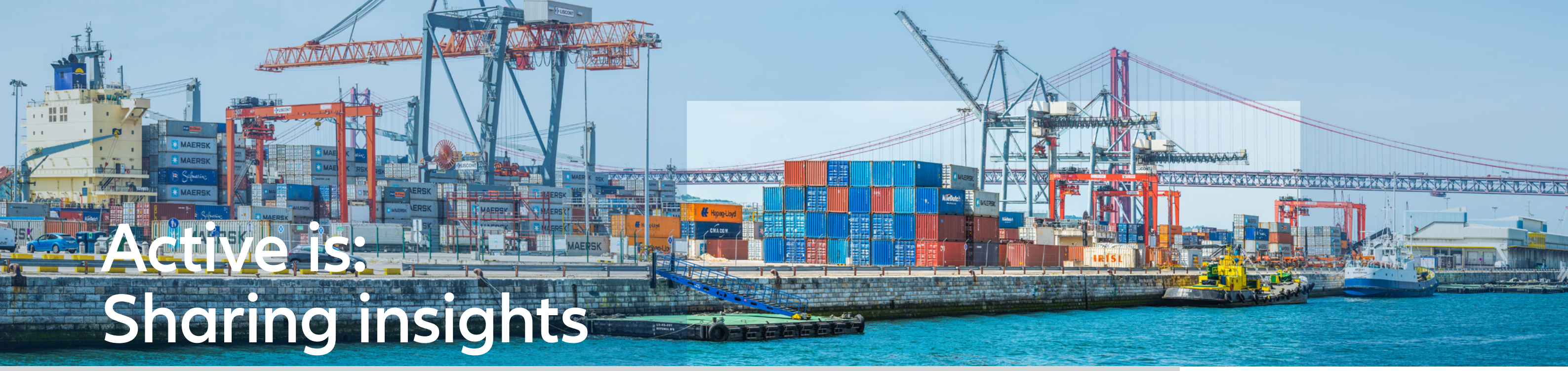

Trump turns the tables on trade

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As President Donald Trump ramps up the trade wars and retaliatory measures spread, investors are entering an unknown landscape – and no one knows what the US will do next. Yet given that trade makes up more than one-third of global GDP, it's critical to assess what we do and don't know about how the status quo could change.

What will President Trump do next?

In his words and deeds, President Donald Trump has been busy transforming the terms and tone of global trade. While he has been careful not to flout WTO rules too flagrantly, he has used the issue of national security to target what he considers the unfair trade practices of others.

One of the reasons President Trump is focusing so intently on trade is that it appears to be a winning political issue. Trade-related issues poll well and the November US mid-term elections are approaching, so we expect to see a steady flow of trade-related headlines. That said, one challenge for the US president is that he may not be able to show enough progress on trade in time for the 2020 elections, particularly given that it has taken decades to build the status quo.

When his administration renegotiates trade agreements, we expect them to be more often bilateral rather than multilateral. President Trump believes that by keeping trade agreements between two countries, he can win the largest discounts and most favourable terms for the US.

He has also brought forth a new and rather extraordinary trade weapon: focusing on companies rather than just individuals or states. Among his targets have been Russian aluminium

Key takeaways

- Trade is a winning political issue for President Trump; expect to see a steady flow of headlines in the run-up to the November mid-term elections
- China's newly restricted access to US technology has been a wake-up call, but it could also cause Asian nations to forge closer trading ties with China
- The trade wars could continue to spread: President Trump could direct his ire towards Germany, and negotiations between the UK and EU will likely not go smoothly
- With so much uncertainty around global trade, investors shouldn't be complacent: watch for currency volatility and keep an eye on shrinking corporate margins

producer Rusal and Chinese cell phone maker ZTE. Given the potentially profound market implications, many corporations will be keen to avoid catching his attention.

President Trump has brought forth an extraordinary trade weapon: focusing on companies rather than just individuals or states

How will the US vs China battle shape up?

We expect President Trump and his administration will continue concentrating their attention on China – in particular, the sharing of and access to US technology – as the trade war between the two countries continues to grow.

Markets are laser-focused on the tension between the two largest economies in the world, particularly given the fact that they are led by two men who aren't known for backing down. This raises the risk of one or both sides making a serious error – with a USD 1 trillion trade relationship at stake.

