Market Bulletin

14 March 2018

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Shedding light on trade turmoil

In brief

- Over the past week financial markets have reacted negatively to the President's announcement of tariffs on steel and aluminum, mainly due to fears of a trade war that could reduce global trade.
- In this note, we address a number of key questions that investors have been asking us about this issue.

1. Why does trade matter?

While there are many aspects to this question, the three most important may be efficiency, competitiveness and international cooperation.

On the issue of efficiency, different countries have different strengths. As an example, the U.S. has a well-educated but expensive workforce. Bangladesh has a less-educated but also less expensive workforce. Both nations could decide to manufacture shirts and develop cutting-edge pharmaceuticals domestically. However, both nations will be better off if they play to their strengths with the U.S. manufacturing and exporting pharmaceuticals and Bangladesh manufacturing and exporting shirts.

Not only is this a good idea in the short run with the potential to raise living standards in both countries, but it also helps in the long run. Foreign competition makes companies better—the quality of U.S. cars is far better today than a few decades ago in large part due to the pressure from Japanese competition in the 1980s.

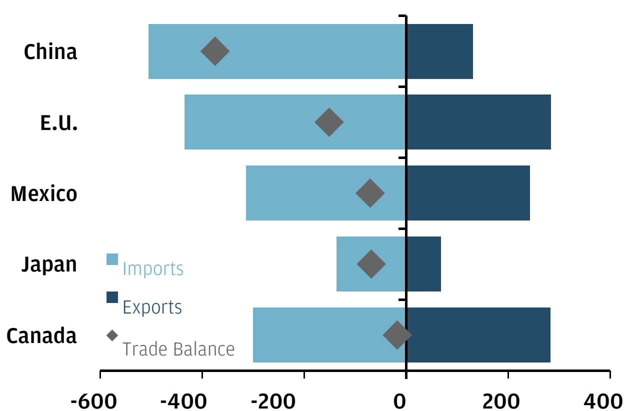
Finally, trade gives countries a common economic interest. After World War II, the European Union was established with the explicit goal of fostering closer relationships among European countries through commerce. Whatever its other failings, the European Union has been spectacularly successful in achieving peace among countries that sought to destroy each other twice in the last century. In summary, when trade grows, the world benefits.

2. What is the current U.S. trade position?

For many years, the U.S. has run a trade deficit consisting of a large trade deficit in goods only partly offset by a small trade surplus in services. Last year, the trade imbalance came in at -USD 568billion or roughly 2.9% of GDP, as a USD 243billion surplus in services was swamped by an USD 811billion deficit in goods. As shown in **Exhibit 1**, our top five trading partners—China, the European Union, Mexico, Japan and Canada—accounted for the bulk of that goods deficit at USD 684billion.

One contributor to this trade deficit has been an imbalance in the application of tariffs. As is shown in **Exhibit 2**, the U.S. currently charges lower tariffs on its imports than some of its major trading partners do on theirs.

EXHIBIT 1: U.S. TRADE BALANCES WITH TOP FIVE TRADING PARTNERS
USD billions, 2017



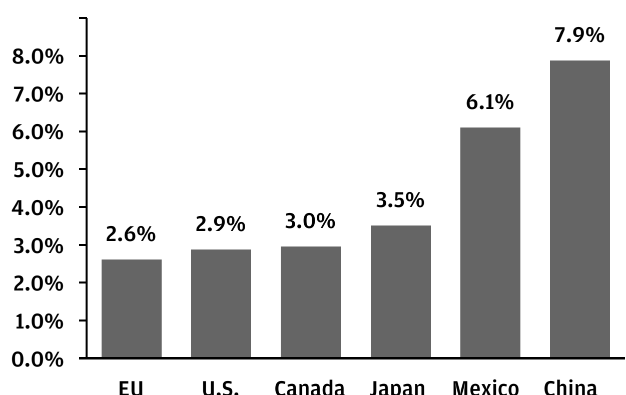
Source: U.S. Census Bureau, J.P. Morgan Asset Management. Data are as of March 6, 2018.

However, two other factors are probably more important—the dollar and the budget deficit. One is the U.S. dollar exchange rate, which has generally been too high to allow the U.S. to achieve trade balance. Put simply, we buy everyone else's stuff because it is cheap while everyone else doesn't want to buy our stuff because it is expensive.

Between August of 2011 and December 2017, the trade-weighted exchange rate of the U.S. dollar rose by 38%, (more than eight times the tariff differential!), hugely undercutting the international competitiveness of U.S. products. The dollar has fallen by about 10% since then but still leaves U.S. goods and services at a competitive disadvantage.

A second factor that is contributing is our budget deficit. To see this, think of a country with a private sector, a government sector and a trade sector. Within the private sector, households are generally net savers and companies borrow from them to invest. However, even if the private sector more or less earns what it spends, if the government demands more goods and services than it earns through taxes, the nation as a whole will do the same. Last year our federal budget deficit grew by USD 100billion, this year it should grow by about USD 150billion and next year it could grow by a further USD 300billion. This, on its own, should make all attempts to rein in our trade deficit hopeless.

