thenavigator

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10% TARIFFS ON USD200BN OF CHINESE GOODS RISING TO 25% BY YEAR-END.

Ready to go with tariffs on another USD267bn of Chinese goods in preparation for January 2019. [1]

Not so obvious

Chinese equity markets are down significantly year-to-date whilst US major indices are up. Trade war won? Hang on a minute, maybe some deeper thinking is required?

Made in America?

Source: REUTERS GRAPHICS; Diagram of the Boeing 787 with details parts and where they are manufactured.

As you can see from a Dreamliner construction, global trade is a lot more complex than many are making out, as are the subtleties in thinking in different countries. The recent escalation in the tariff war with China coincides with a period of time when the nation was preparing a nationalistic commemoration of resistance to foreign humiliation. [2]

In 1820, China`s economy was the largest economy in the world (according to British economist Angus Maddison), but within a decade of the second opium war, China`s share of global GDP fell by about half. [3]

It began in the early 19th century, when the European vogue for Chinese tea and manufactured goods left the Qing Empire with a substantial trade surplus. The British East India Company sought to redress this imbalance by paying for Chinese imports with the opium it grew in India. That stopped the drain on its silver reserves but fuelled a growing addiction crisis in China.[4] It is estimated that between 4-12 million addicts were created as a result of the Opium Wars, which eventually led to the handover of Hong Kong to the British and began what the Chinese view as their Century of Humiliation (1839-1949).

Even some Americans entered the trade by bringing opium from Turkey into China. Some of the American opium traders included the great-grandfather of US President, Franklin D. Roosevelt, and ancestors of US Secretary of State, John Forbes Kerry. [5]

You can perhaps now understand why an imminent capitulation by the Chinese for a trade deal seems unlikely, and why we should prepare ourselves for a long drawn out fight with the escalation likely to continue as Chinese and US nationalistic pride collide.

These issues with China – intellectual property, opening up the economy- are more severe than those of recently negotiated deals with South Korea, Mexico, and Canada, given the current Chinese nationalistic sentiment, overall size of the Chinese economy and its significantly higher importance for the US economy in terms of trade.

Tailwinds could turn into headwinds with the chance of turbulence

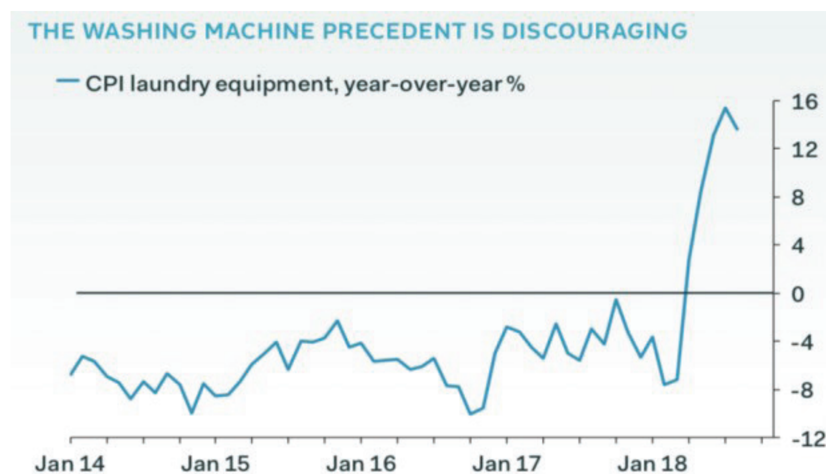
Having just returned from a business trip to the US, I can say that as an outsider the animal spirits seemed to have been rekindled as reflected in the economic performance (recent US GDP print over 4%) [6] and consumer sentiment, mainly due to the tax cuts and deregulation which should be applauded.

BUT

There are some concerns. The recent rate hike by the FOMC (Federal Open Market Committee) with one more telegraphed by year [7] end and another three predicted for next year could result in the FED tightening into a slowdown of the US economy; therefore, the risks of a policy error have increased substantially.

Whilst there is little evidence that tariffs have had an impact on the US economy, there is somewhat of a delay in them filtering through to the real economy. Looking at the recent sharp increase in trade deficits the US has with other countries, one could conclude that many companies have pre-purchased goods before the enactment of tariffs. However, this raises the question of what happens to the future demand, and are we setting ourselves up for weak PMI`s in the future?

Preview of things to come?



Source: Pantheon Economics, Chart showing the consumer price inflation for washing machines, since the US 20% tariffs on washing machines went into effect in January 2018.

