Market Bulletin

August 2, 2019

U.S.-China Trade: Latest 10% Tariff

Trade talks between the U.S. and China resumed this past week with, as expected, little sign of progress. Negotiators will meet again in September. Behind the scenes, both parties were encouraged by the other signaling it may soon move on key issues: for the U.S., negotiators believed the promised Chinese agricultural purchases would soon materialize at a large scale; for China, officials were expecting the U.S. Commerce Department to issue waivers next week that would allow firms to resume sales of non-national-security-linked components to Chinese firms. While neither of these developments are off the table (and both could very well show up in the August trade numbers), the consensus outlook for the U.S.-China relationship has worsened.

Thursday afternoon, U.S. President Donald Trump announced he would proceed with imposing tariffs on all U.S. imports from China (well, effectively all imports, there are a few products that will be excluded from tariffs, namely key pharmaceutical items). 10% tariffs on the remaining roughly USD 300billion of U.S. imports from China that have not already faced higher tariffs under Section 301 actions will now go into effect September 1. While the imposition of 10% tariffs is not a catastrophic increase in prices for the U.S., it does set up two exceedingly negative ongoing disruptions to the U.S. economy. 1) President Trump has confirmed, once again, that businesses will have to contend with an extreme level of uncertainty regarding U.S. trade policy. 2) With the implementation of this round of tariffs, consumers will be directly affected to a large degree (**Exhibit 1** on next page, this 10% round would cover the entire "Proposed" section). The direct inflationary impact will be, to borrow the Federal Reserve's (Fed) favorite word, "transitory", but if businesses feel they can no longer avoid sales-killing tariffs, the costs incurred from restructuring production lines could be passed along to consumers over the next few years, prompting a sustained increase in prices.

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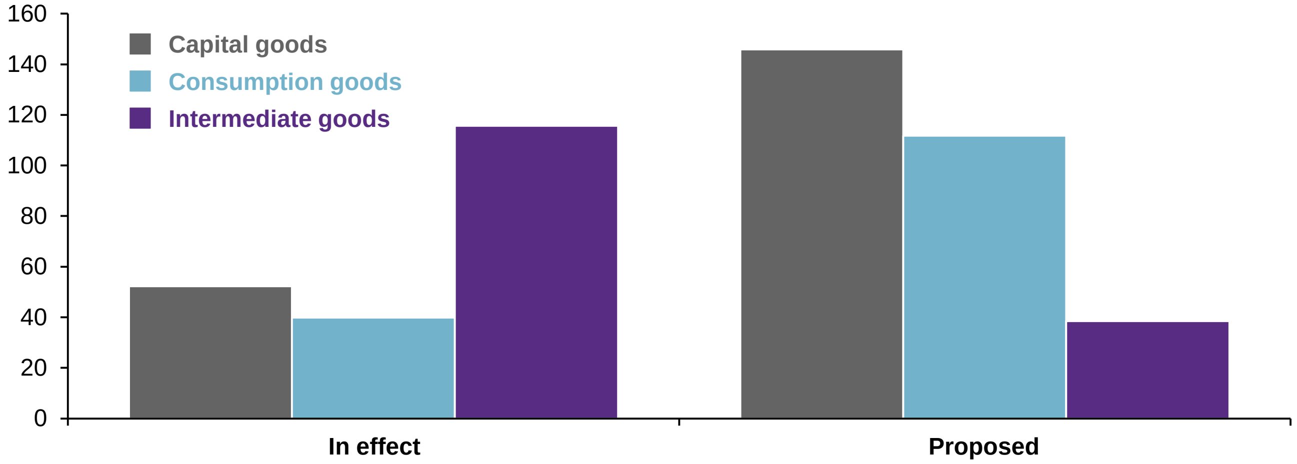
EXHIBIT 1: TARIFFED GOODS DISTRIBUTION ACROSS ECONOMIC CATEGORIES*

USD BILLION



Source. J.P. Morgan Asset Management; Office of the U.S. Trade Representative, U.S. International Trade Commission; United Nations.
*Analysis classifies each individual product the U.S. imports from China to the HTS-8 level that either appears on the 2018 & 2019 tariff lists published in the U.S. Federal Register or has been threatened with higher tariffs into its appropriate System of National Accounts group and aggregates these categories by value of imports in 2017–the last year without increased tariffs for which data was available.
Guide to the Markets – Asia. Data reflect most recently available as of 30/06/19.

We should not underestimate the risk of tariffs being applied on September 1, but this development is not set in stone. The U.S. administration likely hoped for greater progress this week with China and perceives that its tough stance has been successful in bringing China to the negotiating table thus far, while avoiding damaging markets (recent all-time highs in the U.S. equity market go some way toward justifying this position). The global economy would be in a significantly stronger position than it currently is, and markets probably could have gone higher, without trade tensions over the past few years. We continue to believe some small deal on some of the less structural issues will be struck, however the timing of such an agreement has shifted to next, instead of this, year in our view, and progress toward such a deal does not forestall higher tariffs in the interim.

The uncertainty surrounding trade policy is one of the “global developments” the Fed highlighted in supporting its decision to cut rates Wednesday. President Trump has long advocated for lowering rates. In stressing these global developments, the Fed may have given the U.S. administration a road map for doing just that. Continuing to escalate trade tensions sets up the conditions for lower rates, as well as allowing the administration to burnish its protectionist credentials as the U.S. 2020 electoral season gets underway. Markets should not discount the political benefit in the U.S. of actions that seem ‘tough on China’ for candidates of both political parties.

Investing under these conditions remains difficult. However, investors should take some comfort in the fact this dynamic is not exactly new. Trade risks have been present all year and market reactions follow a familiar path: the initial shock of the news prompts a sharp selloff in U.S. equities on the day—the S&P 500 price index was down 2.1% by market close; the uncertainty infects global equity prices (particularly in the U.S. and China) and raises concerns about China’s economic outlook for the next few days, U.S. equity futures currently suggest another 0.5% drop today and the Chinese renminbi sunk in both onshore (-0.7%) and offshore (-1.0%) trading; eventually, barring a continued media focus on trade tensions, investors return to focusing on what they were focusing on before. In that case, it will be the outlook for the U.S. economy amidst a middling earnings season and the appropriate reaction function of the Fed. Between yesterday and today, expectations for the Federal funds rate at end of year have moved down, with the market now pricing in slightly more easing.

Investment Implications

As highlighted many times before, the biggest impact from trade tensions is felt in continued high uncertainty. This uncertainty overhang is one of the reasons high quality fixed income remains so expensive. After the trade announcement, the yield on the U.S. 10-year treasury sunk to 1.88%, while oil prices, a barometer of global demand, fell by over 6%. Trade tensions remain high, headline risk has not diminished, and investors are less certain than ever. The resulting high volatility argues for a more defensive tilt in portfolios, even though such protection remains expensive.