

Market Bulletin

June 22, 2018

Trade tensions: A fight on many fronts

In brief

- Trade related headlines have been overwhelming over the past few months. It is important for investors to separate tariffs that have been enacted from tariffs that are still under discussion.
- The magnitude of tariffs imposed so far by the U.S. and its trading partners is quite small, but their relevance would increase if the situation continued to escalate.
- Making direct and indirect links to an impact on U.S. and global economic growth and inflation is difficult. However, given the increased importance of trade for the global economy, an escalation of trade tensions is a source of downside risk to growth and a source of volatility for capital markets.
- As a result, investors should remain balanced in their asset allocation, and avoid overreaching for yield or return at the current juncture.



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The topic of trade has become a fixture of the news cycle, leaving investors wondering where things stand with respect to tariffs and their potential impact on the economy. Free trade matters for growth in both the short and in the long term, as actions that restrict trade could put sand in the wheels of the global expansion by disrupting production, increasing costs for businesses and/or prices for consumers, limiting the positive transmission mechanism between economies, and, ultimately, decreasing productivity. However, the scope of trade restrictions matters too—to start the conversation, it is important to separate the enacted tariffs from those still under discussion.

A little bit of signal and a lot of noise

So far, tariffs have been imposed on imports of lumber, washing machines, solar cells & modules, and steel & aluminum (with exemptions for certain countries) **(Table 1)**. Together, these account for USD 54 billion of U.S. imports, which is equivalent to 2% of all U.S. imports or 0.3% of U.S. GDP **(Exhibit 1)**. In response to these actions, our trading partners have implemented tariffs on USD 22 billion of U.S. exports, or 1% of all U.S. exports. Seeing the implementation of tariffs is without question a bit unsettling, but the numbers are still quite small and should not yet materially alter the trajectory of U.S. growth and inflation.

TABLE 1: WHAT WE KNOW

	20.83% tariff on USD 6 billion of imported lumber from Canada, effective November 2017
	Tariff-rate quota on USD 1.8 billion of imported washing machines, effective February 2018
	30% tariffs on USD 8.5 billion of imported solar cells and modules, effective February 2018
   	25% tariff on USD 19 billion of imported steel, effective March 2018
   	10% tariff on USD 19 billion of imported aluminum, effective March 2018
= USD 54 billion of U.S. imports subject to new tariffs; tariffs worth USD 11 billion	
Retaliation:	
	25% tariff imposed by the European Union (EU) on USD 3.2 billion of U.S. exports in response to steel/aluminum tariffs
	15-25% tariff imposed by China on USD 3 billion of U.S. exports in response to steel/aluminum tariffs
	25% tariff imposed by Canada on USD 13 billion of U.S. exports in response to steel/aluminum tariffs
	15-25% tariff imposed by Mexico on USD 3 billion of U.S. exports in response to steel/aluminum tariffs
= USD 22 billion total U.S. exports now subject to new tariffs; tariffs worth ~USD 5.25 billion	

What we do not yet know, however, is how much further this situation will escalate. Additional tariffs have been discussed **(Table 2)**, but are still yet to be implemented, especially when it comes to imports from China. On July 6th, 25% tariffs are expected to be implemented on USD 32 billion of Chinese imports, with a remaining USD 14 billion still under review. 10% tariffs on an additional USD 200 billion have been proposed, but no clear timeline is available, and there is even less clarity around the additional USD 200 billion which could come after that (which would bring the total to USD 450 billion). In addition, the Department of Commerce is conducting an

investigation into whether imports of autos and auto parts threaten national security and should be subject to tariffs. This is all occurring against a backdrop where the future of North American Free Trade Agreement (NAFTA) remains uncertain, as discussions with Canada and Mexico are still ongoing.

