THE VIEW

Economic Research

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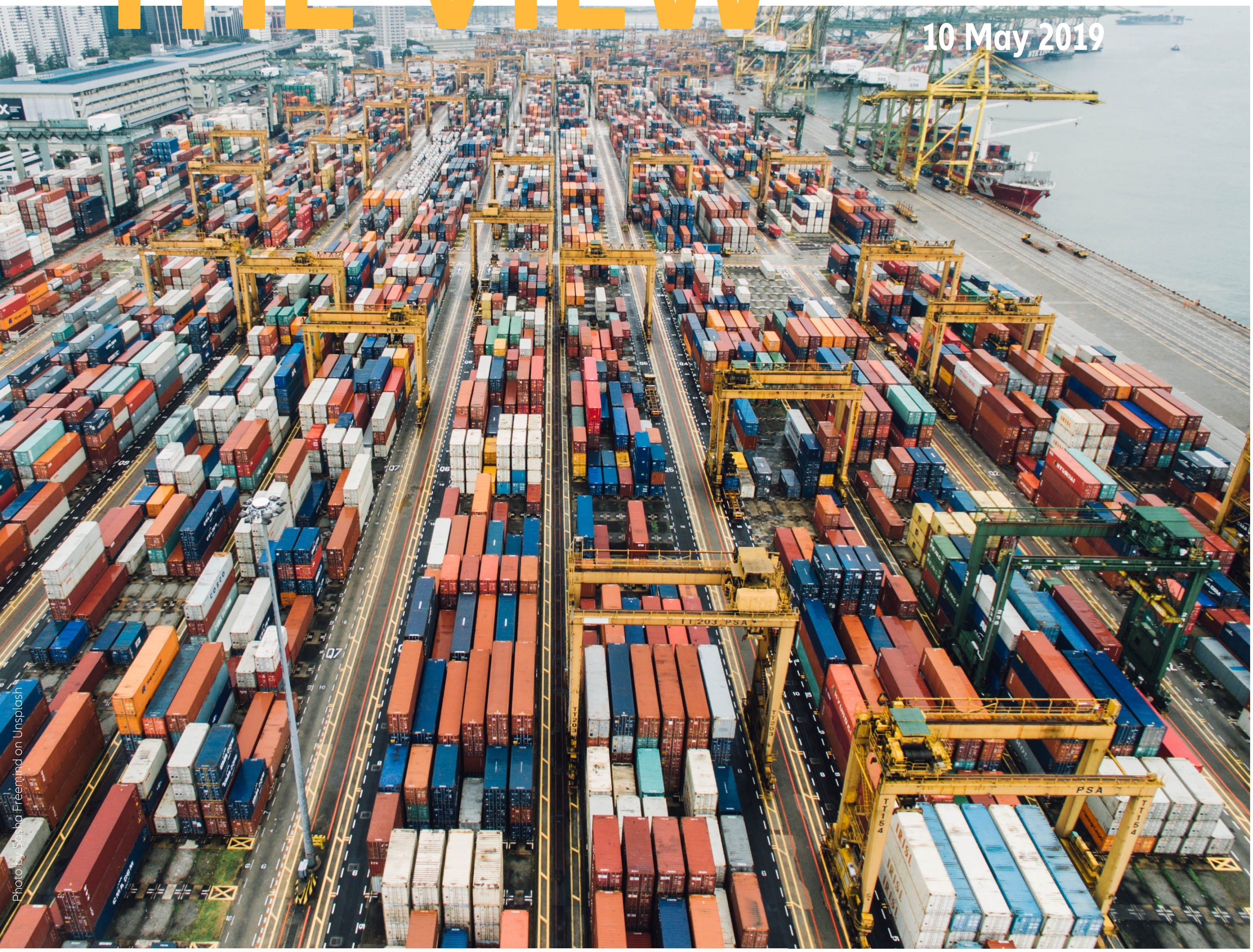

WHAT DO TRUMP'S NEW TARIFFS MEAN FOR THE GLOBAL ECONOMY?

