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13 July 2018
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Macro Insight

Escalating trade tensions: time to worry?

Global trade tensions have escalated, with the US administration pushing ahead with tariffs on imports from China

Our views

Given current valuations, maintaining a pro-risk stance in our multi-asset portfolios makes sense as long as trade tensions do not result in a significant deterioration of global growth

Tensions between the US and its trading partners has contributed to poor asset class performance in 2018 so far. A recent escalation in rhetoric by US President Trump and action on tariffs have raised investor concerns over the global economic outlook. But are these fears justified and at what stage should we really be worried?

Recent developments

On 1 June, the White House ended the temporary exemption granted to the EU, Canada and Mexico on steel and aluminium tariffs (25% on steel and 10% on aluminium). All three responded in kind with countermeasures. The amount of trade affected, however, is small. For example, in the case of the EU, steel and aluminium exports account for only around 0.4% of total EU-28 goods exports. The direct economic impact is negligible.

More significantly, however, the US administration has pushed ahead with previously threatened tariffs on imports from China. The first phase, covering USD34 billion, was implemented on 6 July, with a hearing scheduled for 24 July to review tariffs on another USD16 billion. The US has also begun the process of imposing tariffs on another USD200 billion of imports from China. China is likely to fully retaliate.

The extent of these tariffs is clearly significantly larger than in the case of steel and aluminium. USD250 billion represents around half of Chinese exports to the US in 2017. There is also the potential of further escalation; Trump has threatened to widen the tariffs to cover a further USD200 billion of imports.

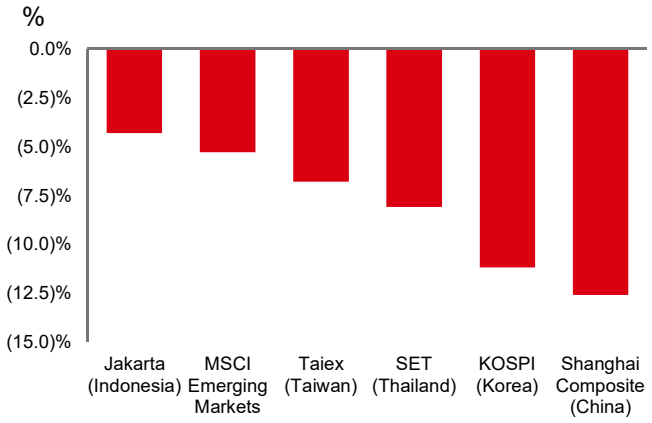
What has the market reaction been?

The escalation of trade tensions has spilled over into financial markets, with Asian asset classes recently underperforming, particularly in those economies with close links to China. For example, the Chinese yuan, Korean won, and Taiwanese dollar have all depreciated by more from mid-June to date than they had over the preceding two months. Asian equity markets have also underperformed other EM equities since mid-June. China, Korea and Thailand have seen the most notable falls in US dollar terms, with the Shanghai Composite down by over 10% (Figure 1).

HSBC

Figure 1: Asian equity market performance since mid-June

Market % change since 13 June



Source: Bloomberg. Data as at 11 July 2018

> The global economic impact of the US fully implementing its threatened tariffs is likely to be limited and manageable

Modelling the impact of US-China tariffs

Using the Oxford Economics Global Economic Model, we can estimate the global impact of the US administration pushing ahead with all threatened tariffs on Chinese imports so far (covering USD450 billion in goods), with matching retaliation. We assume that China would implement a much higher tariff rate given the lower scale of US exports to China. The results are presented in Figure 2.

Figure 2: Global impact of implementing threatened US-China tariffs

Percentage point impact on GDP growth versus no-tariffs scenario

	2018	2019	2020	2021	2022	2023
World	0.0	-0.2	0.0	0.0	-0.1	0.0
US	0.0	-0.3	-0.1	0.0	-0.1	-0.1
China	0.0	-0.2	-0.1	-0.2	0.0	-0.1
Japan	0.0	-0.1	0.0	0.2	0.1	0.0
South	0.0	-0.4	0.0	0.1	0.0	0.0
Taiwan	0.0	-0.3	-0.1	0.1	-0.1	-0.2
Eurozone	0.0	-0.1	0.1	0.0	-0.1	0.0

Source: Oxford Economics, HSBC Global Asset Management, as at 11 July 2018

Positively, this shows the GDP impact is fairly manageable at this level. The hit to GDP growth is concentrated in 2019, knocking 0.3 percentage points (pp) off US growth and 0.2 pp off Chinese growth. But it is worth noting that despite the tariffs being bilateral, other economies are likely to be hit. Japan, Taiwan and Korea should all see a reduction in growth, estimated at 0.1-0.4 pp, reflecting their role in China's supply chain.

Overall, this is a deterioration that the global economy should be able to weather, especially given that most large economies are currently growing at above-trend levels. There is also room for policy, both fiscal and monetary, to support the economy (see the People's Bank of China's action over June for example). This may explain the limited impact seen in China in the above simulation.

