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- Global trade tensions are rising amid the Trump administration's imposition of steel, aluminum, and Section 301 tariffs
- Still, country exemptions suggest the administration is using trade steps as a negotiation tool rather than first strike in a trade war
- Section 301 investigation into China's use of intellectual property concluded that China engaged in unfair trade practices resulting in USD 50 to USD 60 billion in tariffs on Chinese imports
- While these tariffs are likely to be used as a leverage tool in further trade negotiations with China, they also pose a risk of retaliation
- While not our base case, a full blown trade war would pose meaningful downside for global equities, particularly emerging markets
- We maintain exposure to US Treasuries and non-USD reserve currencies to hedge against an escalation in trade tensions

Trade tariffs raise tension

In the year's first Macro Monthly we highlighted three main risks for 2018: accelerating inflation and more aggressive monetary tightening, increased protectionism, and a sharp economic slowdown in China. Last month we discussed how the first of these risks had become more of a concern, and indeed the sharp rise in US Treasury yields played a central role in the abrupt pick-up in market volatility earlier this year. This month we take up the second key risk, trade protectionism, which has also risen in importance to global investors. Specifically we examine recent developments in trade policy, potential paths for escalation or diffusion, and implications for asset allocation.

Recent developments in US trade policy

In early March President Trump announced import tariffs of 25% and 10% on steel and aluminum respectively, on the basis of national security (under Section 232 of the Trade Act of 1962). Markets were unsettled, less because of the direct economic impact (together steel and aluminum make up less than 2% of total US imports and 2% of global trade), but because of uncertainty surrounding the policy signal. Did the move imply a more protectionist lean from the Trump administration and further aggressive measures? Would trade partners retaliate?

Subsequent steps taken by the Trump administration have eased some of those concerns. The President made Canada and Mexico exempt from the tariffs, and allowed other countries to apply for exemption. Given ongoing NAFTA negotiations and a desire to negotiate other trade deals, the steel and aluminum tariffs ended up appearing more negotiation tactic than first strike in an escalating trade war. More recently, the administration also decided to exempt key US allies from the Section 232 tariffs, significantly lowering the trade impact. Importantly, President Trump's trade strategy signals his desire to remain within the World Trade Organization (WTO), which he reiterated to Congress following the tariffs. And while the use of Section 232 was an aggressive move, legal experts suggest it stays within the lines of the WTO framework. While NAFTA negotiations are ongoing, near-term risks appear to have subsided with a softer tone among participants and the growing possibility that upcoming elections (Mexico's on July 1st, US mid-terms in November) could push talks into next year.

The importance of Section 301

But markets and the global economy are not out of the woods yet when it comes to potential trade conflict. The Trump administration concluded its Section 301 (of the Trade Act of 1974) investigation into China's use of intellectual property, finding China guilty of unfair trade practices. This resulted in USD 50 - USD 60 billion in broad-based tariffs on Chinese imports that will come into effect over the coming weeks. The Section 301 investigation differs from the Section 232 tariffs in that it targets only China and there is potential to implement sanctions on a much wider range of goods and investments. The Trump administration is particularly focused on China given the

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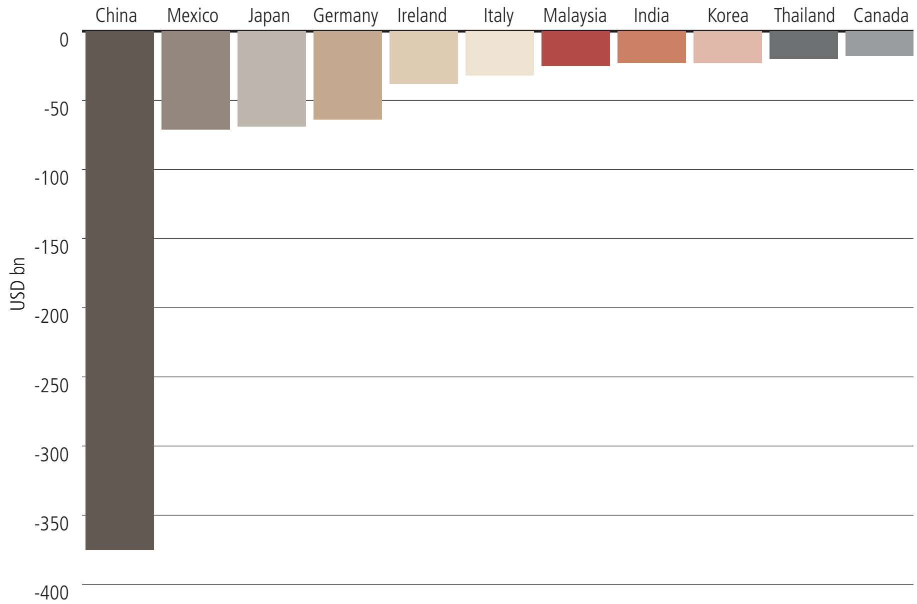
country makes up nearly 50% of the US trade deficit and is viewed as a strategic competitor (Exhibit 1). It will not go unnoticed by President Trump that the US-China trade deficit has widened since he took office (Exhibit 2).