Allianz

EULER HERMES

EXECUTIVE SUMMARY

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- On May 5th, President Trump announced plans to raise tariffs on Chinese imports, arguing that current US-China talks are going too slow. On May 10th, the Trump administration announced a hike in the tariff on USD200bn of imports from China to 25% (from 10% currently). Despite this escalation, we continue to think that an agreement is achievable. The G20 summit in Japan in June, where Presidents Donald Trump and Xi Jinping are expected to meet, could be the next moment of truth.
- Implication #1: A negative shock on trade and growth. The hiked tariffs bring us to a Trade Feud Scenario (average US tariffs above 6%) and will cost -0.5pp of global GDP growth and -2pp of global trade growth over the next two years. If the US administration were to go further and tax all remaining Chinese imports by 25% (we see this as being unlikely as it would, in this case, impact a lot of consumer goods) and USD200bn of car imports by 25%, this would bring us to our Trade War scenario. This would push US average tariffs close to 12% and shave off -2pp from global GDP growth, bringing the global economy into recession.
- Implication #2: A negative shock of uncertainty. The investment cycle will be impacted at a global level. With the US's latest move, it is difficult to foresee a fast de-escalation in the short-term. Uncertainty will likely remain high and hamper investment plans. For each four months of trade uncertainty, we estimate the cost to be -0.1pp of global economic growth. We reiterate our call of a possible technical recession in the US in the first half of 2020. In the Euro zone, the risk scenario could see growth being cut by -0.15 pp per year from our current estimate of +1.2% y/y in 2019 and +1.3% y/y in 2020.
- Implication #3: It is time for policy actions. The Fed and the ECB are likely to adopt a dovish stance. We don't see rate cuts in the very short-term but a rate cut by the Fed as early as Q1 2020 is on the cards. China will likely adopt retaliatory measures (new waves of tariffs, economic patriotism) and step up easing measures. We pencil three RRR cuts of 100bp by the end of this year, and two policy rate cuts of 25bp (first time since 2015).
- Implication #4: Equity markets - brace for volatility. Another sell-off similar in size to Q4 2018 is conceivable. The S&P 500 is likely to correct by more than 20% and come back to the end-2018 level. Safe haven assets will benefit from this as the US 10Y sovereign yield is expected at 2%, compared with 2.44% today. We see the possibility for the RMB converging to 7 RMB per USD by end of 2019 (againt 6.7 end Q1) as authorities step up easing measures. This kind of movment in the CNY is likely to further impact global equity prices as it could be interpreted as a disorderly reaction to US tariffs.

- Implication #5: Credit market to see a large widening of spreads. Credit markets were tight before these events. We expect a significant widening of spreads to 200 bp from 155 bp today for the US corporate BBB segment. In China, industrial profits decreased by -3.3% in Q1 2019. We see a rise of credit risk in China due to a poor sales outlook for exporters and a rise in debt as authorities increase accommodative measures (bank credit to private sector up +13% y/y in Q1).
- To avoid all this, the two sides need to come to a trade truce before the summer this year. A trade agreement continues to be our baseline scenario. Lingering effects of trade uncertainty will, however, remain visible.

Context: On May 5th, President Trump announced plans to raise tariffs on Chinese imports, arguing that current US-China talks are going too slow. On May 10, after limited progress, the Trump administration announced that from May 10th, the tariffs on USD200bn of imports from China would increase to 25% (from 10% currently). The remaining untaxed US imports from China would also face duties shortly.

Good Bye Trade Games, Hello Trade Feud. In Q1 2018, we introduced a proprietary analytical framework around growing trade threats – Protectionism: Trade Games, Trade Feud or Trade War? We defined three scenarios based on a sensitivity analysis of average US tariffs ([3.5-6%]; [6-10%]; and close to 12%); the number of protectionist measures and the resulting global trade dynamics ([2-4%], [0-2%], or contracting). We called them respectively Trade Games, Trade Feud, and Trade War. Before May 10th, we were borderline Trade Feud with US average tariffs around 5%. Now we have clearly entered a full blown Trade Feud scenario. With the US implementing 25% tariffs on USD200bn imports from China (instead of 10% before), US average tariffs are now above 6% (see Figure 1).

Increased U.S. tariffs on USD200bn of Chinese imports, from 10%

25%

IMPLICATION #1

GLOBAL GDP AND GLOBAL TRADE GROWTH COULD LOSE -0.5PP AND -2PP RESPECTIVELY

We estimate that this could cost -0.5pp of global GDP growth and -2pp of global trade growth over the next two years. The GDP growth forecast would be cut by -0.6pp in Europe, -0.5pp in the US and -0.3pp in China. If the US were to implement additional tariffs on USD325bn imports from China and USD200bn of car imports, we would move to a Trade War scenario (US average tariffs close to 12%). This would cost -2pp of global GDP growth, sparking a global recession, as well as -6 pp of global trade growth. Europe would lose -1.9pp of GDP growth, US GDP growth would drop by -1.7pp and China's by -1pp. We consider that the scenario of a 25% tariff on USD325bn of remaining Chinese imports is still unlikely, especially since we are approaching Presidential elections, as it would really penalize the US consumer (Table 1).

