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Amundi Pioneer
ASSET MANAGEMENT

COMPASS Market Insights

A Monthly View from the US

June 2019

Summary:

- **The trade war is taking a toll on the outlook for economic growth, market volatility and inflation.**
- **The recent tariff hike from 10% to 25% on $250 billion in Chinese goods could reduce US GDP growth by 0.2 – 2.3% percentage points (pp) over the course of 12 months.**
- **Many economists estimate that the tariffs on $250 billion in Chinese goods has already boosted Personal Consumption Expenditure Core Index (PCE Core) between 0.05-0.1%, and expect tariffs to fuel another accretion of around 0.2% during the second half of 2019.**

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President Trump began gradually implementing a protectionist trade policy shortly after taking office in 2017, but has sharply accelerated his populist "America First" trade policy in 2019. He renegotiated NAFTA and imposed tariffs on an increasing number of Chinese goods, including dishwashers, solar panels, steel, aluminum, and a succession of other goods totaling $200 million. His protectionist agenda is taking a toll on the outlook for global growth, and adding to volatility in global financial markets. In this month's Compass, we look at the impact of tariffs on the US-China bilateral trade balance, GDP and finally inflation.

Has the Trade War Reduced the US-China Bilateral Trade Deficit?

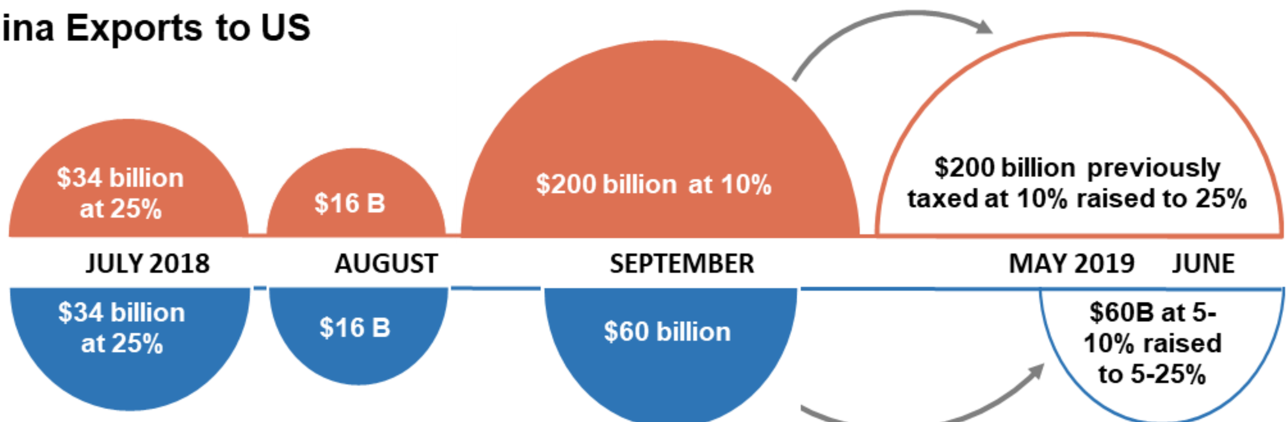
There has been a noticeable decline in the overall trade balance and the bilateral trade deficit with China. We estimate based on data from Bloomberg, the US trade deficit has declined from 3.20% of GDP in Q4 2018 to 2.85% in Q1 2019 since the US imposed tariffs on $250 billion of Chinese goods since Q2 2018 (Chart 1). Our top down analysis is supported by a recent academic study by Amiti, Redding and Weinstein[1] that estimated the US trade deficit has declined by 0.30% due to the tariffs – that was close to our estimate of 0.35%.

([1]"The Impact of the 2018 Trade War on U.S. Prices and Welfare". March 2019)

The trade deficit with China shrank significantly from -2.25% of GDP in Q4 2018 to -1.50% of GDP in Q1 2019 according to Bloomberg data. Initially, the bilateral trade deficit with China rose sharply from $334.8 billion in June 2018 when the first round of tariffs were implemented to $431 billion by October 2018. This was caused by an immediate collapse in US agricultural exports, primarily soybeans, which fell 66.7% year-over-year in April per Bloomberg data.

