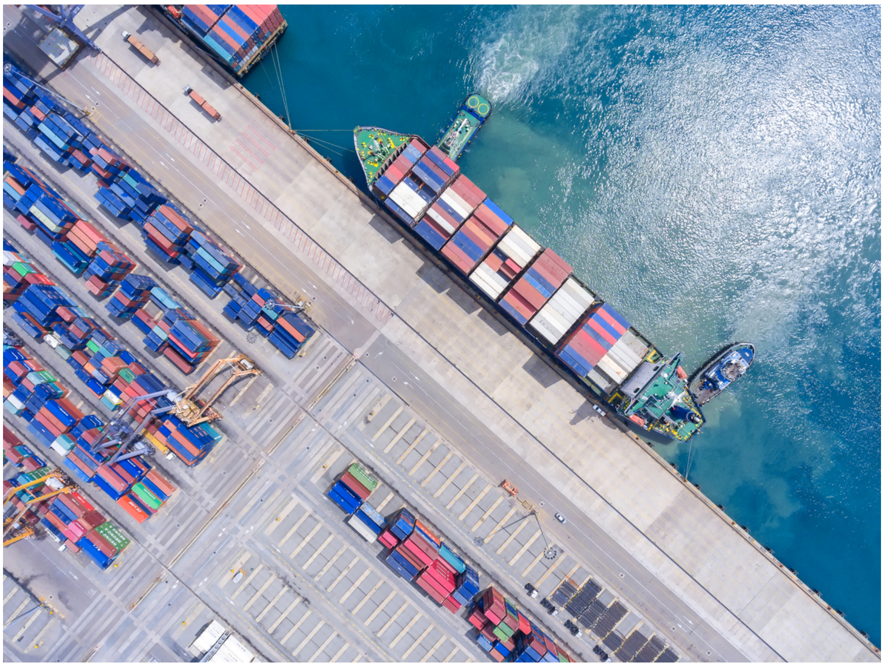
US: Trading down?

Optimism surrounding the outlook for the US economy has been tempered somewhat by the prospect of a global trade war and a tech led equity market sell-off



After success on tax, trade is President Trump's renewed focus

President Trump's renewed protectionist push started off as a relatively minor story relating to imports of solar panels and washing machines, but has escalated quickly to one that includes US tariffs on metal imports and key industrial products from China. This is a risky strategy. China has already announced retaliatory measures; if both sides follow through this could undermine business confidence and increase prices, thereby slowing the economy. It could also have broader implications for financial markets and the pace of Fed rate hikes while intensifying downward pressure on the dollar.

President Trump's initial statement that "trade wars are good, and are easy to win" was quickly followed up with "IF YOU DON'T HAVE STEEL, YOU DON'T HAVE A COUNTRY" as he sought to justify the 25% tariff on imported steel and 10% of aluminium. This presumably came as news to the 70% of the World's countries that don't actually have a steel industry but also raised broader questions over the ramifications of risking a trade war for what is now a minor industry.

Steel under pressure

These two sectors have been under pressure for decades. Just 140,000 people are employed in US steel and 161,000 in the aluminium industry[1], set against the jobs report which showed the US economy created 331,000 jobs in February alone. Moreover, there are 6.5 million US jobs in industries from cars and aircraft to beer cans that are directly impacted by the higher costs from these tariffs.

Questions regarding the efficacy of the tariffs grew more vocal after the Republican Party lost Pennsylvania's 18th Congressional District to the Democrats in a recent special election. Given Pennsylvania's long history of coal and steel, the fact Republicans saw what was a near 20% victory margin in 2016 turn to defeat does not bode well for Trump ahead of November's mid-term elections.

China remains the focus but this is also hurting US tech companies given their role in supply chains. We have subsequently seen NAFTA partners excluded, followed by Australia and European nations. South Korea, Argentina and Brazil are the latest countries to get a temporary exemption. Japan has not, but it is clear that shrinking the US' $370bn trade deficit with China is the aim.

Steel makes up less than 1% of China's exports so we have seen an additional round, targeting tariffs on US$60bn of Chinese technology, aerospace, electric vehicles and health care imports. In addition, US authorities are looking to restrict Chinese investment in sensitive industries while stopping alleged intellectual property thefts.

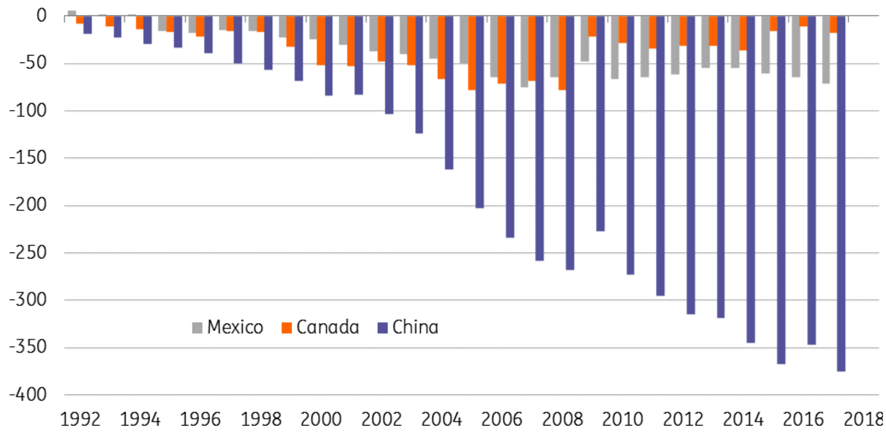
The whole story?

