Global growth and Trade wars

The Devil

One day the devil approaches you and comes up with a deal. If you are willing to accept a negative return of 1% on your investments for one day, he will give you the possibility to invest for the following two days at a positive rate of 2%. Since you are a rational person, and think you are smart because you work in finance, you accept the deal. In jargon that is known as a positive NPV project and everyone knows that the devil is a creditworthy fellow that does not default on his promises. The following day the devil comes back and proposes another deal: if you accept a negative return of 1% on your investments for another day, he will give you the possibility to invest for the following three days at a positive rate of 2%. Again this is a positive NPV project and you being you - as we know rational and smart - you are ought to accept it. But now even you are starting to realise where the problem is. Because, the devil being the devil, he will repeat the improved offer every day, to the infinite or until you run out of money. This is just an example, based on a rather famous paradox, of how **rational behaviour could lead to suboptimal choices** in a repeated sequence or system.

Trade Wars

Trade wars are a bit like the recursive paradox above: you induce some short-term pain in the economy today hoping to see a long-term beneficial effect tomorrow. And the economy, viewed as the set of rational agents which comprises it - people, companies, public institutions, government - mostly do not seem to reject this idea. But does this J-curve effect (ie short term bad vs long term good) really exists, or is it more probable that today's misery will just keep rolling on, like the compounding of negative returns? The answer generally depends on personal beliefs on globalization.

The **Trump administration is pushing aggressive tariffs, quotas and threats** thereof - aka Trade Wars - with China, Europe and several Emerging Markets at the same time on the basis of the dream that they might Make America Great Again.
This policy has **triggered a flight to quality move**, which has seen **outflows from EM investments into heavens**, like EUR and, mostly, USD assets. The result has been a **sharp appreciation of the USD** vis-a-vis EM currencies, which has represented a significant tightening for those economies.

Emerging markets account for 60% of global GDP and global growth since 2010. Thus we cannot pretend that the impact on those economies will not have an impact back on developed markets too.

Trade Wars rationale

Trump has brought to the political and financial landscape a barrage of disruptions; the traditional way of handling diplomacy and the tools of negotiations have been thrown into the bin and substituted by a shoot-first-ask-later kind of attitude. The world is trying to adapt to this new scenario, openly hoping that it is only a four-year hiatus, but secretly fearing it may last much longer.

It has become clear that, **in Trump's view, agreements between countries cannot be mutually beneficial** and there must be a party that wins and one that loses. In this respect, all of the trade agreements currently in place are seen as being to the detriment of the US and to the benefit of the rest of the world. It is therefore easy, within this perspective, to discern the new stance chosen by the US president on international trade agreements.

When the imposition of tariffs was first announced by Trump, investors worldwide mostly thought they were a negotiating tactic, without the real intention to be followed up on; after targeting China, accused of having a disproportionate trade surplus with the US and of stealing technological knowledge, they are now being imposed on (ex?) allies like Canada, Mexico and Europe. All the target countries are obviously retaliating. The ensuing escalation has made the **markets realize that the trade wars are real and are here to stay** at least for as long as the Trump administration is in charge and maybe longer.

We think that **this is one of the most prominent risks**, if not the key one, **to global growth** and stability.

Where do we stand?

The first part of the year has clearly been a busy one for international trade departments with escalating numbers and values over time:

Timeline	Country	Action	Targets
Jan 2018	USA	Tariffs on solar panels and washing machines	Mostly China, South Korea and Mexico
Mar 2018	USA	25% tariff on imports of steel and 10% on aluminium	Mostly EU, Canada and Mexico (permanent exemption granted to South Korea, Australia, Brazil and Argentina)
Mar 2018	USA	Tariffs on $50bio of Chinese goods (1300+ goods)	China
Mar 2018	USA	Threat to impose tariffs on European car manufacturers	EU
Apr 2018	China	Tariffs on 120 US products at 15% and on 114 products at 25%	USA
May 2018	China	Cancellation of imports of soybean from US	USA
Jun 2018	Mexico	Retaliatory tariffs on $3bio worth of products	USA
Jun 2018	EU	Retaliatory tariffs on 180 products + WTO challenge	USA
Jul 2018	Canada	Retaliatory tariffs on 299 products that match the US ones dollar-for-dollar	USA
Jul 2018	USA	Tariffs on $34+$16bio of Chinese goods at 25% + threat to extend to $500bio	China
Jul 2018	China	Retaliatory tariffs on $34bio of US goods	USA
Jul 2018	Switzerland	WTO challenge against US metal tariffs	USA
Jul 2018	USA	Proposed additional 10% tariff on $200bio of products	China
Jul 2018	USA	Threat to extend tariffs to $500bio	China