After the US enacted a 10% tariff on $200 billion of Chinese goods on September 24, 2018, the bilateral trade deficit shrank dramatically, from $431 billion in October 2018 to $207.5 billion in March 2019, according to Bloomberg data. Chinese exports to the US were hit in the machinery and transportation sectors, where goods declined 8% and 46.6%, respectively, between October 2018 and March 2019. On the

Stages of Tariffs



Sources: Peterson Institute for International Economics; news reports. Data as of 5/14/19.

other hand, the large electronics sector has so far not been affected by the tariffs and exports rose 11.4% year-over-year in March. Technology remains highly vulnerable in the final phase of US tariffs.

How might the trade deficit be affected?

Going forward, there might not be a significant turnaround in the large US trade deficit. A United Nations Conference on Trade and Development (UNCTAD) 2019 report estimates that of the $250 billion in Chinese exports effected by 25% US tariffs imposed on May 10, 2019, 82% will be captured by firms in third countries, 12% will be maintained by Chinese companies and 6% maintained by US firms. On the other side, of the $85 billion in US exports subject to Chinese tariffs, 85% will be captured by third countries, 10% will be maintained by US firms and Chinese companies will capture 5%.

The findings from the UNCTAD are in fact materializing. In line with the basic tenet of microeconomics, import substitution is having a big impact. Some analysis show that the US Trade Representative's implementation of the first tariff on $50 billion of Chinese goods resulted in US and China import substitution in 52% of the 1,981 tariffed products. Significantly, US tariffs on China led to US import substitution in mostly electronic products. This indicates there could be even more import substitution if tariffs are enacted for the final $267 billion in Chinese goods, where consumer goods make up 40% of the remaining goods. This should translate to lower demand for Chinese goods, but import substitution ensures the broader US trade deficit may not narrow as much.

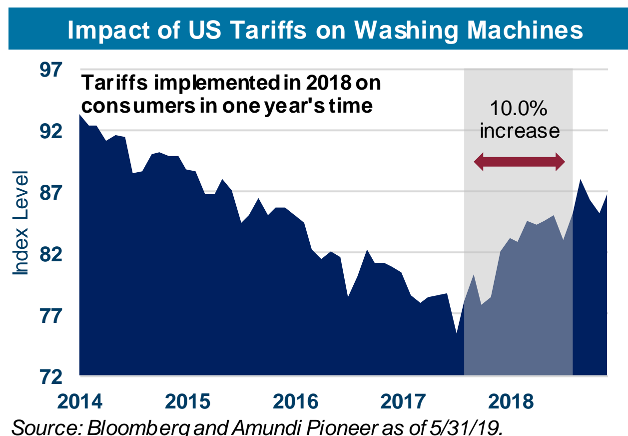
Impact of Tariffs on CPI and Output

We expect the impact from the tariffs on Chinese products will have a negative effect on inflation. We form our view based on a recent Becker Friedman Institute case study on the Trump administration's tariff hike on washing machines. On January 2018, the US implemented a 10% hike on washing machines made in China. According to the study, this tariff led to an equivalent 10% rise in the US Consumer Price Index of all major appliances (Chart 2). The report also found that firms shifted production following each new trade policy, from Mexico/Korea to China, then to Thailand/Vietnam, and finally to the US- to avoid paying import tariffs. This appears to be what is occurring at the present. The paper concludes that there is an economically small increase in the probability that a foreign firm will establish US production in response to anti-dumping rulings. Interestingly, their findings illustrate the relocation of production to third markets as export platforms in response to bilateral tariff changes. This makes it likely that the hike in tariffs will lead to inflation and remains uncertain whether production shifts to the US.

GDP Impact

The impact of the US-China trade war on the US economy is not so obvious. While the boost from net exports of +1.0pp added nicely to Q1 GDP, the weakness in personal consumption might have offset some of the rise in net trade. In Q1 2019, the contribution of personal consumption to GDP fell to 0.9pp, well below its long-term average of 1.4pp from 2004 to 2018, according to Amundi Pioneer data. The recent tariff hike from 10% to 25% on $250 billion in Chinese goods could reduce USG GDP growth by 0.2pp over the course of 12 months, based on our analysis of sell-side bank forecasts. If tariffs are implemented for the last part of Chinese exports, US GDP could detract by as much as 0.9pp over the next 12 months, according to an IMF report published in 2018. Under the worst-case scenario and all else being equal, if the US imports no Chinese goods, the hit to US GDP would be significant, with the economy falling 3% of GDP. Of course, there are substitution effects that would likely prevent the worst-case scenario from materializing; nonetheless, the impact could be significant.

