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CIO Flash Bulletin

Trade war escalation threatens global economy

Investment Solutions

13 May 2019

First US President Trump engineered a trade crisis, now he has increased tariffs on thousands of China's imports to the US market, escalating a trade war that endangers a fragile global economy struggling with weak growth and cheap credit.

Trump argues that the US's record trade deficit is economically damaging and has pledged to reduce it. In 2018, the US had a USD 419.3 billion trade deficit with China and since 10 May is applying a 25% tariff on USD 250 billion of Chinese goods. China retaliated last year with tariffs worth 110 billion, covering almost all of its imports from the US, and has threatened to go further. In November, the US had halted higher tariffs as the two sides agreed to negotiate.

Talks appeared to be edging toward a deal until last week when, shortly before a scheduled US meeting with Chinese Vice Premier Liu He, the US received an amended draft agreement that changed wording deemed unacceptable to the White House, Reuters reported. While any 150-page trade accord would need amendments once translated into Chinese, the US argued that the changes reneged on planned commitments covering industrial subsidies, intellectual property protection and market access.

"They broke the deal," Trump told a rally last week, "they can't do that, so they'll be paying." Trump's statements, often delivered through Twitter, seem designed to make him look tough ahead of his 2020 bid for re-election, while the US president's agitation probably makes Xi Jinping look strong to the Chinese premier's domestic audience.

'No rush'

Estimates of the damage that the tariffs will inflict on the Chinese economy are between 0.5% and 1.5% of GDP, according to the International Monetary Fund, which warns that the dispute threatens the global economy.

Markets initially fell in response to Trump's statements. Then when the tariffs were confirmed, investors took an optimistic view that, because the duties only apply to shipments loaded from 10 May, there may be a deal (unlike previous tariff hikes which were implemented immediately) in the weeks before companies and consumers in the US start paying for goods arriving at the border.

Trump then tweeted on the same day that "there is absolutely no need to rush" to reach a deal as "these massive payments go directly to the Treasury of the US."

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- The US has increased tariffs on USD 200 billion of Chinese imports from 10% to 25% and threatened further escalation on all remaining shipments from China
- China has threatened to retaliate
- The longer the dispute continues, the greater the threat to Chinese and US GDP as well as spillover into wider markets
- Unless a compromise is found, the dispute is the greatest short-term threat to the world economy.

It is worth stressing that this is not how import tariffs work. While the tariff payments end up in the Treasury, it's US importers paying the customs duties at the port of entry. They then, usually, pass on the additional cost to their customers. Nor, incidentally, is the trade deficit a simple negative for the US economy because it leaves Chinese consumers and investors more money to invest in the US economy.

The US president's lack of urgency is worrying because the longer the dispute lasts, the greater the risks of wider contagion as companies look to replace existing trade routes.

"China deeply regrets this, and we will have to take necessary countermeasures," responded the Chinese Commerce Ministry within minutes of the US tariffs coming into effect, without spelling out how it plans to retaliate. While China stands to lose more in a straight tariff fight, it could choose to retaliate by making it harder for US companies to do business in China. Indeed, the Chinese government has some experience in non-tariff retaliations with both Japan and South Korea.

Rapid escalation

Much of the positive news around a negotiated settlement was already priced-in before Trump's initial announcements, and markets fell last week. Any more bad news may quickly undermine markets further.

Frighteningly for businesses trying to ship between the US and China, the lead-time between the first signs that there was a hiccup with the negotiations and the tariff hike has been less than a week. In the past, the Trump administration signalled increases well in advance.

Of course, the dispute is as much about the geopolitical balance of power as trade. China is trying to manage its transition to a more services-led economy along with falling growth, rising wages and the increased social costs that go with an ageing population.

Chart 1 – Escalation in the US / China trade risk

Where to from here?

Deal or significant breakthrough in June

Our base case: recovery materialises & global activity picks up

- The two sides either agree on a trade deal or make significant progress through a number of commitments - including the future removal of some or all imposed tariffs once the final deal is in place.
- Market implications: recent weakness reverts swiftly. Equities perform reasonably well but do not retain the Q1 19 momentum. EM local debt and EM FX benefit from data stabilisation and a Fed on pause. USD gradually weakens.

PROBABILITY: **40%**

Deal postponed to late 2019 or 2020

Recovery in trade delayed, putting domestic demand under pressure

- Minimal progress is made by June (G20). Tariffs remain in place and so does the threat of additional tariff implementation. Despite their differences, the US and China agree to keep the dialogue open. Potentially a deal is reached much later either in late 2019 or in 2020
- The risk is that the trade-related weakness in the manufacturing sector spills over to the domestic side, which has been resilient so far.
- Market implications: Equities give back some of this year's gains. Core yields fall while credit spreads widen. EM local debt and EM FX under pressure. USD appreciates moderately. Safe havens like gold, yen and Swiss franc benefit.

