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Trump's trade war and the global economy

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One politician is dominating the financial markets this year like no other: US President Trump – and his trade war with major exporting nations. In order to deliver on his electoral promise to "make America great again" and improve the chances of the Republican Party emerging victorious from the midterm congressional elections on November 6, Donald Trump has gone the extra mile – but he is also risking a great deal. Above all, his decision to increase the volume of goods with punitive tariffs imposed on China by a factor of five is responsible for the difference between the performance of US equities (upwards) and that of the emerging markets (downwards), as well as the disappointing performance of European equities. With these initiatives, Trump has extended the economic growth difference advantage enjoyed by the US. However, with escalating the trade conflict he is courting the risk of the global economy taking a hit in 2019. This could be to the detriment of US interests, too.

Anyone making a regional comparison of equity performance in 2018 should initially be surprised by the huge discrepancy between the strong performance of the US stock market and those of other regions. Despite the more attractive valuation of Eurozone and emerging market equities, US stocks have further consolidated their performance advantage. But then consider (chronologically) the escalation of the trade war initiated earlier this year by Donald Trump, and it all becomes much clearer. In particular, the announcement in the early summer of the five-fold increase in the volume of punitive tariffs (from USD 50 bn to USD 250 bn) was a key driver of the decline in the value of emerging market equities (particularly those of China), as well as causing European stocks to underperform their US counterparts.

Trump's policy of "making America great again" has thus far stimulated US equities, first and foremost through the twin tax cuts pushed through Congress: on the one hand for US households, thereby significantly accelerating domestic consumer spending (which accounts for 70% of US GDP), and on the other hand through massive tax cuts for companies, which have triggered a rise in US corporate earnings. As a result, US equities have exhibited the best earnings growth of any global region in 2018, and the economic growth of the US has once again raced ahead of other countries. "Make America great again" is actually working – so far.

But in his desire to rein in China's ambitions in the area of technology leadership (as expressed in the "Made in China 2025" agenda) and thereby consolidate America's technological and geopolitical pre-eminence, Trump is taking serious risks. Not least because he is making many enemies. The intensification of the trade conflict with China, as evidenced by the increase in the volume of goods subject to tariffs, is likely to have a number of different repercussions for the US, China and the global economy– depending on whether it remains a 10% punitive tariff on the additional CHF 200 bn of goods or rises to 25% on 1 January 2019.

> "Depending on possible further escalation, the trade war poses risks to global economic growth in 2019 of around -0.5 to -1.5%."
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> Gérard Piasko, Chief Investment Officer

But if Trump were to make good his threat to slap tariffs on the so far excluded half of all Chinese exports to the US, this further ratcheting-up of the trade war would have a much more negative impact: it would mean an extension of tariffs to technology and consumer products such as smartphones and tablets, and a potentially greater impact on inflation and economic growth.

For American, Asian and European companies, a further escalation – which could disrupt globally interlinked supply chains, particularly in electronic and technology products – would be very problematic, and the consequence could be much greater headwinds for the global economy. Why? Because finding a replacement for production or intermediate production from China would take a considerable amount of time and therefore prove costly. Take the iPhone, for example: the touchscreens and memory chips actually come from Japan, Korea, Taiwan and in some cases Europe before then being assembled in China.

Another crucial factor for the development of the global economy in 2019 will be the degree to which consumer and corporate sentiment (and therefore consumer spending and corporate investment activity) is affected. We believe that the repercussions via supply chains and greater uncertainty could be more important than the direct trade effects.

How might China respond to an escalation of the trade war? Up until now, US imports with a value of USD 110 bn have been subjected to fairly low punitive tariffs which could be increased. However, as China only imports goods from the US to the extent of some USD 135 bn, it may resort to alternative measures. Boycotts of US products or sales of US government bonds are both possible scenarios, although the latter could also have the effect of damaging China itself. With holdings of some USD 1.2 trn, China is by far the world's largest owner of US government bonds – a consequence of its reinvestment of US dollars earned through exports to the US. Another possible course of action China might consider in the event of any escalation is to devalue its own currency. But this too would not be without risk, as the result could be capital outflows triggered by the Chinese themselves (like the outflows of 2015/2016, which had to be contained through capital controls). China has already initiated the process of stimulating the economy through interest rate cuts, which could be accelerated and supplemented through a combination of infrastructure expenditure and tax breaks.

In summary, it may be said that a further intensification of the trade war by the US President could also increase the volatility of Western all financial markets, as the clouds of uncertainty would then loom over the global economy in 2019. However, it is still possible that Donald Trump may agree on a compromise after the midterm elections, as long as the Chinese president makes concessions himself regarding the still forced transfer of US technology to Chinese companies, which has been pursued vigorously up to now.

Gérard Piasko

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