EXHIBIT 2: AVERAGE TARIFF IMPOSED ON TRADING PARTNERS
Simple average, all products, AHS basis



Source: WITS, WTO, World Bank, United Nations, J.P. Morgan Asset Management. Data are as of 2016 or most recently available. Data are as of March 9, 2018.

3. What do we know about the current situation?

On March 8, the President signed a document imposing a 25% tariff on all steel imports, and a 10% tariff on all aluminum imports. The imposition of these tariffs was done under Section 232 of the Trade Expansion Act of 1962, a trade authority that was created to inflict economic pain on other countries.

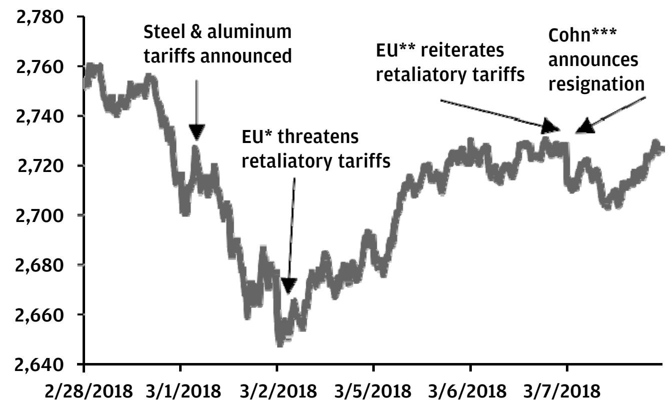
Based on current information, Canada and Mexico will be exempt from this order, but allies, military, and other trade partners have asked the U.S. government to be excluded. Simultaneously, there have been considerable objections from members of Congress, which seem to stem from a view that the current direction of trade policy will lead to retaliation, rather than concessions. Uncertainty is in the air.

Importantly, these tariffs only represent one piece of the Administration's broader agenda on trade—China is still an issue, and North America Free Trade Area (NAFTA) renegotiations remain unresolved. The attempt at linking NAFTA with the recently announced tariffs represents an interesting approach, and initial responses from both Canada and Mexico suggested that they view NAFTA and the steel/aluminum tariffs as two separate issues. Furthermore, with the "easy" work on NAFTA already done, only the thorny issues remain; these include rules of origin (minimum content that products must have from the NAFTA region to be traded duty-free), dispute settlements (are trade disputes handled by multinational panels or U.S. courts?), and the sunset clause (termination of NAFTA after five years unless the three countries actively vote to extend it).

While it seems reasonable to expect the President will continue to use the prospect of tariffs as a bargaining chip in future NAFTA negotiations, the aggressive response from Europe and resignation of Gary Cohn highlights a situation that is clearly in flux. Stay tuned.

EXHIBIT 3: STOCK MARKET REACTION TO TARIFF RELATED ANNOUNCEMENTS

S&P 500 intraday price index



Source: Bloomberg, Standard & Poor's, J.P. Morgan Asset Management. *Jean-Claude Juncker, the head of the European Union Commission threatens tariffs on American made goods. **Cecilia Malmstrom, the European Union commissioner for trade, confirmed the EU had a provisional list of U.S. products that would see higher tariffs. ***Gary Cohn was the president's top economic advisor. Intraday S&P 500 price based on closing price using five minute intervals.
Data are as of March 7, 2017.

4. What has happened historically in terms of response?

The response to the recently proposed steel and aluminum tariffs has been swift and stern, with concern from Congress about the potential for retaliation only representing a first step. The most aggressive response in the wake of last week's announcement has been from the European Union, which has proposed tariffs of 25% on imports of U.S. steel, clothing and other goods (including bourbon and motorcycles). This tit-for-tat approach to trade negotiations may not come to an end soon, but it does seem to echo the historical record.

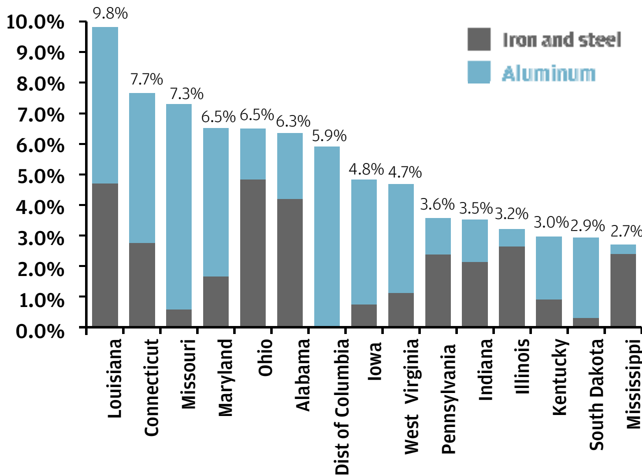
In March 2002, the President George W. Bush implemented tariffs of up to 30% on a number of different steel products. At this time, the former Administration was concerned about the upcoming midterm elections and how the Republican Party would fare in the swing states—a situation not terribly different from where we stand today. These tariffs

were full of exceptions, most notably for Canada and Mexico, but had a significant impact on Europe, Japan, and South Korea; in response to the tariffs, these countries brought the case before the World Trade Organization (WTO), which ruled against the U.S. tariffs. However, the U.S. decided to preserve the tariffs, despite incurring USD 2billion in sanctions, the largest penalty ever imposed by the WTO on a member state.

