Manulife Asset Management

Investment Note

3 July 2018

Understanding the escalating trade row and what it means for global markets

Escalating trade tensions between the United States and China have unsettled investors worldwide. Global market indices took a tumble in the past week, with Chinese equities bearing the brunt of the selling.[1] In this note, Paul Boyne, Lead Portfolio Manager of Global Equity Strategy, takes a look at the key issues, and shares how recent developments have shaped his views on the equity markets.

We have long felt that markets are underestimating the downside risk associated with a number of macro issues. This list includes rising US rates, a shrinking Fed balance sheet, European Central Bank (ECB) Quantitative Easing (QE) tapering, a strengthening US Dollar, rising oil prices and high debt levels—all set against a backdrop of generally elevated multiples and margins. The recent escalation of trade tensions between the US and other countries, particularly China, could also pose a significant headwind for global growth going forward as well.

So far, the Trump administration has announced US$50 billion of tariffs on Chinese imports, the first US$34 billion of which will be implemented on 6 July[2] with the rest possibly coming into force in late August. Most of these tariffs are on intermediate goods, and are therefore likely to increase input costs for US businesses. We have seen this affect some companies that we are following.

The White House has also threatened an additional US$200 billion in tariffs on US imports from China and is constructing a list of goods to be targeted.[3] In response, China is also implementing US$34 billion in tariffs on US imports on 6 July.[4] If this escalates, China could eventually run out of goods to impose tariffs on because it does not import enough items from the US. In our view, China could expand the tariffs to include services and might even take measures such as increasing compliance for US companies operating in China, interfering with licensing and boycotting US products. They could also potentially allow the renminbi to depreciate further, and take steps to rebalance the People's Bank of China's balance sheet away from US Treasuries—all measures that could impact markets significantly.

At the heart of the ongoing tensions we believe, is an ongoing battle for leadership over next generation technological competences such as machine-learning, quantum computing and artificial intelligence. Set against this "phony" war, tariffs may be a relative sideshow. While the Chinese government has made this central to their medium-term growth strategy, encompassed in its Made in China 2025 strategy,[5] we

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1 Source: Bloomberg, MSCI China dropped 3.64% as of 29 June 2018, price returns in US dollar.
2 Source: White House, 15 June 2018.
3 Source: White House, 18 June 2018.
4 Source: Ministry of Commerce of China, 16 June 2018.
5 For more, see Washington Post article, How "Made in China 2025" Frames Trump's Trade Threats, published on 10 April 2018.

do not believe the US would step aside and watch China become the world leader in these areas. As a result, trade tension between the US and China could escalate further.

Even if we think tariffs are a relative side show, it is difficult to see how the brewing disagreement could be limited to just the US and China. The European Union (EU) believes recently imposed steel and aluminum tariffs are illegal according to WTO rules and have responded in kind with tariffs on US products.[6] The US is now considering applying 20% punitive tariffs on European cars, posing an obvious headwind for German and therefore European growth.[7] With the Chinese looking set to implement a series of tariffs on US agriculture, it seems likely the US will respond with offsetting subsidies. In our view, the resultant domino effect could see the EU imposing tariffs and/or sanctions on US agriculture as well.

A key question is whether all these threats are a negotiating tactic to lower trade barriers for US exporters or if the measures will be implemented and do real harm to global trade and global economies. At an extreme, it could lead to the unwinding of globalization and borderless supply chains—factors that have contributed to margin expansion and helped keep price inflation muted. Global cyclicals would be under threat in this scenario and it seems investors have only just begun to react to this risk. Put simply, a trade war would damage growth, margins and ultimately free cashflow generation of these companies.

We have (broadly speaking) adopted a more defensive position and believe we would benefit if these trade issues escalated to the extent that it brought down stock valuation—which we think are stretched and unsustainable. Offset against this is the risk that the US, despite material relative dollar-denominated outperformance over the past couple of years, continues to attract capital owing to its status as a safe-haven. That said, we continue to have a cautious view of US assets, a perspective predicated on relative valuations.

[6] Source: Reuters, "EU plans to hit US imports with duties from July", 6 June 2018.
[7] Source: Wall Street Journal, "Trump Threatens 20% Tariff on European Cars, Seeks More U.S. Production", 22 June 2018.

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