MARKET UPDATE
Trump and Trade War Risks

27 March 2018

In recent weeks, markets have been perturbed by an increasingly uncertain environment with respect to the global trading order. The US, under the Trump administration, has unilaterally announced the imposition of trade barriers. In particular, the US has imposed tariffs on steel and aluminium imports. Trump has taken a piecemeal approach to this with unilateral exemptions and exceptions, to the rules they seek to impose. More recently, the US has also announced its intention to impose tariffs of 25% on Chinese imports and control the transfer of technology in foreign direct investments.

Direct economic impact of US tariffs relatively limited

Our view is that the direct economic impact of US tariffs is relatively limited. Combined with exemptions announced so far, the actual proportion of the US steel and aluminium imports impacted by tariffs is small. Moreover, with the recently announced tariffs on Chinese imports, there remains a significant window of time for consultation and negotiation before the imposition of trade barriers. Reports suggest that up to USD 50 billion of the US imports from China could be impacted; however, even if so, this accounts for a relatively small portion of the US and China GDP. The impact of higher tariffs on US inflation is also limited as the proportion of the US CPI accounted for by affected goods is small. Within China, the impact of tariffs depends on the ability of the US consumers and companies to substitute to similar products from other countries and the structure of supply chains for Chinese exports. Sectors such as technology hardware and personal computers have significant sales exposure to the US, but we do not expect substitution effects to be large as alternative production capacity outside of China is limited.

Most importantly, China's response has been controlled so far, with threats of higher tariffs on USD 3 billion of the US exports to China. China also appears to have already stated its willingness to open up its services sector to the US participation and promise greater protection over intellectual property rights. China's measured response will go some way towards more conciliatory negotiations with the US.

Market volatility to stay elevated over coming months

Despite the limited direct economic impact, we caution that market volatility will stay elevated over coming months. The global trading order has been arbitrated by the WTO over the past decades, and there has been, at least in principle, a belief in a multilateral rules-based system moving towards free trade and the lowering of trade barriers. However, this has now been challenged by Trump's seemingly unilateral approach to trade policy. This may lead to uncertainty in markets and generate a greater risk premium in asset values, especially for economies and sectors more exposed to trade. Therefore, the indirect impact of trade tensions is likely to be larger than its direct impact on economic outcomes. Fear of an escalation in rhetoric and retaliation will also keep markets nervous in the near term.

Our base case remains that global trade wars as characterized by mutually escalating and retaliatory trade barriers are unlikely, and that the economic impact of trade tensions will be manageable. We expect the US will use tariffs as a tool and a threat to force negotiations but that implementation is likely to be limited. Moreover, it is likely that the US and China will negotiate a mutually acceptable compromise on trade issues.

Investment strategy

On asset allocation in multi-asset and balanced mandates, we have stayed vigilant given greater volatility since the start of the year, and our overweight positions in equities have been calibrated to reflect this. Overall, we retain moderate overweight exposures to equities as global growth and earnings cycles remain supportive in the medium term. We still maintain a positive view on Asian equities as ROE cycles have turned higher.

Within Asian equities, certain sectors require close monitoring, such as consumer durables (household appliances, auto parts), industrials (machinery) and electronics (including telco equipment). However, as discussed earlier, we do not expect large economic effects from tariffs. On stock selection, we have positioned and calibrated our equities portfolios to weather trade disputes. We will closely monitor specific stocks where sales are derived from the US. Within the Asian local currency fixed income space, we have increased underweights in Korean Won as downside protection against escalating trade tensions. We expect credit portfolios to be relatively insulated as lower US Treasury yields will help cushion against spread widening.

To conclude, whilst we expect greater volatility as trade tensions would generate greater risk premia, we remain constructive on risk assets in the medium term. Our portfolios and position sizing have been calibrated accordingly, and we remain focused on disciplined stock and credit selection to add alpha during volatile market conditions.