COLUMBIA THREADNEEDLE INVESTMENTS

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THE RETURN OF TARIFFS

The recent breakdown in trade talks between the U.S. and China was a surprising development for financial markets, and one that has analysts sharpening their pencils and reassessing the impact of trade policy on growth and inflation. Up until May, overwhelming consensus was that talks between between the two countries would result in a trade deal with enough changes to end the tariffs. Equities were near all time highs, but the bond market was sending an ominous message with the yield curve (depending on your preferred tenor) either inverting or close to inverting.

After stalling in late May, trade talks between the U.S. and China appear back on track. China is seeking relief from a variety of U.S.-imposed tariffs, including 25% on $200 billion of Chinese imports. Discussions restarted in late June, but the tariffs remain in place. In addition to China, there's also the risk of Section 232 auto tariffs on imports from Europe and Japan.

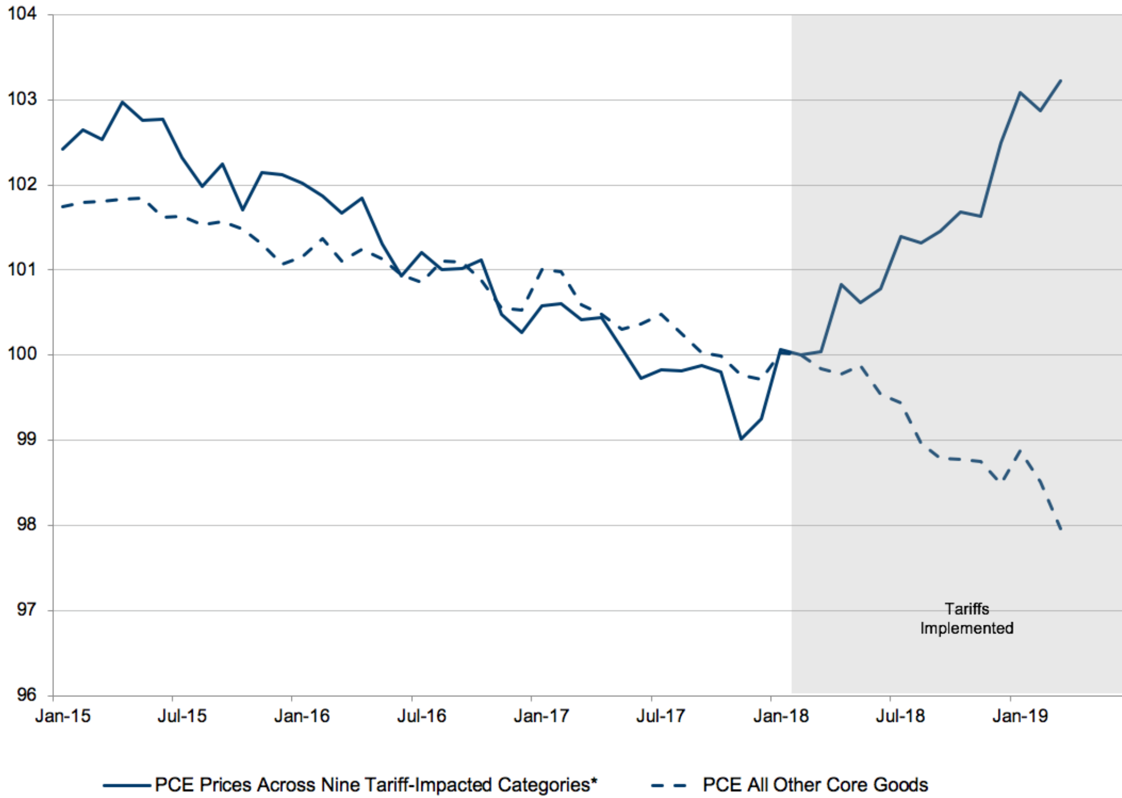
We can assess the economic impact of the tariffs already in place. New academic studies have used data on import volumes, U.S. import prices, U.S. producer prices and U.S. consumer prices to draw some interesting conclusions:

(a) the costs of the tariffs have fallen mostly on U.S. businesses and households. Contrary to expectations that Chinese exporters might lower prices to stay competitive, detailed analysis of import prices (before tariffs) reveals no decline in prices of imported goods that faced tariffs; and

(b) domestic U.S. producers of tariffed goods (not affiliated with a Chinese parent company) have opportunistically raised their prices in response to tariffs on Chinese goods.

