Strategy

April 9, 2018

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Tariffs and Trade Wars

Abstract

Trade tensions between the U.S. and China have been making headlines recently. The Trump administration recently rolled out plans to place 25% tariffs on $50 billion of Chinese imports, to which China responded in kind. In the near-term, tensions may continue to escalate, but ultimately a negotiated settlement is in the best interests of both countries. From a cash investor's perspective, some flattening of the yield curve seems likely but credit quality most likely will not be materially impacted.

Introduction

Protectionism is not a new concept for President Trump. Back in 2015, his fervent Make America Great Again campaign catapulted him from an afterthought to the Republican front runner. His calls for protectionist policies intensified during the run-up to the election, as he called for 45% tariffs on Chinese imports, blamed NAFTA for hollowing out the rust belt, and labeled the Trans-Pacific Partnership (TPP) a potential "death blow for American manufacturing."

While the rhetoric continued after his move to the White House, President Trump largely eschewed overtly protectionist policies in his first year in office, focusing instead on regulatory rollbacks and tax reform. Now, in the second year of the administration, protectionism has come back to the forefront. With the resignation of Gary Cohn as the Director of the National Economic Council (NEC) and the effective demotion of Jared Kushner amidst concerns over his business dealings, Trump lost his two biggest supporters of existing trade policy. At the same time, the promotion of advisor Peter Navarro and re-emergence of Commerce Secretary Wilbur Ross have placed two trade skeptics at the head of the economic leadership team within the White House.

Perhaps it's no surprise, then, that the President's first openly hostile actions towards foreign trade partners came in just the past few weeks. First was the announcement of a 25% tariff on steel along with a 10% tariff on imported aluminum. Second, the President invoked Section 301 of the U.S. Trade Act of 1974 to announce 25% tariffs on an estimated $50 billion of Chinese goods, along with potential restrictions on Chinese investments in U.S. tech firms. The administration also filed a complaint with the World Trade Organization (WTO) alleging, amongst other things, that China uses restrictions on foreign ownership to force companies to transfer their intellectual property to Chinese firms. China, in turn, responded to these actions by issuing reciprocal 25% tariffs on $50 billion worth of U.S. goods.

Given the ongoing nature of this dispute, it's difficult to say exactly what the outcome will be. However, we'll try to parse out some of the possibilities and their implications for short-term cash investors below.

Thoughts on the Actions

The most important thing to emphasize at this point is that nothing is finalized (save the steel and aluminum measures). The administration just wrapped up a two-week process by releasing a list of approximately 1,300 different products it wants to target, centered around high value-added areas such as tech and aerospace. China followed suit, announcing tariffs on 106 products (most notably soybeans and commercial aircraft) only hours later. Such a move highlights the tit-for-tat nature of these proceedings.

Neither side has taken concrete steps to move on the announcements. The White House is allowing for an extended period of public comment on its list of products, until May 22nd. Additionally, a public hearing is scheduled on Capitol Hill for May 15th. Given the backlash from a wide array of industries, it seems likely that the White House will face significant pressure to pare down the list. Furthermore, it could delay action on the finalized version for as long as 180-days under Section 301 procedures. China didn't announce a timeframe for implementation, saying it was dependent on when the U.S. acts.

This time frame leaves open the possibility for reconciliation, a process which may already be under way. Only days after their initial announcement, it was reported that the Trump administration was in ongoing talks with China to expand access to Chinese markets. This would be consistent with the President's negotiation style, in which he often stakes out aggressive positions publicly before ultimately compromising. For example, he initially issued across-the-board steel and aluminum tariffs before exempting all but a few countries (China being a notable exception).