We think there is a good chance the Trump administration uses Section 301 much the way it ended up handling the steel and aluminum tariffs, in which 'remedies' are surfaced as a means to bring China to the negotiating table. The administration has reportedly already asked China to work to reduce the US-China trade balance by USD 100 billion, and Section 301 tariffs could be used as leverage in negotiations. The Trump administration has continuously emphasized the importance of a strong economy and job growth, while pointing to the stock market as a referendum on the success of his policies. There is little doubt that a trade war would undermine these goals. In the end we think President Trump has a high incentive to be pragmatic on economic policy, even if he injects uncertainty at times.

Nevertheless, there is room for miscalculation. Chinese products represent more than 20 percent of US imports, so broad-based tariffs would boost US inflation and weigh on consumer and business spending. Moreover, such a move would be unlikely to escape retaliation and potential escalation. The Peterson Institute[1] modeled that an adverse trade scenario would stall US growth for several years and even cause an outright recession. Global trade would slow down as supply chain disruptions ripple through the global economy.

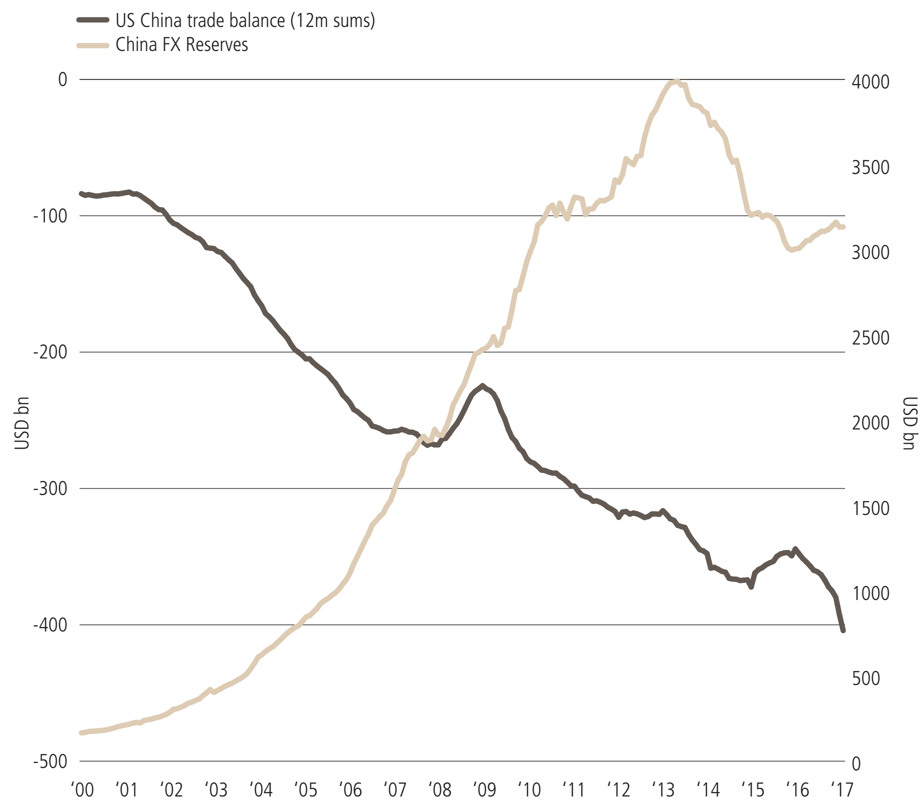
While we do not forecast such a risk scenario, we prepare for one just in case. The uncertainty caused by an all-out trade war would undermine global equities, both via reduced earnings expectations and a fall in multiples amid greater uncertainty and volatility. We would expect emerging markets, which are highly levered to global trade, to underperform. Indeed, EM equities have the

Exhibit 1: China makes up nearly half of the US trade deficit (As at Q1 2018)



