Perspectives, May 2018:

Trade & Tariffs

Opus Investment Management | 440 Lincoln Street, Worcester MA 01653 | opusinvestment.com

Ever since the Smoot-Hawley Act of 1930, economists have held a firm belief in the destructive power tariffs can have on an economy and global trade. This Act is widely blamed for exacerbating the Great Depression, which is why the recent trade dispute has caused so much concern. What initially began with tariffs on steel and aluminum imports by the US has expanded to include intellectual property rights and foreign investment. What drivers are behind these policy shifts and what are their potential impacts?

In early March, the US imposed steel and aluminum tariffs following a series of more limited trade actions targeting Korean washing machines, Chinese solar panels and Canadian lumber. In the weeks that followed, the US administration softened the tariffs by exempting several countries and beginning negotiations that may soften them further, but markets reacted to concerns that policy escalation may start a trade war and could inflate costs and hamper global growth.

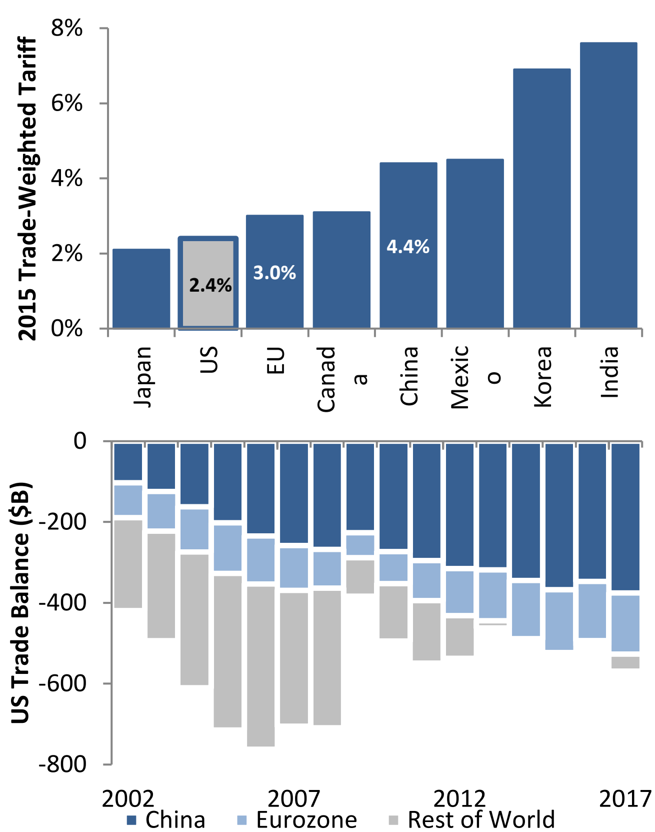
Steel production often a sore topic

Steel production has been an ongoing source of contention between the US and China with penalties levied in each of the prior two administrations. The administration granted exemptions for key trade partners including Canada, Mexico, Australia, Korea and the European Union (EU) contingent on successful completion of negotiations. Notably, the exceptions of Mexico and Canada were tied to ongoing NAFTA renegotiations aimed at reducing trade deficits while Korea accepted tweaks to the KORUS trade agreement. We believe these developments indicated steel tariffs were less of a standalone measure than an initial movement within a broader trade policy aimed squarely at China.

US focus broadens to intellectual property

Intellectual property violations by China shifted into focus weeks after the steel actions as additional tariffs were announced. The administration bolstered its case by citing low existing tariff levels and current account deficits that reached post-crisis highs this year (Exhibit 1). The Office of the US Trade Representative (USTR) found that China failed to uphold prior trade commitments, violated trade law through forced technology transfers, conducted cyber intrusion to obtain trade secrets and restricted foreign investment. In response, the USTR filed a memorandum authorizing international arbitration, 25% tariffs across approximately $50B of Chinese imports and restricted investor access to the US market.

Exhibit 1: The administration argues low tariff levels and increasing current account deficits strengthen the case for more protectionist policies



Source: US Census Bureau, WTO (Most Favored Nations-Applied Tariffs)

The US is not alone in its fight with China

The EU and Japan joined the US in pressuring China's rising protectionism through a joint statement at December's World Trade Organization (WTO) summit. More recently, Japan has petitioned to join the US' ongoing WTO trade case while the EU weighs its own case against China. In March, the EU renewed its own import tariffs (which are as high as 72%) on Chinese steel, drafted legislation restricting Chinese acquisitions of European firms and called for WTO reform amidst poor enforcement and compliance. The alliance with the EU and Japan dilutes any potentially adverse trade actions by China while increasing the likelihood that diplomacy will ultimately prevail through multi-party involvement.

China opens the door for talks

China's response thus far --- raising proportional tariffs spanning $3B and $50B of goods respectively --- has been symmetrical while advocating for negotiations. Next, the US administration raised the possibility of further tariffs covering an additional $100B of imports. The combined potential tariffs would surpass the total value of exports to China, highlighting the limits of a tit-for-tat approach while also heightening the risks of escalation.

Why is the administration going down this road?

The administration's trade policy appears aimed at narrowing the trade deficit with China by $100B, long a goal of President Trump, who personally funded full-page ads calling for tariffs and the elimination of the trade gap as far back as 1987 as a private citizen.

From a policy perspective, the strengths of the US' position arise from a lower reliance on exports, a more stable financial system and its alliance with Europe and Japan. In contrast, China will seek to leverage access to its high growth markets and its status as a large supplier of capital to the US.

The outcome on trade could impact the economy since global trade is a major component of economic activity and many US companies earn substantial profits in overseas markets. If growth slows, interest rates could fall since the Fed may not raise rates any further. However, some inflation may also ensue due to higher prices on goods no longer sourced from abroad. Spreads on corporate bonds could widen in those sectors impacted most acutely, such as auto manufacturing, or perhaps more broadly if corporate earnings decline abruptly. ***Thus far, this is not our base case and we have not altered our investment plans, but we will continue to monitor this issue carefully.***

For more information, contact:
Kevin Seabury, Director of Business Development
508-855-3112
kseabury@opusinvestment.com

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