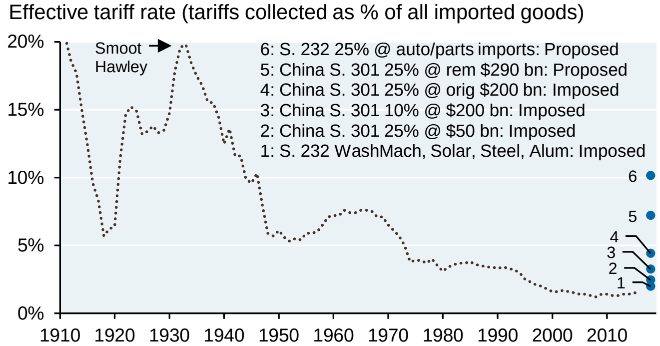
Topics: US-China trade war; US prescription drug price legislation; updated ideological scorecard for 2020 Presidential candidates

Smoot Hardly. I now believe that prospects for a deal are only 50/50 given China's withdrawal of concessions. The *economic* impact of a growing tariff conflict on the US is modest, but the hit to *earnings* could be worse. The negative market reaction is in part a consequence of how high valuations became after the spring rally.

- What's happening is hardly the second coming of the Smoot Hawley tariffs of the 1930's, unless Trump slaps tariffs on everything from China and on European/Japanese autos as well. The dots in the first chart show estimated cumulative impacts of each step on effective tariff rates. However, our estimates assume **no change** in US demand for Chinese goods, and hence no substitution to US goods or non-tariffed foreign goods at lower prices. This is overly conservative since *some* substitution will occur, mitigating the impact on inflation. The table shows the one-time impact on US inflation from different sources; most of them are pretty modest. Furthermore, a recent Yale/Berkeley/Columbia paper estimates a net output loss in the US of just 0.04% of GDP from tariffs imposed in 2018, after incorporating higher consumer prices, the increase in government tax revenues and higher revenues for domestic producers.

US tariff history and projections assuming no change in US import demand from targeted foreign exporters

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



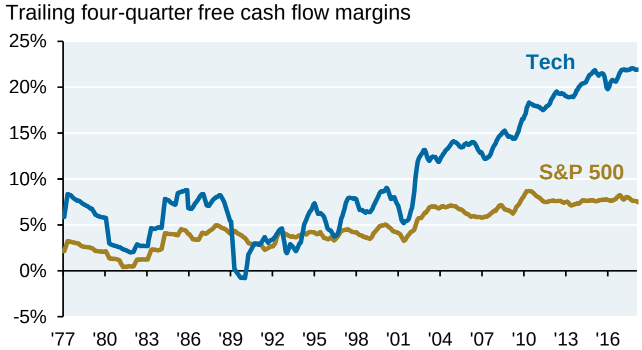
Source: Esteban Ortiz-Ospina and Max Roser "International Trade", US International Trade Commission, USITC, US Census, JPMAM. May 2019.

Estimated one-time impact of tariffs on China on US inflation		
Forecast by	**Impact on 2019 US inflation**	**Resulting from**
J.P. Morgan	0.1% - 0.2%	• Latest hike to 25% on $200bn in Chinese exports
Federal Reserve	0.1% 0.4%	• Tariffs imposed in 2018 • Across the board 25% tariff on all Chinese goods
Bridgewater	0.2% 0.4%	• Partial escalation • Full escalation
Goldman Sachs	0.2% 0.6% 0.9%	• Tariffs imposed in 2018 • Across the board 25% tariff on all Chinese goods • 25% on China plus autos

- That said, tariffs are bad for investor sentiment, and even with substitution effects, Trump tariffs could still roll back the last 20-30 years of tariff declines. Globalization has been a key factor driving US profit margins higher by depressing US price/wage inflation and by boosting offshore S&P revenues. This is particularly true for US tech companies, the sector with the highest percentage of foreign sales (50-55%). While US *economic* data may not be impacted much by the tariff war, the impact on US industrial and tech *earnings* could be larger. So, there's scope for further market downside if current tariffs remain in place permanently, particularly if Trump also imposes tariffs on the remaining amount of US imports from China (point #5) and/or on auto imports from Europe and Japan (point #6) as part of another Section 232 investigation.

