Trade Analysis

July 2019

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INTRODUCTION

- US and China have been embroiled in a trade dispute since early 2018
  - The US imposed tariffs on Chinese goods and China retaliated in kind
  - In December 2018, a truce was announced to halt the escalation of tariffs and negotiate a trade deal by a 1 March 2019 deadline that was eventually extended
  - Initially, optimism in the market improved as news of productive negotiations emerged, but as the weeks progressed, no deal was struck and tensions flared, with the US increasing tariffs (and China retaliating) and Trump threatening to impose tariffs on all remaining Chinese imports
  - However, more recently, President Trump and Xi met at the G20 Summit and the result was a declaration of another trade truce, with the US holding off additional tariffs on China and allowing US companies to resume sales to Huawei
- The US has delayed auto tariffs for 180 days to pursue negotiations with Europe, Japan and other nations
- In addition, tariffs have been used as leverage to pressure countries on other issues, e.g. the US threatening Mexico with tariffs to reach an immigration deal
- The trade outlook remains sensitive to developments and news flow on trade negotiations
  - The prevailing view is that eventually a deal will be struck as parties recognise the damaging impacts but with Trump involved the predictability is particularly volatile
  - The relationship between the US and China is expected to be increasingly competitive going forward, and trade is unlikely to disappear as an issue (e.g. European car exports to the US could be a future flash point)
- This paper explores the impact of global trade war/tariffs on the global economy and financial markets

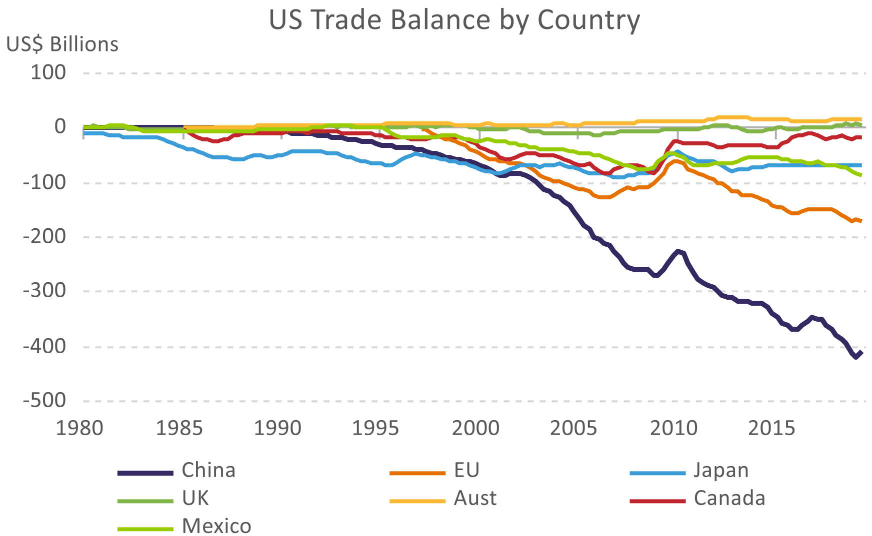
SUMMARY

- Exports between the US and China makes up approximately 0.6% and 3.5% of its GDP, respectively
  - A deeper dive into product level trade shows that Australia may be more insulated from changes in bilateral trade between the US and China than some other trade exposed countries, such as Vietnam that has large trade exposures
  - However, Australia has relatively high export to China, putting it in a complicated position with the US its most important security ally and China is its largest trading partner
- There has been a clear downturn in trade, industrial production and global growth
  - It is difficult to clearly delineate what component of the slowdown has been driven by trade conflict versus global economic growth slowdown, particularly China deleveraging
- Trade restrictions introduce more uncertainty, making it less clear for the US Federal Committee to gauge the broader market outlook and increases the risk of policy mistakes
  - Analysis suggests the costs of the tariffs have fallen almost entirely on US businesses and households, creating a headwind to domestic growth and short-term upward pressure on inflation
  - With the Fed poised to start cutting rates, this upward pressure on inflation may make their job more challenging
  - However, the US Fed is unlikely to be deterred from cutting rates if the higher inflation is seen as transitory, and may be more willing to keep monetary policy accommodative for longer given concerns that tariffs will impact growth
- Currently, direct impacts on inflation and GDP are expected to be manageable but second-order impacts via financial markets and confidence are less clear and could become more significant

