

Major Country Risk Developments December 2019



By Byron Shoulton

Overview

We have a modest outlook for global trade in 2020, with global GDP growth forecast at around 3% (the same as 2019). More investments in 2020 and beyond will flow towards new applications in advanced technology, affecting growth in growing numbers of sectors and services.

Infrastructure investments are needed everywhere; public & private sectors are being forced to upgrade services and processes. Mining, minerals; telecommunications; healthcare; transportation; heavy industry; education; retail & agriculture to gradually adapt to new tech-driven production platforms. Artificial Intelligence and robotics have enabled breakthroughs advancing manufacturing, data collection, and how we learn. Breakthroughs which seemed impossible just a few years ago. These enhancements embody the future of growth and will serve as drivers to growth. More nations in all geographic regions will feel compelled to invest in and to take advantage of the many benefits. Investors will introduce new technological applications and ways of doing things in the workplace – across the globe- made possible via 5G network connectivity, among others. It is the impact of such new technologies that will determine the speed, skill and ways of engaging new business partners going forward. The global marketplace, will as a consequence, become more transparent, visual and more accessible to young and old entrepreneurs from all destinations. Whose companies will dominate this new era of advancement, trade and human relations, remains the key question.

More companies are looking to locate to lower-cost manufacturing countries in Southeast Asia, Latin America, Mexico, the Caribbean and Africa. Others will consider repatriation of production to advanced countries via automation.

The global automotive sector is expected to return to growth in 2020, according to the Economist Intelligence Unit. While sales slumped in major Asian markets such as China and India following an overall downturn in consumer confidence in 2019, a slight upturn is expected in 2020 across some 58 markets covered in EIU's forecast. New car sales will rise by 1.7% in 2020, following a fall of 6.2% in 2019. The EIU focused on a shift away from fossil fuel vehicles, in favor of low-emission or electric vehicles.

Meanwhile, concessions have been made between the U.S. and China leading to a truce on trade. While initially a limited, interim agreement about which details are scarce, the U.S.-China Phase 1 Agreement – is a positive note on which to begin the new decade. It buys both sides some time. It also removes some of the tension in the air. The amount of new U.S. product that will be imported by China over the next two years – will be determined in due course (despite representation of \$40-\$50 billion worth each year). U.S. agricultural exports to China were just \$10 billion during the first 10 months of 2019, down from \$20 billion in 2017 before the trade war began.

Many are speculating about China's non-compliance with some terms of the interim agreement. It will take time for the implementation of new measures and to determine their effectiveness on U.S.-China relations. Nevertheless, the interim agreement will establish minimal rules for future talks and engagement. The U.S. promises to withhold additional tariffs on Chinese goods. Commitments to discuss and address larger goals (i.e. ending intellectual property theft, forced technology transfers, etc.) at a later date have been included. The road ahead promises to be long and bumpy. China won't be a pushover. But the U.S. holds a strong hand.

USA

The U.S. economy remains a bright spot among advanced economies. Steady if modest GDP growth (2.2%), 50-year low unemployment, low energy costs, low inflation and strong consumer confidence – have helped in trumping all recession fears.

The U.S., Mexico, Canada Agreement [USMCA which replaced NAFTA] has been finally ratified by the U.S. Congress; receiving a collective sigh of relief in all three countries; while thousands of workers, traders, exporters, importers and financial services firms who continue to actively participate in this market space, cheered. Trade across the three borders will proceed without restrictions except as stated in the agreement. It is hoped that the successful template used in this case, can be replicated in other trade negotiations/agreements going forward. Labor unions, companies and politicians alike made much of the fact that the USMCA has been finally ratified: A reflection of how much distrust have been generated around the issue. More agreements are to be negotiated with the U.S. over auto imports from the European Union and Japan.