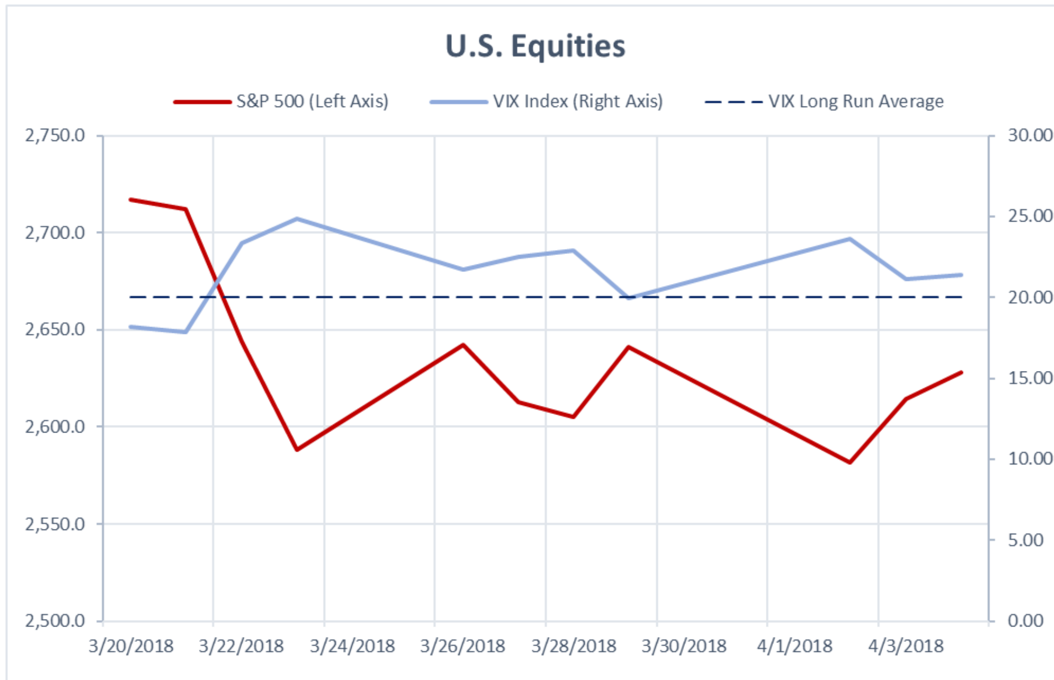
Of course, there's always the possibility that the negotiations will go sideways or backwards. Both Trump and China's President Xi Jinping are strong-headed leaders who will not want to be seen as giving in to the other side. President Trump has already called for consideration of an additional $100 billion in tariffs as retaliation for China's actions. Should he move ahead with them, it seems likely that Xi's government would respond in kind.

Furthermore, some of the U.S.'s requests heading into negotiations, namely that China reduce its bilateral trade surplus by $100 billion, are unrealistic to say the least. Nevertheless, it remains in both countries' best interests to come to some sort of deal. A trade war is a negative sum game, which could put economic pressure on Xi at a time of transition and heap political pressure onto Trump heading into the midterm elections.

Impact on the Yield Curve

As would be expected, the turmoil has led to some volatility in financial markets. Stocks sold off on the announcement and have bounced up and down in the past two weeks. Even so, the VIX (a measure of implied volatility of the S&P 500) is trending right around its historical average.