Who will be affected and how?

We see **several different levels of impact: on companies, on supply chains, on consumers and on economies as a whole**.
Firstly, the companies in the targeted sectors of course. Two of the most discussed, and tweeted about, are the steel and carmaker sectors. For instance, few weeks ago Daimler issued a profit warning due to the impact of Chinese retaliation on its US production; that is even before the threat of 20% tariff on EU car imports is being followed through. The impact is going to be felt by US companies as well, as the example of Harley-Davidson shows: the company announced it will shift production of motorcycles for the EU away from the US as a result of EU retaliatory tariffs on imported steel and aluminium.
Secondly, the supply chains and the consumers. Tariffs tend to push up prices and limit the availability of intermediate and final goods, which in turn would disrupt productions and exert negative wealth effects on consumers.
Lastly, whole economies. Spiking inflation dynamics will affect everyone and make monetary policies, everything else equal, more hawkish. The resulting additional increase in interest rates will negatively impact GDP growth.
Rational arguments, inevitable reciprocation and historical comparisons all point to a situation in which no country wins and even when the tide turns again in favour of globalisation, it would take many years to mend the relationships and negotiate new fair rules. In fact the recent Fed minutes showed that the central bank has detected rising concern among US business about the potentially harmful impact of tariffs, resulting in lower investment expenditure.