Table 1 Good contained in each tranche by end-use category 2017 US import num-

	Tranche 1+2 (USD50bn)	Tranche 3 (USD200bn)	**All goods subject to tariffs (Tranche 1+2+3)**	**No tariff at the moment (USD 250bn)**
End-use (%)	*100,0%*	*100,0%*	*100,0%*	*100,0%*
Capital	42,1%	30%	32,40%	46,30%
Intermediate	53,1%	46,90%	48,10%	15,50%
Consumption	1,1%	22,10%	***18,00%***	***38,20%***
Not classified	3,6%	0,40%	1,10%	0,00%

Source: IHS

IMPLICATION #2

UNCERTAINTY WILL LIKELY REMAIN ELEVATED IN THE SHORT-RUN AND THIS IS A NEGATIVE FOR BUSINESS

With the US's last move, it is difficult to foresee a fast de-escalation in the short-term. Uncertainty will likely remain high and hamper investment plans. We estimate that while US tariffs cut global trade growth by -0.3pp in 2018, US-led trade uncertainty cost -0.5pp. If China and the US fail to come to an agreement in Q2 or Q3, uncertainty would remain and both global trade and global economic growth could slow further. For each two months of trade uncertainty, we estimate the cost to be -0.1pp of global trade growth, and for each four months, -0.1pp of global economic growth. For now we maintain our central scenario with the US economy expected to grow by +2.5% y/y in 2019 (we are already below the consensus at 2.7% y/y) and +1.7% y/y in 2020. Our scenario of a possible technical recession in the first half of 2020 now has a higher probability. We actually estimate that a probability of a recession in the US economy currently stands at 52% compared with an estimate at only 25% for the New York Fed. In the Euro zone, the risk scenario could see growth being cut by -0.15 pp per year from our current estimate of +1.2% y/y in 2019 and +1.3% y/y in 2020, should no rapid solution be found in these negotiations. In China, we still expect growth to reach +6.4% y/y in 2019 thanks to its powerful stimulus policy, the latter being likely to see some reinforcement to offset the negative shock on external demand with a support for domestic demand.

IMPLICATION #3

IT IS TIME FOR POLICY ACTIONS

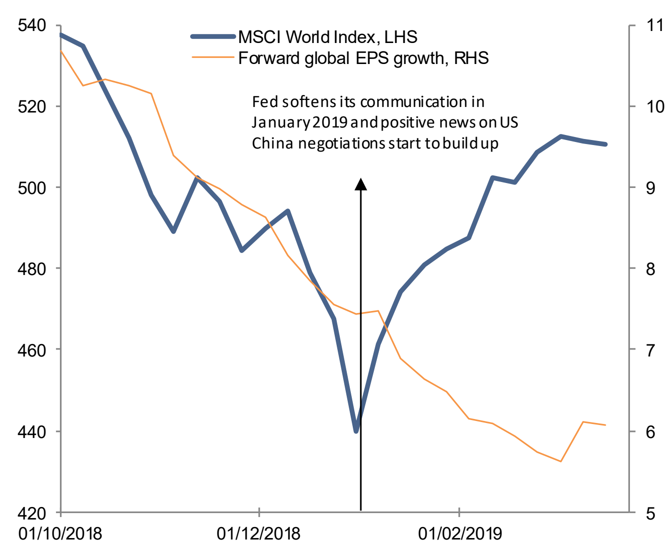
The Fed and the ECB are likely to adopt a dovish stance. We don't see rate cuts in the very short-term but a rate cut by the Fed as early as Q1 2020 is on the cards. The sequence will be the fllowing: A severe correction of equity prices and a large widening of credit spreads will trigger a severe tightening of monetary and financial conditions, in a similarly manner to Q4 2018. In these circumstances, this tightening will weigh on domestic demand. In contrast to the perception of the US authorities, protectionism will have an impact on US growth, not via a trade channel but rather via a credit and financial channel. In a context of doubts on the sustainability of both public and private debt, the Fed will have to react and ease its policy in Q1 2020. From the ECB we expect more of a wait-and-see approach, with an easing being envisaged only in a case of recession. In China, there are two sets of policy actions that will likely follow the announcement. One relates to retaliatory measures. Options include (in order of likelihood) new waves of tariffs (e.g. more on agricultural products to undermine President Trump's political base), economic patriotism (boycott or tightened regulation against US products), currency depreciation and the dumping of US treasuries. The other relates to easing measures. We see three cuts in the Reserves Requirement Ratios by the end of this year (-100bp each). More importantly, China will likely start cutting its benchmark interest rate for the first time since 2015. We see two policy rate cuts at least (-25bp each) by the end of this year. Out of China, we see more central banks easing monetary policy in the coming months. In Asia-Pacific, India opened the door in the beginning of the year. Malaysia and New Zealand recently followed. We expect Indonesia and South Korea to also change their policy stance and become more accomodative.

