Investment Insights

Trade War

Rebecca Patterson
Chief Investment Officer

Highlights

- Early Friday, the U.S. implemented tariffs on $34 billion worth of Chinese goods, prompting retaliatory tariffs by Chinese officials
- These latest steps follow other, smaller tariffs implemented earlier this year (on various countries) as well as stricter controls around U.S.-Chinese cross-border investments; looking ahead, additional tariffs including autos, remain a risk
- Clearly this is a significant, negative development for the global economy and financial markets; the muted market reaction so far reflects the offsetting strong economy (helped by unusually large U.S. fiscal stimulus) as well as some expectations of this development that were already discounted in market valuations
- We view our current portfolio construction as appropriately balancing these two forces; however, we stand ready to take additional defensive steps should the trade war create notably greater recession risks

Early Friday, the U.S. formally implemented tariffs on $34 billion worth of Chinese goods, with China immediately retaliating and accusing the U.S. of violating World Trade Organization (WTO) rules. China's tariffs include products in areas of the U.S. dominated by supporters of the president, apparently in an effort to extract political as well as economic pain. Such goods include soybeans, corn, pork and poultry. U.S. President Trump has suggested in recent weeks that such steps could be met with additional U.S. tariffs on up to $500 billion of Chinese goods (the "$500" figure is new and at least $100 billion more than previous threats).

President Trump had campaigned on getting a better deal for U.S. manufacturers, highlighting trade with China in particular. The campaign rhetoric led many to fear that his election could lead immediately to a trade war. When his first year in office came and went with almost no follow-through, and instead a focus on business-friendly deregulation and lower tax rates, equities soared and the economy continued to strengthen. After the tax cuts were implemented, however, the president seemed to refocus on trade, first moving on tariffs on washing machines and solar panels in January, followed a few months later by steel (25%) and aluminum (10%) tariffs. The first leg of the tariffs was largely brushed off by investors, as it was very targeted and had a minimal economic impact. The second leg, however, started getting investors much more anxious — instead of focusing metals tariffs on China, where there had clearly been oversupply issues for years impacting many countries — the administration initially made the tariffs global, only exempting certain countries afterwards. This step was followed by threats of retaliation; so far, seven countries along with the European Union (EU) have suggested they will respond with tariffs on U.S. goods — ranging from aluminum, pork and fruit to bourbon and motorcycles.

Beyond this latest U.S.-China step and the possibility of escalation, autos are the focus. President Trump has suggested he would like zero tariffs globally on autos, and that his negotiation tactics are a means to an end. For now, though, the more likely next step (in our view) would be auto tariffs, something the CEO of General Motors has said would hurt U.S. autos and related jobs

(she and other auto executives are urging the president not to move forward with this). Many U.S. drivers have imported cars, and every vehicle assembled in the U.S. has at least a quarter foreign parts (and often much more). Global supply chains today mean that trade wars are much harder to be targeted; spillover to other countries (including the U.S.) is almost unavoidable. There is no specific timeline for the auto tariffs; at this point, it is a research project of sorts for government officials. Based on recent tariff developments, though, actual auto tariffs could kick in as early as later this year.

Frankly, we do not know how this will end. We remain hopeful that the administration will accept a small victory on trade — something that could be shown to voters ahead of midterm elections as a positive development for U.S. exporters — rather than continue to escalate. That seems to be the consensus “hope” as well, in part because of the pattern of the administration to threaten but then pull back on actual actions such as exiting NAFTA. However, it is difficult to have much conviction around this scenario, partly because it is not clear that there is even agreement within the administration over the path and intended outcome of these efforts. For now, we see the trade war as a growing risk that must be monitored carefully, as it has the potential to change our underlying economic assumptions.

Meanwhile, the actual U.S. and global economy remains solid, thanks in part to exceptional stimulus in the U.S. around the turn of the year. Just Friday, the U.S. reported job gains in June of 213,000, well above expectations, and a rise in the number of people actively looking for work. Put another way, so far, trade has not made a real dent in growth — the only real evidence we are seeing is in certain commodity prices (U.S. soybean prices are down nearly 20% since mid-May while copper is down about 15% since early June), and leading sentiment indicators. On the latter, business confidence indices (PMI surveys) ask corporate leaders for their view on future orders. That question has seen a notably less upbeat response in recent months (in the U.S. but also abroad). This is clearly only sentiment, and it is reasonable for corporations to be more cautious given what is going on. But if we see trade-related uncertainty drag on for months and months to come, with fears of escalation and more retaliation, there clearly would be a growing chance that caution becomes action — less hiring, less investment — ultimately, less overall economic growth.

At the same time, tariffs more often than not cause prices to increase. While some commodity prices are indeed falling, other impacted goods are seeing costs go up. *The Washington Post* reported Friday that the price of washing machines in the U.S. rose by 9% in April and another 6% in May; both are the largest monthly increases since the Bureau of Labor Statistics began collecting this data in the late 1970s. A trade war, should it increase input costs, creates challenges for companies. Do they pass on higher costs to end consumers or eat the cost and see profit margins fall? And trade impacts must be considered alongside all other global growth developments (which as we indicated, remain positive overall). It’s a difficult time for companies to plan and make large investment decisions — perhaps feeding through into U.S. companies using a lot of their tax windfall for share buybacks rather than new, large capital spending efforts.

A few upcoming dates and events we would watch closely as we monitor this issue:

- July 13: President Trump visits the U.K. and is expected to discuss bilateral trade with Prime Minister May.
- July 21-22: Group of 20 finance ministers and central bankers meet in Buenos Aires; trade will clearly figure prominently on the agenda.
- July 24: PMI surveys for July are due and are worth watching to see if trade is impacting business confidence more meaningfully (so far it hasn’t).

Overall, we feel our current portfolio construction straddles these two forces. A neutral (versus benchmark) equity weighting plus defensive positions within equities has helped dampen tactical volatility; the commodity exposure (especially Brent crude) has also been additive, in equities and via the Strategic Opportunities mandate. Our bias for U.S. exposure is

also acting defensively, as we had expected. As we noted in our latest *Quarterly Investment Perspective*, "The Defensive Playbook," we do not yet see enough evidence of a pending recession to take that next de-risking step — going underweight equities. However, should the trade war continue to escalate and start to show real evidence that it is undermining growth, we would not hesitate to act. We know our clients count on us to protect.

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