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CIO Flash Bulletin

Global Trade Hits a US-Built Tariff Wall

Investment Solutions

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Trade negotiations are usually about removing commercial barriers. The United States' decision to impose tariffs on Chinese imports and the UK's decision to leave the European Union have reversed that idea and are proving just how quickly trade flow disruptions can undermine economic growth. What does this tell us about the economic importance of trade, and what are the prospects for investors in the year ahead?

Global trade fell 1.4% year-on-year by volume in December 2018, a decline not seen since 2011's European sovereign debt crisis (see chart 1) as companies reduced capital expenditure in the face of uncertainty, lost their established markets and saw supply chains disrupted.

The Trump administration took office promising to reduce the US's trade deficit. To meet that promise it stepped-up investigations into other nations' trade practices, started trade disputes with China and last week India, and has threatened to leave the World Trade Organisation (WTO). Aside from the faulty logic behind the idea that a trade deficit is an indication that others are taking advantage of the US, **the strategy has undermined financial market confidence and is clearly not working.** The US trade deficit reached USD 621 billion for 2018, its highest level in a decade, according to data released last week and the deficit in goods widened to USD 891.3 billion. The deficit was further widened by factors such as the dollar's strength undermining demand for US exports and boosting demand for imports as well as government-financed tax cuts and the slowing global economy.

The WTO last month predicted slower global trade growth this year. The organisation's own index of trade strength is now at its lowest in nine years, and forecasts added that its estimates "could be revised downward if trade conditions continue to deteriorate." While trade-facilitating measures increased in the 12-months through mid-October 2018, "the trade coverage of the import-restrictive measures (USD 588.3 billion) is more than seven times larger than that recorded in the previous annual overview," the WTO reported in December.

This shift toward protectionism inevitably has a disproportionate impact on open, exporting economies such as China, Japan, the European Union and Switzerland.

US-China Talks

US-China trade negotiations designed to end the dispute have covered everything from intellectual property protection and industrial subsidies to market access. In retaliation for the US tariffs, China has imposed import tariffs on many agricultural products that targeted politically vulnerable regions, undermining farmers' earnings and markets. Still, there are reports that both sides are close to an agreement in the year-old dispute that may include commitments by China to buy US crude oil and agricultural commodities, at the expense of other exporters such as Russia, Brazil, Australia and the Middle East. This does not leave much room, or expectation, that the more tricky questions around technology and security can be resolved.

Recent events have confirmed our central expectation that the impact of tariffs would make a compromise in some form likely.

China has cut its 2019 growth target from 6.5% for 2018 to between 6.5% and 6.0% this year, an almost three-decade low, as part of a series of stimulus measures including tax cuts, some moderate policy easing, lower interest rates and infrastructure spending to boost the slowing economy.

Widening the war

The next opportunity for a breakthrough may fall around a summit scheduled for March 27. For political reasons, both sides need to win concessions before they can sign up to any compromise. Even in the event of a compromise, exporters will still have to repair their supply chains, disrupted by the tariffs, and recover markets.

The US announced a new target last week for its trade policy. It plans to suspend India's preferential trade status, which in 2017 allowed the economy to export USD 5.6 billion worth of goods to the US tariff free under this programme. Two months ahead of India's general election (see our November article), the country's Ministry of Commerce has played down the impact, saying the loss would affect around USD 190 million of exports. The US is India's biggest export market, accounting for more than one-sixth of its exports by value, giving the US a trade deficit of USD 27.3 billion with India in 2017.

