

20 June 2018

Il Sole 24 ORE FINANZE & MERCATI

WHAT THE ANALYSTS SAY

Customs duties - how investors are getting ready for the Trump-China trade war

–by Alb.Ma.

The trade war between the United States and China is heating up with the latest shots going back and forth between Washington and Beijing. Trump is threatening to impose a 10% tax on Chinese goods for a value of \$200 billion, destined to rise to \$400 billion if Beijing retaliates. China has lost no time in announcing tariffs that could affect US goods to the tune of \$50 billion. Diplomatic circles have been well aware of this escalation for several months, with both the European Union and other longstanding partners trying to open a dialogue with “the Donald”. How have the markets reacted? So far, not well.

Wall Street was in the red for the whole of the day’s trading on Tuesday, buckling under the pressure of losses in all the main indexes (the Dow Jones lost over 300 points, S&P 500 around 0.80%, Nasdaq nearly 1%). The morning brought the first tremors, with the yuan (the Chinese currency) hitting the lowest point of the last five months, Japan’s Nikkei index dropping 1.8%. Other currencies were under pressure too, including the Australian dollar and South African rand, down 3.2% in the last two days.

Investors’ reactions: the main line is “defensive”

A more “tactical” phase now begins for investors, as the US agency Bloomberg describes it. They need to understand what to do in a situation of open conflict between trade policies erupting when the year appeared to have begun with a move towards homogeneous growth. In the words of an investment manager quoted by the US media, “we’ve gone from a cooperative game to a comparative game”. The line taken by funds and managers is mainly one of prudence. In other words, they are favouring hedge assets and anti-cyclical securities and avoiding sectors where trade disputes are likely to weigh on balance sheets. On the foreign exchange market, purchases favour the two “safe” currencies par excellence, the Swiss franc (which has gained 0.6% against the euro) and especially the yen (now up 0.7% against the dollar).

According to Shinkin Asset Management, a fund interviewed by Bloomberg, the tendency is to purchase the Japanese currency “as risk aversion”, sending the indexes into a spin.

Esther Baroudy, manager at State Street Global Advisors, tells *Sole 24 Ore* that the risk of escalation on the US-Europe-Asia axis is "indiscriminately damaging stocks". Indeed, it's putting pressure on the commodities market as well: the new climate of protectionism is slowing trade and raising commodity prices, to the detriment of the countries that depend most on exports. These include Germany, where exports account for 47% of GDP: the vulnerability of Europe's "engine" will have repercussions on the rest of the Old Continent, making investing in Eurozone countries less and less safe. Ms Baroudy points out that investors are taking shelter on "safe shores", such as the dollar and US government stock. Moreover, "tax incentives and cuts to corporate tax", adds Ms Baroudy, "could encourage some European companies to move their new investments to the US".

How will China react?

Another source of concern is China's "retaliatory measures", above and beyond the immediate response in terms of customs duties. Basically, according to the asset management company Schroders, China imports "only" €130 billion worth of goods from the US, against more than \$500 billion worth of exports.

According to Craig Botham, Emerging Markets Economist, China's "revenge" could take other forms. For example: mass sales of US Treasury Notes in order to increase yields and thus the cost of loans granted to the US government; devaluing the yuan, although the Bank of China seems unlikely to do this at the moment; sudden tightening of rules on vulnerable sectors for US production in China, jeopardising the accounts of the mega corporations producing good returns on the stock exchange. "For instance", Botham points out, "Apple generates 20% of its sales in China, Boeing and Nike 14% and 12% of their gross sales". Which of the three alternatives is the most likely? In theory, prudence should prevail, but Trump's escalation could unbalance many situations. "As the damage wrought by Trump's customs duties increases, so does the likelihood of a tough response from China", Botham explains. "A devaluation of the currency could become an option that will generate much speculation".

Italy will be penalised

This reading of the situation is similar to that of Angelo Meda, equity manager of Banor Sim. "A reduction in world trade would diminish global growth over the coming years", he explains, "resulting in lower estimates for gross sales and profits for the leading world stock market indexes". The consequences are already visible, starting with the slowing of the bond market, where yields on ten-year bonds have been at a low point since the beginning of the year in Europe and the US. "If this is the scenario for the next few years", he continues, "then the best securities are defensive ones carrying a high dividend, steering clear of financial and cyclical securities such as automotive and industrial". Indirectly, we could be the ones to bear the brunt as well. As Ms Baroudy adds, "Italy's stock market index, in which financial securities weigh heavily, could be among the worst hit".