It started with an election promise in 2016 and now threatens to be the major story of the US economy in 2018. It was a major pillar of Donald Trump's election campaign that he would push to make trade fairer for America versus its global trading partners and that election pledge is now becoming a reality. The ramifications of the US president's aggressive rhetoric and tit-for-tat trade tariffs has started to feed through into equity markets. As volatility has risen, so investment risk has also increased with each fresh round of tariff announcements. This month we consider the rationale for Trump's actions and explore the implications of his policy for global markets both now and in the future.

"Trade wars are good, and easy to win" – Donald Trump March 2018

Chronology of a trade war

In February 2016, 12 countries that border the Pacific Ocean signed the Trans-Pacific Partnership (TPP) trade deal. Those 12 countries account for 40% of global trade and have a population twice that of the EU's single market – it was lauded as a massive deal for the previous administration under President Obama. During the election campaign, Trump described it as a "horrible deal" and once elected he proceeded to pull the US out of the agreement in January 2017, rendering the pact redundant as a result. The world perhaps should have seen this action as the start of a major shift in trade policy that has culminated in the president's actions over the last few months.

In January of this year, Trump imposed tariffs on the importation of selected goods, including solar panels and washing machines.

On March 1st, he announced his intention to impose a 25% tariff on steel and a 10% tariff on aluminium imports to the US from the EU, Canada and Mexico.

Then on 15th June, Trump announced a further 25% tariff on over $50bn of goods from China, ranging from pharmaceuticals to flat-screen TVs, announcing that "The United States can no longer tolerate losing our technology and intellectual property through unfair economic practices."

China sent a strong retaliatory message, imposing tariffs on $50bn tobacco, whiskey, cars, orange juice and beef from the US – an overt attempt to hit Trump's key elector base where it hurts.

Angry, and perhaps surprised at this response, Trump has now gone further, threatening, but not yet imposing, tariffs on a further $200bn of Chinese goods.

The major battle is now being waged between the US and China.

Both sides are posturing and currently neither will backdown, at the very least to save face. This is a very dangerous game of bluff that threatens price rises and a possible slowdown in the US economy.

The global response

Trump's trade policy has been poorly received, even within his own camp. It is rumoured that trade policy was the main reason why Gary Cohn, his key economic adviser and former Goldman Sachs Chief Operating Officer, resigned soon after the steel and aluminium tariffs were announced. It has been widely condemned by everybody from America's major G7 allies to his own party and seemingly his own key staff (even his replacement for Cohn, top economic adviser Larry Kudlow, told Fox News that the tariffs could undermine US growth!) yet he presses on with this policy regardless.

"If you end up with a tariff battle, you will end up with price inflation, you could end up with consumer debt," – Gary Cohn – the former economic adviser to Donald Trump.

Most economists agree that this policy is bad news. Here are some of the reasons:

The FT predicts that a global trade war would knock 1-3% off world GDP over the next few years.

Maurice Obstfeld, the International Monetary Fund's chief economist, wrote in 2016 that a 20 per cent US tariff on imports from East Asia, would (without retaliation) raise the dollar by 5 per cent, and cut US output by 0.6 per cent over five years.

In 2002, President George Bush imposed tariffs of 8 percent to 30 percent on a range of steel imports. Around 200,000 Americans lost their jobs due to higher steel prices that year – more than the 187,500 people employed in the steel industry itself, according to Trade Partnership WorldWide LLC.

Some of the biggest names in US business have a great deal to lose if the US continues to poke a stick in the ribs of the Chinese Dragon. See below household US names and their corresponding percentage sales to China:

Deere:	8%
Caterpillar:	9%
Boeing:	11%
Nike:	12%
Tiffany:	13%
Starbucks:	15%
McDonalds:	15%

Justification for and the implications of a global trade war

By imposing tariffs, Trump's primary aim is to force foreign companies to "build" in the US rather than overseas, thereby bringing jobs to the US economy whilst also ensuring that intellectual property is kept in the US rather than used and abused abroad. By doing so he proposes to make the US more self-sufficient, this protectionist stance being the bedrock of his election campaign and at least partly responsible for his election victory.

