

## **Trade Tensions Boil Over**

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Early last week, it appeared President Trump may have been using recent U.S. economic and market strength as a cushion to exert greater pressure on China at the tail end of their trade negotiations. It has now become apparent the Chinese do not want to lose face by caving into U.S. demands for changes to technology transfer and intellectual property protection laws.

## **Initial Market Reaction**

On May 10, the U.S. increased the tariff rate from 10% to 25% on \$200 billion of Chinese imports and has threatened to place tariffs on the approximately \$300 billion remaining products if an acceptable agreement is not reached over the coming weeks. In response, China has placed additional tariffs on \$60 billion of imported U.S. goods. This tit-for-tat impasse has taken its toll on the markets. U.S. equity markets are down roughly 4%-5% from their late April highs.

## The Potential Impact on Global Economies

While the magnitude of the economic impact is highly uncertain, a slowdown in global economic growth seems likely. This most recent round of tariffs is expected to add roughly 0.30% to the U.S. inflation rate, which is currently hovering around 2.0%. The economy could probably absorb this level of increased inflation, but it may take a bite out of consumer spending. Corporate profit margins may also be negatively impacted if businesses are unable to pass through input price increases to the ultimate consumer. Should the tariffs remain in place for a year, U.S. GDP growth rates could decline by approximately 0.5%. Our primary concern is the effect trade frictions could have on business confidence and capital spending. We believe spending on productivity-enhancing business equipment is key to the continuation of this record-long economic expansion.

Exports to the U.S. make up a meaningful percentage of China's GDP so the Chinese economy will likely slow even more. Although, the government is expected to increase its already ample fiscal and monetary stimulus to help prop up the domestic economy. In addition to tariffs, China could retaliate by reducing the value of its currency against the dollar. If the government goes down this path, it will have to tread carefully to avoid sparking a flight of capital from the country. Longer term, companies might look away from China as a source of product, slowing economic growth further and making it even more difficult for the government to offset with stimulative policies.

Growth rates and market sentiment in Europe, Japan and the emerging market economies may be more negatively impacted as these countries collectively rely more on China as a destination for their exports. Another concern is the possible extension of trade tensions and U.S. tariffs to Europe and Japan.

## **Putting Recent Events in Perspective**

Perhaps this type of difficult back and forth negotiation had to occur so the parties could combine to strike a truly transformational agreement. When China entered the World Trade Organization, at the turn of the century, the developed economies were excited to welcome a very cheap source of labor and ultimately a large potential consumer of their products and services. A "wink and a nod" was continually given to China's unorthodox trade policies as they were generally viewed as needing an uneven playing field. Twenty years later and successfully integrated into the global economy, the Chinese will likely need to change their approach if they want to become a true global leader. While the U.S. is exerting the overt pressure, the other developed economies most likely agree with this overall assessment.

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As we attempt to discern the timing and ultimate market reaction to these heightened trade tensions, it is important to remember that an autocratic regime like China is usually able to inflict more pain and economic suffering on their population because the government does not have to concern itself with re-election. With campaign season rapidly approaching here in the U.S., a more severe economic and market reaction may persuade the administration to strike a deal with China even if it means conceding on some of the terms.

All this trade jousting is occurring in a reasonably good U.S. economic environment. GDP growth has finally reached its long-term potential, and consumer and business balance sheets are generally healthy. As long as the current situation does not dissolve into a protracted global trade war, which would not benefit anyone, the equity markets should not experience more than a classic 10% correction before resuming its upward advance. Given the current uncertainty, we remain cautious as we await the release of more economic numbers, earnings reports and a possible trade resolution.

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