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INVESTMENT MANAGERS

Investment viewpoint

Trade Turns into War

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Executive summary

The risk of a full-blown trade war is high – not least because both sides believe strongly that they are in the right. The dispute has already, in our view, affected investors' risk tolerance, leading to the underperformance of many risk assets. There is significant potential for a period of tit-for-tat retaliations.

President Trump has signalled his next move: a tariff on the imports of cars into the US. If imposed, this would primarily hit Canada, Japan, Mexico, Germany and Korea. The biggest impact would likely be on Canada, Mexico and Japan, as car exports to the US represent 11%, 7% and 6% of their total exports, respectively.[1]

The shock to Canada's economy would be particularly severe and the country could be plunged into recession. Though not quite as exposed as Canada, Mexico could face a similarly painful outcome. For Germany, while the auto sector is very important for the economy, its direct trade with the US is smaller than the other countries, shielding it somewhat.

In terms of economic growth, the potential direct impact of the tariffs enacted thus far remains modest. But the risk arises from the signals being sent to markets, which have started to focus on the possibility of a severe escalation. Investors need to monitor carefully their exposure to risk assets, especially equities and emerging markets.

However, it is important to note that the underlying fundamentals of many segments within developing economies are much stronger than they were in 2013. If external risks stabilise, we would expect a sharp rebound in risk assets, based on both valuations and fundamentals. The strategic thesis for accessing emerging markets risk premia remains strong.

The NATO Summit in July will provide an occasion for President Trump to engage his counterparts. Whether we get a repeat of the confrontation of the recent G7 or a more conciliatory tone will be key for the markets.

Investment implications

- Markets are beginning to focus on the possibility of a severe escalation in the trade dispute between the US and its trading partners
- Investors need to monitor carefully their exposure to risk assets, especially equities and emerging markets assets
- If the US follows through on its threat to impose tariffs on car imports, Canada and Mexico would likely be worst hit. We believe both countries could face recessions
- We believe there is a significant risk that trade relations will deteriorate further, with damaging consequences for global trade and the global economy
- However, if signs of a compromise emerge, we would expect a sharp rebound in risk assets, based on both valuations and fundamentals

[1] Source: UN Comtrade.

Introduction

The first salvo in the trade war was fired when the US administration decided to impose tariffs on steel and aluminium imports and on USD 34 billion of imports from China, and to restrict Chinese investments in the US. The US's trading partners retaliated by targeting specific imports from the US.

The threat that the dispute could deteriorate into a full-blown trade war is real. In our view, it has already impacted investors' risk tolerance, leading to the underperformance of many risk assets, especially emerging markets and global equities. We believe that the risk of a trade war is high, and that until recently it has been underappreciated by the market.

Currently, the ball is in the Trump administration's court. Whether the US decides to hit back at the retaliations of its trading partners will be key. The outcome could be bleak, given that President Trump is considering imposing a further USD 200 billion of tariffs on imports from China and a tax on imports of foreign cars, and that the EU is already planning its counter-attack to potential tariffs on cars with USD 300 billion worth of tariffs.

"My actions are legal; yours aren't"

A major reason the likelihood of a trade war is significant is that both sides view their actions as legitimate – and believe strongly that the other camp is acting illegally. To understand the possible next steps by each side, it is essential to understand their views in the conflict.

The US view

The US administration firmly believes that its initial tariffs are legal under World Trade Organization (WTO) rules because they were put in place for national security reasons. This is permissible, unless the WTO rules against such an action following an official complaint (which could take years). Consequently, the US administration thinks that the retaliatory tariffs imposed on it are in violation of WTO rules – giving it the moral high ground to strike back at these "illegal" acts by its trading partners.

There have been some reports in the press suggesting the US is preparing to exit the WTO. However, we believe the US is unlikely to leave until a ruling given on the initial tariffs. The US will only exit if the WTO rules against the use of tariffs for national security reason.

The partners' view

The trading partners view the situation entirely differently. They believe that the initial action by the US is illegal because, in their view, the traded goods do not represent a security threat to the US. For example, Canada has argued since the beginning that it is dubious to suddenly consider Canadian steel and aluminium a threat to US national security when both products have been a major input for the US military industry for decades. Since the trade partners regard the US tariffs as illegal, they believe they have the right to retaliate.

The fact that both sides are so convinced they are acting legally increases the probability that we will enter a period of tit-for-tat of retaliation, with damaging consequences for global trade and the global economy.

