Trump and his Trade Wars

By Jean-Philippe Bry, July 7, 2018

With so much rhetoric from the Trump administration on tariffs and trade wars, we believe it's helpful to provide an overview of recent developments and our take on how they could pan out.

Even though markets have corrected, especially those most dependent on trade, they are arguably still seeing Trump's manoeuvres as a tactic to drive better conditions for the U.S. to lower its trade deficit. However, uncertainty on this strategy is rising and will likely rise further in the weeks ahead.

Flawed economic logic

The logic behind Trump's trade initiative is deeply flawed, which means it is not likely to succeed in achieving his goal of lowering trade deficits. The U.S. problem is one of too high consumption and too little savings. Americans have consumed more than they produce for over a generation. Trump says the world uses the U.S. as a piggy bank to steal from, when in fact it is the exact opposite. It is the rest of the world's piggy bank that the U.S. feeds off to finance their over consumption. The result is trade and current account deficits.

Scrapping the global trading system, symbolized by the World Trade Organization (WTO), in favour of bilateral deals like the one Trump is trying to negotiate with China, will not solve the U.S. trade deficit problem. Assuming a deal is eventually signed with China, goods that are curtailed from that country or taxed via tariffs will be moved to another country. So, the U.S. trade deficit with China might eventually improve but will increase with a third country, keeping the overall trade deficit intact. That is the nature of our globally integrated economic system. Conceivably the U.S. could impose tariffs globally, but this is arguably a nuclear option that has not been proposed. This would stifle trade and likely send the global economy into recession. Such a probability is currently very low.

A possible solution to the U.S. trade deficit, without going into extensive detail, is to encourage higher savings which lowers consumption, make debt less attractive and, most importantly, introduce initiatives to improve the long-term competitiveness of the U.S. via education and training. None of these are attractive short-term solutions for politicians judged on economic performance. Certainly, balanced budgets would also help. Higher budget deficits stimulating the economy means society consumes more and, in the case of the U.S., imports more.

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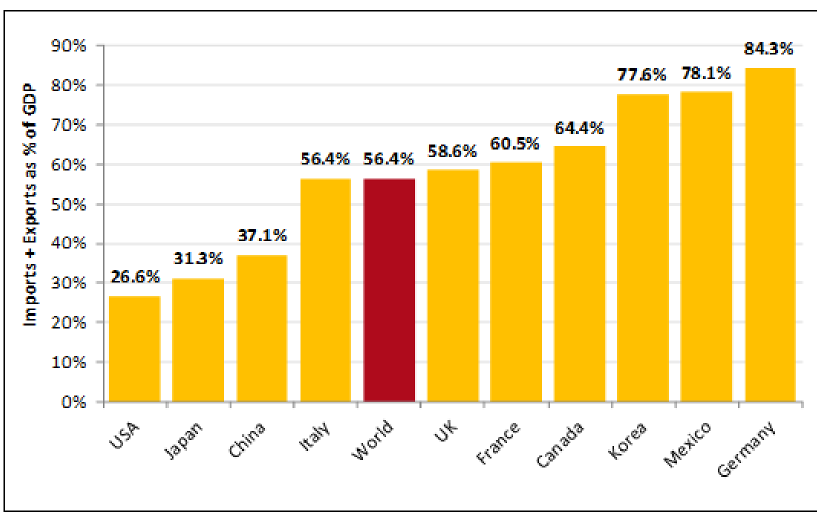
Losers and bigger losers

Markets have repriced to reflect higher tariffs and some higher costs, but are still not pricing for a dramatic escalation of the trade war. Markets are still betting this is a trade tactic on the part of Trump and we would tend to agree.

The problem is that one must be ready to see that strategy through to its logical end. In other words, it needs to **keep escalating to create the necessary tension to drive the targeted countries, whether China, Europe or NAFTA partners Canada and Mexico, to the negotiating table**.