We are still likely at the early stages of this confrontation, and the outlook is very unclear. Positively, measures announced thus far should have a fairly minor economic impact. Trump has also softened his threat of new curbs on Chinese investment in US firms, with China having recently eased limits on foreign ownership in various sectors. This arguably signals that China is willing to make concessions that may eventually appease the US administration, even if China has failed to address more widespread complaints that it appropriates foreign technology.

A further ratcheting up of tensions?

However, a more worrying scenario would see Trump continue to implement protectionist policies, ignoring warnings and increasing evidence of their adverse economic consequences. Apart from the full 450 billion US dollars' worth of China/US tariffs being implemented, the US could push ahead with its threat to impose blanket 20% tariffs on autos and auto parts.

> The introduction of blanket auto tariffs is a more worrying prospect as more economies would be affected

This would cover around USD350 billion of US imports (15% of total US imports), a significantly larger share than for steel and aluminium. Again, most trading partners are likely to retaliate, perhaps leading the US to widen its targets to other goods.

What makes auto tariffs more worrying is that they broaden the dispute across a range of economies, rather than the current largely bilateral dispute between the US and China. This would be a politically and economically more damaging prospect.

The hit to the global economy in this scenario would come from a number of channels. Rising inflationary pressures on the back of tariffs would act as a tax on consumption. Economies would also be hit by supply-chain disruptions and, in the longer term, a loss of productivity. Falling business and consumer confidence could contribute to a tightening of financial conditions as markets reacted, whilst investment and spending decisions could be delayed.

Why the situation may not significantly deteriorate

There are arguments that imply the situation will not escalate to the point of a more economically-damaging full-blown global trade war.

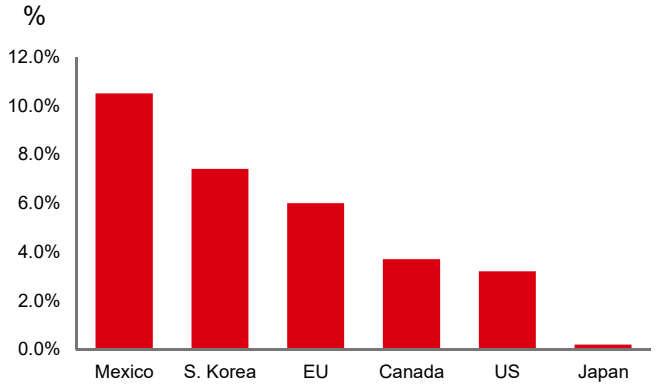
> The situation may not significantly escalate if the US economy starts to show signs of being adversely affected by recent measures

One reason the Trump administration may be pushing its protectionist agenda could be to gain political support ahead of the November midterm elections. There is a feasible scenario where the president dials back on his aggressive stance following the vote, especially if recent measures begin to show signs of adversely affecting the US economy. Although US economic performance remains robust, these signs may become more apparent as the benefits of fiscal stimulus enacted earlier this year start to wane, and the impact of Fed tightening begins to bite.

Furthermore, US businesses are more exposed to China than the trade data imply. Sales of US affiliates in China reached almost USD500 billion in 2015, significantly higher than the value of US goods exports to the country. The US administration will be wary that China might squeeze these interests as a means of retaliation.

Finally, recent media reports suggest the EU is considering talks with other major auto exporters (including S. Korea, Japan) to reduce auto import tariffs, ahead of a meeting between European Commission President Juncker and President Trump scheduled for later this month. This may help in addressing Trump's complaint that the US sector is being unfairly treated (Figure 3).

Figure 3: WTO average applied import tariffs for auto & auto parts by country



Source: WTO, data as at 11 July 2018

Investment implications

Given current valuations, we believe that maintaining a pro-risk stance in our multi asset portfolios makes sense as long as the dispute remains largely bilateral (between the US and China) and does not extend beyond tariffs on USD450 billon of US imports from China. The adverse economic impact in this scenario is likely to be manageable. There is scope for monetary and fiscal policy to offset the detrimental impacts of protectionism, although tariff-induced inflationary pressures will limit room for manoeuvre. Taking this into consideration, we think increased market volatility creates buying opportunities.

> Given current valuations, we think maintaining a pro-risk stance in our multi-asset portfolios makes sense as long as trade tensions do not result in a significant deterioration of global growth

A scenario of significantly escalating tensions and subsequent signs of deteriorating global growth would require us to reassess this stance, in the context of prevailing market moves and valuations. But we would also need to consider the investment horizon. In the longer term, there is scope for the global economy to counter an increasingly isolationist US economy with its own push for deeper integration. Indeed, the vast majority of economies – including China – remain tied to the rules-based multilateral trading system. Recent progress with the Trans-Pacific Partnership (TPP) and the Regional Comprehensive Economic Partnership (RCEP) in Asia, as well as the ongoing Belt and Road Initiative, are examples of deeper ties in a region that accounts for an ever-larger share of world GDP and trade flows.

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