Manulife Asset Management

Market Note

9 July 2018

After the July tariffs, what next?

On 6 July 2018, the United States and China each placed tariffs on selected bilateral imports. The move raises questions over what is the next step in the US-China trade relationship and its potential impact on both economies and markets. Geoff Lewis, Senior Asia Strategist of Manulife Asset Management believes that although the first round of tariffs is likely to have a minimal economic impact, bilateral trade friction may well continue until the US midterm elections in November or beyond. He also notes that in mid-term election years the S&P500 index typically performs poorly in the summer months ahead of the vote but later stages a strong rally into year end.

A bad day for free trade and the global economy

Friday (6 July 2018) could go down in history as a black day indeed for free trade and the global economy, if the US government's imposition of a 25% tariff on US$ 34 billion of Chinese imports were to escalate into something more than a mere skirmish. A trade war scenario is still a low probability event in the eyes of most economists, policy analysts and trade specialists. We agree, although it cannot be ruled out entirely. The risks have definitely increased after last Friday's US measures.

Investors have become more concerned over the deepening US-China disagreement on trade, intellectual property copyright, forced technology transfer and China's "Made in China: 2025" plan. It has been one of the key reasons for the weakness in global stock markets since March; although a number of other factors were also at work, such as fears of a more hawkish Federal Reserve. Business and investor uncertainty has the ability to dampen economic growth[1]. It is, however, impossible to gauge the magnitude of this indirect channel of the trade dispute on economic activity, growth, jobs and inflation – there are no reliable estimates available, not even "guestimates." It is likely to show up as reduced business capex and hiring, but with such a strong US economy the losses from trade protection – both direct and indirect – are likely to be "lost in the counterfactual."

What next?

Only a few weeks back we were toasting what appeared to be an initial agreement after intense discussions between senior Chinese and US trade officials.[2] But the draft US-China agreement on trade that seemed to be on the table plainly did not satisfy President Trump, who ratcheted up the pressure, scotching hopes of an early deal.

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[1] For more on the links between uncertainty and the global economy, see www.policyuncertainty.com and the work of Professor Nicholas Bloom and his colleagues.
[2] Source: White House, "Joint Statement of the United States and China Regarding Trade Consultations", 19 May 2018.

So what will happen now? China has gone to great lengths not to appear over-aggressive in response to US pressure, even taking world time zones into account to avoid giving the impression that China launched the first blow. But whilst continuing with an accelerated program of opening up the Chinese economy and financial sector as promised, Beijing has at the same time stressed that it will match US import tariffs dollar for dollar, blow by blow.

So we can assume that US tariffs will be expanded to cover an additional US$16 billion of items on the USTR's “hit list” in order to reach the Administration's US$ 50 billion target. We may safely assume that China will immediately follow suit with tariffs on an additional US$16 billion of US exports to China.

The economic impact of tariffs

Our chief economist Megan Greene has argued that this first round of tariffs is the equivalent of a single mosquito bite as far as world trade and the global economy is concerned.[3] Everybody now knows that the 25% tariff on US$50 billion of US imports from China is only regarded as a small negative shock by economists. Their macroeconomic models point to a drag on China's GDP growth of just 0.1% to 0.2% in a full year under the new tariffs.

If the US-China trade dispute were to deteriorate further, what might we expect? Let us suppose that President Trump proceeds with his threat to place a 10% tariff on a further US$200 billion of Chinese imports, which most commentators have regarded as bluster. By simple extrapolation of the initial US$ 50 billion of tariffs, we could be talking about a worst case hit to China's GDP of 0.6% to 1.0% next year.[4]

That would be a shock that is certainly big enough to matter in macroeconomic terms. Yet it would still not be large enough to tip the global economy into recession. But it would be enough to have spillover effects across Asia. These spillovers would nearly all be negative. In a few countries, such as Vietnam, a few sectors or industries might experience net gains as alternative supply sources to China. A previous paper on the International Monetary Fund (IMF)’s model implies that a 10% effective increase in import tariffs between the United States and the rest of the world leads to a 1% fall in world trade and ½ % fall in world GDP.[5] Perhaps more clues can be found in the upcoming IMF World Economic Outlook update.

