On the Minds of Investors

August 2019

How could trade tensions affect global markets?

Since his election, President Trump has sought to correct what he and his administration perceive to be trade injustices working against the US economy. These policies have considerable backing from the US electorate and the Democratic Party. Whilst China is the key focus, there is still a risk that the dispute broadens to the EU. This is weighing on global growth, largely because companies are deferring investment. If a further escalation prompts companies to cut jobs then the risks to this expansion will rise, regardless of more dovish central banks. It doesn't seem politically optimal for the President to take risks with the expansion given he hopes to gain a second term in November 2020. But our conviction on the outlook for the trade conflict is not high and investors should think about adding assets to a portfolio that will perform in times of market stress.

What is the root of the dispute?

Global trade tensions began in 2018 when the US government imposed tariffs on certain imports, including solar panels and metals—ending a multi-decade process of US trade liberalisation. Since then, tariffs as a percentage of all imports have remained relatively low. But, if the US goes ahead with proposed further charges on Chinese imports and new taxes on auto sector imports, the average US tariff rate will return to levels not seen since the 1940s (**Exhibit 1**).

The US government's initial objective was to use tariffs to reduce America's large trade deficit with China[1]. However, there are other areas of dispute less directly linked to trade, such as the protection of intellectual property rights and the non-tariff barriers faced by US companies in China.

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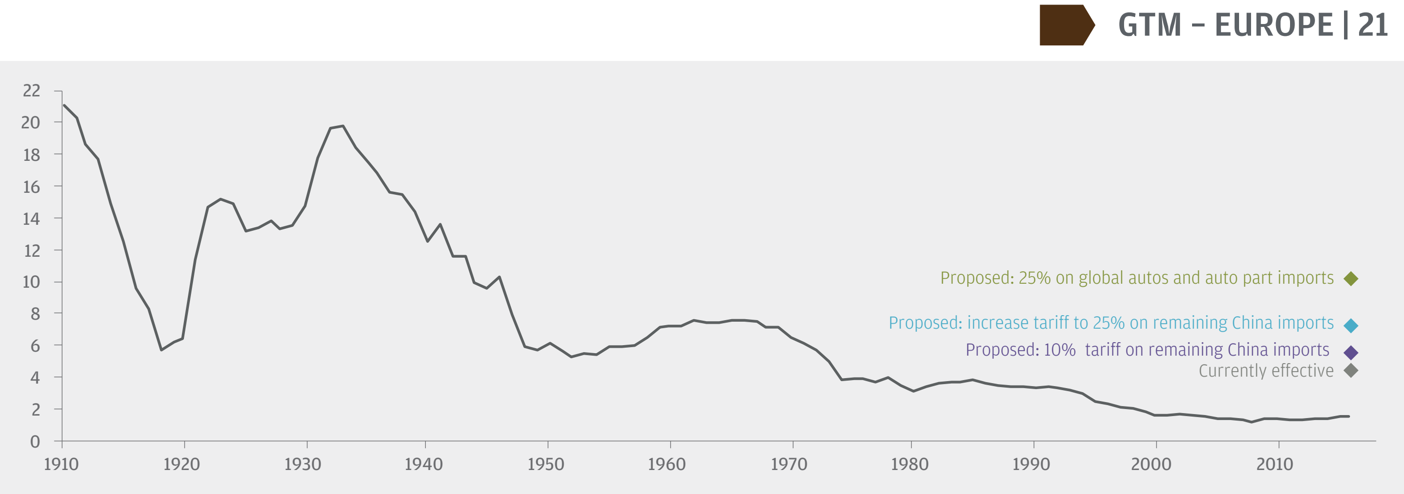
[1] The US trade deficit versus China of USD 420 billion is the result of USD 540 billion of US imports from China and total exports to China of USD 120 billion. Data as of 31 December 2018.

EXHIBIT 1 - US EFFECTIVE IMPORT TARIFF RATE

% effective tariff rate (tariffs collected as % of all imported goods)



Source: Esteban Ortiz-Ospina and Max Roser "International Trade", US Census Bureau, US International Trade Commission, J.P. Morgan Asset Management. Currently effective and proposed data are JPMAM calculations. Currently effective tariffs includes tariffs on washing machines, solar panels, steel and aluminium, as well as tariffs implemented on approximately USD 250 billion of China imports. Remaining China imports and global autos (including auto parts) are measures proposed on approximately USD 290 billion worth of goods for each. ***Guide to the Markets - Europe***. Data as of 1 August 2019.