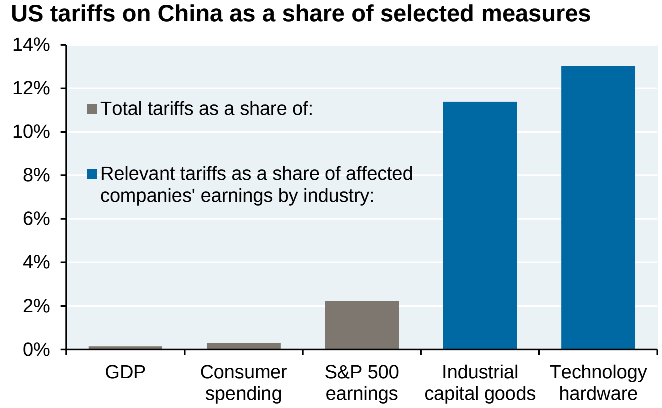
Tech: the primary driver of US margin expansion

Trailing four-quarter free cash flow margins



Source: Empirical Research Partners. August 2018. S&P 500 excludes financials, utilities, REITS, energy and industrial commodities.

US tariffs on China as a share of selected measures



Source: Empirical Research Partners. October 2018.

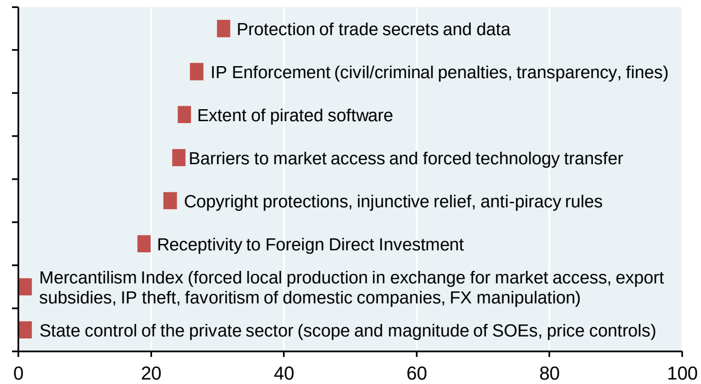
- **I understand why the Trump administration is pushing back** on last-minute Chinese reversals of concessions[1]. After all, China joined the World Trade Organization in 2001 and here we are 18 years later, with China still ranked close to the bottom on intellectual property protection, software piracy, receptivity to foreign direct investment, forced technology transfer and preferences for domestic companies. The ITIF "**Mercantilism Index**" encompasses all of these measures, and ranks China as the most mercantile country in the world. That's the reason why US trade negotiators since the Bush Administration have been trying to get China to make concessions, so far without much success. In the Appendix, I summarized the 2019 US Trade Representative Report on China's WTO compliance. **Short version**: there may never have been an agreement that any country signed in the post-war era that it adhered to less. I still believe there will be a US-China trade agreement this year, but this entire issue puts the odds at just 50%.

The world opened its doors to Chinese trade in 2001, but China kept its mercantile system in place

The seismic impact of China joining the WTO
US$, trillion

Source: International Monetary Fund. 2018.

Points of dispute in the US-China trade war
China's rank vs developed & emerging economies, 100 = best, 0 = worst



Sources: OECD, BSA, GIPC, ITIF, Fraser Institute, JPMAM. 2019.

- You *might* have thought that given a trade dispute between the US and China (which has the largest weight in the Emerging Markets equity index at 30%, and which is expected to grow to 40% with inclusion of more A-shares), that European and Japanese equities would finally outperform the US and EM. **And you would be wrong (again).** The US/EM equity barbell has outperformed Europe and Japan again in 2019 through May 10, for the 10th year out of the last 13. Consistency may be the "hallmark of the unimaginative" (Oscar Wilde), but remember that Wilde died broke.