Implications for investors

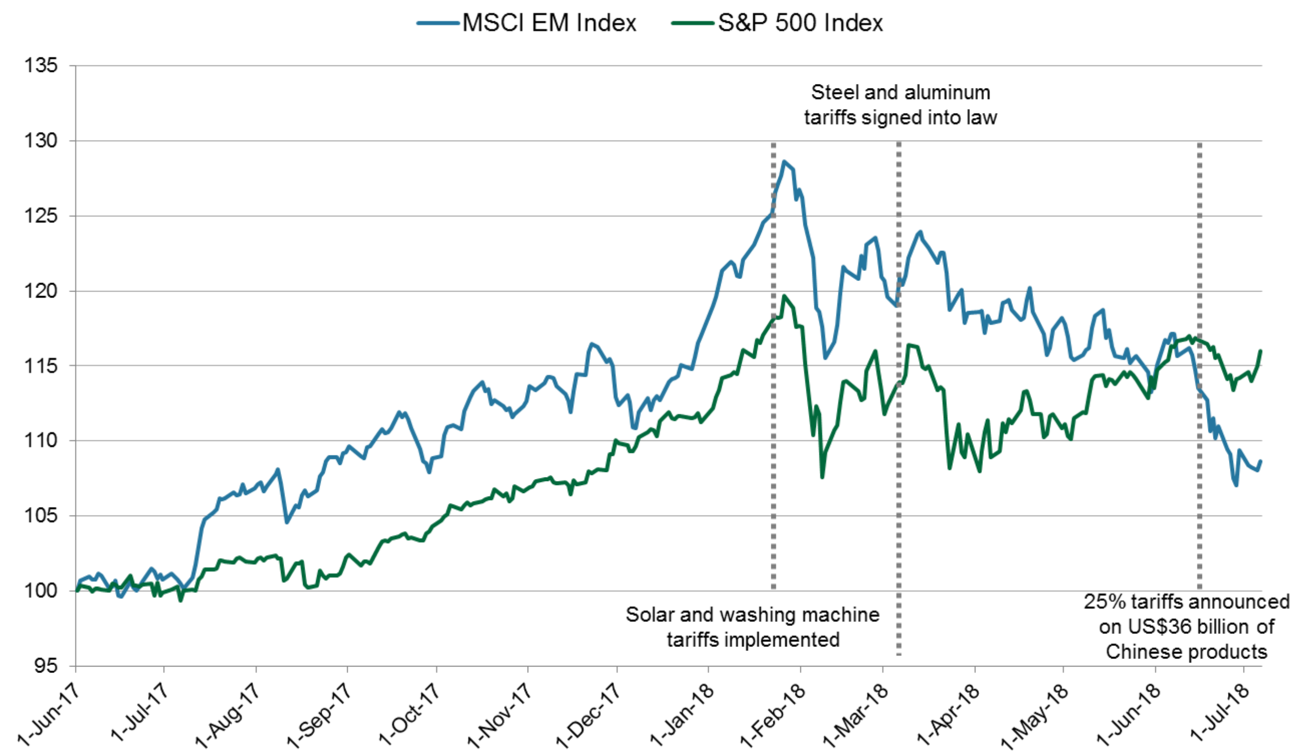
To stress again, we doubt that matters will deteriorate this far. Even if the Trump administration remains determined to keep up the pressure on China, before a full-scale trade war is reached, we would expect to see far greater pushback domestically than we have seen so far. There would likely be vocal complaints and lobbying from US multinationals, trade and industry associations, consumer groups, labour unions etc. And, ultimately, from Congress where legislation to reduce the scope of the president's discretionary powers on trade and tariffs is reported to already be under consideration.

[3] Source: Financial Times, “Forecasts of the impact of a US-China trade war fool markets”, 12 June 2018.
[4] Source for estimates: "China: Impact of US tariffs remains small for now," Credit Suisse, 19 June 2018.
[5] Source: IMF working paper, July 2017

Noise and posturing on trade therefore looks set to continue at least until the US midterm elections in November are over. We trust that Beijing's patience and remarkable restraint continues to hold. Thereafter, any rational policy assessment would call for rapprochement between the US and China. But who knows? Should President Trump decide to go beyond the initial US$ 50 billion of tariffs on China, possibly including US auto imports in his sights, the negative impact on confidence and investment intentions would inevitably be much larger than we have seen so far.

For investors, our advice is that much of the uncertainty over the initial trade skirmish is likely already discounted in the weak performance of global stock markets since early June (see Chart 1). In the absence of further escalation, there could be a growing risk in being out of the market as the US mid-term elections draw near. Before Americans go to the polls on 4 November, there is a good chance that President Trump decides to declare a victory on trade, agreeing to a new deal with China and pocketing the concessions on offer. Lastly, we note that in mid-term election years the S&P500 typically performs poorly in the summer months ahead of the vote but later stages a strong rally into year end. Investors willing to put up with the volatility and stay with the markets may yet have cause to celebrate before the year is over!

Chart 1: Impact of US tariff actions on equity markets[6]



[6] Source: Bloomberg, as of 6 July 2018, total returns in US dollar, index rebased to 100 on 1 June 2017.