On both the issue of trade and intellectual property the negotiations looked to be proceeding amicably. They have faltered, however, on the issue of the state-led support China provides to its technology industry. While China has demonstrated a willingness to make concessions in "old China" sectors, such as consumer goods, its plans to reshape the Chinese economy are reliant on growth in the technology sector. Therefore at the heart of this dispute is a desire from both sides to be the dominant global player in global technology. The revival of US-China trade talks, announced at the June G20 Summit, was encouraging, but a comprehensive agreement looks unlikely until there is agreement on the technology sector.

What impact could trade tensions have on the Chinese and US economies?

Currently the US has applied a 25% tariff on roughly half of the US imports (USD 250 billion) from China, and have announced that from 1 September a 10% tariff will be applied to the remainder (USD 290-300 billion) of the imports from China. With Chinese exports to the US worth 3.6% of Chinese GDP, the impact on the Chinese economy is increasing. However we are also likely to see a more notable impact on US consumer prices as the products that face tariffs are broadened towards consumer facing goods. To provide support, the Chinese authorities are pursuing a mix of monetary and fiscal stimulus measures aimed at stabilising growth close to the declared target rate of 6%-6,5%.

US exports to China are less than 1% of GDP. Nevertheless, the US manufacturing sector could be hit by higher costs for imported intermediate goods, which can only be partially mitigated by lower Chinese prices or a devaluation of the renminbi. With production costs rising, wages growing and no room to increase final prices, corporate profits would be expected to come under pressure[2].

Exhibit 2 shows the correlation between falling world export volumes and S&P 500 forward earnings downgrades. Economic uncertainty and lower profits could further dampen corporate investment and capital expenditure, which have already stalled.

What could be the global impact?

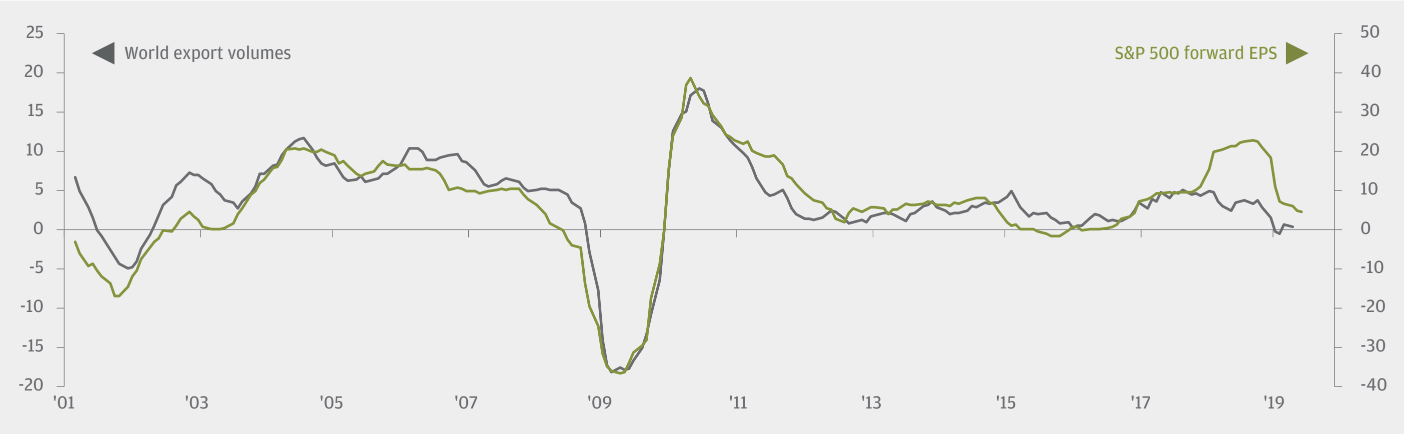
These direct effects of the tariffs are small compared to the indirect effects. Faced with geopolitical uncertainty, companies are deferring plans to invest, which has already caused a global industrial and export slowdown. As a result, the eurozone economy looks particularly vulnerable, given many European countries have export-oriented economies (**Exhibit 3**). The European Union (EU) is also facing potential higher US tariffs on the auto sector. Currently, cars made in the EU attract a 2,5% US import tariff (25% on trucks and vans), while the EU imposes a 10% duty on US car imports. The US is the top market for European carmakers, with 1,155,500 units exported to the US in 2018—four times higher than US car exports to the EU.

[2] According to the June labour market report the unemployment rate was 3,7% and year-on-year wage growth was 3,1%.

EXHIBIT 2 – WORLD EXPORT VOLUMES AND US EARNINGS

% change year on year, export volumes are a three-month moving average

GTM – EUROPE | 70



Source: CPB Netherlands, IBES, Refinitiv Datastream, J.P. Morgan Asset Management. EPS is earnings per share. The sharp increase in S&P 500 forward EPS at the start of 2018 is attributed to the Tax Cuts and Jobs Act of 2017, which came into effect at the beginning of 2018. Past performance is not a reliable indicator of current and future results. ***Guide to the Markets - Europe***. Data as of 30 June 2019.