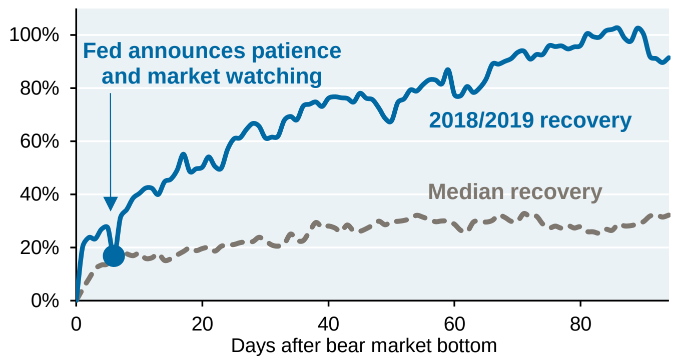
Section 232 **washing machine** tariffs, imposed by the US on almost all countries last year:

- US imports of washing machines from countries subject to tariffs fell by 31% from 2017 to 2018, even as US washing machine imports from China *rose* by 24%. In other words, US consumers switched to cheaper Chinese models and also to domestically produced US models
- US washing machine prices rose by 12%, and would have risen by more if not for the fact that non-tariffed dryer prices went up by 12% as well (they are often sold bundled together)
- Samsung and LG announced plans to increase washing machine production in the US and hire 1,600 workers. University of Chicago and Fed researchers claim that the economic cost for these jobs was steep given the additional $1.2 billion in washing machine prices paid by US consumers

[1] **China reversals**. A May 8 Reuters article cited last minute Chinese government edits which "blew up" months of negotiations by deleting commitments in all 7 chapters of the document. Many of the changes were related to verifying compliance, which US negotiators believe is critical given China's history as a WTO member.

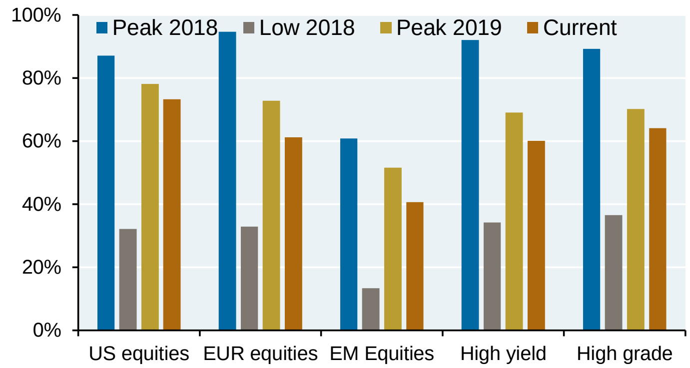
- **Part of the reason for equity market weakness: heading into the rupture in talks, market valuations were elevated, as we wrote in both our February and April 2019 *Eye on the Market* notes.** The spring 2019 rally was the fastest post-bear market recovery in the post-war era, pushing equity and credit valuations well above the lows of last December[2]. Valuations are getting closer to median again, particularly with the weakness priced into the equity markets this morning

Fed Zeppelin: the Fed fuels the bounce
% of S&P 500 bear market recovered since market bottom



Source: Bloomberg, J.P. Morgan. May 10, 2019.

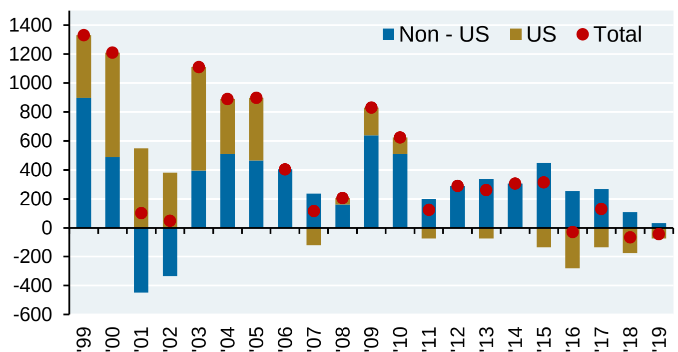
Valuation percentiles back above median



Source: Bloomberg, JPM Global Index Research, Datastream, JPMAM. May 10, 2019. Equities (12m forward P/E), Bonds (spreads).

