Trade wars: A worldwide web of worry

Weekly Market Compass: Concern grows about the impact of tariffs on the global economy

Jul 23, 2018 | Kristina Hooper, Chief Global Market Strategist

Global stocks have been in positive territory thus far in July with even emerging markets stocks eking out a tiny gain.[1] With positive returns and relatively low volatility in July, it appears that the stock market is not worried about the burgeoning trade war. Admittedly, it's easy to ignore since investors don't have a frame of reference for the impact of a major trade war – and so far, earnings season has been very good. But other markets may be telling us that we should be worried.

Treasuries and metals may be sending a message

The yield on the 10-year US Treasury has finished below 2.9% for the past month, while industrial metals prices fell last week.[2] In particular, copper – widely viewed as an economic indicator – hit a one-year low last week.[2] Clearly there are concerns about an economic slowdown in some parts of the globe, especially China. But I would argue that the yield on the 10-year Treasury as well as the fall in industrial metals prices also reflect concerns about trade and its potential impact on global economic growth.

After all, this was a momentous week in terms of the unfolding tariff drama, with US President Donald Trump stating in an interview that he was ready to raise tariffs on China's goods to $500 billion. And then there was the statement from German Chancellor Angela Merkel on Friday, warning that US tariffs on European cars represent "a real danger for the prosperity of many people in the world" and that the European Union (EU) was working on "countermeasures."

What's ahead for trade?

I believe there is a growing likelihood that the Trump administration will move forward with tariffs on imported automobiles based on its Section 232 investigation – the old "national security" rationale that was also recently used to apply tariffs on Canadian aluminum and steel. US Commerce Secretary Wilbur Ross suggested as much when he explained, "President Trump does understand how indispensable the US automobile industry is."[3]

If this occurs, it would be unfortunate for a number of reasons, in my view. First, it is likely to result in retaliatory tariffs, as Merkel warned last week. This could plunge the world deeper into trade wars, heighten economic policy uncertainty and depress business investment. Also, in the last few decades, supply chains have become globalized, making the situation far more complicated; US automakers can be negatively impacted along with automakers outside the US. In addition, trade wars could impact productivity and efficiency if companies move their production facilities and resources based on tariffs as opposed to comparative advantage.

Quite frankly, I would argue that the US auto industry has historically benefited from competition, especially from Japanese imports in the 1970s, although at the time US automakers argued for tariffs being imposed on those imported cars. Competition forced US automakers to improve quality and efficiency, and this was certainly good for US consumers, who benefited from price reductions as well as greater quality. There were also negative consequences, and I do not want to gloss over the fact that American autoworkers lost jobs. However, over the course of several decades, jobs have been created in the US by non-US auto companies, suggesting that the collateral damage of globalization diminishes over a longer time period.

The broader issue of trade diplomacy

This is not just about US tariffs – this is about what I would call trade diplomacy. The US has accused the EU and China of currency manipulation, called the EU a "trading foe," and threatened to increase tariffs on China to $500 billion, even though China hasn't yet retaliated on the $200 billion in US tariffs announced several weeks ago. These are the types of actions that could ultimately hurt the US. Last week, the EU and Japan signed a major trade deal that creates a very open and free trade relationship between these two major economies – which can hurt the US. For example, removing Japanese tariffs on European agricultural products will likely negatively impact American agriculture. It's clear that countries are quickly figuring out how to operate around the combative and unpredictable US – just look at the renegotiated Trans-Pacific Partnership. That's why I believe that, while other countries may feel more pain in the shorter term, the US may end up being the bigger loser in a trade war over the longer term as most developed countries double down on globalization.

Concerns about a trade war's impact on the global economy were heard again this past weekend at the G20 meeting in Buenos Aires. Finance ministers and central bankers acknowledged that downside risks have increased, as the International Monetary Fund recently recognized as well. In particular, trade was finally recognized as a major concern – it was included in the official statement coming out of this meeting (although it's important to note it hadn't been included in the statement from the March meeting).