The general idea is that higher prices of imported goods will both force foreign companies to "build local" and also to incentivise consumers to "buy local" instead of buying foreign goods that are now more expensive due to tariffs. However, the problem is that whilst tariffs do serve to increase prices at home for foreign goods, they do not necessarily create enough justification for foreign companies to build those goods in the US. After all, foreign companies build their products outside of the US for good reason – because it is much cheaper to do so, even after transport costs are factored in. Tariffs lead to companies being less productive, by forcing them to consider producing their goods in a country where it is less efficient to do so. This is not a healthy economic outcome.

If we therefore assume that at the very least there is a big delay to companies shifting production to the US as a result of these tariffs, in the meantime prices of these goods are forced upwards by the levies imposed on them, and because prices are rising, inflation increases.

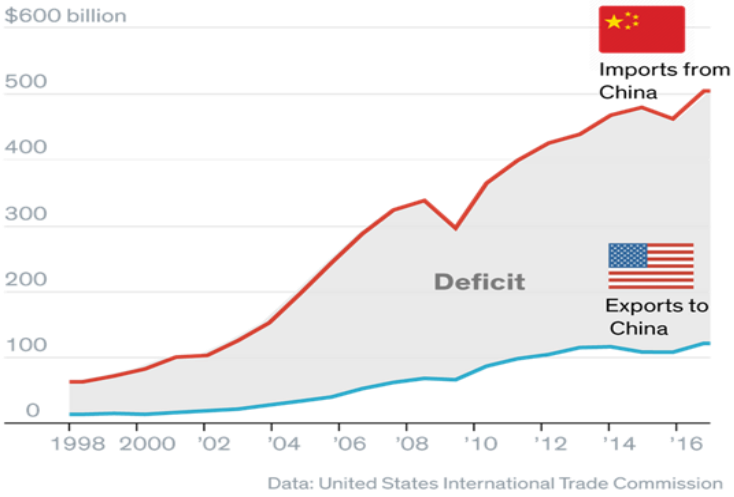
Let's hypothesise though that Trump "wins" and foreign companies do eventually build more in the US. The problem is that the US economy is currently at close to full employment anyway and whilst creating new jobs is great if they are needed and/or if there are workers available, if there is no spare capacity in the system then the US has a dilemma. Companies will either need to pay their staff more to stay in their existing jobs instead of being enticed away by these new entrants, or labour will need to be 'imported' from other countries to fill the gap created. Can you see Donald Trump relaxing immigration controls to allow more foreign workers into the US? Not likely. Therefore, wages are forced upwards instead and this is also inflationary.

Even if trade tariffs do manage to stoke some demand by creating jobs and boosting productivity, when the recipients of your tariffs (China and the EU) retaliate in kind, you lose productivity abroad for exactly the same reasons as you might gain productivity at home, from imposing your own tariffs. So, despite Trump's assertion that trade wars are easy to "win", in reality no-one wins – there are just varying degrees of losers.

US v China

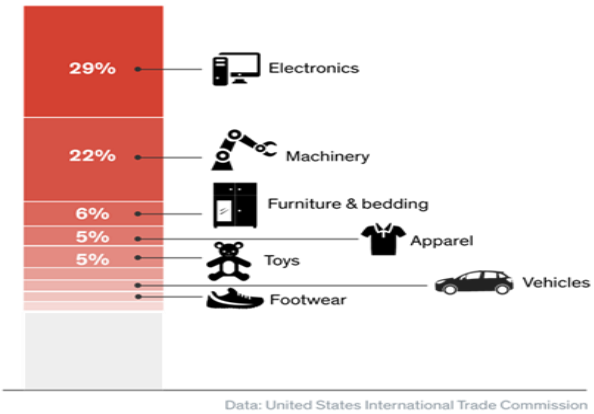
Trump is relying on the fact that China will have more to lose than the US and that it will therefore back-down in this giant game of chicken. China imported $130bn from the US in 2017 whilst the US imported three times as much from China - $507bn in total. Trump has imposed or threatened tariffs on over $250bn of these imports and so on the surface of it China has more to lose than the US by entering into a trade war.