PROBABILITY: **40%**

Deal breaks down

No deal before the elections
Negative supply shock

- Complete breakdown in negotiations. China tries to inflict as much damage as possible to the US to diminish Trump's chances of re-election.
- Disrupted trade would hurt global economies to a point where it might be difficult to avoid bouts of recession.
- Market implications: Risk assets sell off with core yields falling and credit spreads widening significantly. Gold rises. EM local debt and EM FX depreciate abruptly with USDCNY approaching and potentially exceeding the 7:00 level. USD appreciates strongly against most peers. JPY appreciates substantially.

PROBABILITY: **20%**

Source: Lombard Odier

The US argues that China should provide more support and leadership for the global trading system, and that China's policies distort many industries. In November 2017, U.S. Trade Representative Robert Lighthizer called China's decade-long plan to modernise the country's manufacturing capacity "a very, very serious challenge, not just to us, but to Europe, Japan and the global trading system." (See chart 1 for details of escalation risks, which we are updating as events unfold)

Breternity

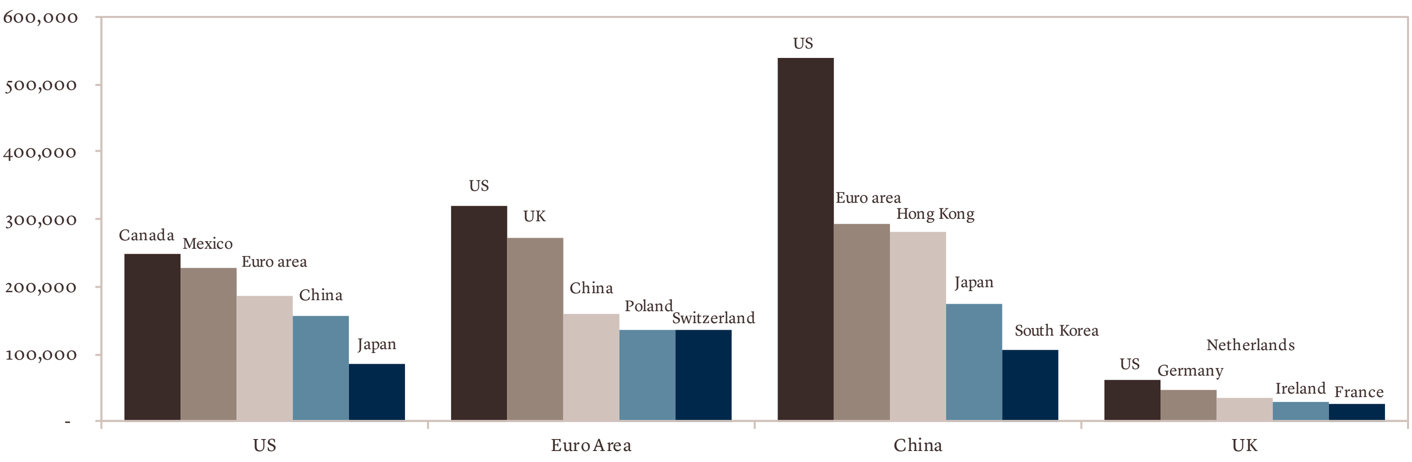
Different trade negotiations continue in London. The two main British political parties are engaged in lacklustre talks to reach a consensus about leaving the United Kingdom's biggest market. Despite the fractured and partisan discussion, whoever eventually takes over from Theresa May as UK prime minister will likely be left with the withdrawal deal that is already on offer today. And probably then blame May's legacy and the democratic decision taken under faulty assumptions in June 2016 for the effects that follow.

As we have written before, once a withdrawal agreement is in place, the Brexit negotiations become more technical. And it may become even clearer that every alternative to EU membership in the name of greater independence leaves the UK economy weaker. While destabilising, that relationship does not contain the seeds of a wider threat to international trade.

That is not true for the US-China dispute. China is uniquely dependent on its US exports, which dwarf even its shipments to the eurozone and through Hong Kong (see chart 2).

As we go to print, president Trump has said that "the process has begun" to impose a further 25% tariff on all remaining Chinese imports. Unless the US and China can find face-saving grounds to reach a compromise, this trade row looks like the greatest immediate threat to global economic stability.

Chart 2 – US, EU, China: major export markets



Sources: Bloomberg, IMF, Eurosat, Lombard Odier calculations

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