09 March 2018

Heartwood Investment Management

Investment Insight

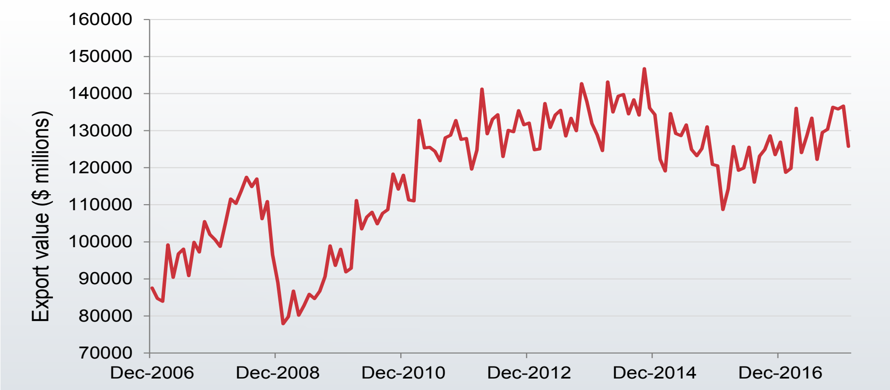
Weekly Insight

Trump's political trade wars

This week's US trade report could not have been more timely for President Trump. Amid discussions around US trade tariffs and the resignation of Trump's top economic adviser, Gary Cohn, January's US trade deficit was reported at its widest level since 2008 (at -$56.6 billion). Adding fuel to the fire, China's February trade data showed a hefty surplus with the US being maintained ($21 billion compared with $10.4 billion in February 2017).

As ever with month-to-month data points, the headlines probably exaggerate the true picture. The underlying details show that most of the US trade deficit in January was due to petroleum imports rising to a three-year high. This imbalance should be redressed in the coming months as US oil production rises. Furthermore, the decline in US exports from December to January was mainly attributed to specific factors, especially aircraft orders. On the other hand, US exports of consumer goods rose 7% month-on-month and shipments of vehicles and parts were the highest since July 2014. Indeed, US exports have been on an improving trend since the financial crisis and, given expectations for above-trend US growth this year, we expect the longer-term upward trajectory to be sustained.

Total US export data on an improving trend

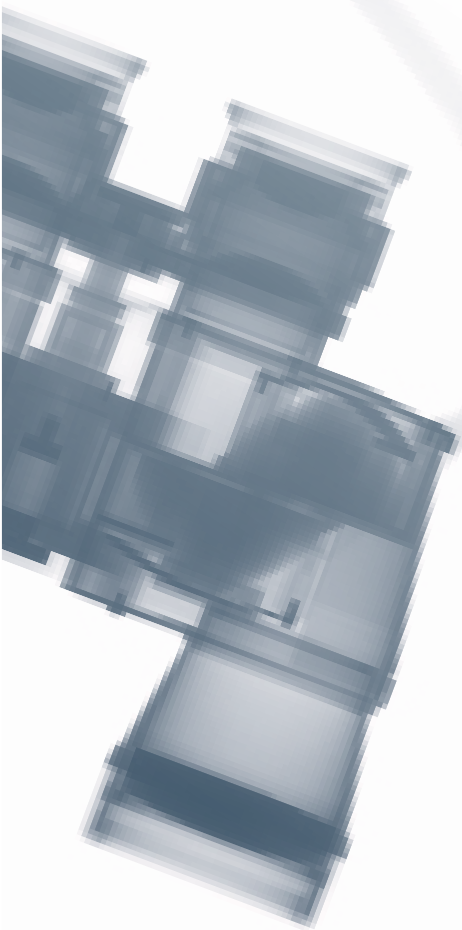


Source: Bloomberg

Past performance is not a reliable indicator of future results.

Nonetheless, for Donald Trump the politician, who was elected on the mantra of putting 'America First', there is little escape from the fact that the US economy remains the world's largest consumer of goods and services (imports totalled $2.21 trillion in 2016). President Trump has a political intent to shift that balance and, in his view, improve the external competiveness of US companies. Or at least, this is what he wants his electoral base to believe. Economic logic, though, tells us that trade wars would ultimately make American goods less competitive, resulting in higher inflation and higher interest rates, in turn hurting the US consumer. So why would Trump derail an economy that now appears to be firing on all cylinders?

While there has been a lot of media hype, the protectionist measures being proposed so far are fairly limited in scope. If Trump is truly aiming to inflict economic damage on China and protect American interests, then steel tariffs would not be the first line of attack. After all, China only exports 0.2% of its steel



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production to the US and the impact on creating American jobs is likely to be negligible, given that steel comprised just 1% of US imports in 2016. There are two other more likely explanations.

First, the threat of steel and aluminium tariffs presents a useful bargaining chip as the US currently renegotiates the North American Free Trade Agreement (NAFTA). Canada, which is the biggest steel exporter to the US, and Mexico, the third largest steel exporter to the US, are currently exempt from tariffs during these renegotiation efforts. While both countries have a temporary reprieve, the threat of tariffs may help the US Administration to apply pressure in securing terms that it deems fair.

Second, Trump has his eye on the mid-term elections in November. A key test will come in a special election on 13 March in Pennsylvania, which forms part of the rust-belt America that elected Trump to power: heavily unionised (including active steelworkers) and where retired coal miners and their spouses make-up one-quarter of the electorate. Trump won this district by a sizeable margin in the Presidential elections, but the Republicans may be on course for an upset. Steel is a potent political symbol and the announcement of tariffs provides the perception that Trump is keeping to his campaign promises of protecting American interests.

Satisfying domestic political considerations is a high stakes game. The Trump Administration's war of words risks opening the US economy to retaliatory efforts. We are not there yet, but there is a danger that the announcement of tariffs could lead to a negative turn in US and global policy setting. Trump has so far played to the tune of financial markets through his pro-growth agenda. However, markets will not react favourably if he responds too heavily to populist impulses.

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Important Information