A widening trade gap between the two most important economies in the world:



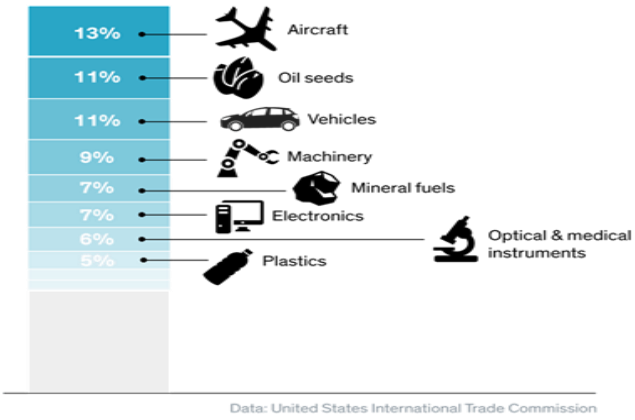
Yet, China has more tools available to fight this war than tit-for-tat trade tariffs. After Trump announced his latest round of tariffs, Chinese regulators freed up an extra $100bn for bank lending to small businesses and consumers by reducing the amount that banks need to keep on deposit in reserves. This amounts to financial stimulus by the central bank and may well serve to weaken their currency, the Remnimbi, as a result, therefore making Chinese goods cheaper for importers. The message from China is clear – you have more of our imports to play these games with, but we can cut prices by devaluing our currency. Your move, Mr Trump!

US imports from China— toys, tools & TVs



Vs

Chinese imports from US— planes, cars & soybeans



Also, China's exports to the US amount to only 22% of its overall exports and total net exports only account for 2% of China's GDP. Domestic consumption now accounts for the majority of China's economic growth and more than half of its GDP and so the country is fairly well insulated from the measures. Even still, it will have an impact and the Chinese currency and stock-market have been rattled by the measures over the past few weeks.

Unintended consequences

Trump's actions have already had unintended consequences at home, including:

On news that the EU would impose a 31% tariff on Harley-Davidson's made outside of the EU, the company announced that it would be forced to move more of its production out of the US to avoid those penalties. Trump was furious that a bastion of American consumer values would be so unpatriotic, threatening to tax the company "like never before". Yet the company is based in Wisconsin, a swing state where Trump won the election by a mere 1% and so caution is needed.

General Motors warned on Friday that US tariffs on imported vehicles being considered by the Trump administration could "could lead to a smaller GM, a reduced presence at home and abroad and risk less - not more - US jobs."

Investment into the US by China has already dropped dramatically. In 2016 there were 56 deals totalling $53.7bn and this dropped to 27 deals totalling $24.2bn in 2017.

Figures released last week showed that in the first five months of 2018, China invested only $1.8bn into the US, the least since 2011.

On the 27th June, more than 270 American business groups warned of the "serious negative economic impacts" of Donald Trump's escalating trade war with other countries. These companies have pledged their support for a bill, tabled by Republican Senator Bob Corker from Tennessee, which would curtail the president's powers to place tariffs on imports. The bill would require the president to submit any proposal to raise tariffs to Congress for approval on the grounds of national security.

Conclusion

The whole world is against him on this policy and he doesn't seem to care. Yet maybe, just maybe, he is playing a clever game ahead of the mid-term elections in November. If he takes the decision to backdown before the midterms, either in full or in part, then he reinforces his political capital with his core supporter base because headlines will show that he has taken action, whilst backing down later therefore does minimal damage to the world economy.

However, if he is simply being typical, unpredictable Trump, then we must hope that either legislative changes are made to force his arm or that he decides to soften his position because stock-market jitters make him realise that the world is anxious. At the time of writing he has just softened his stance on China and markets are rallying across the world but whatever his thought process (is there one?), we'd prefer that this game of chicken ends soon before any lasting damage is done to the prospects for world growth.

Total global exports, per county. China, US & Germany are by far the biggest exporters