- One factor which may eventually provide support to equities: an unprecedented **low level of net equity supply**, both in the US and globally. Even the elevated pace of US IPO issuance hasn't been enough to change net supply dynamics very much given the fast pace of stock buyback and M&A activity.

Unprecedented low levels of net equity supply
US$ bn, based on MSCI All Country World Equity Index



Source: JPM Global Markets Strategy Flows & Liquidity Report. 2019.

Why is global net equity supply so low?

Elevated stock buyback and M&A/buyout activity, combined with low levels of new equity issuance and other dilutive corporate actions, have resulted in very low levels of US and global net equity supply. This is the case even after accounting for the recent surge in US IPOs, which when projected for the full year would match 1999. This backdrop provides a level of technical support for equity markets in both good years and bad years.

JP Morgan Flows & Liquidity Report, 5/3/2019

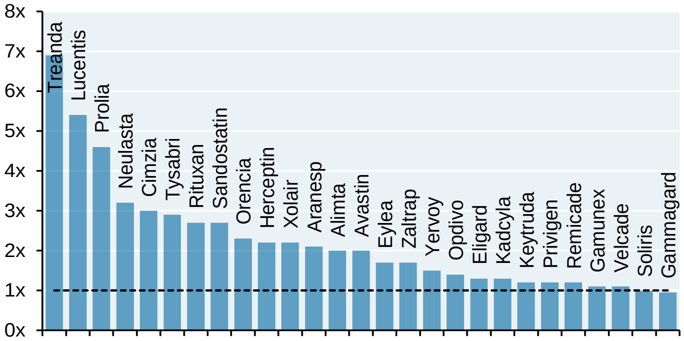
It may be a while before there's any clarity on what happens next, and the next set of concrete outcomes are regrettably binary (very good or very bad). In the meantime, here' a look at two more topics in the intersection between markets, economics and politics: the outlook for prescription drug price legislation, and an updated look at the political ideology of 2020 Presidential candidates. The growing influence of progressive candidates is related to the drug price issue; I don't think it's a coincidence that long-discussed drug price controls of some kind may finally be enacted, even before the 2020 election.

[2] The valuation chart above compares P/E ratios for equities (and credit spreads for corporate bonds) to their own histories for as long as we have the data, and shows the valuation percentile for the dates cited in the chart. For example, Europe equity P/E ratios are currently at the 60th percentile of expensiveness compared to their history.

Healthcare: pressure for US prescription drug price controls of some kind is growing

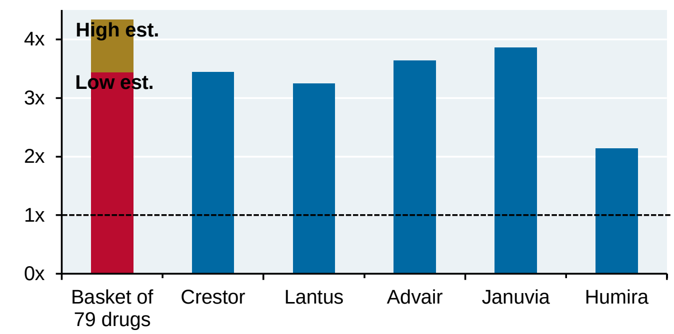
There's increasing momentum for some kind of legislation or agency ruling to **cap prescription drug prices**. According to our contacts in DC, with the 2016 departure of senior Senate Democrats who were not in favor of drug price legislation, and with a couple of GOP Senators ready to break ranks and pass something, there's a window that might be seized upon before the 2020 election. Potential policy options partially explain why large cap pharma and biotech stocks have underperformed the S&P 500 by 12%-18% this year. **New studies** from Health & Human Services and Johns Hopkins on US prescription drug prices vs other industrialized countries help explain why this issue is gaining momentum in Congress.

US vs international prices for top Medicare Part B drugs
Ratio, US discounted price /average international price per gram



Source: *"Comparison of U.S. and Int'l Prices for Top Medicare Part B Drugs by Total Expenditures"*, U.S. Department of Health & Human Services. 2018.