TABLE 2: WHAT WE DON'T KNOW

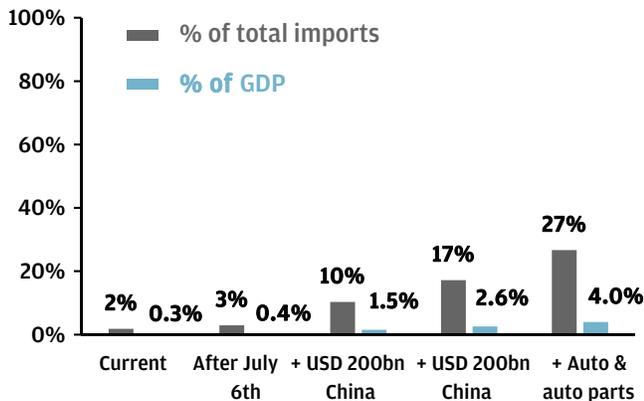
	25% tariff on USD 32 billion of annual imports from China, effective July 6 th 2018
	25% tariff on the remaining USD 14 billion of annual imports from China
	10% tariff on an additional USD 200 billion of imports from China
	Tariff on an additional USD 200 billion of imports from China
	Section 232 investigation of imports of auto and auto parts
	Renegotiation of NAFTA agreement with Canada and Mexico
Retaliation:	
	25% tariff proposed by China on USD 50 billion of U.S. exports in response to Section 301 U.S. tariffs
	Additional tariffs based on escalation of tariffs from the U.S. side
	Tariffs from the EU and other trading partners in response to any tariffs on autos and auto parts

A worst case scenario would entail tariffs on imports of USD 450 billion from China and USD 275 billion of autos and auto parts taking effect. Under this scenario, we could see 27% of U.S. imports subject to new tariffs, which is equivalent to 4% of U.S. GDP (**Exhibit 1**). Determining the direct impact on inflation and growth is a bit tricky, as it involves many assumptions about the extent to which higher prices are passed on to the consumer and how that would affect spending decisions. Trickier still is factoring in potential indirect effects from a decline in confidence and supply chain disruptions.

Potential impacts and lessons from the past

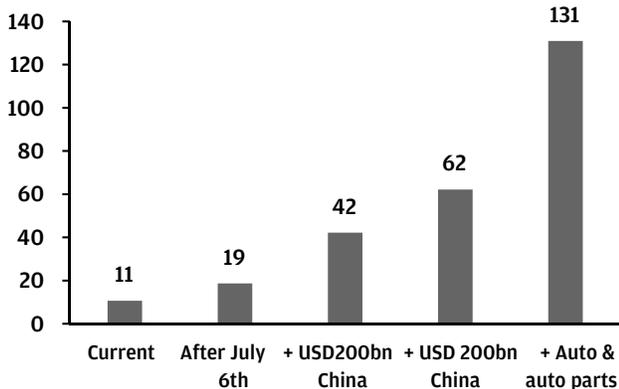
From where we sit, further escalation of the current trade situation is fraught with downside risks. Tariffs deemphasize specialization, restrict global trade, and harm economic progress. In other words, tariffs create losers on all sides. While we are not yet in a trade war, and our base case remains that one will be avoided, the balance of risks has shifted and forced us to entertain what a worst-case scenario might look like.

EXHIBIT 1: SCENARIOS OF THE SCALE OF TARIFFS IMPOSED ON U.S. IMPORTS



Source: BEA, J.P. Morgan Asset Management. Data are as of 6/22/2018.

Value of tariffs imposed on U.S. imports, USD billions



Source: BEA, J.P. Morgan Asset Management. Data are as of 6/22/2018.

The growth impact would be more severe for China than the U.S., as the USD 450 billion of Chinese imports which could potentially be taxed account for 3.2% of China’s GDP. On the other hand, the U.S. exported approximately USD 130 billion of goods to China last year, which is about 1% of U.S. GDP. So from a pure growth standpoint, tariffs stand to hurt China more than they would hurt the U.S. That said, there are ways other than tariffs (such as restricting U.S. business operations in China) that the Chinese could strike back. Importantly, however, China is not the only player in this game, and retaliation in aggregate could