China represents a unique adversary: No previous U.S. opponent held a population that was many times the size of the U.S. population; an economy equal in size of the U.S.; global investments, a footprint, and growing influence that are considered equal to that of the U.S. Both sides are in no hurry to cut a substantial deal with each other. Both countries are prepared to wait for the “right” deal. However, China appears slightly more pressured given ongoing weakness in its demand growth; high debt levels; and a need to rely more on domestic economic activity and less on export growth. The U.S. will continue to monitor the Chinese threat; in foreign and economic policy terms especially. None should doubt China’s commitment to its vision or underestimate its abilities. Neither should they underestimate U.S. resolve. Either way, uncertainty over trade between both countries will remain a big issue.

No previous U.S. opponent held a population that was many times the size of the U.S. population; an economy equal in size of the U.S.; global investments, a footprint, and growing influence...

Meanwhile, investors are pulling away from the riskiest parts of the U.S. corporate bond market, fearing that a brightening domestic economy may not be enough to save hundreds of companies struggling under heavy debt burdens. Corporate bond markets enjoyed a big rally in 2019, buoyed by lower interest rates and the U.S. economy remaining on firm footing.

U.S. junk bond debt returned almost 12% in 2019, as bullish fund managers looked lower down the credit spectrum in pursuit of higher returns. But in those furthest reaches of the market there are signs of strain. More than 200 of the bonds in the ICE index of junk-related debt are trading with yields more than 10 percentage points above equivalent government bonds- a commonly used definition of distress assets. That share now stands at 11.6% of the index, the highest proportion since 2016. Beneath the surface of what appears to be a willingness to take credit risks, there is an awareness that all is not rosy.

Three years ago, pain among U.S. companies with junk ratings was mostly limited to companies in the energy sector, which was grappling with a steep slump in the price of crude. Now distressed borrowers are spread more widely, including several in the retail sector, as bricks and mortar stores continue to battle online sellers. The telecoms sector has been hit as well. A private-equity backed provider of trading technology, defaulted on its debts in December, taking the tally of defaults in the sector to eight in 2019. Signs of stress in bond markets are concerning given that broad economic indicators are holding up. Even supportive monetary policy may not be enough to prop up borrowers which have taken on more debt than they can handle. Investors are willing to take a

fair amount of risks, but they would rather do it in higher quality companies. Creditors who are willing to take risks will however be also looking to avoid very weak credits in the year ahead.

The recent data confirmed that the U.S. economy expanded at a 2.1% annualized rate at the end of September. That is up from an initial estimate of 1.9% and an increase from a 2% pace in the second quarter. Still, the picture around the world is more mixed. In November the IMF confirmed global growth of 3% for 2019, its lowest level of growth in a decade. The macro credit picture is not great. Low quality credit requires a strong economy to grow into its capital structure.

The Federal Reserve left its policy interest rate unchanged at 1.5-1.75% and indicated without dissent that it had no plans to make any more moves in 2020. Policymakers showed more confidence in the U.S. labor market, lowering predictions for unemployment over the next three years, and even dropping their estimates of the likely long-term unemployment rate to 4.1%, from 4.2% when they were last published in September.

The Fed carried out three rate cuts in 2019, in what it described as an insurance policy against trade uncertainty, low inflation and a global slowdown. In October it indicated that it would pause and wait for a "material reassessment" of economic conditions. The latest Fed Statement of Economic Projections show a strong shift toward consensus around the current policy rate. Previously, there were several Fed presidents or governors proposing a rate above 2% for 2020. Now there are none. Despite new language suggesting concern over inflation, the Fed's economic projections show no changes to inflation predictions, over the short or long-term.

The latest Fed Statement of Economic Projections show a strong shift toward consensus around the current policy rate.

The U.S. is aiming to capitalize on growing unease in Asia about the risks and costs of China's Belt and Road Initiative. It unveiled a certification scheme that will set international standards for big infrastructure projects. The American-led Blue Dot Network will, its organizers say, vet and certify projects to promote "market-driven, transparent, and financially sustainable infrastructure development" in Asia and around the world.