US vs international prices for Medicare Part D drugs
Ratio, US discounted price / average international price



Source: Red bar - Johns Hopkins School of Public Health, 2019. Blue bars - Commonwealth Fund, 2017.

The first chart[3] using HHS data shows the ratio of US Medicare Part B drug prices to average international prices; **a US premium of 2x-4x is common**. Most of these drugs are cancer-related given the Medicare Part B population. A study just released from the Johns Hopkins School of Public Health did the same for a basket of 79 Medicare Part D drugs with the largest spending, and also found US drug prices that are **3x-4x higher** than in three comparable high-income countries. This study follows a 2017 Commonwealth Fund report with similar results. In both Part B and Part D studies, prices reflect estimated discounts and rebates received by insurers from drug manufacturers. Competition from generics has since narrowed some premiums included in the Commonwealth study, but the point stands that large premiums can exist before prescription drug patents expire. What's notable about the Johns Hopkins study: many Part D drugs with higher relative prices were not new innovations, and have already been on the market for 9-10 years.

Cost savings estimates

- Medicare accounts for 31% of all drug spending; of this amount, 75% is Part D and 25% is Part B
- HHS estimates that If Medicare Part B drug prices declined to international averages, there could be a 50% decline in Part B drug spending, amounting to $8 bn per year
- Johns Hopkins estimated $40-$80 bn in potential annual savings if Medicare Part D drug prices converged to international averages. However, as explained below, legislation would be required to empower the Federal government to influence Medicare Part D drug prices

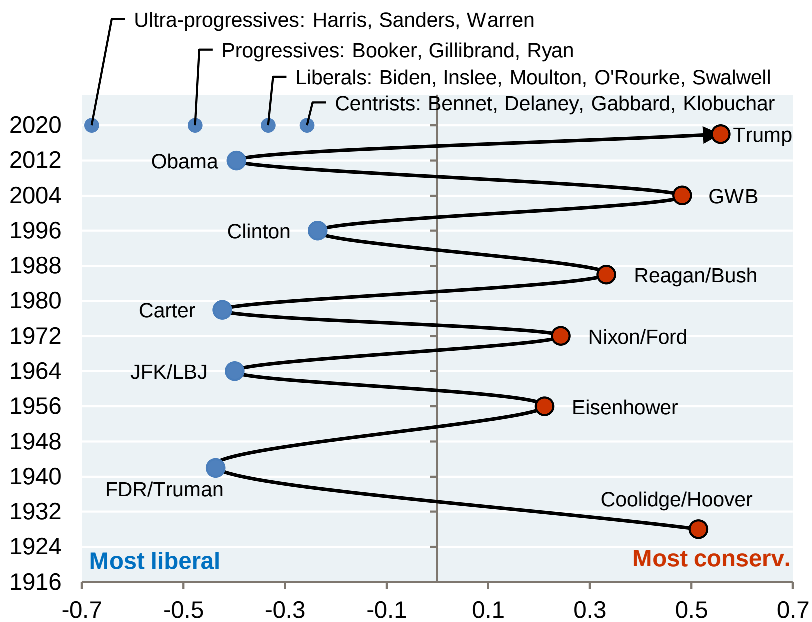
[3] **It can be hard to get good data on US drug prices vs other countries**, since in the US, private insurers negotiate directly with drug companies to set prices (i.e., there are multiple prices for the same drug depending on the insurer-drug company permutation), and given rebates/discounts which obscure what is actually paid. Medicare essentially acts as a **payment conduit** between private firms, and there's a "non-interference" clause preventing the Federal government from using its negotiating power to influence Medicare Part D drug prices. A 2017 poll by the Kaiser Foundation found **90%+ public support** across both political parties for legislation allowing the Federal government to negotiate drug prices, a proposal also endorsed the National Academy of Sciences, Engineering and Medicine.

Updated Presidential candidate ideological scorecard

If drug price legislation gets passed, it would reflect the growing influence of progressive politicians in Congress. According to Brookings, 44% of 2018 House primary candidates identified as progressive (up from 29% in 2016), and the Congressional Progressive Caucus is the largest in the Democratic Party with 100 members. Given the expanded field of declared Presidential candidates since we first published this chart last December, we have now updated it. One important development to watch: how many progressive policies proposed so far[4] will also be adopted by the Liberals and Centrists shown in the chart.

