

FX: The art of trade wars

After President Trump's decision to slap tariffs on aluminium and steel products last week, the focus now turns to how trading partners will retaliate. A buyers' strike on US Treasury debt could be one way



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USD: Trump's trade war a reason for foreign investors to shy away from US Treasuries

The supreme art of war is to subdue the enemy without fighting – Sun Tzu

While President Trump's imposition of tariffs on US steel and aluminium imports last week may have been the first move in what could ultimately climax into a global trade war – the focus now turns to how key affected trading partners will choose to retaliate. Indeed, investors may need to be aware that the choice of response could have varying implications for global markets in the near-term. The logical response from major trading partners directly hurt by the latest US protectionist policy move – namely the likes of the EU, Japan, Russia and China (note Canada and

Mexico's exemptions from these tariffs means that their 'war' will now take place on the NAFTA battleground) – would be to enact retaliatory levies on US exports. But given that any challenge via a formal WTO process will be complex and lengthy, trading partners may alternatively seek to adopt the Sun Tzu philosophy of 'subduing the enemy' via a more indirect form of attack.

One way could be a collective buyers' strike on US Treasury debt – and it just so happens that the next few days will see some pretty important US Treasury auctions (US\$21bn of 10-year notes on Monday and US\$13bn of 30-year notes on Tuesday). Foreign investors shying away from US Treasuries would be no new phenomenon – with recent auctions showing evidence of this already occurring.

Indeed, the US administration's desire for a weaker US dollar – which the latest tariff policies merely corroborate – presents an opportunity cost for holding USD reserves and certainly undermines the attractiveness for any foreign investor (including central bank reserve managers) to hold US Treasuries. Structural macro reasons – namely a burgeoning US 'twin deficit' – further underpins the theoretical case for the dollar to depreciate further. In a weak dollar paradigm, there are sufficient economic reasons for the largest holders of USTs (China and Japan) to diversify out of US Treasuries. The prospect of a global trade war may just well have lit a fuse under this diversification process – with major trading partners potentially rotating out of US debt holdings at a quicker pace (or at least using the threat of this as a negotiating tool). Watch the US Treasury auction space – with the USD trading soft given the Trump policy uncertainty.

EUR: Officials looking to avoid the Eurozone trade surplus elephant in the room

In a fairly quiet week for data and events, there will be some focus on the Euro Area Finance Ministers meeting today – where exchange rates and protectionism will be discussed. With the Eurozone enjoying a massive 3.5% GDP current account surplus and the EUR not particularly volatile, we suspect it will be very hard for EZ finance officials to talk down the EUR. In fact, the latest set of ECB staff projections has the EZ's current account surplus rising to 4.5% in 2020. Provoking the 'trade war general' residing in the White House may not be the best form of attack (the Tweeter-in-Chief did allude to the EZ trade surplus over the weekend – with an added treat of US tariffs on EZ auto exports).

GBP: Caught in global crossfires amid lower sensitivity to Brexit headlines

The near-term focus for the pound remains on the 22-23 March EU leaders summit – and the odds of a Brexit transition deal being struck this month. However, while newsflow over this may give the pound some short-term directional impetus, we note that Brexit headlines are having less of a long-lasting impact on the currency – with investors opting to trade the reality of the UK economy (hard data) and the facts from any Brexit progress. The Chancellor's Spring Statement should be a non-event given that no new policies will be announced, though the forecast for lower UK gilt issuance could be a positive development for GBP's structural outlook.