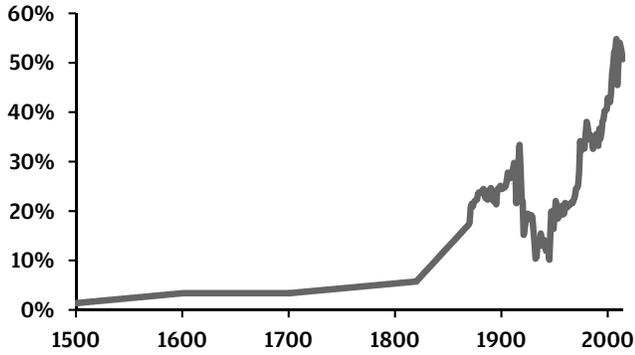
potentially offset recent fiscal stimulus, impact business and consumer sentiment, and prove more harmful to economic growth than expected. Furthermore, U.S. inflation could accelerate if the cost of the tariffs is passed entirely to the consumer, which has implications for the trajectory of interest rates and Federal Reserve policy.

Many ask if the past can provide any insight into the current situation; the Smoot-Hawley tariffs of the 1930’s seem to be the best point of comparison. Although economists continue to debate whether Smoot-Hawley exacerbated the Great Depression, what is clear is that the application of these tariffs at a trying time for the global economy sparked international outrage and retaliation, and undoubtedly weakened the global economic system.

With trade now accounting for a far larger share of both the U.S. and global economy than it did in the 1930s (**Exhibit 2**), further escalation could prove to be quite harmful to a global economy that is finally seeing the lingering effects of the financial crisis wear off. While we are not yet at a point where direct comparisons to Smoot-Hawley can be drawn (**Exhibit 3**), engaging in a full-on trade war could lead the global economy on a fairly unpleasant journey over the coming years. On the other hand, there is a way these tensions can be resolved amicably. When the U.S. imposed tariffs on steel in the early 2000s, politically-targeted tariffs from the EU in response prompted the U.S. to remove those tariffs years earlier than planned. Ultimately, investors need to realize that tariffs will not solve our trade imbalance; the trade deficit equals the private sector deficit plus the government budget deficit, and with the budget deficit set to expand in the coming years, there is clearly more to this situation than meets the eye.

EXHIBIT 2: THE IMPORTANCE OF TRADE FOR THE GLOBAL ECONOMY

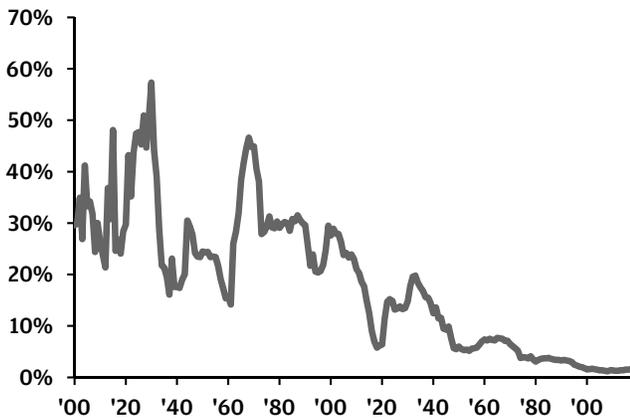
Global imports and exports as a % of global GDP



Source: Estavadeordal, Frantz and Taylor, Klasing & Milionis, Penn World Tables, J.P. Morgan Asset Management. Data are as of 6/22/2018.

EXHIBIT 3: U.S. TARIFF RATES OVER TIME

U.S. tariff revenue over total imports



Source: USITC, Census, NBER, NABE, Irwin, Douglas A. "New Estimates Of The Average Tariff Of The United States, 1790-1820," Journal of Economic History, 2003, v63(2,Jun), 506-513, J.P. Morgan Asset Management. Data are as of 6/22/2018.

Investment Implications

While trade tensions remain as a downside risk to growth and source of volatility for capital markets, we find it too early to change our constructive view of the U.S. and global economy. Tariffs enacted so far have been limited in scope, and as a result, global earnings growth should remain solid, providing support for risk assets to continue moving higher. That said, trade related headlines are unlikely to subside, meaning that this ascent will be bumpy; as a result, investors should remain balanced in their asset allocation, and avoid overreaching for yield or return at the current juncture.

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