Weekly Strategy

Multi Asset Navigator

UNIGESTION

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War Edwin Starr, 1970

In our view, the possibility of a global trade war is the greatest source of uncertainty for the second half of this year. From statements made by various heads of state, it seems that such a trade war would be bilateral, with the US taking on perceived economic enemies as well as allies, and not a multilateral war where trade barriers rise between many countries. Nonetheless, a bilateral trade war with the world's largest economy (the US) taking aim at the next two largest economies (Europe and China) would certainly entangle other nations given the breadth and depth of the global supply chain. We believe there are two key questions: what is the likelihood of further escalation? And what is the impact on markets if there is a meaningful escalation?

WHAT'S NEXT?

What's the likelihood?

If you had asked us last quarter, we would have said the likelihood of a real escalation was low and that most of the noise was just that, noise. But the last few months have seen the White House shift to a more bellicose tone, which has been met in kind by other world leaders. This shift is reflective of the rise and fall of particular advisors to US President Donald Trump (see Table 1), with more pragmatic, moderate voices. This game of palace intrigue does not bode well for de-escalation, but there are political pressures that we believe will restrain the warmongering voices coming from the White House:

- Implemented tariffs are now starting to hit, and high profile firms like GM and Harley Davidson have spoken in clear tones about the negative impact of these and potential new tariffs on American companies and jobs; surveys on business forward-looking sentiment have also meaningfully declined over the last couple of months
- Retaliatory tariffs are surgically aimed at Trump's base and would make an abstract trade war very real for his supporters
- US midterm elections are approaching, and most Americans do not support these protectionist policies; recent polls indicate that only about 25% of Americans are supportive

On balance, we believe the political realities will prevent a meaningful escalation of the trade war. But given that Trump himself is not up for re-election, his predilection for confrontation instead of compromise, and the desire of ideologues in his inner circle for escalation, we cannot discount the risk that there is ratcheting up of rhetoric and action.

What's the impact?

Looking at the impact of a meaningful escalation on financial markets, we estimate that the direct cost of the US implementing a 10% tariff on all imports (a significant increase of the 1.6% total for announced tariffs) and other countries responding in kind to US exports would be roughly a 0.23% loss to global real GDP over two years. We would also expect higher inflation as input costs rise and are eventually passed on to consumers, estimating the impact to be about 0.15% on CPI. Of course, depending on the central bank response to such a rise in global prices, growth may be further hampered by additional monetary policy tightening. But taking the direct impact of a contraction in real GDP and rise in inflation, we expect such a shock to macro fundamentals would reduce global equity prices by about 2%. However, if we consider historical cases where there was an exogenous shock similar to a tariff hike, such as the Smoot-Hawley Tariff Act of 1930 (which raised US tariffs 20%) and the oil shocks of 1979 and 1990, we estimate an expansion in the equity risk premium would cut another roughly 7% from equity prices, for a 9% total loss. Thus far, it seems to us that the parts of the market that would be most impacted by the tariffs, such as the MSCI Emerging Markets index and the Autos Sector in Europe, have roughly priced in such an event. But bear in mind this is quite a significant escalation and not our baseline, suggesting that so long as the trade war does not spiral out of control, parts of the market have over corrected.

We should mention that our estimates are based on a stylised model and do not account for the myriad of intricacies of the global economy, including other potential actions like currency devaluation or selling of US Treasuries on the part of China. We also look at the aggregate picture, which belies pockets of stress for particular regions and industries that will disproportionately bear the brunt of protectionist measures. The secondary impacts from these micro effects can be large and difficult to quantify: consider towns heavily focused on soybean farming and what the contraction of that industry would mean for the various other industries that service soybean farmers. These complex dynamics add yet another layer of uncertainty on top of the political machinations.

Table 1: Voices on international trade in the Trump administration

Name	Position	Notes
Wilbur Ross	Secretary of Commerce	Officially recommended steel and aluminum tariffs as head of Commerce Department
Steven Mnuchin	Secretary of the Treasury	Considered more moderate among the administration, nonetheless pushed G20 to remove language opposing protectionism in their official March statement
Peter Navarro	Director of the National Trade Council	Author of *Death by China*, highly critical of German and Chinese trade and currency policies, has advocated for high tariffs and repatriating global supply chains
Larry Kudlow	Director of the National Economic Council (NEC)	Formerly supported free trade, but after his appointment has become an advocate for protectionist policies, considered a placater
Gary Cohn	Former Director of the NEC	Strong supporter of global trade, resigned after Trump rejected his attempts to stop steel and aluminum tariffs
Rob Porter	Former Staff Secretary	Was responsible for trade policy meetings, resigned following domestic abuse claims leaving vacuum of policy coordination

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Sources: Bloomberg, Unigestion, as at 9 July 2018