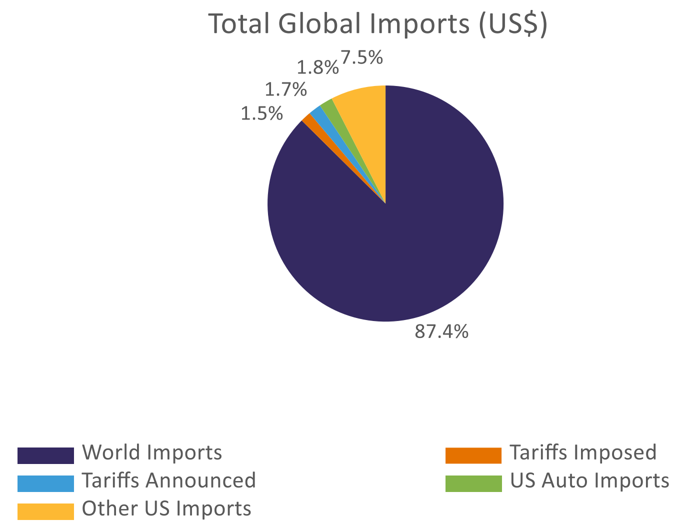
SUMMARY CONT.

- Despite the US appearing to bear the brunt of the economic impact of the tariff escalation, US equities in aggregate appear less negatively impacted by trade news while Chinese equities have suffered more amid the trade tension
- US equities with international sales exposure have had earnings deteriorate since the trade dispute arose
  - US equities with international sales exposure have underperformed US equities with domestic sales exposure when the trade dispute has escalated
  - However, expectations of more positive trade negotiation outcomes have contributed to positive 2019 year to date equity returns and US equities with international sales exposure have re-rated back from valuation discounts
- The ongoing risk around global trade feeds into our general view that risks are heightened and market volatility will rise
  - Frontier suggests a trend path of reducing risk in portfolios
  - It now appears there is little discount in equity market valuations for negative trade outcomes so the risks to equity returns from trade developments are skewed to the downside
  - This supports our view to favour an approach of selling into market strength

