Trade Wars!

Trade, Tirade and Talk

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Background

The US has recently embarked on a series of actions which, while not our base case, have the potential to escalate into a full blown international trade war.

During his election campaign, Trump was very vocal about being more protectionist and putting “America first” but when he assumed office and started building his team markets breathed a sigh of relief as many in the administration were seen as business friendly. In particular, the market swung to believe the protectionist rhetoric as exactly that – just rhetoric. However that changed when Gary Cohn resigned as the National Economic Council director on 6 March, having epitomised global trade and capitalism as he was formerly the President & COO of Goldman Sachs and tipped to succeed Lloyd Blankfein as CEO.

Cohn’s resignation followed Trump’s proposal to impose import tariffs on steel and aluminium. These not only came into force but were followed by narrative from the administration that these may just be the first of several such measures. The good news was that the friends and allies of the US would be allowed to apply for exemptions. Responses from the EU, China and others that reciprocal action would be taken if exemptions were not granted raised the alarm across capital markets. While some countries were indeed exempt, China was not. In response China declared tariffs on some USD3 billion worth of US imports.

The concerns reached fever pitch on 22 March when Trump hit China with trade tariffs and other penalties on as much as USD50 billion worth of Chinese products (a list of more than 1,300 products), including restrictions on investment into corporate America. This move was made (it said) in retaliation for years of unfair business practices surrounding intellectual property and protectionism of local Chinese companies.

China does not make it easy for foreign firms to do business in the country. There are some formal tariffs but mainly, it is the higher level of bureaucracy through which foreign firms must wade. There are some industries that are simply not allowed to operate in the country, while for others, there is a pre-requisite of technology and intellectual property sharing. This is a high barrier to access the Chinese consumer market. Furthermore, there are limits on foreign ownership of Chinese companies.

The tariffs were designed by the Office of the US Trade Representative to target the “Made in China 2025” strategy of China, which aims to focus the country’s industrial development in high technology sectors such as robotics, aerospace, electric vehicles and biopharmaceuticals, to name a few.

On 4 April, China imposed additional tariffs on US products worth USD 50 billion. In what seems almost elegant, Beijing’s action was on only 106 items and included soybeans, cars and chemical products which link directly to home states for key members of the US administration.

Despite signs that both sides are open to negotiation, on 6 April President Trump requested the US Trade Representative to consider an additional USD100 billion worth of tariffs, with Beijing responding they will fight “to the end, and at any cost”.

We have seen a significant 7.5% decline in the S&P500 Index, together with 6%+ declines in a number of emerging markets since the recent high on 12 March. Over the last week, it has emerged there have been back-channel discussions between high ranking officials on both sides and a more conciliatory tone has been struck between Presidents Trump and Xi indicating they do not want to enter a trade war and prefer a negotiated solution.

Trade Wars!

Trade, Tirade and Talk

Why has the US done this?

For most individuals and corporate consumers it makes little sense to impose tariffs on goods and services since doing so only increases the cost of those goods and services – so what gives? Is this another Trump tirade or is there a real issue beneath the lambasting?

Closely linked to the Office of the US Trade Representative ("USTR") is a body called the US International Trade Commission ("US ITC") which investigates the effects of dumped and subsidised imports on domestic industries and intellectual property right infringements, amongst others. It was on their findings that tariffs on steel and aluminium were raised in March, following earlier targets of solar cells and washing machines back in January.

The USTR itself released its 16th annual report to Congress on China's WTO compliance in January 2018 which appears to have been the trigger for the broader USD50 billion tariffs. In this report, the USTR goes to some length identifying numerous ways in which China has violated the rules of the World Trade Organisation ("WTO") including how:

- the Chinese authorities continue to operate state control of several industries,
- actively encourage selection of Chinese companies (over international peers) across industries,
- create regulatory and legal barriers to operation of foreign firms in the country and
- insulate several parts of their economy from foreign competition by excluding the competition altogether or applying limits on foreign ownership.

Country members of the WTO are required to abide by a set of key principals as condition for membership. These principals include:

i. non-discrimination, such as the fair treatment of products and services across member nations
ii. openness, such as lowering of trade barriers
iii. reciprocity, being the encouragement of reciprocal arrangements between member countries
iv. fairness, including remedies for situations where trade is deemed unfair
v. transparency, such as responding to requests for information and notification of any changes in trade policies

The report also cites bilateral US-China trade negotiations dating all the way back to 2003 (two years after China's accession to the WTO) where in the view of the USTR there had been commitments made but no action taken. Such bilateral discussion took placed as recently as April 2017 with President Trump and President Xi, in Trump's Mar-a-Lago resort. During this time, it was proposed the two sides agreed to a 100 day action plan for commitment to five outcomes. One hundred days later in July 2017, China had not achieved any of the five outcomes.