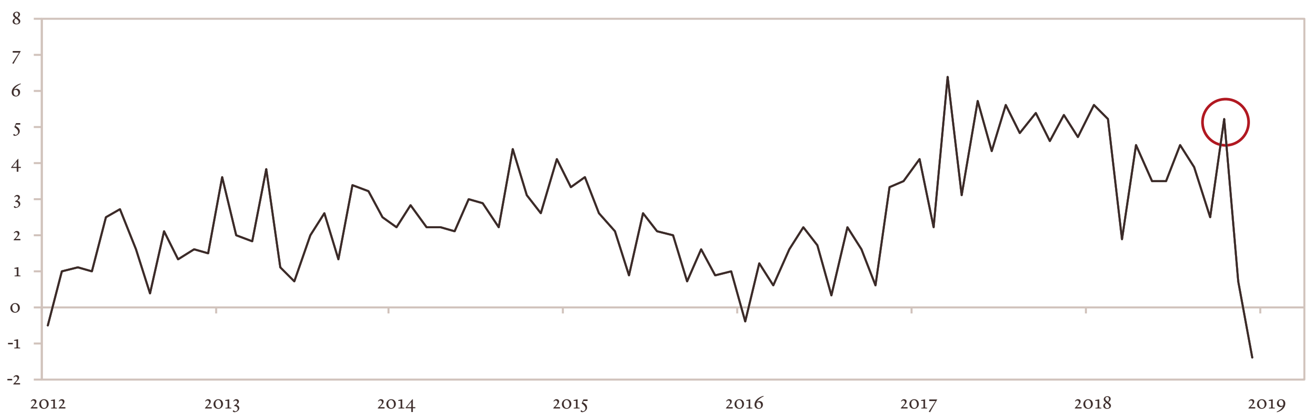
Brexit bites

It is not all about the US. **The United Kingdom has its own self-inflicted trade damage as it potentially turns a constitutional and political crisis into an economic emergency**. One of the Bank of England's monetary policy committee members said last month that the UK's economy has lost some 2% of Gross Domestic Product as a result of the Brexit vote, equivalent to GBP 40 billion annually (USD 52.6 billion).

Whether or not the Brexit date of 11 p.m. London time on March 29 is postponed, the toughest negotiating work lies ahead once the UK has left. So far, the debate has been about political intentions. Negotiations in the next phase, which will tackle the detailed breakdown of tariffs, quotas and market access, will be considerably more complex as they balance the interests of each of the remaining 27 European member states. The UK has a trade deficit in goods with the rest of the world, and a services trade surplus and the EU accounts for slightly less than half of the UK's total trade (see chart 2).

Chart 1 – Global trade flows collapsed as US tariffs were implemented

Trade volumes year-on-year growth in %



Source: Datastream, Lombard Odier calculations

2019 trade outlook

Our central expectation for the world economy over the coming year is for a muted recovery. Despite the historic reversal in trade trends, we anticipate a compromise at some point between the US and China, and a solution to the UK's Brexit woes as they begin the serious work of hammering out the details of a relationship with their biggest trade partner.

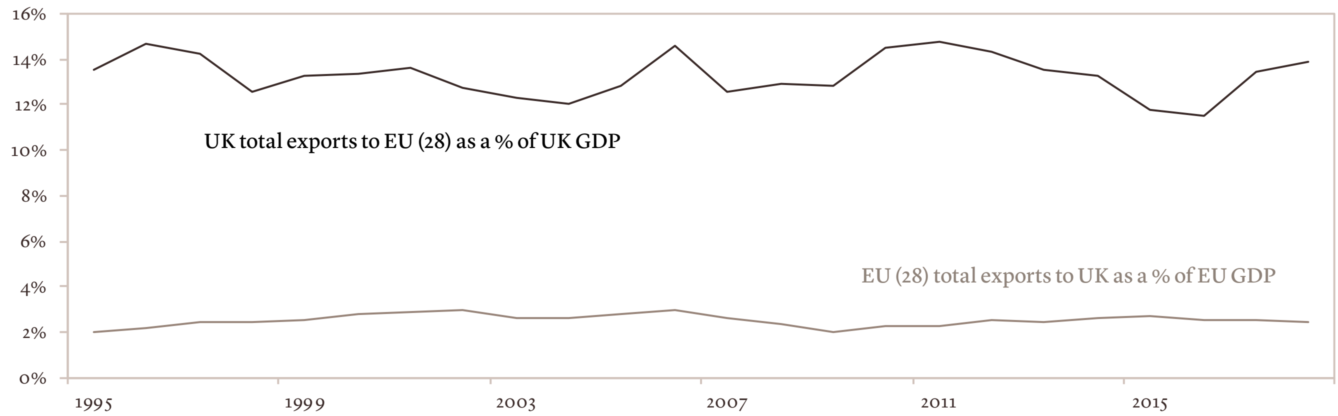
The US Federal Reserve's January decision to pause its monetary tightening process followed higher market volatility and lower inflationary pressures. It does not, we think, signal that the hiking cycle is over. Sound economic data would bring the possibility of a hike back to the table later in the year.

Over the last six months, US markets have outperformed the rest of the world. We continue to expect the USD to weaken slowly against major currencies as the US's tax benefits fade and the current and fiscal deficits rise. **As the dollar weakens, the gap in economic performance between the US and the rest of the world may narrow**. In the eurozone, last week's European Central Bank guidance put rates on hold for 2019 and lowered GDP growth forecasts. This looks mostly linked to trade protectionism. A more dovish ECB will put a brake on the euro's strengthening against the dollar, keeping the common currency more export-competitive. Simply put, if the trade environment were to improve, China and the EU would be the main beneficiaries.

In the light of this, we have gradually reduced portfolio risk, shifting emerging market exposure from equities to local debt, and taken advantage of carry strategies by investing some cash holdings into credit.

Chart 2 – UK exports to the EU are significant...

...while EU's exposure is limited



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