Impact of US Tariffs on Washing Machines



Source: Bloomberg and Amundi Pioneer as of 5/31/19.

Inflation Impact

Many economists estimate that the tariffs on $250 billion in Chinese goods has already boosted Personal Consumption Expenditure Core Index (PCE Core) between 0.05-0.1%, and expect tariffs to fuel another accretion of around 0.2% during the second half of 2019. The Fed's preferred measure of inflation, PCE Core, has been on a downward trend since the beginning of the year. Had it not been for the tariffs, core inflation would have fallen below 1.5% in Q1 2019 -- a level mentioned by some members of the Fed that could trigger a rate cut (Chart 3). We anticipate that the hike in tariffs should help eventually push PCE Core to the Fed's target of 2% by Q1 2020.

We have long feared that if tariffs are hiked for the final $267 billion in Chinese exports, then it will have consequences that are more inflationary. This is because 40% of the goods are consumer oriented, such as clothing, shoes, toys, handsets, electronics, etc. We estimate that imposing 25% tariffs on this last part of Chinese goods would add 0.5% on PCE Core within one year to as much as 0.8% rise.

This is likely to send core inflation above the Fed's 2% target, and potentially as high as the 2.25-2.50% range, which would present the Fed with a quandary to monetary policy. Slowing US economic activity will present the Fed with an opportunity to cut rates. However, an overshoot in inflation could complicate matters.

Investment Implications

The escalation in the US-China trade war has led to a rise in financial market volatility. The VIX Index, which is an options

index that represents the market's expectation of 30-day forward-looking volatility in the S&P 500, has risen from an average of 13.7 in March and April to spike to 16.6 in May, while the Merrill MOVE Index, which measures investor expectations of volatility in the Treasury market, has risen from 49.2 to 54.8 during the same period. The rise in equity and fixed income volatility is an indication of the nervousness among investors. In the event of negative news, this could transcend to periodic sharp sell-offs in risky assets. It may be a fool's game to predict when the trade war might end, if at all. There are many variables that could play a role whether there is an eventual settlement or not. It appears both sides are digging in for a protracted dispute, and investors should as well. Uncertainty over the trade war will continue to affect sentiment surveys and could delay a global growth recovery.

Market Insights

Fixed Income

In our view, the recent decline in US yields has gone too far. Futures market pricing as of May 31 implied nearly 70 percent probability of a cut in the Fed Funds rates by year-end, which implies market expectations of a near-term recession. We do not expect a recession and continue to expect above trend GDP growth of 2.2% (down from 2.9% in 2018) as growth slows toward the potential growth rate of roughly 2% in 2019.

A breakdown of the US-China trade talks remains the biggest near-term risk, while in the largest medium term risk is a recovery in economic growth and a pickup in inflation that brings the Federal Reserve off the sidelines. We continue to prefer non-agency securitized sectors relative to corporate credit. We believe these assets potentially offer attractive valuations relative to their risk.

Developed market sovereigns outside the U.S. continue to look unattractive, with negative real yields. Emerging markets may offer select opportunities in expectation the Dollar's strength may moderate going forward. In addition, certain emerging markets continue to benefit from more solid domestic growth. In particular, we believe that select emerging market currencies may offer value, given that the Dollar may have peaked in this cycle. Overall, we expect more carry-like returns not spread tightening.

Equities

We are concerned that equity prices may decline further if the trade issues with China and Europe are not resolved. A continuation or escalation of trade issues will likely cause economic growth to slow and corporate earnings to decline. Though the Fed could respond with an interest rate cut, we believe that is unlikely this year if inflation is close to the Fed's target rate. With unemployment at record lows, net profit margins at record highs, and stock valuations that are at historical averages, we believe there is more that can go wrong at this point in the economic and market cycle than can positively surprise on the upside. The biggest potential catalyst for stocks is a resolution of the trade dispute with China. While this is a possibility, we remain cautious given that both the Trump Administration and President Xi Jinping appear to be firmly entrenched in their positions related to trade.

In an environment where the risks to economic growth and the equity markets are elevated, we believe investors can potentially be defensively positioned by investing in attractively valued high-quality stocks that have strong underlying business models, lower than average debt levels, and secular (versus cyclical) growth opportunities.

Important Information

Past performance is no guarantee of future results.

Diversification does not guarantee a profit or protect against a loss.

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