As a reminder, this chart measures the degree of ideological liberalism or conservatism of politicians based on their voting patterns in Congress[5]. The dots for prior Presidential administrations reflect voting patterns of its Executive Branch members, and of prominent members of Congress that supported major legislative initiatives of that administration, and/or defended its political and governing principles[6]. In other words, we are not making subjective judgments and are basing this on empirical data. Your mileage may vary.

Presidential administration ideology and a look at 2020



Source: VoteView Roll Call Votes database, JPMAM, 2019.

Administration ideology constituents	
Trump	Cotton, Graham, Hatch, McCarthy, Meadows, Paul, Perdue, Ryan, Scalise, Sessions
Obama	Biden, Durbin, H. Clinton, Kennedy, Kerry, Obama, Pelosi, Reid, Waxman
GWB	Ashcroft, Blunt, Cheney, DeLay, Kyl, McConnell, Santorum
Clinton	Bentsen, Carper, Chiles, Gephardt, H. Ford, Nunn, Robb
Reagan/Bush	Baker, Bush, Dole, Kemp, Latta, Laxalt, Lugar, Michel
Carter	Bayh, Byrd, Hawkins, Mondale, O'Neill, Wright
Nixon/Ford	Ford, Lott, Percy, Rhodes, Sandman, Scott, Wiggins
JFK/LBJ	Bolling, Humphrey, JFK, Johnson, Mansfield, McCarthy, McCormack
Eisenhower	Dirksen, Dulles, Flanders, Nixon, Saltonsall, Smith, Taft
FDR/Truman	Barkley, Black, Byrns, Garner, Guffey, McCormack, Robinson, Sabath, Truman
Coolidge/Hoover	Curtis, Hawley, Longworth, Moses, Tilson, Watson

Michael Cembalest
JP Morgan Asset Management

[4] Here's a partial list of **progressive policies** proposed so far: 70% tax on incomes over $10mm, or on incomes over $600k; financial transactions tax; corporate tax rate back to 35%; wealth tax over $50mm and $1billion in assets; "Accountable Capitalism Act" (US Federal Office of US Corporations would be empowered to grant and revoke charters for public companies based on whether they generate a "general public benefit" and "a material positive impact on society"); outright ban on stock buybacks; one third of board seats must be chosen by employees; 7% surtax on corporate profits over $100 million; Medicare-for-All; estate tax exemption reduced to $3.5 million; break up big banks, big tech and big agriculture firms; free public university tuition; wipe out student debt for households with less than $100k in income, with partial debt forgiveness up to $250k in income; $500 billion for affordable housing programs; and eliminating the Electoral College.

[5] The following candidates do not appear on the chart since they **have no Congressional voting history**: Buttigieg, Castro, Hickenlooper, Messam, Weld (Republican), Williamson (spiritual healer/author) and Yang.

[6] For more details on our methodology, here's the original piece from last December.

Appendix: Summary of February 2019 US Trade Representative Report on China WTO Compliance

On page 8 of the 183-page report, the USTR summarizes China's general lack of compliance with WTO rules.
I have listed just some of them below, without any edits or comments by me.