GLOBAL TRADE



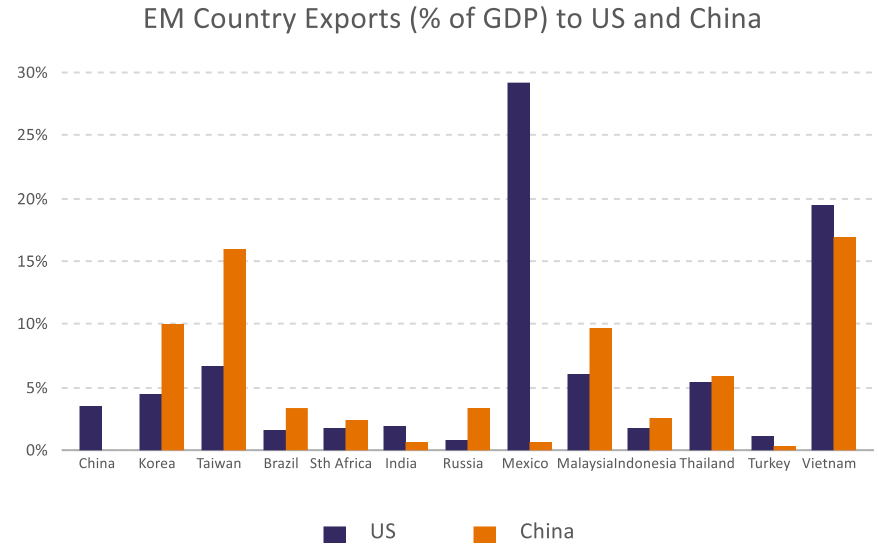
Source: Refinitiv Datastream



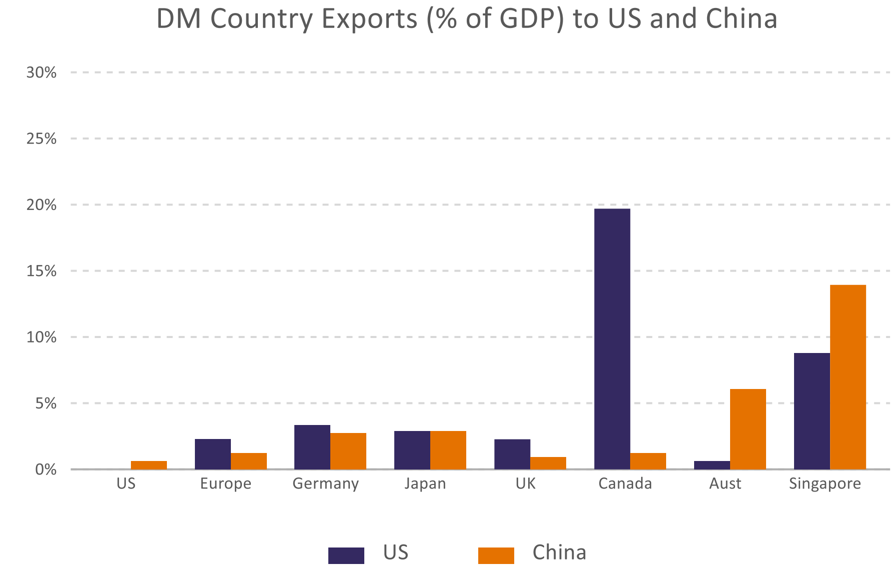
Source: Refinitiv Datastream

- The US trade deficit with China has increased significantly over the last 20 years and is by far the largest deficit of the US at around US$400 billion p.a.
  - European trade to the US has also been increasing and is a significant US deficit
  - Australia is actually a small trade surplus for the US
- From a global perspective, trade between US and China makes up only 3.5% of total trade
  - In total, imports into the US make up less than 15% of world trade

COUNTRY EXPOSURE TO US AND CHINA TRADE



Source: Refinitiv Datastream

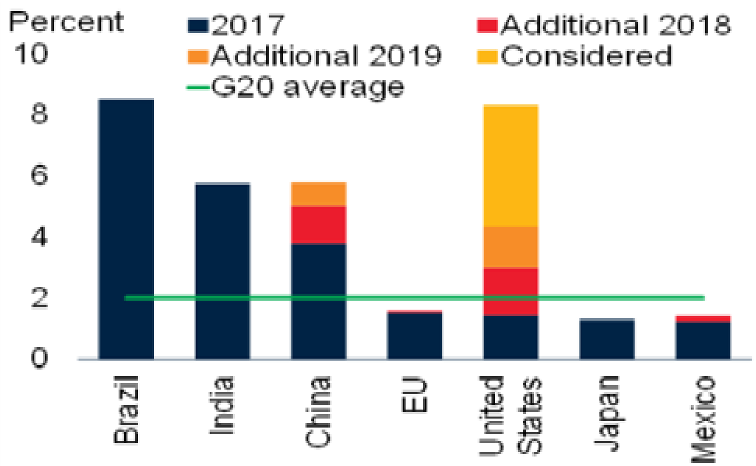


Source: Refinitiv Datastream

- China's exposure to US trade as a proportion of its economy is relatively small compared to other more highly trade exposed countries
  - Taiwan, South Korea, Malaysia, Vietnam and Singapore have higher exposure to trade to China and the US
  - Mexico and Canada have very high exposures to the US
    - The outcome of a new United States-Mexico-Canada (USMCA) trade agreement is critically important for these economies
- Australia has a high export exposure to China but little to the US

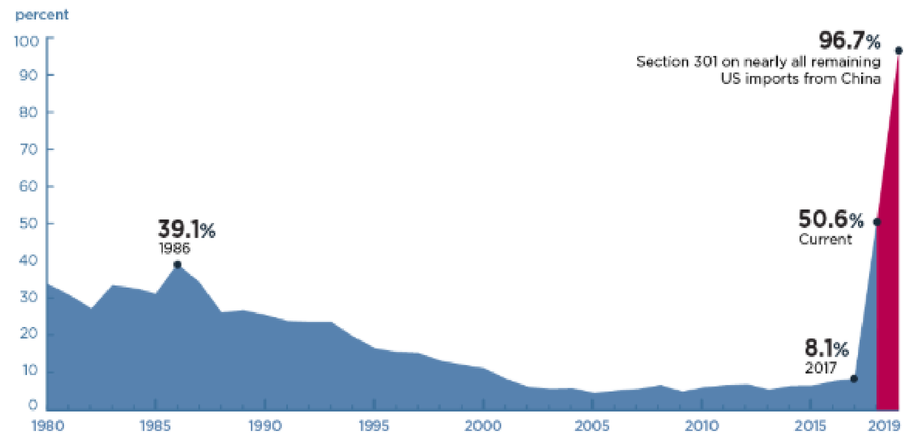
TARIFF LEVEL

Average Import Tariffs in G20 Countries



Source: Bloomberg; Dealogic; International Monetary Fund; World Bank.