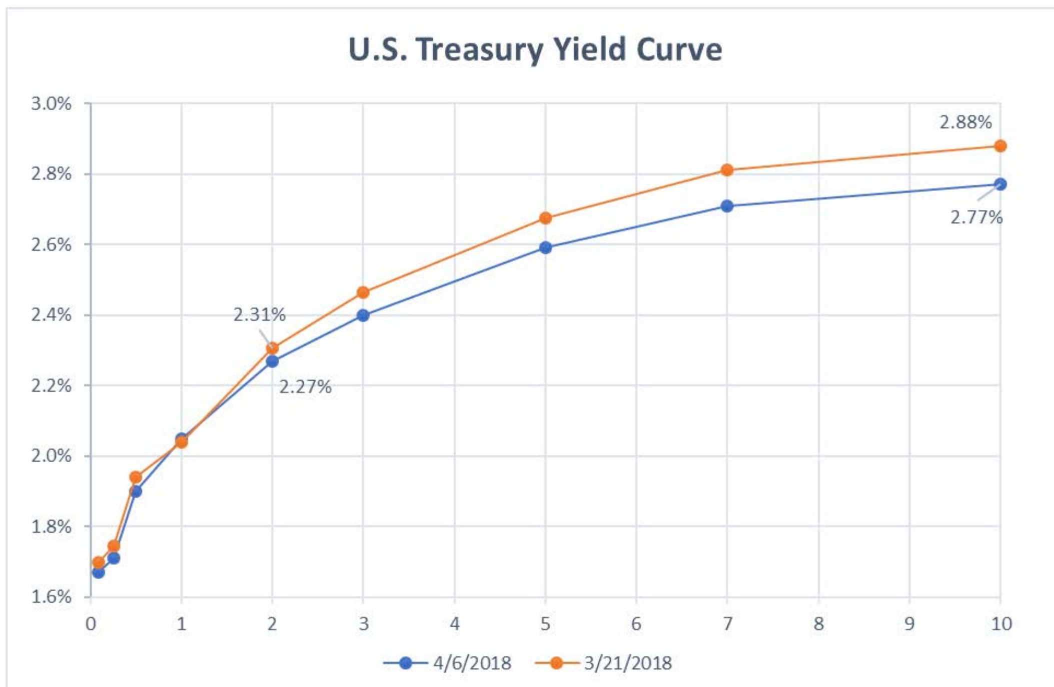
Figure 1: U.S. Equities



Source: Bloomberg, CBOE

There's also been some movement in the bond market.

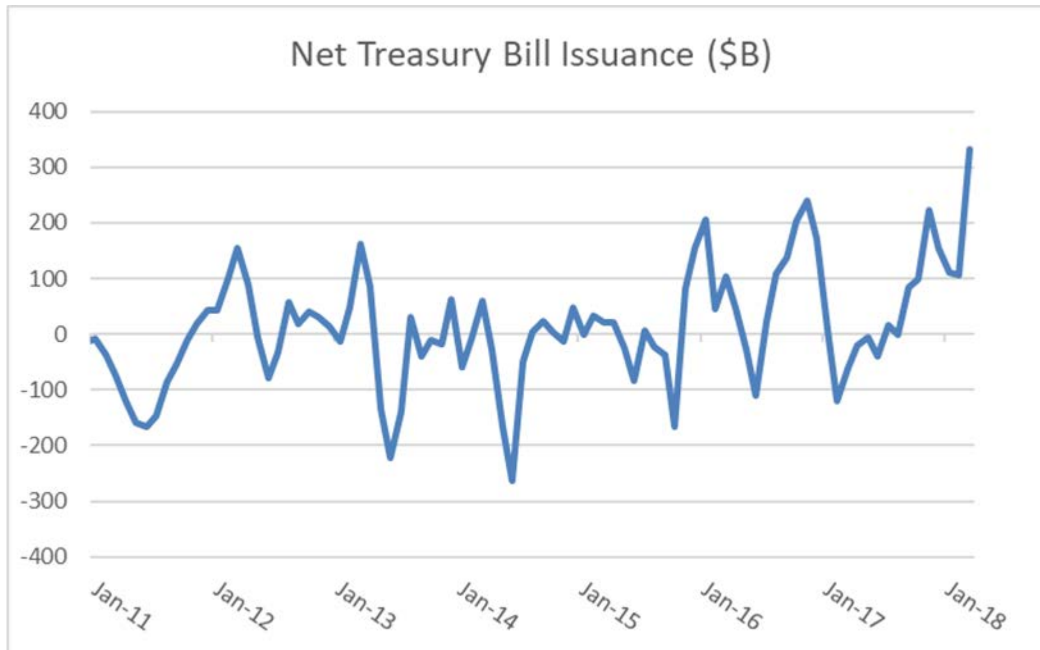
Figure 2: U.S. Treasury Yield Curve



Source: Bloomberg

Since the tariffs were announced, the front end of the yield curve (out to 2 years) hasn't moved all that much. This makes intuitive sense, as the tariffs are not expected to have much impact on economic activity in the near-term. Most estimates peg the impact on Chinese GDP growth at just -0.1% this calendar year, with the U.S. even less than that. Moreover, there are likely some supply pressures coming into play here, as T-bill issuance has been rising of late.