Chinese officials are at pains to point out that the US$370bn trade deficit figure doesn't tell the whole story. China imports many sub-components from other countries (including the US) that are then assembled and re-exported to the US. As such, they argue that the "true" deficit is closer to US$150bn. Indeed, their position in supply chains is why, in addition to Trump's criticism of Amazon and the potential for greater regulatory scrutiny, US tech stocks have been hit so hard in the latest equity market wobble.

Nonetheless, China has responded robustly to US trade aggression by imposing its own tariffs on US$50bn of US exports. The targets include soybeans and other agricultural goods, which are both a major export for the US and particularly sensitive politically given the importance of farm states in the mid-term elections this autumn.

Though this step marks a significant escalation of tensions, both sides have indicated some willingness to negotiate. Media stories about behind the scenes negotiations on technology, Chinese car imports and foreign ownership limits in Chinese companies suggest there is hope that a tit-for-tat trade war can be averted. Nonetheless, this is a politically charged environment and politicians will be wary of "losing face" at home.

US trade deficit with NAFTA & China (US$bn)



Source: Macrobond, ING

Europe's muted response

We've not heard much from Europe, but any escalation risks prohibitive tariffs on cars. We will have to wait and see if calmer heads prevail and deals can be done that satisfy everyone. Nonetheless, the potential for escalating tensions cannot be ruled out. We have to remember that Canada and Mexico's reprieve on the steel and aluminium tariffs is only temporary and could be reinstated should they fail to make sufficient concessions in the ongoing NAFTA renegotiation saga. Europe has also been told that the tariffs could come back should they not take steps to help lower the US trade deficit or fail to support the US' effort to make China adopt "fairer" trade practices.

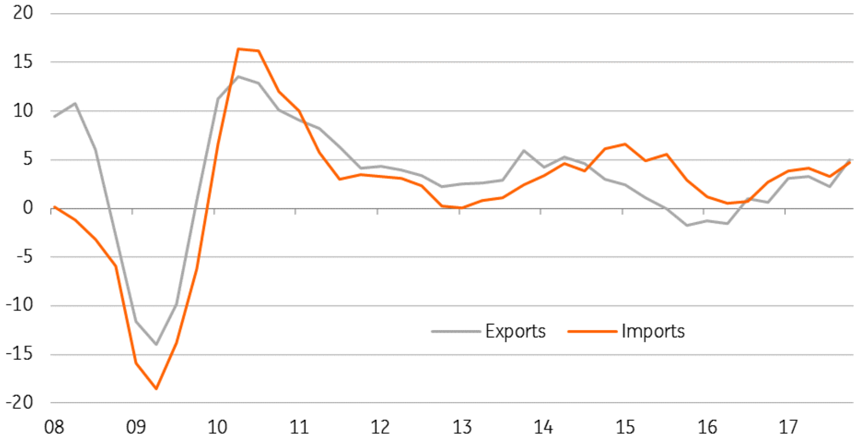
Consequently, Europe could still carry through with threatened counter tariffs on Harley Davidson motor bikes, Wisconsin cheese (House Speaker Ryan's home state) and Kentucky Bourbon (Senate Majority leader McConnell's constituency). But this would then raise the prospect of a new round of tariffs on cars. Cars account for 25% of European exports to the US and any action here would have severe ramifications.

Trade balance questions

We see little prospect of a meaningful improvement in the US trade balance. A full-blown trade war risks putting up prices for consumers while hurting business sentiment and overall economic activity, which would be a drag on asset valuations. Meanwhile, the bond market would be vulnerable to any musings from China on potentially slowing purchases of Treasuries at a time when the US fiscal deficit is heading towards US$1trillion and the Federal Reserve is shrinking its balance sheet.

Either way, we have our doubts that President Trump's protectionist initiatives to try and shrink the US' trade deficit will be very effective. A tight jobs market is putting upward pressure on pay and Trump's huge tax cuts are putting on average $900 extra per year in the pockets of US households. Given consumer confidence is at such high levels we suspect much of this extra money will end up being spent on imported consumer goods, which will inevitably keep the trade deficit elevated. Instead, the ongoing downward pressure on the US dollar (see the FX section) is likely to provide a more successful route to ensuring the deficit doesn't deteriorate significantly from here

Trade Volume growth in goods and services (YoY%)



Source: Macrobond, ING

If trade fears recede the economic outlook remains strong

Assuming back-room, face-saving deals can be agreed and trade tensions ease, the prospects for the US economy remain very good. Economic activity is strong with business surveys close to all-time high levels and the jobs market looking strong. Consequently, we are seeing more evidence of price pressures. As such it was no surprise to see the Federal Reserve hiking interest rates by 25bp in March. We continue to look for three further rate rises this year. For now, we are sticking with two hikes for next year, but if trade fears recede this will be raised to three, taking our forecast for the Fed funds target rate to 3% for end-2019.

This article is taken from our Monthly Economic Update, which you can read here.

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[1] http://abcnews.go.com/Business/key-facts-us-steel-aluminum-industries/story?id=53616380

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