US Special Trade Protection Coverage

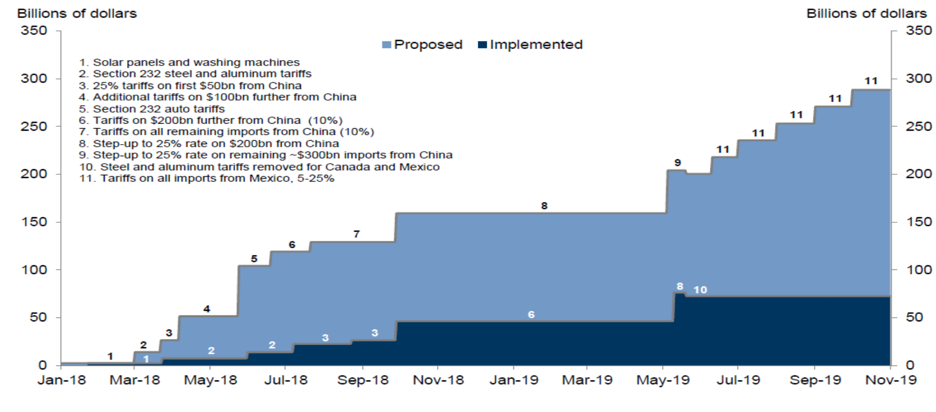


Sources: Figure 3 in Chad P. Bown, 2019, *The 2018 US-China Trade Conflict After 40 Years of Special Protection* (PIIE Working Paper 19-7). Authors' calculation based on products listed in the Federal Register at https://ustr.gov/sites/default/files/enforcement/301Investigations/May_2019_Proposed_Modification.pdf

- In 2017, the level of import tariffs in the US sat below the G20 average. Since Trump's protectionism, the level of import tariffs implemented and considered is now one of the highest among G20 countries
- Historically, the US has imposed trade protection tariffs on China. However, the scope of the more recent tariffs has reached an unprecedented level

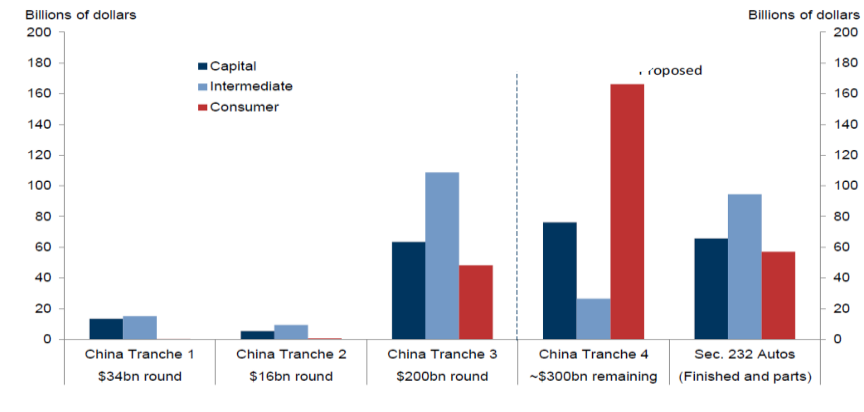
CHINA TARIFFS

Value of US Tariffs Proposed and Imposed



Source: Goldman Sachs Global Investment Research

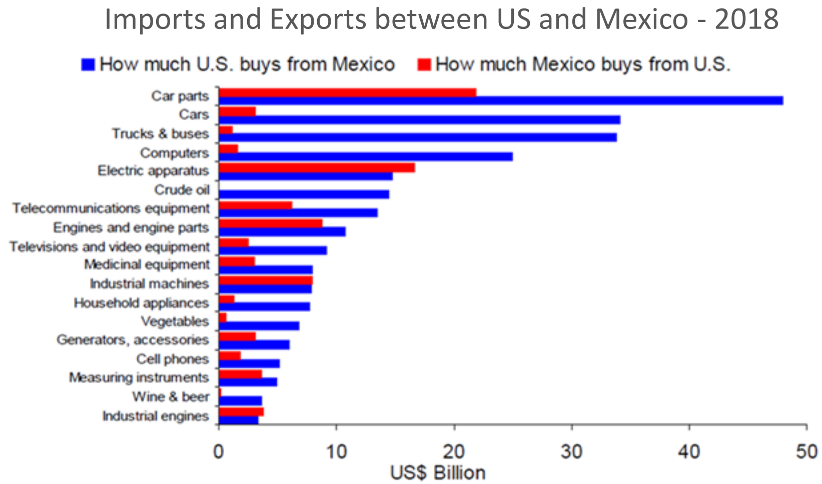
Tariff Rounds by Broad Economic Category