This is why the threats from Trump keep coming, the latest being tariffs on European cars. Arguably, this will also be implemented to heighten the pressure. Interestingly, the collateral damage is predominantly being borne by the largest trading nations. This is the reason Trump claims the U.S. can easily win a trade war. What he really means is that the U.S. *loses less* than the rest of the world – a correct assumption based on the table below from CIBC.

Those countries most dependent on trade, calculated by adding total export and total imports as a percentage of GDP saw their markets drop the most, year to date. Germany, Korea and Canada have suffered most. The U.S., which trades less than most nations, saw its stock market perform better as did Japan. So, everyone loses but the U.S. less so.



	2018 YTD Total Return	
Country	Local Terms	USD Terms
USA	2.8%	2.8%
Japan	-1.0%	1.3%
Australia	4.8%	-0.7%
France	2.0%	-1.1%
UK	0.2%	-2.0%
Italy	0.1%	-2.9%
Canada	1.8%	-4.2%
Germany	-5.3%	-8.2%
Korea	-6.6%	-10.5%

Source: CIBC. Market figures taken as of June 27, 2018

What's next?

Escalation is a necessary part of Trump's strategy, but it entails risks.

Companies might prefer to wait before investing in the U.S. or elsewhere until there is more clarity on how the situation evolves. That could undermine general market confidence and increase costs on companies that delay investment.

The European tariffs on Harley Davidson are forcing the closure of some U.S. production. There will likely be more closures in the U.S. and other parts of the world. For now, this remains very small and should not be exaggerated.

China is likely to want to find a negotiated solution with the U.S., but it also has a long-term domestic and global agenda that suggests they will not easily acquiesce to U.S. demands. This is already affecting emerging markets negatively.

Global markets have weakened more than those in the U.S. as noted above, but the impact of U.S markets could rise with further global deterioration and fears over the escalation.

Politics in the U.S. are already toxic, but Trump's tariffs are popular with his base and Republicans in general. Democrats, meanwhile, are moving left but are also increasingly favourable to more protectionist measures. How much of Trump's trade war remains part of a lasting legacy with more protectionist politics remains to be seen. We would argue that protectionist politics are set to continue beyond Trump with negative long-term implications for markets.

The Trump put?

Trump reacts to force both politically and economically. He maintains positions but will reverse them relatively easily when he sees they will hurt him politically. A case in point is the recent controversy around the separation of migrant families that saw over 2,000 children separated from their parents. The pressure and negativity associated with the policy were beginning to affect Trump politically which caused him to relinquish his position. Would the same happen if the market dove 10% on the back of trade tensions? Arguably yes because **Trump has tied his economic success with the stock market**.

What concerns us?

Longer-term, the cost of doing business generally is going to rise. This will have to be absorbed with companies accepting lower margins or consumers paying higher prices.

We are in the late innings of the economic cycle but in the middle innings of the inflationary cycle. Adding costs with tariffs at a time of full employment could accelerate the inflationary cycle and bring forward interest rate hikes in the U.S.

Confidence in the global order continues to deteriorate on the back of Trump's policies that seek to undermine well-established U.S. institutions. Even NATO appears threatened under Trump.

Rising rates and quantitative tightening in the U.S. are reducing liquidity in segments of the financial markets – developments that need to be monitored.

The U.S. economy remains strong but Europe and emerging markets have slowed even if they remain at decent levels.

Conclusion

Assuming that trade deals can be made – hopefully in the next few months – despite their economic flaws, the world can return to some normality on trade and move on, likely with a lower U.S. dollar and a rebound in emerging markets.

The resilience of the global economy currently allows the markets to absorb many of these negatives, but the longer they continue and escalate the more confidence is eroded, threatening that resilience.

Volatility is likely to rise as trade disputes escalate and linger, causing market disruptions and possibly some backing off from either the U.S. Federal Reserve and/or Trump watering down his demands.

Our positioning remains neutral with a bias towards late-cycle sectors in equities, but we will be in a position to move rapidly as events unfold over the next several months.

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