The European Union then threatened tariffs of their own, with a particular focus on products made in the politically sensitive swing-states that were supposed to benefit from the change in U.S. policy. This led the U.S. to withdraw these tariffs within about 20 months of them being enacted, and avoided a broader trade war. We would not be surprised to see current events play out in a similar fashion; domestic, but particularly foreign pushback, should minimize the chance of escalation, as the cost of a trade war would be high for all parties involved.

EXHIBIT 4: SOME KEY SWING STATES WILL BE HURT THE MOST BY RISING PRICES OF STEEL AND ALUMINUM

Iron & steel and aluminum imports as a percentage of total state imports, 2017



Source: U.S. Census Bureau, USA Trade, U.S. Import and Export Merchandise trade statistics, J.P. Morgan Asset Management. Data is based on HS commodity classification groups. Groups included for iron and steel are (72) Iron and steel and (2601) Iron ores & concentrates. Groups included for aluminum are (76) Aluminum and articles thereof and (2606) Aluminum ores and concentrates. Top 15 states shown based on combination of iron & steel and aluminum imports. Data are as of March 7, 2018.

5. Should investors be worried about recent trade measures?

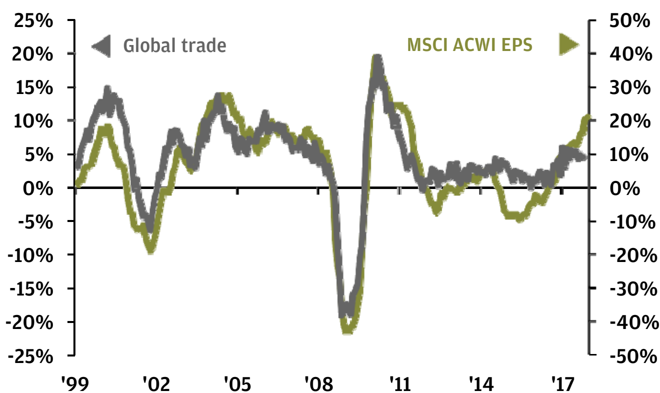
Free trade matters both in the short and in the long-term. Actions that restrict trade could put sand in the wheels of the global expansion by disrupting production, increasing costs for businesses and/or prices for consumers, limiting the positive transmission mechanism between economies, and, ultimately, decreasing productivity. However, the scope of trade restrictions matters too: so far this year, actual changes to trade policy have been narrow in focus, and can be absorbed by the global economy. From the U.S. perspective, steel and aluminum imports only represent 0.2% of GDP, while from our large trading partners' perspective steel and aluminum exports to the U.S. only present 0.1% and 0.3% of GDP, respectively. Thus, actions on tariffs so far would likely have a fairly limited economic impact, in isolation, and the wheels of the global economic expansion would keep on turning.

However, investors are rightly looking ahead and wondering whether trade actions expand and, hence, whether negative economic impacts are amplified. Put another way, do these trade skirmishes turn into a trade war? At the moment, we simply do not have enough information. Investors should watch the following: 1) details of the aluminum and steel tariffs (especially whether certain countries are exempted); 2) whether retaliatory tariffs are implemented by our trading partners and what the subsequent response is from the U.S.; 3) signs of progress on the renegotiation of NAFTA, and 4) the upcoming decision on Chinese intellectual property "theft" under Section 301, which could impact a much more significant subset of imports.

Ultimately, history shows that since the economic costs of a trade war are high, it is not in any party's interest to truly get the troops ready for battle. In the end, the standoff is likely to continue. In this case, the positive backdrop of accelerating U.S. and global economic and earnings growth continues, a positive backdrop for risk assets over bonds. However, we are unlikely to get clarity for a while, with trade-related headlines crossing the wires frequently. This is likely to keep investors on edge and, thus, volatility more elevated compared to last year's low levels. As a result, investors should be wary not to swing the pendulum too far in the direction of risk assets.

EXHIBIT 5: TRADE AND EARNINGS

Year-over-year % change, global trade volumes, USD earnings per share



Source: FactSet, MSCI, Netherlands Bureau of Policy Analysis, J.P. Morgan Asset Management. Data are as of March 7, 2018.

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