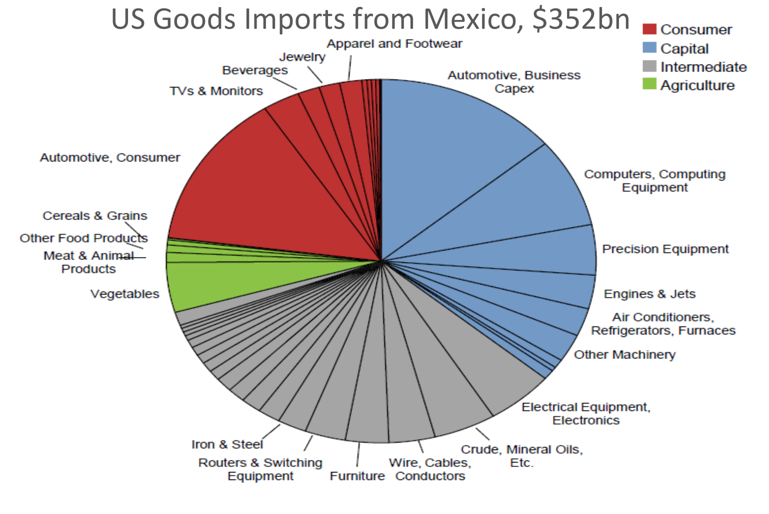
Source: Goldman Sachs Global Investment Research

- On 10 May 2019, President Trump increased the 10% tariff on $200 billion of imports from China to 25%. He also indicated he would shortly impose 25% tariffs on the rest of US imports ($300 billion) from China not yet targeted with his Section 301 tariffs
  - Tariffs on the remaining Chinese imports would hit more consumer goods
- China retaliated on 13 May 2019, announcing that on 1 June 2019, it intended to increase the tariff rate covering some of the $60 billion of US exports it had already hit in September
- Additional escalation could come through non-tariff retaliations
  - The US government placed Huawei on the export control list
  - Chinese authorities could restrict the export of rare earth minerals to the US and blacklist more US firms

MEXICO TARIFFS



Source: Census Bureau, DB Global Research

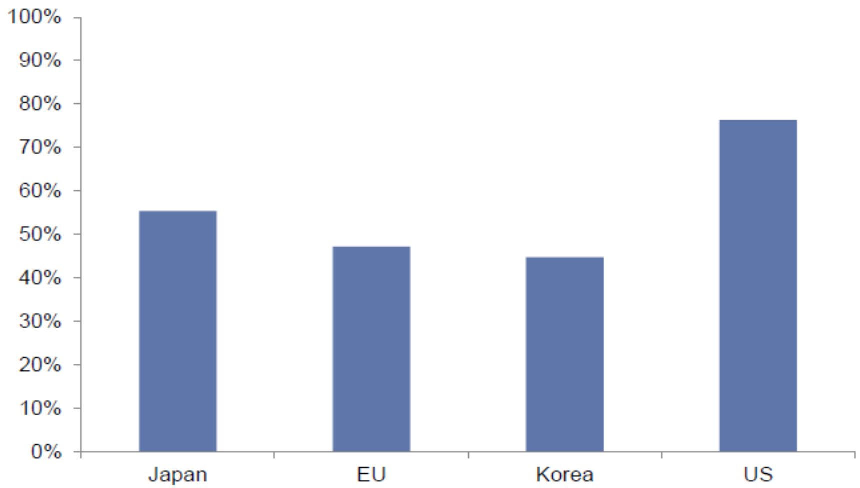


Source: Goldman Sachs Global Investment Research

- On 31 May 2019, President Trump threatened to impose a 5% tariff on all imported goods from Mexico beginning 10 June 2019; the tariff would be raised to 10% on 1 July 2019, then by an additional 5% each month for 3 months. Tariffs would then remain at 25% until Mexico remedied the illegal immigration issue
  - In a matter of days, Mexico capitulated to the US, which resulted in a signed immigration deal between the two countries and the indefinite suspension of tariffs
  - If Mexican tariffs went live, it would likely have a negative effect on the auto industry as autos and auto components represent the largest US import from Mexico. Furthermore, many consumer goods would be subject to additional tariffs, risking a greater impact on US businesses and households, as well as investor sentiment