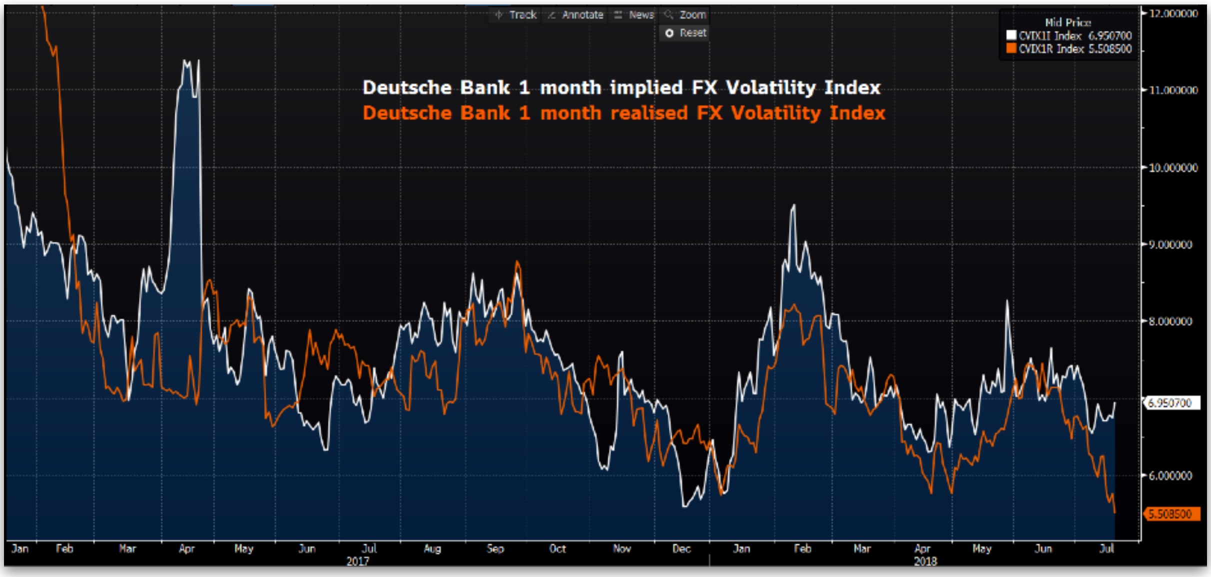
Impact on China

Many words have been said on the impact on China, allegedly the main target of the Trade Wars. Apparently though, it seems that the recent softness in GDP growth to 6.7% yoy has more to do with internal reasons than tariffs. An internally induced tightening of credit pushed by the party in order to rein in the excesses of the easy credit is to blame for most of the slowdown so far.
But let's not get carried away and let's do some quick back-of-the-envelope calculation to imply the impact of the tariffs on China.
First, we need to consider that Trump's fiscal stimulus (tax cuts and public spending) in the US is already helping the Chinese economy because part of the stimulus will go back abroad, for example with increasing imports.
If we assume 2% of GDP in stimulus, of which 30% goes abroad and that China gets 1/3 of that (roughly its weight in trade with US), then we get that 0.2% of US GDP (ie more or less $40bio) is a boost back to China. $40bio represent roughly 0.35% of China's GDP.
Now, the $250bio of tariffs imposed so far are estimated to have a negative impact of around $30bio, which just offsets the positive impact from the stimulus.
Clearly the math would change should the tariffs hit all the $500b of trade with China, as it is being threatened at the moment.
The bottom line is that the biggest risk to China's growth still comes from the possibility that

the domestic tightening may have gone too far, but should the trade tensions intensify then the drag would be real.

What are the effects on financial markets?

It is obviously very difficult and probably impossible to assess all the implications of what can only be described as seismic waves in the usually calm world of international trade. We can only start to underline some of the immediate impacts and speculate on the longer term ones.
The currency markets are obviously going to be directly impacted: changes in international trades have an immediate effect on the flows of money in the local currency and in the base currency, which is mostly the US dollar. Curiously, as can be seen in the chart, the realised FX volatility is actually collapsing.



1 month implied and realised FX Volatility Index.
Source: Bloomberg, Deutsche Bank.