Then in November 2017 when Trump visited Beijing, the USTR reports the US disengaged in bilateral discussions, making it clear the US is seeking fundamental changes to China's trade regime, including the overarching protectionist policies that dominate China's state-led economy. The viewpoint of the US is summarised best in the following excerpt from the USTR report:

> *It is difficult to envision this troubling situation changing significantly as long as China continues to remain committed to an economy dominated by the state and built on mercantilist industrial policies designed to promote, guide and support domestic industries while simultaneously and actively seeking to impede, disadvantage and harm their foreign counterparts. If China does not truly embrace a market-oriented approach, rooted in the fundamental WTO principles of non-discrimination, market access, reciprocity, fairness and transparency, the very serious and harmful problems generated by China's trade regime likely will persist.*

The full USTR report can be found in this link and the tariff proposal on USD 50 billion in this link.

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Trade Wars!

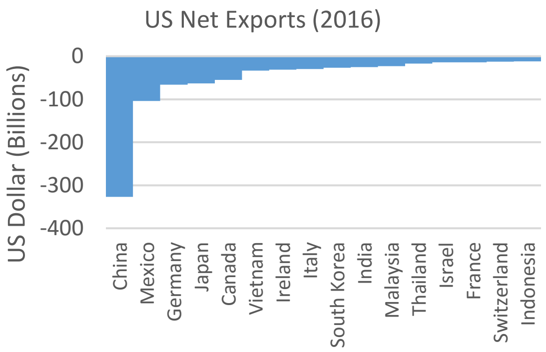
Trade, Tirade and Talk

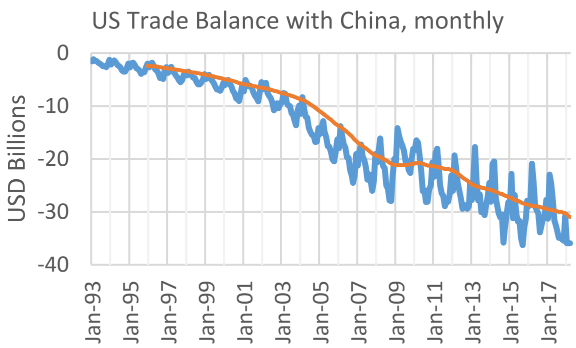
How big is the problem?

The first point to note is although the solar panel & washing machine tariffs from January and the steel & aluminium tariffs from February are live, the tariffs on USD 50 billion of Chinese products and the USD 100 billion headline have not come into force. The tariff on USD 50 billion of products is merely a proposal that is now out for public/ corporate opinion while the USD 100 billion headline is a question from the President to the Office of the US Trade Representative ("USTR").

The first hearing to review submitted comments on the first set of tariff proposals will be on May 15th. The reciprocal tariffs and possible currency devaluation announced by China so far are contingent on the US tariffs being enacted. So there is still some time before tariffs could possibly come into force but it also gives a fairly clear time line for a negotiated settlement.

The US is a huge trading partner with total trade of USD3.6 trillion in 2016 but similarly to a number of developed world economies, they import more than they export and so run a trade deficit. In 2016 the deficit was USD 800 billion. Digging under the bonnet, the issue with China is hard to miss.





China is the biggest supplier of goods and services to the US, by a country mile! Purely through trade, there is around USD30billion a month that is transferred from the US to China and as the chart above shows, there seems to be little sign of the pace changing. In aggregate, since WTO accession, the cumulative net trade balance between the US and China is a trade deficit of USD4.3 trillion. The issues around intellectual property add to this figure even further.

There are lies, there are damn lies and there are statistics

A study by Deutsche Bank, echoing comments from the Centre for Economic Policy Research, suggests that reviewing trade statistics alone leads to inaccurate conclusions.

For example, products designed in the US, manufactured in China and then sold in China should represent economic value sold by the US to China as part of the measure of US exports. However, since the product never leaves China after manufacture, it is absent from official trade statistics that capture the value of goods and services when they cross borders.

The economic value of course does show up in US corporate profits. The Apple iPhone and cars made by General Motors are two examples of this. General Motors sold more cars in China than in US last year (2017). There are 310mn active iPhones in China, more than double the number in the US. When viewed in this light the economic relationship between the two countries is far better balanced (c. USD30 billion deficit) than trade statistics currently show (c. USD 337 billion deficit).

