Trade wars or strong U.S. growth?

July 30, 2018

Growth in the U.S. is strong right now. But trade disputes could affect economic growth and forecasted returns across asset classes.

When we recently updated our five-year forecasted returns, the Global Asset Allocation Team spent a lot of time assessing how trade disputes could affect economic growth and returns across asset classes. We still think the most likely scenario is for global business-friendly conditions to continue. But increased trade disputes and tariffs pose the biggest risk to our outlook right now.

The economy is still poised to grow almost 3% in 2018

At the start of the year, there was a considerable amount of optimism about synchronized global growth. The passing of the 2017 Tax Cuts and Jobs Act along with the U.S. administration’s emphasis on deregulation was expected to provide a significant boost. And in the first half of the year, growth was indeed reasonably strong. Real GDP grew 2.0% in Q1, slightly weakened by softness in consumer spending, but business investment grew at the fastest pace since 2014 — up 10.4%. This has kept the growth momentum at 2.8% year-over-year, which is the strongest pace we’ve seen in about three years.

• Economic data in Q2 pointed to an even stronger rebound. Annualized GDP growth is more than 4%. U.S. economic fundamentals across all growth sectors are solid, led by the U.S. consumer.
• A healthy labor market is adding more than 200,000 jobs per month. We believe the unemployment rate could go down to mid-3% by the end of the year.
• The consumer is benefiting from moderate wage gains of around 2.7%, lower tax burdens and still-low interest rates.
• Watch how low savings rates and rising gasoline prices impact future spending. It’s a worrisome development, but consumer confidence is high and supports near-term spending.
• Business spending has also been strong, supported by fiscal stimulus and energy sector activity, resulting in about 6% investment growth this year.¹
• Housing is facing supply-side challenges and high prices, but low rates and
consumer income growth are keeping the residential housing market a modest contributor to GDP.

- After several years of being a drag, net exports are expected to add to growth this year. Stronger global activity is helping U.S. exports, while strong domestic demand is pulling in more imports.

Growth may slow down a bit in the second half of the year, but the economy is still poised to grow almost 3% in 2018. After years of not reaching the Fed’s target, inflation is firming and core personal consumption expenditure (PCE) is expected to be around 2% this year. The members of the Federal Reserve are pleased with the current state of the economy, describing it as “strong” and expecting inflation to stabilize. The Fed is expected to continue to raise rates to a level “at or above” its estimate of a long-run neutral rate, or a rate at which monetary policy is considered neither accommodative nor too restrictive.

**Trade escalation is a risk to this optimistic outlook**

What seemed like a low-level risk to our economic outlook last year is unfolding as a potentially meaningful threat to growth. So far, the U.S. has imposed tariffs on solar panels and washing machines with largely negligible impact on overall inflation and growth. It also imposed tariffs on steel, aluminum and $34 billion worth of goods imported from China (with another $16 billion under review). Not surprisingly, China has retaliated with tariffs of similar magnitude. Key trading partners such as Canada, Mexico and the European Union have also imposed retaliatory tariffs. President Trump also announced his intent to impose 10% tariffs on another $200 billion worth of imports from China, which could go into effect later this fall.

**Timeline of trade escalation**

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
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<tbody>
<tr>
<td>January 22</td>
<td>U.S. imposes tariffs on washing machines and solar panels, 20% for the first 1.2 million imported machines, with an increase to 50% for all subsequent imports in the first year.</td>
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<td>March 1</td>
<td>U.S. imposes tariffs on steel and aluminum, 25% tariffs on steel ($29 billion) and 10% tariffs on aluminum ($17 billion) with immediate implementation for some countries but negotiations with the European Union, Mexico and Canada.</td>
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<td>June 15</td>
<td>U.S. announces $50 billion worth of tariffs</td>
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<tr>
<td>June 15</td>
<td>China announces in-kind retaliation, China announces retaliation to U.S. tariffs by imposing 25% tariffs on 545 products affecting $34 billion of U.S. exports of agricultural, automotive and products.</td>
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<td>June 19</td>
<td>U.S. announces additional $200 billion tariffs in retaliation to China, 10% tariffs on $200 billion imports from China, but requires another two to three months of compiling, commenting and drafting the list. China also announced implementing a forceful, “quantitative and qualitative” response of similar magnitude. However, China only imports $1.68 billion from the U.S. and doesn’t have another $200 billion in “goods” to restrict. It does, however, have $280 billion in business with local operations of U.S. subsidiaries.</td>
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<td>July 6</td>
<td>$50 billion worth of tariffs go into effect, with $34 billion being tarifed on 818 items. The remaining $16 billion is to be negotiated. In addition, China has prepared a second list of goods worth $16 billion to tariff.</td>
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Source: Columbia Threadneedle Investments as of July 15, 2018.

The impact of tariffs implemented so far is small, but there is potential for a noticeable impact if the additional tariffs under discussion are imposed and if trading partners continue to retaliate with similar levies.
The first order economic impact is through higher import prices (tariffs) which cascade through the supply chains and raise inflation. In the U.S., this could drive down demand, and this would lower economic growth. More importantly, higher inflation and lower growth implies degradation in the components of nominal growth — the backbone of fundamental earnings. Higher inflation could also accelerate the path of policy normalization, which could restrict growth even further. Even before the trade dispute escalation possibility, markets were worried about overheating and overshooting inflation because this could have accelerated monetary policy normalization at a pace faster than the markets could digest. And it’s now an increasingly larger risk because the Fed is likely to react to tariff-induced acceleration of inflation.

The second and subsequent order impact is harder to estimate, probably larger and comes from supply-chain disruptions, increased uncertainty, slower capital spending and global spillover effects. These broader effects are inherently difficult to estimate, and there is considerable uncertainty about exactly how and in what magnitude this would impact growth. Another source of uncertainty comes from the fact that China can only partially retaliate because there’s a limited amount of Chinese imports from the United States.

However, countries can retaliate in ways other than tariffs — by taking steps that impact U.S. business interests abroad or through Chinese monetary policy tools. These possibilities further add to private sector uncertainty, and markets are beginning to discount an escalation of trade risks scenario. We see this in the outperformance of domestic-oriented stocks in the U.S. over large company stocks that are more exposed to international earnings. Equity markets in Asia are also reflecting a slightly worse outcome than in the United States.

**Tariffs have winners and losers**

The impact will vary by industry and by state. Recent tariffs have focused on spacecraft, technology and medical devices, so U.S. producers of these goods will benefit from less competition. U.S. exports to China are concentrated in transportation equipment, computer and electronics, and agricultural products, and Chinese tariffs could hurt U.S. producers of these goods. A tit-for-tat strategy would eventually erode any benefit from protectionism and hurt economic growth globally.

**Bottom line**

Current U.S. growth trajectory is solid, but there is an increased risk that trade-related conflict could begin to have measurable economic effects. This scenario is reflected in our five-year forecasted equity returns, which are still positive but have fallen given the current climate.

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1 Source: Columbia Threadneedle Investments