Trade Tension: Market Opportunities and Challenges

With tax reform enacted, budget caps raised and regulation rolled back, the US Administration has shifted its focus to trade policy, which has turned more hawkish in 2018. That said, strong rhetoric has been diluted to relatively restrained, well-orchestrated and targeted actions thus far, and so we see limited near-term macro or market impact.

We maintain our optimistic outlook for growth, and still see more potential investment opportunities than challenges. Within fixed income, we remain constructive on emerging market (EM) currencies and see little protectionism risk beyond China. Within equities, we think potential for slower global trade favors exposure to small-to-medium cap companies over large cap.

2018 Trade Events (so far)

The White House has announced tariffs on a range of goods, from solar panels to steel (see Exhibit 1). The measures are unsurprising given US President Donald Trump campaigned on a protectionist agenda; however, the shift away from globalization creates a more nuanced and uncertain policy outlook, and introduces microeconomic costs such as loss of efficiency and productivity. On balance, we see limited near-term risk to global growth and markets as tariffs are mainly targeted toward China, with lower-than-anticipated scope and magnitude.

EXHIBIT 1: SNAPSHOT OF 2018 TRADE EVENTS

January	March		
Jan 22, 2018 (Section 201)	**March 8, 2018 (Section 232)**	**March 22, 2018 (Section 301)**	**March 23, 2018**
US introduced tariffs on solar panels and washing machines.	US announced tariffs of 25% and 10% for steel and aluminium imports, respectively, with country exemptions.	US anounced China-focused trade measures. A 25% tariff is expected to apply on approximately $50bn of imports.	China announces tariffs on $3bn of US products including pork, fruit, wine, and recycled aluminium.

Source: GSAM As of March 26, 2018. Text in parenthesis denotes relevant section of US Trade Law.

Investment Implications: More Opportunities than Challenges

In our 2018 Outlook we discussed the potential for more volatility after a benign 2017, and while the equity market correction in early February was greater and earlier than we anticipated, it was not unexpected. Looking ahead, a material escalation in trade tensions is not our base case; however, greater policy uncertainty may prompt further bouts of volatility and inject more risk premium into markets. Against a backdrop of still-healthy global growth and accommodative financial conditions, we think this presents more investment opportunities than challenges. Below we outline key investment views that are broadly associated with recent trade and volatility developments.

- **Fixed Income:**
  - **We remain constructive on high-yielding EM currencies,** particularly from countries which are recovering from commodity-induced recessions or benefiting from global growth. While we are alert to trade developments, we do not expect the US Administration's protectionist agenda to extend to early-cycle EM countries that have a small trade surplus with the US, such as Indonesia. We also see opportunities in assets from countries with an improving political picture, as is the case in South Africa. Central Eastern Europe also presents investment potential as closed output gaps are accompanied by competitive labor markets.
  - **Recent weakness in credit markets presents an opportunity to add exposure.** US corporate credit spreads have widened amid heavy supply, higher policy uncertainty, and in part due to higher funding costs, but remain close to historical tights. In investment grade credit, we think recent widening is overstated, and we see value in adding select exposure to select credits and sectors, such as US Banks and Insurance companies who stand to potentially benefit from a rising rate environment.
- **Equities:**
  - **We remain bullish on EM equities.** The earnings and valuation profile of EM companies continues to look more attractive relative to developed market (DM) counterparts. We are particularly bullish on Indian equities, supported by favorable demographic trends, significant reforms and a profitable and diverse corporate universe.
  - **In the US, we favor small-to-median cap companies over large cap.** Greater volatility and higher policy uncertainty increases dispersion in performance among sectors and companies. We think small-to-median cap companies in niche sectors will outperform if trade policy becomes more protectionist, particularly those who benefit from lower competition and greater pricing power. Furthermore, small-cap companies have less foreign exposure with 80% of revenues in the Russell 2000 small-cap index generated domestically.

Looking Ahead

The balance of risks around our optimistic growth and benign trade outlook would shift materially if the scope and magnitude of tariffs were to broaden across countries and sectors, or if we encountered greater retaliation from China and other countries impacted. In this scenario, we believe macro costs would likely include higher inflation and rates, and lower global growth. So far, developments on both fronts suggest the economic impact of President Trump's turn to protectionism may be relatively contained:

- **Lower magnitude and smaller country and sector scope of tariffs than expected.**
  - **US tariffs introduced so far exempt a specified unit of initial imports or certain countries**, and in the case of solar panels and washing machines, are temporary. The country exemption for steel and aluminum imports has expanded from Canada and Mexico initially, to a temporary reprieve for the European Union, Australia, Argentina, Brazil and South Korea.
  - **Focus is squarely on reducing competition from China.** The "Section 301" investigation concerns China's intellectual property protections and technology transfer practices, and on March 22 the US Administration announced a 25% tariff will apply on $50bn of imports from China. Sectors affected by these tariffs are not yet clear, but will likely include aerospace, information communication technology and machinery. And while there will be micro, company-level implications, the macro calculations do not raise concerns. For context, $50bn is equivalent to around 2.2% of China's exports or 0.4% of its gross domestic product (GDP), and a 25% tariff on $50bn amounts to just 0.1% of China's GDP.
  - **Restrictions on investments have not yet been implemented.** The White House has noted "restrictions on investment by China in sensitive U.S. technology" are in the pipeline, but reports that the US and China are discussing trade issues to avoid escalating tensions suggest there may be some compromise in this area.

- **Soft retaliation**
  - **China has been measured in its response so far**, though the announced tariffs on $3bn of US products on March 23 may be in response to steel and aluminum tariffs rather than the more recent Section 301-related tariffs.
  - **Other trade partners have not yet hinted at retaliatory measures.** Japan is not on the list of countries exempt from tariffs on steel and aluminum exports, but we do not anticipate near-term retaliation. Japanese goods are high value-add and therefore well-positioned given a lack of substitutable products from other countries. Any economic impact would be manageable given aluminum and steel exports only account for only around 2% of Japan's total exports. Canada and Mexico will likely continue to receive exemptions until renegotiation of the North American Free Trade Agreement (NAFTA) concludes, and as discussed earlier, within emerging markets, we do not expect US focus to extend beyond China.

Last year we noted greater protectionism would reconfigure trade relationships and plot a new distribution of winners and losers. Fast forward one year, and we are reassured that a "Trade Showdown" has not played out. The US has withdrawn from the Trans-Pacific Partnership, pressed ahead with renegotiation of NAFTA and introduced targeted tariffs, but rhetoric appears to be toning down and measures may be insufficient to steer earnings and growth momentum off track. **Global markets remain underpinned by healthy growth and accommodative financial conditions, but evolving US trade relations demonstrate that headwinds remain, and so we believe investors should continue to look beyond traditional asset classes and borders.**