In the US-China trade war, one or both sides could make a serious error – and a USD 1 trillion trade relationship is at stake

China will have a hard time addressing the enormous trade imbalance it has with the US. The US does not make much that it can sell to China – which is precisely the point President Trump is making about his country's large trade deficit. At the same time, the US's tough negotiating stance is hamstrung by the fact that China is fully integrated into the global supply chain of consumer and manufactured goods, of which the US consumer is the largest purchaser. As a result, President Trump will have to balance being aggressive towards China while not hurting the consumers who vote for him.

For China – as well as Russia and a few others – President Trump's new focus on restricting access to US technology has been a wake-up call. Chinese firms may now need to develop their own operating systems and source code to reduce further risk to their businesses. With the tech sector representing over 30% of US and Asian benchmarks, this could be seriously disruptive. Suppliers in Singapore, Taiwan and South Korea could even need to choose which nation they will supply: the US or China.

Could the trade war spread to the rest of the world?

President Trump is of the view that the world has taken advantage of the US for many years. With China and Russia under fire, could he next train his crosshairs on Germany, another major exporter? Or could China, the European Union (EU), Canada and others band together, using the Trans-Pacific Partnership or another preferential trade agreement to lower tariffs for each other while excluding the US? These scenarios may sound far-fetched, but they are worth preparing for given their serious implications for investors.

At the same time, Europe and the UK face their own trade war in Brexit, with no guarantee that negotiations will end smoothly. Brexit has the potential to disrupt the EU's economic engine, which would hurt Germany, as the world's largest exporter, as well as the UK, Europe's largest consumer.

If the trade wars heat up, and retaliation rather than reciprocity becomes the order of the day, investors could face a host of new challenges. Retaliatory measures could be subject to the whims of politics, since industries, supply chains and consumers can be specifically targeted. Retaliation can also be difficult to price in and it can have the opposite effect. Consider autos and auto parts – the largest traded-goods sector, worth USD 1.3 trillion. Interference in the auto-supply chain may raise prices and reduce consumer demand, but it could also open up competitive opportunities along the supply chain.

If the trade wars cause more retaliation than reciprocity, investors could face a host of new challenges

China could retaliate by selling some of its USD 3 trillion worth of US Treasuries or by steeply devaluing its currency. We consider both scenarios to be unlikely, since China's clear economic goal is to open up its markets and gain international credibility – plus where else could the country park 3 trillion US dollars? However, China is not without weapons: it could target large US corporations that do business in China, as it did with South Korea a few years ago.

What should investors watch out for?

1. **Prepare for the end of NAFTA**
   President Trump has been ramping up tensions with Mexico, and it is entirely possible that the US could pull out of the North American Free Trade Agreement, particularly given the United States' push for new bilateral agreements that bring greater benefits to the US. An end to NAFTA would affect not just goods but services: financials, tech, banks and insurance companies could all be hurt.
2. **Keep an eye on non-tariff barriers**
   While news headlines are all about tariffs, the US and many other countries use other, non-tariff trade barriers to control foreign competition. For example, "rules of origin" have become more elaborate to seek to address the effects of unfair trade competition. In fact, when subsidies and state aid are included alongside tax relief and industry bailouts over recent years, more than 55% of trade interventions are not tariff-related.* Investors should focus on these more granular details, which will affect corporate prospects.
3. **Watch for currency volatility**
   For decades, the US dollar has been the world's reserve currency, but a growing number of countries have sought to diversify away from the dollar standard – and this may accelerate as trade wars evolve through retaliation. This process would create currency volatility

* Source: Global trade alert database, ifo Institute, AllianzGI Global Economics & Strategy. As of Dec 2017.

in countries moving away from the dollar, and it would also pressure the US to fund its own deficits though higher savings and investments.

4. **Mind the margins**
   Corporations around the world have been caught up in the trade-war maelstrom, and politics are winning over economic common sense. Margins could be affected as production is relocated away from the outsourcing partners that once made production cheaper and more efficient. Consider the global tech titans of the US: if they are no longer able to rely on labour and equipment from Asia, they may be forced to rebuild their manufacturing capabilities in the US or select from a dwindling list of allies.

Corporate margins could be hurt as production moves away from existing outsourcing partners

5. **Guard against complacency**
   For some time, US enthusiasm about President Trump's tax cuts and deregulatory efforts has made markets complacent. So while the markets are nervous of the changes in trade, they seem to be counting on common sense to prevail, which is making them relaxed about the eventual outcome. This is already undermining corporations and investment.

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