Figure 3: Net Treasury Bill Issuance ($B) – 3 Month Rolling Average



Source: Bloomberg, U.S. Treasury

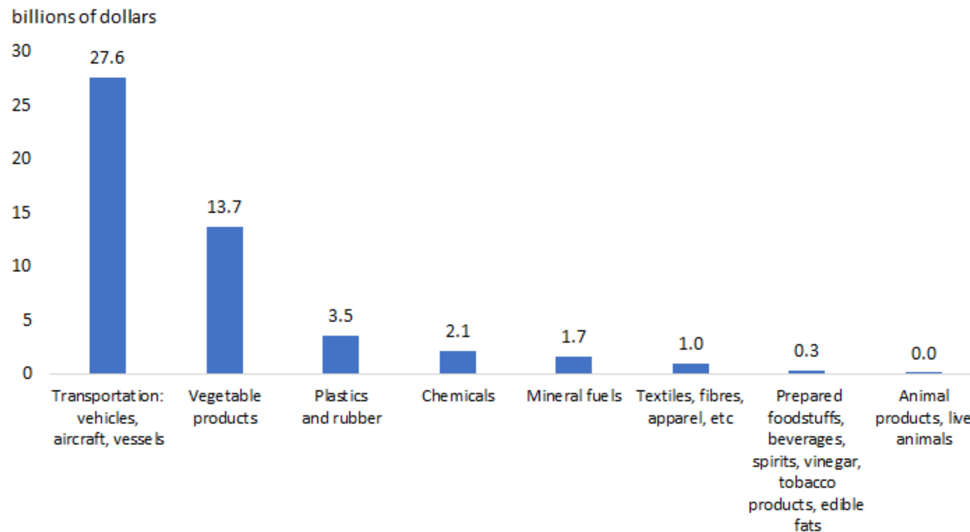
Additionally, Fed officials have yet to comment on the impact the tariffs would have on their projections for the path of rate hikes. Both the FOMC and financial markets are projecting two further rate hikes this calendar year, which would leave the fed funds range at 2.00%-2.25%. Other things being equal, standard economic theory would suggest that tariffs would put upward pressure on inflation due to higher input costs for firms, which would in turn lead to a faster pace of rate hikes. A weakening of the dollar due to capital outflows would only further support the inflationary trend. However, inflationary pressures could be counterbalanced by any negative impacts to growth (however small), which could in turn bleed over to unemployment and cause the Fed to move in a more dovish direction.

Out beyond two years, we've seen some moderate flattening of the curve, with the spread between the two and ten-year falling from 57 to 50 bps. Again, this makes sense, as investors generally flock to Treasury bonds during times of uncertainty, and unlike short-term bill issuance, long-term bond issuance hasn't increased much. Furthermore, the negative impacts of trade restrictions are more pronounced over the longer run. Loss of comparative advantage via tariffs eventually leads to lower productivity growth as input costs rise and firms are forced to allocate capital less efficiently. This in turn eats away at the economy's potential growth rate, putting downwards pressure on real interest rates. Marginally higher inflation could put some upward pressure on nominal rates, but should trade confrontations escalate, we'd expect to see a further flattening of the yield curve.

Credit Implications

The credit impact is largely contained to profitability and growth issues. First-order impacts will be most directly felt by companies targeted by China.

Figure 4: Peterson Institute for International Economics (PIIE)



Source: Peterson Institute for International Economics (PIIE), https://piie.com/blogs/trade-investment-policy-watch/more-soybeans-trumps-section-301-tariffs-and-chinas-response

As the above graphic illustrates, agricultural companies will be impacted. In particular, soybean companies are likely to face revenue pressures. China makes up about two-thirds of the global soybean import market, and more than half of the $23 billion in U.S. soybean exports annually are directed to China. This leaves American soybean farmers in somewhat of a bind, as there's no other country that can come close to replacing China's demand. Meanwhile, China will likely redirect some of its import orders away from the U.S. to other large exporters such as Brazil. Interestingly, there are also some political implications here. Soybean producers are largely located in the rust-belt, an area which was important for the President's victory in 2016.