- Local content requirements in the automobile sector
  - China allows foreign automobile manufacturers to operate in China only through joint ventures with Chinese enterprises, and since none of these JVs can be majority foreign-owned, this requirement effectively requires foreign automobile manufacturers to transfer their core NEV technologies to their Chinese JV partners
- Discriminatory taxes in the integrated circuit sector
- Hundreds of prohibited subsidies in a wide range of manufacturing sectors
  - China continues to shield massive sub-central government subsidies from scrutiny of WTO members. Together with other non-market practices, these subsidies contribute to the serious excess capacity problems that plague industries like steel, aluminum, solar panels and fishing and devastate global markets and foreign competitors
- Inadequate intellectual property rights (IPR) enforcement in the copyright area
- Significant market access barriers in copyright-intensive industries
  - Especially troubling is China's treatment of foreign companies seeking to participate in the development of cloud computing services, including computer data and storage services and software application services provided over the Internet. China prohibits foreign companies from directly providing any of these services. Given the difficulty in providing these services on a cross-border basis (largely due to restrictive Chinese policies), the only option a foreign service supplier has to access the Chinese market is to establish a contractual partnership with a Chinese company, which is the holder of the necessary Internet data center license, and turn over its valuable technology, IP, know-how and branding as part of this arrangement
  - China restricts the online supply of foreign video and entertainment software through measures affecting both content and distribution platforms
- Discriminatory regulations on technology licensing
- Severe restrictions on foreign suppliers of financial information services
- Export restraints on numerous raw materials
- Denial of market access for foreign suppliers of electronic payment services
  - China blocks US suppliers such as Visa and MasterCard from its market despite the fact that it committed to open its market to foreign suppliers by 2006, and despite a WTO dispute settlement panel confirming this commitment in a case brought by the United States. China's industrial policy objective is to protect its national champion, China Union Pay, from competition in China so that it can use the revenues from a captive domestic market to fund its own global expansion
- Repeated abusive use of trade remedies
  - China has made a practice of launching antidumping (AD) and countervailing duty (CVD) investigations that appear designed to discourage its trading partners from the legitimate exercise of their rights under WTO rules. The United States' three successful WTO cases challenging the duties imposed by China on imports of U.S. grain-oriented electrical steel, U.S. chicken broiler products and U.S. automobiles offer telling examples of this problem. China did not comply with the WTO's rulings, and the United States was forced to bring Article 21.5 compliance proceedings to secure China's compliance.
- Excessive domestic support for key agricultural commodities
- Opaque and protectionist administration of tariff-rate quotas for key agricultural commodities
  - Remarkably, China has still not completed its update to its Harmonized System (HS) 2002 tariff schedule. Although WTO members approved a final HS 2002 tariff schedule for China in March 2017 after 12 years of negotiation, China continues to withhold its schedule for certification, claiming that its domestic approval process, which so far has lasted 18 months, is not yet completed. China has not even begun the process of certifying its HS 2007, HS 2012 and HS 2017 tariff schedules. Accordingly, WTO members today do not have accurate, current information on all of China's tariff schedules and tariff bindings.
- China's legal system continues to function as an instrument by which the government and the Party can secure discrete economic outcomes, channel broader economic policy and pursue industrial policy objectives. Key legal institutions, such as the courts, are structured to respond to the Party's direction, both broadly and on a case-specific basis

Sources

"*The Return to Protectionism*", Fajgelbaum, Goldberg, Kennedy and Khandelwal; NBER Working Paper 25638, March 2019

"*Inflationary Effects of Trade Disputes with China*", Federal Reserve Bank of San Francisco, February 2019

"*The Production Relocation and Price Effects of U.S. Trade Policy: The Case of Washing Machines*", Flaaen, Hortacsu and Tintelnot, April 2018, Becker Friedman Institute Working Paper 2019-61

"*Using External Reference Pricing in Medicare Part D to Reduce Drug Price Differentials with Other Countries*" in May 2019 *Health Affairs*, by Kang, Di Stefano, Socal and Anderson

"*Comparison of U.S. and International Prices for Top Medicare Part B Drugs by Total Expenditures",* US Department of Health and Human Services, October 2018

"*China reportedly backtracked on nearly all aspects of U.S. trade deal*", Reuters, May 8, 2019

Acronyms of the week

BSA Business Software Alliance Trade Group
EM Emerging Markets
GIPC Global Innovation Policy Center
HHS Health and Human Services
IPO Initial Public Offering
ITIF Information Technology and Innovation Foundation
NBER National Bureau of Economic Research
P/E Price/earnings ratio
S232 Section 232 of the Trade Expansion act of 1962 allowing the President to impose tariffs if imports impair national security
S301 Section 301 of the 1974 US Trade Act which authorizes the President act against foreign govt's that violate trade agreements
WTO World Trade Organization