Autos are next on the list (this could hurt)

On 22 June, President Trump signalled his next move with this tweet: "Based on the Tariffs and Trade Barriers long placed on the US & its great companies and workers by the European Union, if these Tariffs and Barriers are not soon broken down and removed, we will be placing a 20% Tariff on all of their cars coming into the US Build them here!" In a similar vein, at a recent rally in North Carolina, he invoked the spectre of a tax on Canadian cars in response to long-standing Canadian tariffs on dairy (the latter are part of a supply-management system to stop Canada being flooded by cheap and heavily subsidised dairy from elsewhere).

As explained above, and by way of reminder, the latest proposed US tariffs are a reaction to those imposed by the EU and other trade partners on US goods (about USD 13 billion for Canada and USD 3.5 billion for the EU), which themselves were in retaliation for the initial US tariffs on steel and aluminium.

Investors should not be surprised: the actions of the US administration are in keeping with policy suggestions made during and since the presidential election campaign by Peter Navarro, one of Trump's main advisors on trade along with Robert Lighthizer and Wilbur Ross.

Tariffs on car imports to the US would primarily hit Canada, Japan, Mexico, Germany and Korea. Respectively, each country represents about 25%, 23%, 17%, 12% and 9% of US imports of cars.[1] The biggest impact would likely be on Canada, Mexico and Japan, as car exports to the US represent 11%, 7% and 6% of their total exports, respectively. For Germany and Korea, the impact would be much smaller as auto exports to the US represent only 2% and 3%, respectively, of their total exports.[1]

Nevertheless, the auto industry is very important for those economies, as the exports from the sector represent 25% of total exports for Mexico, 21% for Japan, 18% for Germany, 15% for Canada and 11% for Korea.[1]

Some car manufacturers and car parts manufacturers (BMW, Hyundai, GM and Magna) have already written to the US administration stressing that the tariffs would have a serious impact and could lead to cuts in operations and staff in the US.

Canada, Germany and Mexico

Canada is an interesting case. The auto sector is an important part of its economy, representing about 10% of the manufacturing sector – which itself represents about 10% of the Canadian economy – and directly employing about 125,000 people (about 8% of manufacturing jobs).[2] Considering that almost 80%[1] of Canadian

[2] Source: Statistics Canada.

car production is exported, mainly to the US, the imposition of an import tax by the US could have important economic consequences, especially since Canada's auto industry is heavily concentrated geographically.

The impact on Canada's economy could be reminiscent of the shock caused by the sharp decline in oil prices in 2015 and could plunge the country into recession, given the potential economic effects beyond the auto sector. It remains to be seen whether the US will follow through on its threat, but relations between the US and Canada are testy. After hearing Canadian Prime Minister Justin Trudeau say that Canada would not be "pushed around" following a recent G7 meeting, Trump responded: "That's going to cost a lot of money for the people of Canada."

The car industry is also a big part of the German economy. We estimate that the motor vehicle industry represents about 5% of German GDP (about 22.4% of the manufacturing sector). Moreover, while employing about 2% of the German workforce, the total wages and salaries of the sector represent about 6.5% of GDP. Similar to Canada, a negative shock to the German auto industry could have important ramifications for growth and spill over to other sectors. What shields Germany somewhat is the fact that it only exports 12% of its production to the US.[3]

For similar reasons, we believe Mexico could also be at risk of recession. However, the impact of US tariffs on the Mexican economy would be somewhat lower because Mexico is less dependent on the US than Canada, with 30%[1] of Mexican car exports going elsewhere than the US.

Investment implications

The uncertainty generated by the risk of a trade war continues to increase, arising from two sources: first, potential US tariffs on car imports; and second, potential additional US tariffs on Chinese imports. These may lead to further tit-for-tat retaliation.

In terms of economic growth, the potential impact on the various parties of the tariffs enacted thus far remains modest. However, the signalling effect around these tensions is the main source of risk, in our view. Markets have started to focus on the possibility of severe escalation amongst the major economic powers, with potential implications for both foreign exchange and capital account policies. This backdrop could generate negative sentiment for both markets and business or consumption decisions, leading to fears of fundamental deterioration down the line.

As a result, investors need to monitor carefully their exposure to risk assets, especially equities and emerging market assets given the short-term risks emanating from both trade relations and the current strength of the US dollar.

But it is important to note that the underlying fundamentals of many market segments within developing economies remain much stronger than they were in 2013. Any stabilisation in external risks would likely result in a sharp rebound, based on both valuation and fundamental support, as the strategic thesis behind accessing emerging markets risk premia remains strong.

Looking ahead, the NATO summit in July will provide an occasion for President Trump to engage with his counterparts. Whether we get a repeat of the confrontation of the recent G7 or a more conciliatory tone will be key for the markets.

[3] Source: Federal Statistics Office (Destatis).

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