 8.3% from 8.5% (core 6.2%/6.5%), inflation peaked, but drop to be slow PPI inf (Apr) 11.0% vs 11.5%, core 8.8% vs 9.6% Financial conditions continue to tighten sharply Powell reaffirms 2 x 50bp outlook, will achieve 2% CPI inflation, but this “will include some pain” Jobless claims exceed expectation at 203k, up from mid-March low of 166k Fed Chair Powell reappointed for 2nd term. Cook and Jefferson appointed Fed Governors 	<ul style="list-style-type: none"> Retail sales (Apr), rebound in vehicle sales to lift headline, real-ex auto sales still falling Existing home sales (Apr) expected to usher another round of slowing housing market data Jobless claims trend Industrial production (Apr) expected to continue to rise solidly Empire and Philly Fed Surveys (May) manufacturing side of economy remains solid MBA mortgage applications
	<ul style="list-style-type: none"> Euro area industrial production fell by 1.8%mom in March, consistent with a -1.1% Q2 carry over coming after +0.9%qoq in Q1 	<ul style="list-style-type: none"> Local elections in Germany Second estimate of euro area Q1 GDP and Q1 employment Euro area final April HICP
	<ul style="list-style-type: none"> Emerging weakness in growth as GDP (Mar) fell by 0.1%mom and Q1 2022 rose 0.8% below expectations BRC sales fell by 1.7% lowest since Mar 2020 Dr Swati Dhingra selected to replace Michael Saunders on MPC in Aug 	<ul style="list-style-type: none"> Fears UK will suspend parts of NI protocol LFS (Mar) and HMRC payrolls (Apr) for signs of tightness, unemployment expected at 3.8% UK CPI (Apr) expected to peak at 9%yoy with utility price rises driving, risks to upside Retail sales likely to dip after weak BRC sales
	<ul style="list-style-type: none"> Final Svcs PMI (Apr) slightly up to 50.7 (+0.2p) Households spending (Mar) progressed faster than expected (+4.1%mom after -2.8%) / real consumption activity down -3.4%qoq Eco Watchers Poll (Apr) rose to 50.4 (+2.6p) 	<ul style="list-style-type: none"> Corporate Goods price (Apr) is expected to stabilise at high level (around 9.5%yoy) Tankan Mfg and non-Mfg indices (May) Prelim GDP print (Q1) should be negative (AXA IM: -1.1%qoq, cons: -0.4%)
	<ul style="list-style-type: none"> Trade data shows both external and domestic demand conditions deteriorated in April 	<ul style="list-style-type: none"> April data to show the economy contracted due to tightened containment against the virus flare up
	<ul style="list-style-type: none"> CB: Romania hiked +75bps to 3.75%, Mexico +50bp to 7.0%, Peru +50bps to 5.0% & Malaysia +25bps to 2.0% Q1 GDP (%yoy) accelerated in Malaysia and Philippines. It remained stable in Indonesia April CPI (%yoy) rose in India (7.8%), Indonesia (3.5%), Mexico (7.7%) & Romania (13.8%) 	<ul style="list-style-type: none"> CB: South Africa is expected to hike +50bps to 4.75%. Philippines to stay on hold at 2.0% Q1 GDP (%yoy) should pick up in Hungary, Peru, Poland, Romania & Thailand. It should slow in Chile, Colombia & Russia March economic activity (index) figures in Argentina, Brazil, Colombia & Peru
Upcoming events	<p>US : Mon: Empire State mfg survey (May), TIC Long-term investment flows (Mar); Tue: Retail sales (Apr), Ind prod (Apr), Business inventories (Mar), NAHB housing market indx (May); Wed: Housing starts & building permits (Apr); Thu: Weekly jobless claims (14 May), Philly Fed indx (May), Leading indx (Apr), Existing home sales (Apr), SARB announcement</p> <p>Euro Area: Tue: EU19 GDP (Q1,p), Fr ILO unemployment rate (Q1), It HICP (Apr); Wed: EU19 CPI (Apr); Thu: ECB meeting account (14 Apr); Fri: EU19 Consumer confidence (May,p), Ge PPI (Apr)</p> <p>UK: Tue: ILO Employment data (Mar); Wed: Inflation (Apr); Thu: CBI Industrial trends survey (May); Fri: GfK consumer confidence (May), Retail sales (Apr), BoE’s Pill & Tenreyro speak</p> <p>Japan: Wed: GDP (Q1,p); Wed: GDP (Q1,p), Ind prod (Mar); Thu: Trade balance (Apr), Private ‘core’ machinery orders (Mar); Fri: CPI (Apr)</p> <p>China: Mon: Ind prod (Apr), Retail sales (Apr), Fixed asset investment (Apr); Fri: One-year Loan Prime Rate</p>	

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