STATE STREET GLOBAL ADVISORS

State Street Multi-Asset Funds

Trade Wars – Spreading Across Asia

- Growing politicalisation of trade
- Australia's largest trade partners locked in disputes
- Growth outlook looking increasingly uncertain

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While the popularity of "Gangnam Style" by PSY propelled K-Pop into the international main stream, other South Korean exports are exposed to increasing trade risks.

From an Australian perspective the increased global trade wars have significant impacts as noted by the RBA who cited the impact to global growth in their accompanying statements to the rate cuts earlier this year.

But what has that got to do with South Korea?

While we are seeing an increase in the politicization of trade, it is not the exclusive instrument of the US and China. The latest eruption in trade wars is between Japan and South Korea and is just as significant for Australia.

China, Japan, the US and South Korea make up the top 4 (two way) trading partners for Australia with almost a 50% share, and so events between Japan and Korea will need to be followed closely.

Figure 1. **Australia's Top 10 Two-Way Trading Partners** 2017-2018.

Rank	Trading partners	Goods	Services	Total	% Share
1	China	174.5	20.2	194.6	24.4
2	Japan	71.3	6.2	77.6	9.7
3	United States	44	26.2	70.2	8.8
4	Republic of Korea	49.3	3	52.3	6.5
5	India	21.9	7.2	29.1	3.6
6	New Zealand	17.3	11	28.3	3.5
7	UK	13.8	14	27.8	3.5
8	Singapore	17.3	10.5	27.8	3.5
9	Thailand	20.4	4.3	24.7	3.1
10	Germany	17.2	5.1	22.4	2.8

Source: Department of Foreign Affairs and Trade: Trade and Investment at a Glance 2019

So what is behind the latest global spat between the two nations?

The current dispute traces back to failures to resolve private reparations claims over World War II atrocities but has resulted in Japan's tightening export restrictions on fluorinated polyimide and resist and high-purity hydrogen fluoride (HF). While all sound relatively unknown, they are key components and inputs needed to make display panels and semiconductors for smartphones. Japan, who is the largest producer of those chemicals, has subsequently removed South Korea from its white list of countries. South Korea's removal from the list means their companies will need to go through an extended approval process which could put a strain on supply chains, especially for two major South Korean tech companies Samsung and SK Hynix. It now poses a threat to the world's tech supply chain and the global economy.

However, the recent spat centers on the acrimonious history between the two countries. Here is a brief explanation of relevant events between the two;

- Japan annexed Korea in 1910 but for the next 35 years, Japan is accused of the mistreatment and brutalization of Koreans. Negotiations to establish even basic political relations between Seoul and Tokyo dragged on for more than a decade.

- However former President Park Chung-hee saw economic development as essential for South Korea's prosperity. In 1965, Park signed a treaty with Japan that obliged Japan to pay compensation in grants and loans. From Japan's perspective the treaty laid to rest any further matters of compensation. The treaty aimed to normalize the relationship between the two but the victims of the crimes were incensed as compensation flowed into development projects and not to the victims leading to some civil unrest.

- In 2013, a lower court ruled in favor of Korean wartime forced laborers, who were suing Japanese companies for compensation. The court sided with the plaintiffs in contravention of Article II of the 1965 treaty, which declared all financial claims between the countries and their people to be completely settled.

The recent flare up between the two nations is a result of a South Korean Supreme Court decision following that of the lower court that ordered Japanese corporations accused of exploiting Korean labor, to compensate forced-labor victims.

While Japan deems all claims to have been settled under the 1965 treaty, the South Korean Supreme court has effectively ruled that the treaty only resolved issues between the two countries at the state level without resolving individual claims.

When the Japanese companies refused to comply with the ruling citing the 1965 treaty, the court ordered the seizing the Japanese companies' assets in South Korea. Tokyo has since punished South Korea by removing it from its "white list" but characterized the move as a separate matter rather than retaliation. Seoul retaliated in kind by removing Japan from a list of nations receiving preferential treatment in trade and has also unwound some of the security pacts that were formed between the two countries since normalization of the relationship.

It is unlikely that there will be a resolution in the near term and while South Korean protests call for the boycotting of Japanese made goods, Japanese tourism is also taking a hit as well as the manufacturing sector. South Korea in turn is seeing a fall in exports, down 14% in August (on a year on year basis)[1].

With close ties to all four countries involved in trade disputes, the RBA will be keeping a close eye on the impact on global growth and may (as is expected) need to cut rates below 1% before the end of the year.

[1] Source: Bloomberg Finance L.P., South Korea Exports YoY (KOEXTOTY Index)

Portfolio positioning and performance[2]

August saw global markets falter after the increasing tensions seen in the US/ China trade war become too much for markets to handle resulting in a risk-off environment with most global equity markets selling off. Other tensions included ongoing inverted yield curve concerns and the ongoing drama of Brexit with fears of a no-deal Brexit coming to the fore with GBP selling off dramatically. During the month, global markets sold off aggressively with Emerging markets (MSCI EM Index Net total return local) down over 7% before recovering into month end delivering a -4.9% return in August. In the US, we saw negative returns in August with the market (MSCI US Net total return local) down -1.8% but it remains up a strong 18.1% year to date. Other major markets were also negative in August with Europe (MSCI Europe Net total return local) and Japan (MSCI Japan Net total return local) down 1.7% and 3.2% respectively. In local equity markets we saw an end to the seven positive months in a row in 2019 with the S&P/ASX 200 Index delivering a negative -2.4% return for August but year-to-date it is up a very strong 20.3%. Local based fixed income returns again saw positive returns in August with Australian government bonds up for the month after negative yield moves with the markets continuing to reprice the direction of interest rates moving forward. Our investments in Emerging markets bonds (SPDR Barclays Emerging Markets Local Bond ETF) was marginally positive for the month and is positive since the start of the year. Looking into our average positioning across the portfolio for the month of August, the Growth assets allocations have been approximately 56% for the State Street Multi-Asset Builder Fund. Our exposure preferences in August were again an overweight in global equities relative to fixed income. Performance wise, our diversified exposures across equities, fixed income and alternatives helped mitigate the underperformance seen in equity markets, with the fund delivering a marginally negative return in August, outperforming equity markets.

[2] Bloomberg Finance, L.P. SSGA. As at 30 August 2019. Past performance is not a reliable indicator of future performance. This information should not be considered a recommendation to buy or sell any security or sector shown. It is not known whether the securities or sectors shown will be profitable in the future. Characteristics are as of the date indicated, subject to change, and should not be relied upon as current thereafter. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income.

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