Hong Kong

Six months of non-stop turmoil in Hong Kong is not only a blow to political stability within this semi-autonomous territory of China; but it highlights Beijing's other vulnerabilities along with strained relations with the U.S.; a slowing economy and weakening demand amidst global uncertainty.

The U.S. threw its support behind protesters in Hong Kong, who have made clear their displeasure with mainland China's oversight and its overall method of ruling Hong Kong as a territory. The demonstrations and protests that now confront the PRC and Hong Kong governments are the worst and most extensive since Hong Kong was handed back to the PRC in 1992 by the UK. The U.S. Congress recently passed two legislations into law; signed by President Trump – that aim to pressure Hong Kong and impose restrictions and tariffs on U.S. companies doing business via Hong Kong.

Tensions in Hong Kong hit new highs in December, drawing in demonstrators from large swaths of society, including working families, middle class & professionals – joining forces with students who have been at the forefront of the protests. Clashes with police have become ugly, more confrontational, resulting in deaths, hundreds of arrests, destruction of property & complaints of police brutality. The demonstrators are seeking greater democracy in the running of the territory; and want a say in how HK's leadership is selected. They seek more Hong Kong influence and input in running the affairs of the

territory. Opposition grows against Beijing's seemingly high-handed oversight style, which citizens believe gives Hong Kong the appearance of being a vassal-state of China.

Meanwhile, Hong Kong is fully aware of its significance as China's finance hub. China cannot afford to risk or compromise Hong Kong's primary position as its strongest gateway to global capital markets; or to underestimate the value of its globally integrated banking system, its legal knowhow and the strength of its financial infrastructure. The Chinese Communist Party's leadership in Beijing have tried not to be seen as directly controlling responses to the conflict by Hong Kong authorities (even if it is). Instead, Beijing has publicly offered unequivocal support to the HK administrative leadership and to the HK police for their handling of events so far.

Meanwhile, the Chinese government reacted angrily to the U.S. Congressional and White House support for the demonstrators, stressing that the demonstrations are an internal Chinese matter in which the U.S. [or other westerners] should not meddle. Under international law the resolution of such conflicts does not allow external, uninvited involvement by another state [i.e. the U.S.]. A delicate dance will now ensue as the sides attempt to maximize demands, with Hong Kongers growing anxious for signs of concession; while the PRC leadership look to tighten its grip more firmly over the territory. With Hong Kong's ruling elite working to defuse tensions, all sides are offering tips on how to resolve the existing grievances in exchange for assurances of a mechanism for long-term conflict resolution. Such a body is a must going forward. Both sides have a lot at stake.

The Chinese Communist Party's leadership in Beijing have tried not to be seen as directly controlling responses to the conflict by Hong Kong authorities.

China

China has ordered all government offices and public institutions to remove foreign computer equipment and software within three years, in a potential blow to U.S. companies HP, Dell and Microsoft.

China has ordered all government offices and public institutions to remove foreign computer equipment and software within three years, in a potential blow to U.S. companies HP, Dell and Microsoft. The directive is the first publicly known instruction with specific targets given to Chinese consumers to switch to domestic technology vendors.

The move is the flip side of the U.S. administration's efforts to curb the use of Chinese technology by the U.S. and its allies. China's retaliation to U.S. moves is part of a broader campaign in China to increase reliance on home-made technologies going forward. The tariff war with the U.S. has helped reinforce a new creed in China: to be not reliant on foreign sources for crucial technology, equipment, expertise or funding - which determine future growth and development. The level of awareness to these risks, have risen on both sides and have become painfully acute to U.S. and Chinese companies and consumers. Trust levels between both countries today are at 40-year lows. If no action were to be taken to improve relations, it would likely fuel debate over U.S.-China economic decoupling; suggesting the possibility of supply chains between both countries being severed [should a mutually beneficial solution to existing tensions - not be worked out].

U.S. hi-tech companies including Cisco, Intel, et, al, export some \$520 billion worth of equipment annually to Chinese entities. These companies have seen a

dip in Chinese orders if not boycotts over the past year. The U.S. Administration banned U.S. companies from doing business with Huawei, a leading Chinese controlled equipment maker- that is believed to be the global leader in 5G technology, equipment & connectivity.