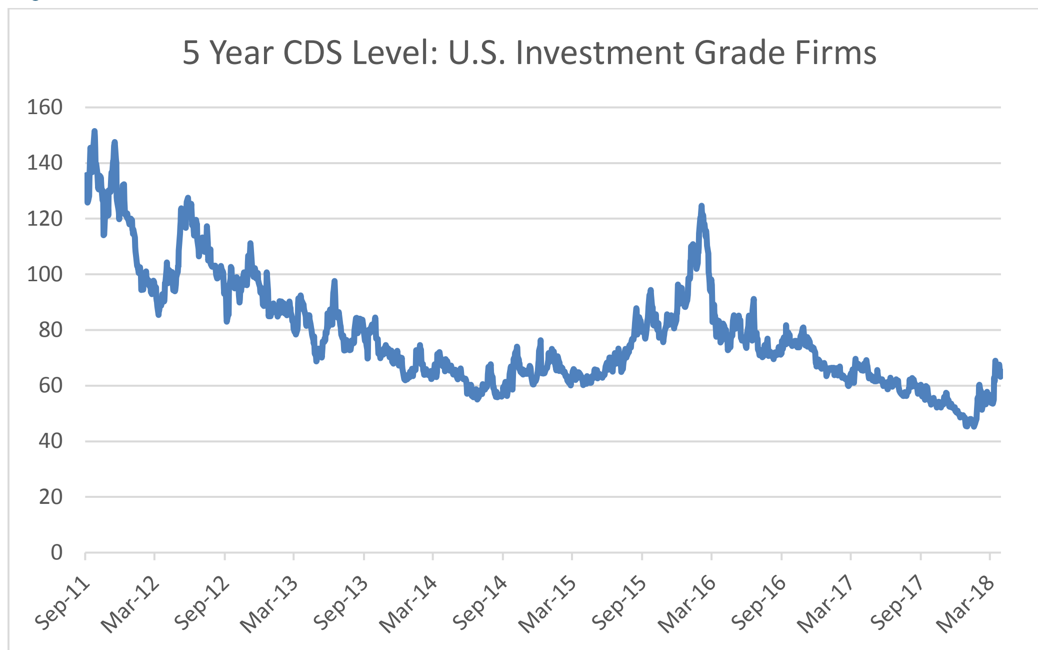
Aircraft and vehicle exports are the other main targets of China's tariffs. Firms such as Tesla and Boeing will face revenue pressure, with some mitigating factors. Boeing's largest aircraft, the 787 and its offshoots, will be exempt from the tariffs. As a result, some industry experts are saying that the impact on the company's core business won't be as large as initially anticipated. For Tesla, the tariffs pose a threat to its access to China's fast growing electronic vehicle market. However, similar to other U.S. auto manufacturers, the company is working on opening a manufacturing facility within the region in order to bypass the tariffs. Somewhat ironically, the new auto tariffs are also likely to impact German carmakers such as BMW and Daimler, who do final assembly for some vehicle models in the U.S.

A wider array of companies will face margin compression from rising input costs. This is especially true for firms in industries such as manufacturing and pharmaceuticals, which have globally integrated supply chains. Ultimately, these firms will need to either eat the higher costs, pass them on to consumers, or balance some combination of the two. There is also the possibility that firms could choose to repatriate their supply chains; however that would leave them at a relative disadvantage compared to their global competition.

Nevertheless, these are largely manageable long-term issues that do not affect short-term credit quality. From a cash investor's perspective:

- Domestic and global economies continue to grow at a solid pace.
- Profitability, cash flow, interest coverage, and leverage metrics for U.S. companies remain healthy.
- Corporate debt continues to trade at reasonable spreads, suggesting that there is ample liquidity in the market.
- Default risk, as measured by CDS levels, is largely unchanged.

Figure 5: 5 Year CDS Level: U.S. Investment Grade Firms



Source: Bloomberg, Markit

Conclusion

It's hard to make any definitive statements as to how this will all play out. The base case scenario isn't an all-out trade war between the U.S. and China, but escalating measures are certainly not out of the question. Further tariffs from either side have the potential to roil financial markets, which could negatively impact business and consumer confidence.

Still, as Paul Krugman and other economists have pointed out recently, it's unlikely that the tariffs currently under consideration will have a substantial near-term impact on economic growth.[1] Even with these measures, the U.S. will remain a relatively open economy, something that is not expected to change in the foreseeable future. While the tariffs could inhibit performance by putting downward pressure on yields across the curve, they are unlikely to have a meaningful impact on underlying portfolio credit quality.

[1] Paul Krugman, New York Times, "Trade Wars, Stranded Assets, and the Stock Market (Wonkish)": https://www.nytimes.com/2018/04/04/opinion/trade-wars-stranded-assets-and-the-stock-market-wonkish.html

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