Hopes for a reciprocal zero tariff agreement are complicated by the US request to include agriculture in any trade deal, which is rejected by the EU. German carmakers are the most exposed to a rise in US import tariffs, but other EU countries look vulnerable, including Italy, which is also a major exporter of auto components to the US.

Perhaps most concerning has been signs that the US Administration is willing to use tariffs to meet broader foreign policy objectives. Mexico, for example, was threatened with higher tariffs if it didn't control illegal immigration flows across the US border. US president Donald Trump has also tweeted that China and Europe are playing currency manipulation games, suggesting possible new measures.

Will trade tensions escalate?

It is unclear whether President Trump will ease up on the trade agenda as focused on his reelection in November 2020. Trump would like to be able to point to some achievements from the conflict with China, but he also needs to avoid an escalation in the trade dispute that could lead to a slower economy, weaker equity market and falling corporate profits.

China, meanwhile, has exhausted room for retaliation against US imports but it does have other ammunition. Some have questioned whether China could hit back by selling its treasury holdings. At present, China remains the largest foreign holder of US debt at USD 1,113 billion. However, it is worth remembering that China buys treasuries largely for the purposes of controlling the currency. A significant sale of US Treasuries, of a magnitude sufficient to push up US bond yields, would involve an appreciation of the renminbi. This would compound the problem for Chinese exporters in a world of rising tariffs.

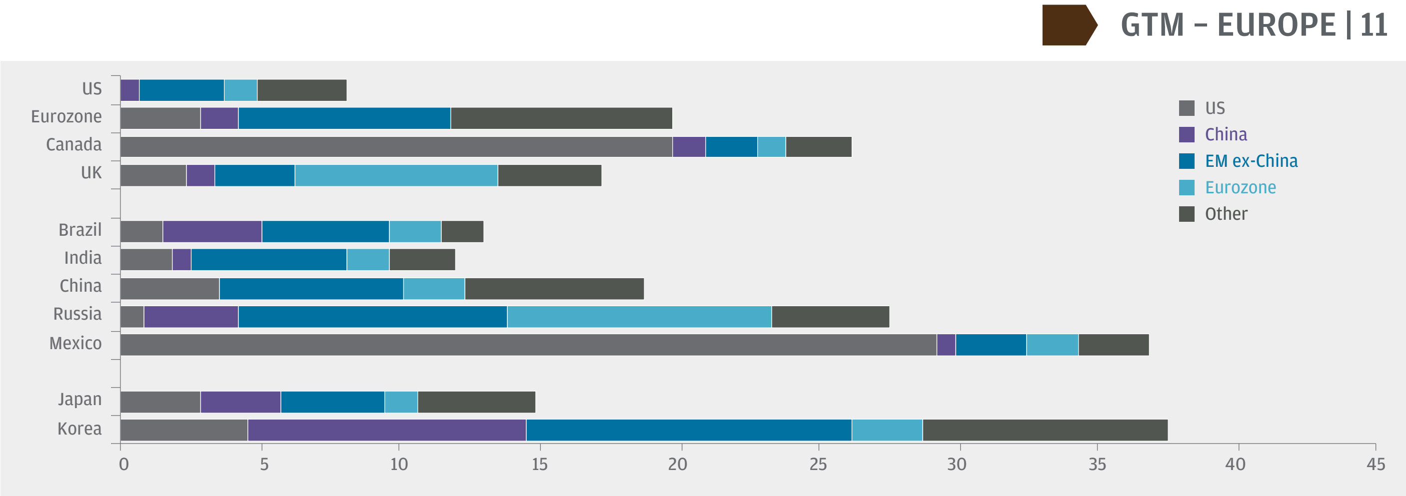
What are the implications for investors?

Trade tensions are weighing on global growth, largely because companies are deferring capex. The measures so far imposed are unlikely to lead to a global recession but should the uncertainty caused by a further escalation cause firms to cut jobs as well as capex, then the risks of recession will rise. Central banks are responding to the weakness with lower interest rates which, alongside increased demand for safe haven assets, has pushed up bond prices, gold and the Japanese yen.

Our core scenario is that it is not in the President's interest to increase the trade conflict further ahead of the election but there is considerable uncertainty around this view and investors would be well placed to think about adding assets to a portfolio that would be expected to perform in stressed market conditions such as US Treasuries, and strategies less correlated to the equity market, such as macro funds.

EXHIBIT 3 – EXPORTS OF GOODS

% of nominal GDP, 2018



Source: IMF Direction of Trade, IMF World Economic Outlook, J.P. Morgan Asset Management. J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. ***Guide to the Markets - Europe.*** Data as of 30 June 2019.

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