The U.S. is reportedly exploring ways to help funnel capital to Huawei's European competitors -which is one way to attempt to freeze them out of advanced projects around the world.

Huawei networks appear to provide fastest-access data collection, storage and dissemination availability. Notably: Huawei's capabilities are currently considered ahead of the competition. The U.S. is reportedly exploring ways to help funnel capital to Huawei's European competitors -which is one way to attempt to freeze them out of advanced projects around the world.

Those attempts may be a bit late, however. Chinese inroads with authorities, vendors and professionals around the world; offering contracts/agreements [which China funds via loans] have already opened wide access to Chinese networks. Visionaries, vendors, equipment makers and planners who design programs, gather data, distribute information, technology and knowhow – used in conducting trade and services and in making payments globally- can perform multiple advanced functions via virtual platforms.

The future integration of 5G capability across sectors linking healthcare, engineering, bio-science, mining, exploration, manufacturing, financial services, distribution & logistics and utilizing artificial intelligence, robotics and blockchain technologies combined-represents a new wave. Whose companies will dominate this new frontier, with all its implications – remains at the center of the confrontation with China.

Pakistan

Pakistan bowed to pressure from China to revive a string of Beijing-backed infrastructure projects that have run aground. [Pakistan appointed a senior military official to streamline decision-making over the multi-million dollar investments.]

The China-Pakistan Economic Corridor (CPEC) is a key part of China's Belt and Road Initiative, which is seen by Beijing as a 21st-century Silk Road to connect Asia, Africa and Europe. Only one-half of the announced \$62 billion worth of projects in Pakistan are under way as Islamabad scales back its financial commitments while it implements a \$6 billion IMF bailout package.

China is frustrated with the slow pace of the initiative, which is supposed to be a shining example of China's economic transformative investments; and has put pressure on Pakistan to put its military in charge. A retired Pakistani lieutenant-general was appointed chairman of a new CPEC authority, reinforcing the military's grip on the project and insulating it from possible changes in the leadership of the government. The role of the CPEC authority (outside of political dictates) will bring focus to this vast project and the General's presence will ensure adequate security. Beijing is already recalibrating. On Prime Minister Khan's first visit to China after assuming office, he asked for a bailout. China says it has always wanted to avoid just handing out money.

Pakistan has slashed imports, depreciated its currency, lowered development spending and raised taxes in an effort to cut its substantial fiscal and current account deficits. GDP growth fell from 5.8% in 2018 to 2.4% in 2019. Exports have flatlined. Large scale manufacturing production fell 5.9% in the third quarter, with some industries, including cars and pharmaceuticals - suffering double-digit decreases in production. China has long faced criticism that its BRI projects burden fiscally weak countries with unus-

tainable debt. Pakistan expects to pay \$40 billion in debt repayments and dividends to China over the next two decades. While some Pakistani experts say CPEC-related debts are not unmanageable, they caution that Pakistan's ability to meet its debt obligations hinged on increasing exports. CPEC-related debt eventually must generate enough exports to be able to deal with the debt repayment schedule. Pakistan is worried about falling into a debt trap. Even if loan payments are later deferred, they are going to take a toll on Pakistan's economic development potential and could even hamstring Prime Minister Khan's reform agenda.

China dismisses these fears pointing out that debt incurred from CPEC stands at \$4.9 billion, less than one-tenth of Pakistan's total debt. The Pakistanis have their eyes set on moving CPEC from grand infrastructure projects into the copper, gold, oil and gas sectors. It is unclear if a major railway project, the \$9 billion ML-I scheme which has already been delayed by four years, will go ahead.