The source data quoted in the Deutsche Bank study is from the Bureau of Economic Analysis. Strangely, data beyond 2008 is no longer available on their website despite having been up to 2015 previously. Additionally the data that does remain has been "suppressed to avoid disclosure of data of individual companies".

The Apple iPhone was launched in June 2007 and started selling in China in October 2009.

Trade Wars!

Trade, Tirade and Talk

My view on what's happening

From my analysis, the US action on tariffs has as much to do with unbalanced trade as it does with the US being fed up of China flaunting WTO principals of non-discrimination, openness, reciprocity, fairness and transparency. As easy as it is to look at trade statistics and the impact of tariffs on GDP (as most economic commentators have done to date), the message coming from the Trump administration has equally been about intellectual property theft.

In my opinion, the nub of the issue is China's protectionist modus operandi together with their focus on "Made in China 2025" high tech sectors. These sectors are key not only to China's development but indeed are key focus industries for most developed economies.

In the view of the US, China is positioned to leapfrog the whole developed world in a technological arms race, all while maintaining its own barriers to competition from foreign firms and thereby emerging as a global leader in the major industries of the future. Indeed, this is the stated objective of the Chinese Communist Party!!

Despite dialogue dating back to 2003 (two years after China's WTO accession), including as recently as mid-2017 between Presidents Trump and Xi, there has not been enough progress in China towards opening up its economy to foreign competition in the same way it has been able to compete freely on trade amongst the rest of the world since 2001.

International firms are impeded from competing fairly in China and it seems President Trump has accepted the challenge of accelerating China's adherence to the principles of world trade.

Possible implications for markets

Much like Brexit, this feels like it's somewhat binary:

- In the positive scenario, China and the US get around a table and agree on an action plan for China opening up some industries of interest (e.g. autos, financials). However, the US and China have tried to do this for years without China moving much, so I expect the talk will be firm from Trump.
- In the negative scenario, talks fail and we end up in an escalating US-China trade war that may drag other countries along with it. Interestingly, according to an analysis by Bloomberg's economists, given how China's exports are 20% to the US and 80% to the ROTW, any tariffs on trade with the US will not have nearly as much impact as it might have done in years past. Additionally, China's current account surplus is only 2% compared to 10% in 2007 meaning trade is far less important to growth today.

In the positive scenario:

- It should be positive for equities generally, but especially so for US equities as they would have a newly opened market to them.
- Other equities should benefit in a similar fashion, though one would have to assume US equities benefit the most.

In the negative scenario:

- We should expect to see prices rise (inflation) more than currently forecast in the US due precisely to the tariffs. According to Bloomberg, the chain-links are weaker to other markets so the impact on inflation from US-China tariffs would not be as high elsewhere.
- Higher inflation will put pressure on US corporate profit margins and will also be negative for US fixed income.
- US financials could be a winning relative outperformer in this scenario (benefitting from higher inflation/ rates environment and being less sensitive to tariffs on goods).

The test will then be whether Europe, Japan et al agree with the US view on China's WTO rule flaunting behaviour and choose to follow the US lead with tariffs on Chinese goods. Alternatively they could use the opportunity to garner closer ties to China. After all, the US doesn't have a monopoly on innovation and European/ Japanese technology could be of great interest to China.

- If they follow suit, it will be a major market sell off event
- If they pivot to the East, it should be positive for both European and Asian equities

So the question for the SAAC to discuss is...

1. Do we ride through the volatility, hoping what seems like common sense to prevail with a negotiated solution for both sides. This is a high risk strategy if anything goes wrong in the political discussions between the US and China, over which we have no informational edge.
2. Reduce our equity holdings across the board, notably to the US; hold cash/ low risk assets until there is a clearer path forward. This option sees us miss out on gains if the dispute is settled amicably.

Afterthought

There is another angle to the problem in the US, which is American jobs. Trump has indeed shown he will strong arm companies when last year he forced Carrier and Ford to abandon plans to move manufacturing facilities to Mexico. However, the problem here is that most American jobs have been lost to China or Mexico.

More manufacturing jobs have been lost to robotics and automation. The US manufacturing sector is producing more products than ever, it just takes fewer people to do the same jobs as it did several years ago. Fighting with China over trade will not solve the problem of jobs in the Rust Belt of America (Trump's biggest supporters).

So tackling China on trade and open/ fair competition serves a long term geo-politically strategic objective for the US while also giving American voters the impression Trump is fighting for them, even if the longer term solution for American jobs is unlikely to be solved with any immediacy.