Tariffs, indirectly, are essentially a tax on the consumer, and as they start to bite, are likely to lead to price inflation, as is the recent increase in the price of oil, again perhaps causing the FED to tighten monetary policy at a faster pace. The FED has also found itself in an increasingly uncomfortable position having been attacked by the President for raising interest rates.[8] So perhaps, at the back of their minds, there is a worry that if they pause it could be read as acquiescence.

The tariffs already imposed plus the ones threatened being implemented at a 10% rate would cost USD households an average of USD400 per year [9] (assuming the rate doesn`t ramp up). These combined with the rising cost of oil and higher interest rates, could have an impact of squeezing US consumers purchasing power (discretionary income) given the relatively modest wage growth we have seen.

With an unemployment rate of 3.90% [10] (pretty much full employment), who is going to be left to do the jobs brought back to the country?

Whilst US corporate profit growth has been excellent this year, [11] earnings expectations for 2019 have still to come down, and earnings comparisons are going to become more difficult. Simple maths!

All of these combined factors contribute to what we believe is an invisible wall of worry which could materialise over the next nine months.

“Abandon hope all ye who enter here “- Dante

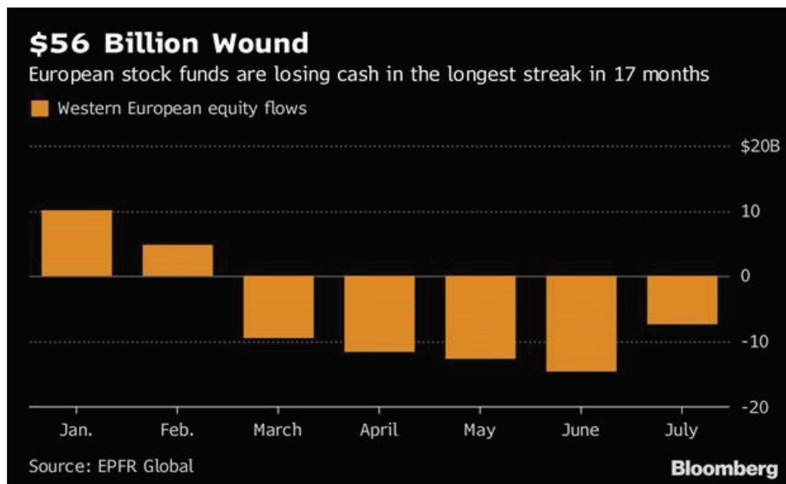
Is the supposed inscription at the entrance to Hell, but he might as well have been talking about European equity markets!

Looking at the outperformance of the US equity market (S&P 500) versus European equities (Euro Stoxx 50), the gap has never been wider and now appears to be at unsustainable levels. It feels imminent that something is going to change soon and the broad negativity towards European stocks in favour of the US suggests we are close to an inflection point. The chart resembles the jaws of a crocodile

Source: HiddenLevers.com; Monthly stock price indices and returns of S&P 500 and Euro Stoxx 50 from 1980-2018.

The 56 billion outflow this year from European stocks (highest level since the peak of Eurozone crisis in 2011) only reinforces the point.[12]

There is strong evidence to point to the European economic revival being self-sustaining. Whilst unemployment has declined from a peak of just over 12%, with a current unemployment rate of 8.27%,[13] there is still an excess capacity of cheap labour ready to enter the market as the recovery broadens.



Source: Bloomberg L.P; Western European equity flows between January-July 2018.

Although the recent headlines on Italy have only served to deter investors with Italian 10-year government bond yields spiking to 3,4%, [14] this is still a long way from the 7% yields reached in 2011.[15] Whilst we believe that what happens in Italy stays in Italy, there may be a chance of a contagion of the good kind. We expect Italian bond yields to decline from the current levels and expect the compromise to be reached. If the fiscal stimulus that Italy is proposing in its next budget,[16] works to stimulate growth and eventually bring the deficit under control, we may expect other Eurozone countries to try the same experiment. After two decades of almost zero growth of the Italian economy, it might be time to try something different.

With European equities trading at half the book value of their US counterparts and profit growth pretty much level pegging for both regions, in 2019 there seems to be more chance for a positive surprise compared to their US brethren. The stronger euro in the first half of the year, which provided a headwind, could very well turn into a tailwind (assuming that euro indeed weakens). Whilst the US and China are duking it out, Europe is happy to do business with both sides.

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