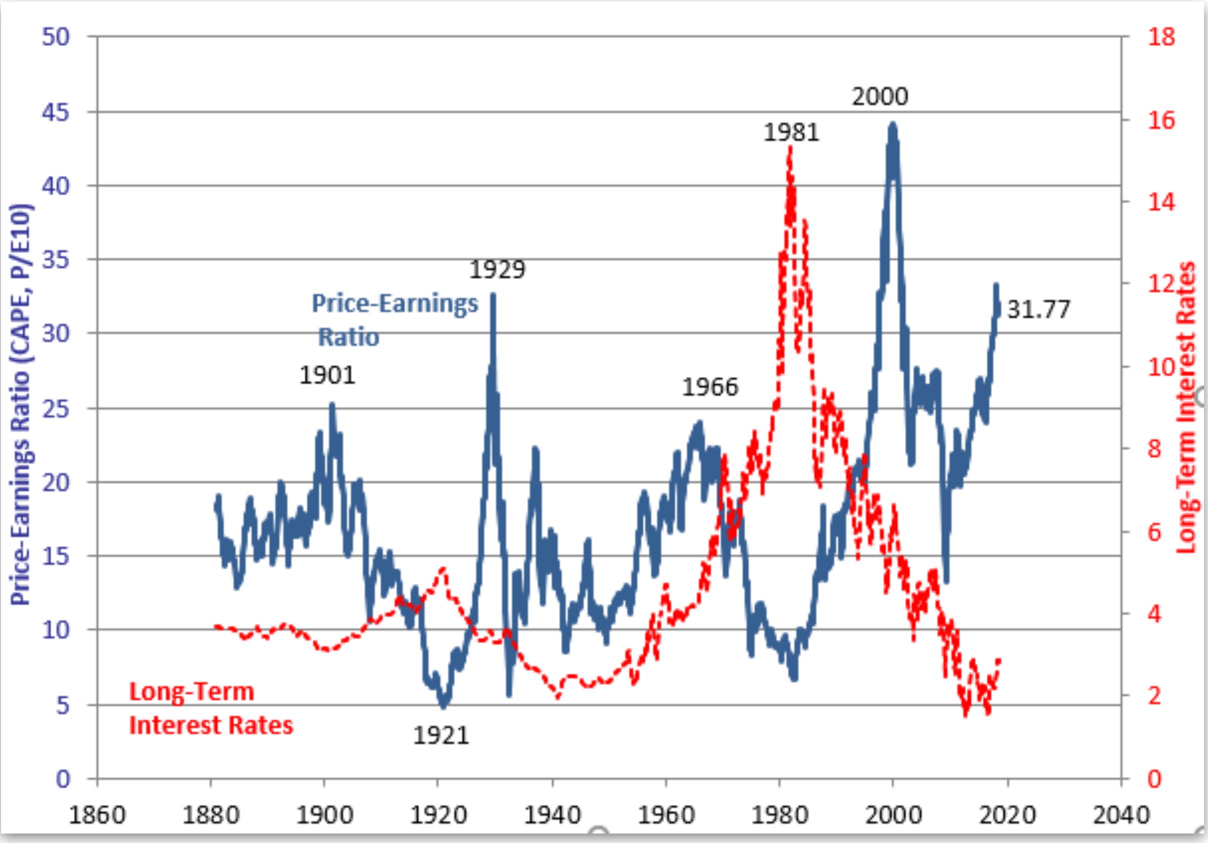
The market reaction **we expect is the appreciation of the USD vis-a-vis the other currencies** for three basic reasons. Firstly, if Americans buy less foreign goods and services there will be less demand for the foreign currencies. Secondly, and more importantly, the other countries can retaliate in a subtle way against the US by pushing a depreciation of their currency (for example via direct intervention, dovish monetary policies or by building expectations of the two). We have seen this in action for China and probably as a by-product of the ECB rhetoric and (in)action (even if it would never be acknowledged as such by the ECB). Thirdly, we expect a more aggressive monetary policy by the Fed to counter the resulting increase in inflation, even though the actual direct impact on inflation could be limited.

Chinese Renminbi vs USD: the first part of the year showed appreciation of the CNY as tariffs were dismissed as a tactic on sectors of secondary importance; the second part of the year is witnessing a depreciating CNY as tariffs are considered more risky and China seeks to retaliate.
Source: Bloomberg

Another naive expectation, this time for the long term, is about a **re-pricing of risky assets, i.e. equity and credit markets**. More international disruptions, negative feedback loops, companies' profit warnings and more hawkish monetary policy all point towards a sell-off in stock prices and a widening of credit spreads. Whether these will trigger a deep repricing or a mild one it is impossible to say now. The experience so far this year is that equity markets in US are unfazed by the Trade Wars, while EM risks are suffering greatly.

Finally, it is worth mentioning another potential event that could have significant market impact, which is the decision by the Chinese government to sell down its portfolio of US Treasuries. Such an action could disrupt the liquidity of the treasury market and push up rates very quickly, with reverberations on funding rates and asset valuations. Although it is considered an unlikely event, if it happened, it could lead to negative returns in bonds and to a depreciation of the USD in the short term. In the medium term though, higher US rates would be beneficial for the USD, but with likely some negative impact on equity markets, again especially in the emerging market regions.

Investment strategy



CAPE: the cyclically adjusted PE is now historically very high, beaten only by the dotcom bubble of the late 90s/early 2000 and on par with the Great Depression..
Source: Yale/Robert Shiller data website (http://www.econ.yale.edu/~shiller/data.htm).

All in all, we envisage to navigate this period of heightened uncertainty with caution, given that the **valuations do not seem historically cheap neither in equities nor in credit** (see the chart on CAPE), **macro opportunities do not abound** and market direction can change as quickly as the time needed to write a tweet. If nonetheless it still doesn't feel the right time to bet on a downright selloff of equities and credit markets, then one could **consider selling upside risk** via options.

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