Trade War with China Has No Winners

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Key Takeaways

- The move from initial steel and aluminum tariffs to an investigation into illegal trade practices could spur a trade war with China, the world's second largest economy.
- More U.S. companies would be hurt by a trade war than helped, with negative impacts on margins and profitability.
- The Chinese have shown a willingness to negotiate and we believe that a compromise agreement will ultimately be reached.
- We believe volatility emanating from these issues represent a buying opportunity for longer-term investors.

We have been expecting the Trump administration to put steel and aluminum tariffs in place since early last year. The initial level of rhetoric when tariffs were first announced in late February was louder than we anticipated and has only escalated since. However, the administration is now specifically targeting China, which could lead to a trade war that could have broad consequences for equity markets and the global economy.

The Chinese know they have misbehaved in the past and were likely expecting these actions. If Section 232 tariffs on steel and aluminum were the appetizer, the main course is undoubtedly the Section 301 investigation into unfair Chinese trade practices and intellectual property theft. Surprisingly, this was not on the radar screen for many investors even though it was a pivotal part of the Trump campaign. Nobody wins in a trade war as measures enacted by one country are reciprocated by the other countries affected. This can lead to the disruption of complex supply chains that have been developed over the past 30 years, hurting corporate margins and profitability.

The Section 301 investigation could have several outcomes, including additional tariffs, the U.S. blocking of Chinese investment into the U.S., restrictions on the ability of Chinese companies to do business in the U.S., the U.S. working with trading partners to isolate China, and limiting visas to Chinese citizens.

Although the U.S. imports far more from China than it exports (a negative trade balance), more U.S. companies would be hurt by a trade war than helped. Industries most negatively impacted include aircraft, autos, agriculture, semiconductors, and chemicals. Industries that would be most positively impacted include steel, aluminum, telecommunications equipment, furniture, and textiles.

The Great Depression provides a historical perspective on why trade wars are a lose-lose proposition for all involved. In 1930, Smoot-Hawley was enacted, which resulted in a 20% tariff on all imports into the country. Within two years, over 20 nations had retaliated with similar tariffs, and global trade collapsed. Importantly, we believe that a Section 301 ruling will not come anywhere close to having the effect of Smoot-Hawley. Currently, the Section 301 findings are calling for 25% tariffs on products in the specific areas of aerospace, information and

communication technology, and machinery. With a more limited scope of tariffs being discussed and policymakers having hopefully learned the lessons of the past, we believe that a compromise agreement will be reached rather than a trade war breaking out.

Section 301 has been utilized in the past, with three investigations into Japanese trade practices from 1985-1995. These targeted semiconductors, electronics, and autos. In fact, there are strong parallels between Japan's past trade relationship with the U.S. and China's today. At its peak, Japan accounted for close to 60% of the U.S. trade deficit, while China currently accounts for close to half. In our view, the objective of bringing forward these investigations is not imposing tariffs, but rather to increase leverage in negotiations with the opposing country. Most of these historical 301 investigations, including several in the 1990s and 2010 against China, led to new trade agreements rather than the establishment of tariffs.

An often-overlooked aspect of this issue is that China has shown the willingness to negotiate. During Trump's visit in 2017, China announced it would open up its financial services sector in the medium term, coupled with trade agreements worth $250 billion. This is a good barometer of the intentions of Chinese leadership even with its announced retaliation plans. This is not to say the market won't have anxiety about this tenuous relationship in the near term. The tariffs are subject to a 30-day comment period from the day of the announcement on March 22, a fluid situation as the specific product categories targeted and overall tariff levels will likely change. Alternatively, an agreement may be forged with Chinese policymakers, similar to what has happened in the past. Investors, however, do not like uncertainty and the market may see additional volatility as these events play out. Ultimately, we believe volatility emanating from these issues represent a buying opportunity for longer-term investors.

About the Author

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