The charts below from the Goldman Sachs economics team, shows how price increases have made their way into inflation measures.

Exhibit 1: Impact of tariffs on personal consumption expenditures

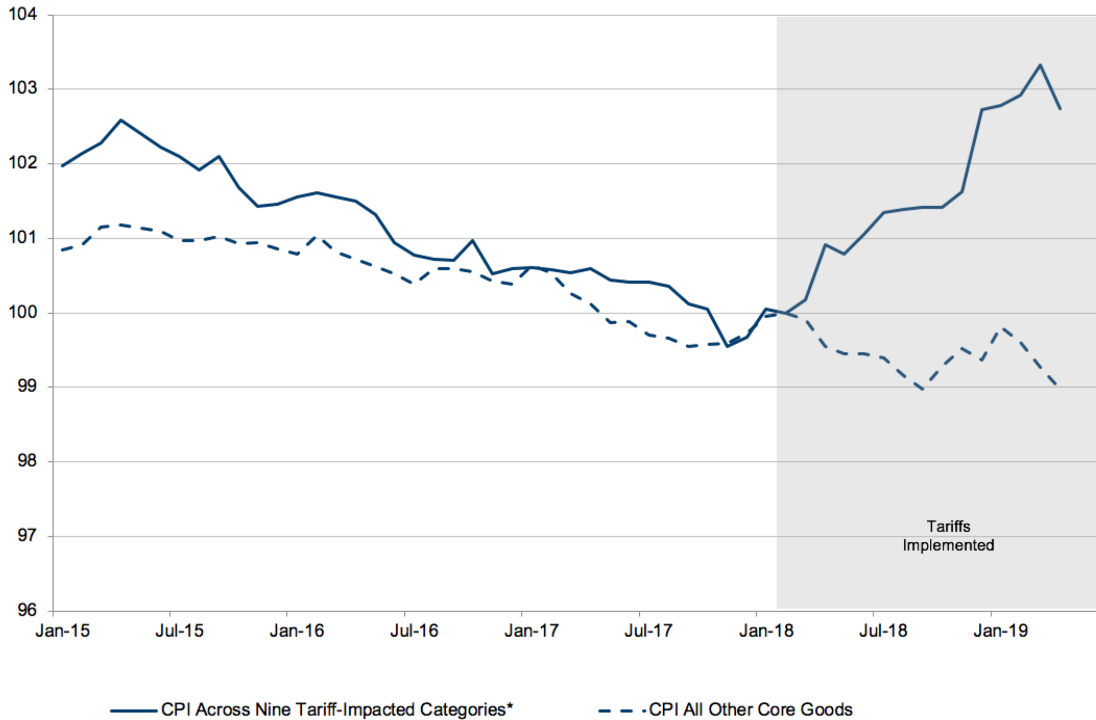


Index (Feb 2018 = 100)

Source: Goldman Sachs Global Investment Research, used with permission.

*Includes laundry equipment and other appliances, furniture, bedding, and floor coverings, auto parts, motorcycles, and sport vehicles, housekeeping supplies, and sewing equipment and materials. Weighted by relative importance to headline index.

