Perspectives, July 2018:

There's a New Tariff in Town

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Recently, trade actions have accelerated as the US expanded its focus beyond steel and aluminum, targeting a broader array of goods on multiple fronts. For their part, the involved counterparties have proven unyielding, fueling further uncertainty. How did we get here?

In the months leading into July, rhetoric with China increased as the US moved closer to adopting tariffs spanning $50B of Chinese goods and China vowed retaliation. At the same time, trade representatives from the three NAFTA nations took turns voicing optimism that a deal was just around the corner despite several sticking points. Despite a frantic pace of discussions, cutoffs came and went for the new deal to be approved ahead of the Mexican presidential elections and under the sitting US Congress ahead of midterms. Ultimately, discussions were tabled pending the results of Mexico's presidential race, in which polls indicated leftist Andres Manuel Lopez Obrador (AMLO) was leading by a large margin.

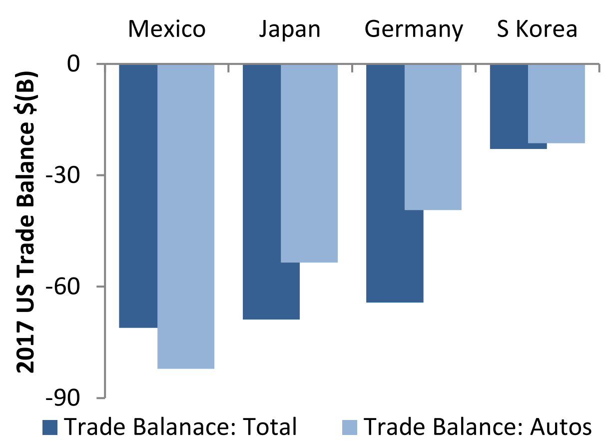
NAFTA Know How

On July 1st, AMLO won the Mexican presidential elections by a landslide with his party gaining a majority in Congress. As a leftist, AMLO ran as an outsider on a populist campaign viewed as problematic for negotiations given his nationalist roots and prior strong positions against NAFTA. Yet his campaign has shown willingness to support the outgoing administration's stance on negotiations. Focal points in the negotiations with Mexico have primarily centered on lifting minimum content requirements and auto worker wages within the Mexican auto industry and establishing a sunset clause forcing periodic NAFTA renegotiations. Mexico has insisted the higher wage and content requirements would lose business overseas while a sunset provision would create added uncertainty. However, the AMLO administration may prove more receptive to the issue of higher auto wages. With the election now settled, negotiations are set to resume with AMLO's transition team which has indicated a willingness to seek an agreement before he assumes office on December 1st.

Hitting the Brakes on Auto Imports

Amidst negotiations, the administration initiated an investigation into auto imports in May with final hearings scheduled for late July. Autos form the largest category of the trade deficit led by Mexico, Japan, Korea and Germany (Exhibit 1). While the outcome of the auto investigation is unclear, under the existing framework tariffs could be put in place as early as late summer and used as a tool in negotiations. Following the steel and aluminum tariff playbook, temporary exemptions are likely, pending the outcome of negotiations including NAFTA. The threat of tariffs and resulting benefit of tariff exemption through NAFTA may improve the economics of the wage increases for Mexico, but politically much remains unknown. Korea indicated it will seek an exemption as it had already renegotiated its KORUS trade agreement, while the EU recently reached a tentative agreement to halt escalation to allow for further trade negotiations.

Exhibit 1: Autos are the leading contributor to the US current account deficit

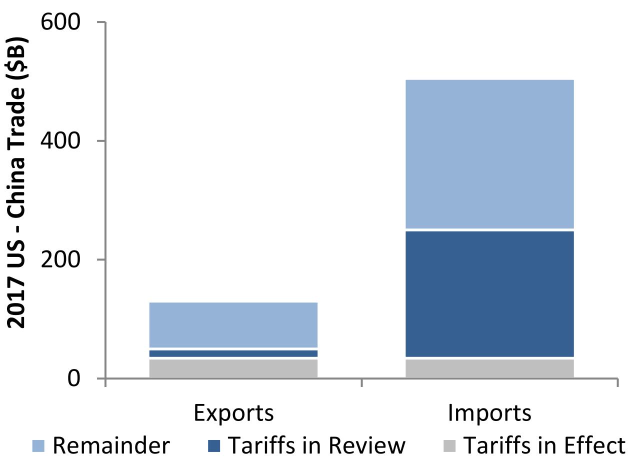


Source: US Census Bureau

Riding the Trade Escalator

The first week of July was eventful, with the US implementing tariffs on $34B of Chinese goods and another $16B expected in August. China reacted quickly, matching the tariffs on the same day. Four days later, on July 10, the administration unveiled a list of potential tariffs on $200B of Chinese goods subject to public hearings in late August with the earliest likely implementation in the fall. China has signaled it will retaliate, although the structure of their response will likely vary, limited by the lower available amount of US imports (Exhibit 2).

Exhibit 2: With relatively fewer imports to impose tariffs on, China may alter its approach



Source: US Census Bureau

Following this most recent round of activity, the list of goods under US tariffs globally has risen to $90B with a further $575B of notional imports under review, highlighting the risk of escalation inherent to trade conflicts. However, it is helpful to place these numbers within the context of the broader US economy which has remained healthy, and in which these goods account for 3.4% of US 2017 GDP.

Matters of Import

The closed nature of the US economy largely shelters it from the direct impacts of the trade dispute as it stands today, with broad-based indicators continuing to exhibit stable growth. However, the uncertainty regarding trade may have large indirect impacts if companies restrain investments in plant and equipment or consumers adopt a more cautious outlook. Given the complexity of the issue at stake, there is much greater certainty that regardless of the path taken by negotiations, trade will remain a driving factor in the investment environment for the medium term.

Rising uncertainty has complicated the outlook for investors and management teams alike amid an otherwise healthy economic backdrop. Yet selectiveness and care should continue to create opportunities for the prudent investor.

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