IMPLICATION #4

EQUITY MARKETS - BRACE FOR VOLATILITY

Another sell-off similar in size to Q4 2018 is conceivable. The S&P 500 is likely to correct by more than 20% and come back to end-2018 level. Safe haven assets will benefit from this as the US 10Y sovereign yield is expected at 2% compared with 2.44% today. In China, we see the RMB converging to 7 RMB per USD by end of 2019 (against 6.7 end Q1) as authorities step up easing measures to absorb tariff costs, and capital outflows intensify due to higher risk aversion. This kind of movment in the CNY is likely to further impact global equity prices as it could be interpreted as a disorderly reaction to US tariffs. We see the 10-year Chinese government bond at 3.1% (after 3.7% in 2018), reflecting monetary interventions, and a rush of domestic investors to get less risky assets. We are not confident on Chinese equities. While it is likely that the national team (of state-backed funds) and the authorities will likely intervene to prop up the market, we see limited room for gains as the external demand outlook darkens. The expected correction of the global equity market at a level similar with end-2018 is justified as the rebound was artificially driven by an easing of monetary policies (without links with fundamentals) and a factor-in of a positive outcome in US China negotiations (Figure 1).

Figure 1 MSCI Index and forward EPS growth

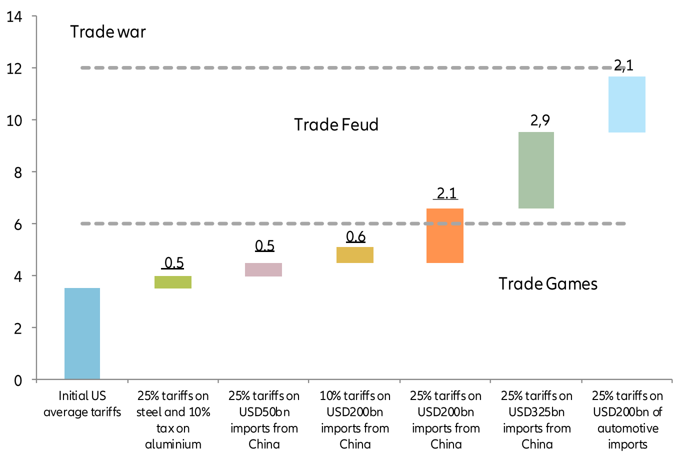


Sources: IMF, Euler Hermes Allianz Research

IMPLICATION #5

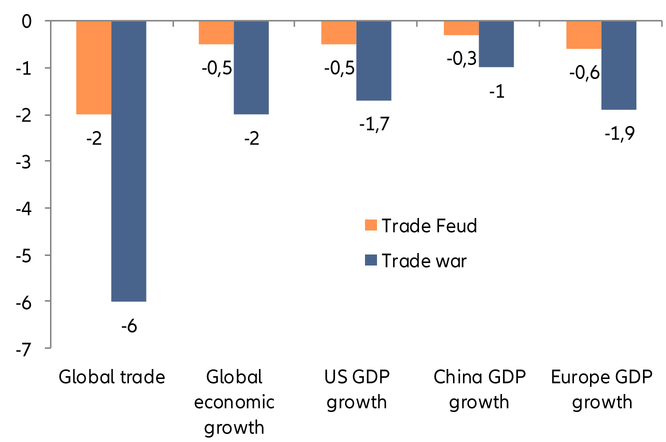
CREDIT MARKET TO SEE A LARGE WIDENING OF SPREADS

Figure 2 US average tariffs – shock simulations. Underlined figures are those that have been implemented



Sources: Euler Hermes, Allianz Research

Figure 3 What does that mean for the global economy? 2-years impact (pp)



Sources: Euler Hermes, Allianz Research

Credit market to see a large widening of spreads. Credit markets were tight before these events. We expect a significant widening of spreads to 200 bp from 155 bp today for the US corporate BBB segment. We had already estimated that US corporate spreads were underestimated, and that unfortunate events (rapid downturn, market defaults, negative outcome in trade negotiations) could end up pushing up spreads by 70-190bps (see The View – US corporate leverage is probably underestimated). China's industrial profits decreased by -3.3% in Q1 2019. Debt is on the rise as authorities are increasing accommodative measures (bank credit to private sector up +13% y/y in Q1). Looking ahead, we see a rise of credit risk in China due to a poor sales outlook for exporters and the rise in debt. We see room for growth for domestic demand and policy-led companies (infrastructure and private consumption-related companies)

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