For its part, China fears it has heavily invested in Pakistan, with little prospect of return, both strategic and economic. Right now, the focus is about CPEC's reputation, and Beijing cares about salvaging that. They need to show BRI has been a success, that it hasn't put Pakistan's economy in trouble and that there isn't a backlash. The project's performance in Pakistan, a close ally of China, could be a yardstick used for measuring BRI success elsewhere.

Mexico

President Andres Lopez Obrador [AMLO] continues to battle stagnant economic growth, corruption, crime and reducing inequality. Jitters over the strength of the business environment and electioneering prior to the U.S. 2020 presidential vote, will tend to slow Mexican growth next year. AMLO's dominance over Mexican institutions will continue to raise concerns

regarding the rule of law and the quality of the country's democracy. AMLO's campaign promise to be a "transformational" president has so far eluded him. His support among the voting population has steadily declined since taking office.

With the USMCA now in place, there is potential for a pick-up in manufacturing, while new investment shifts from China (to take advantage of lower tariffs) are expected to register in Mexico over the next few years.

Weak growth and the poor health of the state oil firm PEMEX continue to weigh on Mexico's fiscal outlook. Average fiscal deficits are projected at 2.4% of GDP over 2020-24. Still, the country's debt stock will peak at a manageable 50.6% of GDP in 2020. Amid potential sporadic currency volatility, the peso is expected to depreciate in 2020, as export earnings may suffer due to U.S. election uncertainty. Thereafter, the peso is expected to gain strength as global stability brings a pick-up in 2021-24. With the USMCA now in place, there is potential for a pick-up in manufacturing, while new investment shifts from China (to take advantage of lower tariffs) are expected to register in Mexico over the next few years.

It is expected that better terms will be offered to public-private partnerships going forward. Beginning with the strong need for private sector companies to take on greater mining and exploration activities in the oil and gas sector, given PEMEX's ongoing credit crisis, we expect Mexican authorities to actively encourage foreign participation. The Mexican energy sector is likely to attempt to set a new trend in transparency and openness as a way of attracting crucially needed foreign investment to exploit new oil fields. The weak response to the recent oil block auction means renewed, full-blown efforts to convince potential investors will become top priority. Private partici-

pation in the energy sector is expected to begin showing benefits in 2022-24. The government will seek financing for more infrastructure investment.

Over the coming two years the market for debt and equity issues are forecast to gradually grow stronger, owing to expansion of investment portfolios and as private pension funds exploit greater investment flexibility in this market. The development banking sector is also likely to expand over the coming years owing to banking sector reform.

Advanced 4G and 5G connectivity will expand rapidly with help from China; from a rate of 50% of mobile connections in 2017. The number of internet users now exceeds 100 million.

The next elections (congressional, provincial and municipal) will take place in 2021. The outcome will largely depend on the success of AMLO's rule, and whether traditional political parties are able to rehabilitate their images; or if anti-incumbency sentiment leads to further breakdown of the traditional party structures.

Persistent investor/creditor unease toward Mexico, relating to policy uncertainty and the international environment, will begin to ease a bit in the year ahead. The country should begin to crawl out of recession in the coming quarters – especially if the sitting government is disciplined and is able to send consistently positive messages to potential investors/creditors over the coming months. The opening up of the telecommunications and energy sectors will support FDI inflows, which are projected to average 2.3% of GDP in 2020-24.

*By Byron Shoulton, FCIA's International Economist
For questions / comments please contact Byron at
bshoulton@fcia.com*

FCIA's Deals Of the Month

Bank Policy: \$10,000,000 limit of liability, participation on import finance coverage in food sector from Brazil.

Single Buyer Policy: \$10,000,000 limit of liability in petrochemical sector, USA.

What is Trade Credit Insurance?

If you are a company selling products or services on credit terms, or a financial institution financing those sales, you are providing trade credit. When you provide trade credit, non-payment by your buyer or borrower is always a possibility. FCIA's Trade Credit Insurance products protect you against loss resulting from that non-payment.

* **Non-Cancelable Limits:** *Subject to policy terms and conditions, after issuing the policy, the insurer may not unilaterally reduce any country or buyer limits.*