Source: US Census Bureau, UBS Asset Management

Exhibit 2: US trade deficit with China has widened since Trump took office

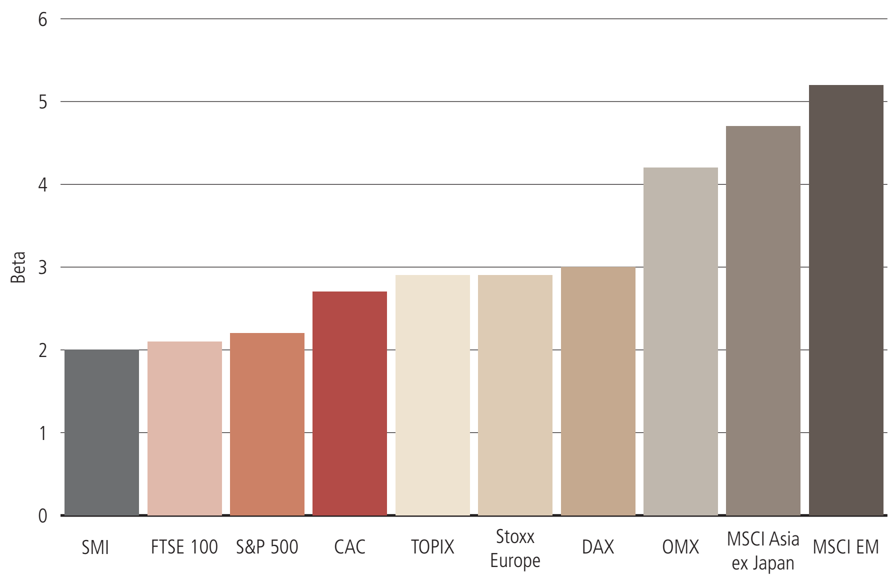


Source: Datastream, UBS Asset Management

[1] PIIE Briefing 16-6, Assessing Trade Agendas in the US Presidential Campaign. Marcus Noland, Gary Clyde Hufbauer, Sherman Robinson, and Tyler Moran, September 2016

highest sensitivity of global equity markets to world trade growth (Exhibit 3). The impact on global fixed income is less clear, as the effects of trade barriers are initially inflationary, which should put downward pressure on sovereign bonds. Still, we suspect investor uncertainty and fears of a growth slowdown triggered by a trade war would catalyze a flight to safety in US Treasuries. Finally, we would expect dollar performance to be somewhat bifurcated. The dollar could falter against reserve currencies like the euro and yen as political risk grows in the US. However, the US dollar would be likely to gain against emerging market currencies due to negative growth effects on those countries.

Exhibit 3: Equity beta to prior year world trade growth



Source: Datastream, Goldman Sachs Investment Research Q1 2018

The bottom line: Asset allocation

At this point we view incentives within the administration as sufficiently aligned to avoid a major trade confrontation. We thus remain overweight equities given the still constructive macro backdrop and gradual removal of accommodation from central banks. That said, we maintain exposure to US duration in the event of a flight to quality due to trade. In currencies we have a bias to be underweight the dollar versus reserve currencies like the JPY and EUR, which provide a hedge against disruptive developments on the trade front.

The bottom line: Chinese equities and fixed income

While the Section 301 tariffs announced by the US increase the level of uncertainty, it's worth noting that even if they are executed in full, we estimate the impact on China's GDP to be just 0.1% - 0.2%. And this figure can be mitigated by further diversification of exports to other countries. Our view is that despite the negative headlines, there are clear signs that both sides have left room for negotiation and compromise. We believe that both the US and China are fundamentally pro trade and keen to avoid a major escalation.

Within China equity portfolios some of our stocks do have a small component of revenue exposure to the US. But overall, these portfolios are predominantly exposed to the theme of China's economic rebalancing from 'old economy' manufacturing toward 'new economy' consumption and services. With a focus on the domestic economy rather than exporters we believe we are well positioned to ride out this volatility with key holdings in healthcare, consumers and internet/ecommerce.

Within China fixed income portfolios our view is that these tensions will ultimately amount to very little. There are some clear lessons from the past. In the 1980s, the US threatened Japan with wide-ranging tariffs to address deficits, open up Japanese markets, and protect US firms' intellectual property. While various special commissions investigated trade malpractices, what happened then largely boiled down to political noise. We see a similar scenario this time round. Of much greater significance is the announcement today that RMB-denominated Chinese bonds are to be phased in to the key Barclays Bloomberg Global Aggregate Index over a 20-month period starting April 2019.

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