One question I am often asked when I speak at conferences around the world is, "Do we have enough dry powder to combat the next crisis?" My answer is always honest – we can only hope. After all, many countries have taken on so much debt that they may not be able or willing to conduct the kind of fiscal stimulus necessary to bring an economy out of recession. More importantly, a number of major developed central banks recently have had extremely low interest rates, and some have bloated balance sheets, so they do not have the tools that were available to them during the global financial crisis a decade ago. And while some central banks are in the process of normalizing monetary policy so they are better capable of combating the next crisis, attempts at normalization could help trigger a new crisis – for example, we have been seeing pressure being placed on emerging markets sovereign and corporate debt as well as European corporate debt as a result of lower global liquidity as the US Federal Reserve reverses course (I will address this in more detail in an upcoming blog).[4] But I have never contemplated the bigger issue that Merkel raised last week. She argued that the world would not have been able to successfully combat the global financial crisis if countries had acted unilaterally, as the US is now doing. That is some serious food for thought as we contemplate the future.

Looking ahead

There are several events that I'll be watching this week:

- **Auto company earnings.** Earnings should be strong, in my view; what we'll want to pay attention to are comments about the trade war and its potential impact on future earnings.
- **Tech earnings.** I expect strong earnings reports from most industries in the technology sector. I believe we should see earnings growth in the double digits from several different industries within the sector. The tech sector should report even better revenue growth than earnings growth this quarter, in my view. I expect investors will reward those companies with higher top-line growth, which should be positive for the sector. This is important because a small group of tech companies has played an outsized role in the performance of the S&P 500 Index in recent years.[5]
- **Trade talks.** Jean-Claude Juncker, president of the European Commission, will visit the US this week to try to de-escalate trade tensions. I don't think he will have much success, but we will want to follow the situation closely.
- **European Central Bank (ECB) meeting.** The Governing Council of the ECB is meeting this week. I don't expect anything significant to occur at this meeting, given its major announcement last month that tapering would end in December. Therefore, I don't see any reason why the weak euro would strengthen in the very near term.
- **US growth.** The Commerce Department will release the first estimate of second-quarter US gross domestic product (GDP) growth, and I believe it's likely to be very strong. The Atlanta Fed GDPNow model is forecasting 4.5% annualized growth for the second quarter while the New York Fed Nowcast model is forecasting 2.7% annualized growth for the second quarter.[6] I believe we will see growth somewhere in between these two forecasts.

Source

[1]As of July 20, 2018, based on the MSCI EAFE Index, MSCI Emerging Markets Index, MSCI World Index, and MSCI Pacific Index

[2]Bloomberg, L.P.

[3]Bloomberg News, "Wilbur Ross Dismisses Idea Auto Imports Hearing Is a 'Show Trial,' July 19, 2018

[4]The Wall Street Journal, "Prolonged Slump in Bond Liquidity Rattles Markets," July 22, 2018

[5]CNBC, "The big influence FANG, tech have over market could become a concern if volatility rises," July 28, 2017

[6]Federal Reserve Bank of New York (as of July 20, 2018) and Federal Reserve Bank of Atlanta (as of July 18, 2018)

Important Notice

All investments involve risk, including risk of loss.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

The Federal Reserve Bank of Atlanta's GDPNow forecasting model provides a "nowcast" of the official GDP estimate prior to its release by estimating GDP growth using a methodology similar to the one used by the U.S. Bureau of Economic Analysis.

The Federal Reserve Bank of New York's Nowcast model of GDP growth incorporates a wide range of macroeconomic data as it becomes available. The aim is to read the real-time flow of information and evaluate its effects on current economic conditions.

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The MSCI EAFE Index is an unmanaged index considered representative of stocks of Europe, Australasia and the Far East.

The MSCI Emerging Markets Index is an unmanaged index considered representative of stocks of developing countries.

The MSCI World Index is an unmanaged index considered representative of stocks of developed countries.

The MSCI Pacific Index captures large- and mid-cap representation across five developaed-market countries in the Pacific region.

The S&P 500® Index is an unmanaged index considered representative of the US stock market