Exhibit 2: Impact of tariffs on consumer price index



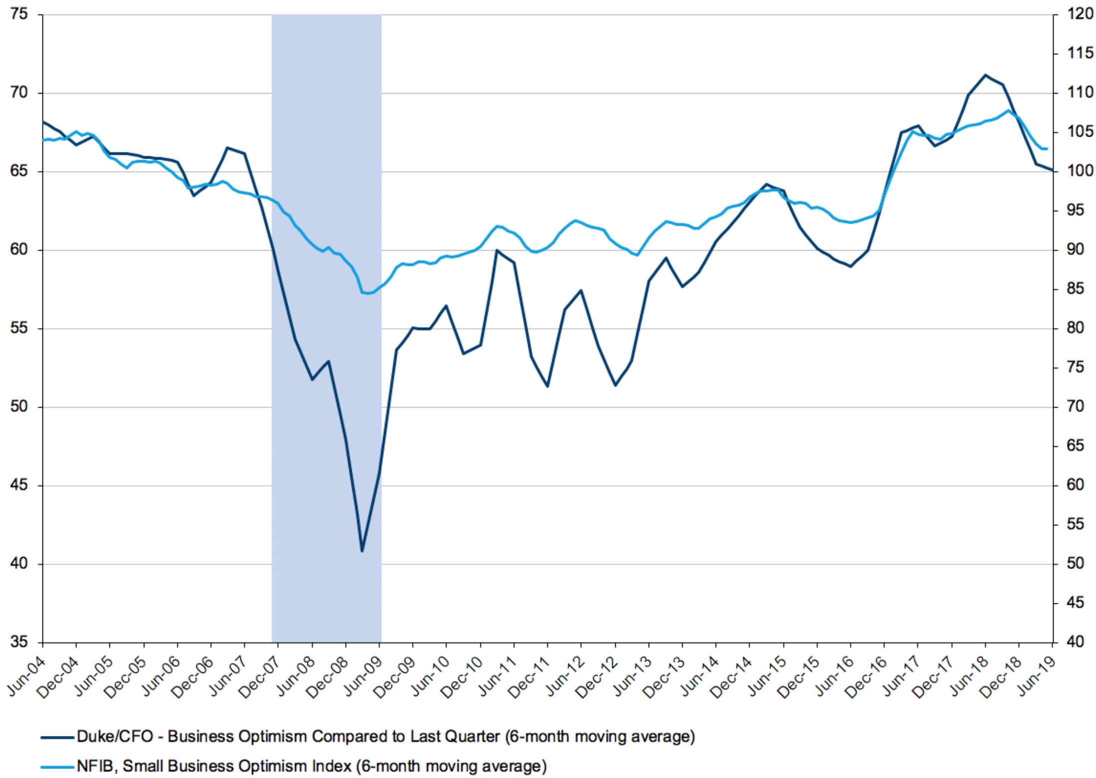
Index (Feb 2018 = 100)
Source: Goldman Sachs Global Investment Research, used with permission.

*Includes laundry equipment and other appliances, furniture, bedding, and floor coverings, auto parts, motorcycles, and sport vehicles, housekeeping supplies, and sewing equipment and materials. Weighted by CPI relative importance.

If the trade war continues and all of the new tariffs under discussion are implemented, the likely immediate effect would be higher inflation. Estimates among economists vary, but it is projected to be in the range of 0.5% to 0.9%. This would be a temporary, or one-time increase in prices. A bigger concern is the impact such distortions would have on growth. Unfortunately, the impact on domestic growth is much harder to gauge. Thinking of "direct" effects, economic theory tells us that higher prices reduce real purchasing power while lowering demand for goods and services. Depending on consumers' ability to substitute tariffed goods, this impact may or may not be consequential, ranging from 0.1% to 0.5%. The "indirect" effects of tariffs are harder to estimate. First, an atmosphere of increased uncertainty damages business sentiment, reducing companies' propensity to plan for projects and make capital investments. We have already seen a decline in business sentiment since the recent escalation of trade tensions. (See Exhibit 3: Decline in sentiment measures.) Companies that had imported goods from China are rushing to realign their supply chains; there has been a decline in imports from China, while those from neighboring countries, such as Vietnam, Taiwan, and South Korea, have risen. But there's no gaurantee that

all imports are substitutable, and finding new sources will take time. Breaks in supply chains are likely to impose significant costs on U.S. manufacturers.

Exhibit 3: Decline in sentiment measures: Business optimism



Source: Columbia Threadneedle Investments

Another "indirect" effect of tariffs, also sentiment-related, is a deterioration in market sentiment and increasing anxiety around the escalation of tariffs. As of late June, stock markets were performing quite well, but have shown increased volatility as the market analysis of trade war expansion shifts from week to week. Deterioration in market sentiment and tightening financial conditions are additional channels that could have a negative indirect effect on growth. In the final analysis, if there is a significant impact on growth—from a reduction in real purchasing power, reduced business capex, and a stock market sell-off—the impact of these tariffs might indeed be deflationary.

The Federal Reserve (Fed) recognizes and has acknowledged the risks to growth from tariffs. Against a backdrop of slowing global growth, with a renewed threat of escalating tariff wars, the Fed is likely to stay accommodative for a longer period of time. A stagflationary environment (i.e., a temporary rise in inflation and hit to growth) would raise the odds of Fed rate cuts.

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