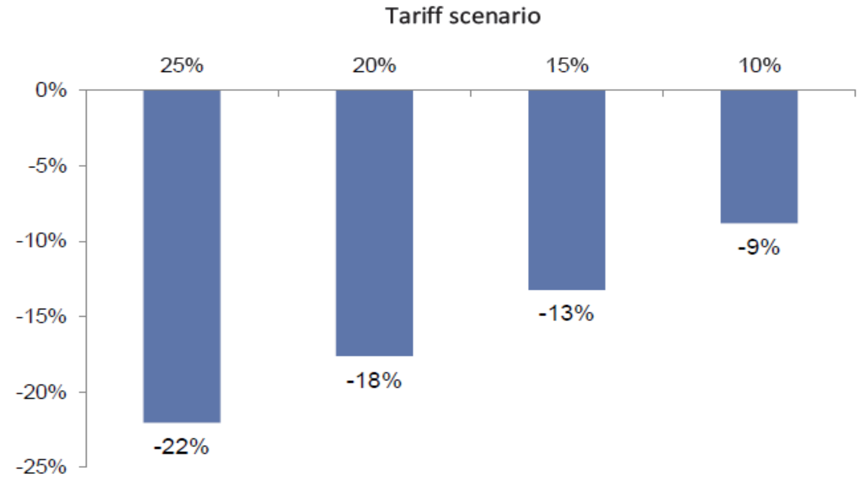
AUTO TARIFFS

Local Production in the US Market



Source: Company Data, Goldman Sachs Global Investment Research

Estimated Impact of Potential Tariff on Operating Profits

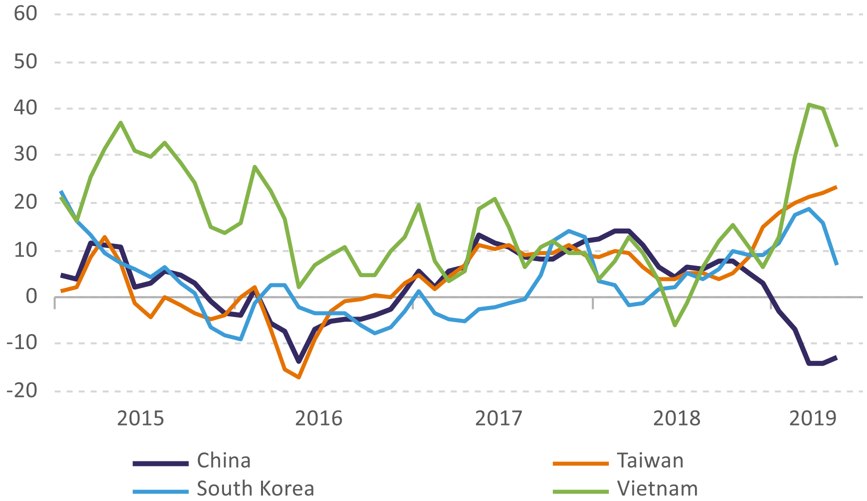


Source: Goldman Sachs Global Investment Research

- Potential auto tariffs on foreign automakers are on the horizon. But the Trump Administration has delayed auto tariffs for 180 days to pursue negotiations with Europe, Japan and other nations
- Within the US market, the local production weighting across non-US automakers is approximately 50%
  - Non-US automakers may be pressured to increase production in the US
- Research suggests that auto tariffs are likely to reduce the operating profits of non-US automakers
  - Tariffs could increase the cost of components and finished vehicles
  - Higher vehicle prices could impact US demand

TRADE AND GDP IMPACT

US Imports (% of Annual Growth) - 3MMA



Source: Refinitiv Datastream

Forecast of Trade Impact on Economic Growth

	GDP Impact (%)				
	World	**US**	**China**	**Europe**	**Japan**
Capital Economics	-0.5	-0.4	-0.6		
Goldman Sachs	-0.5	-0.9	-0.9	-0.3	-0.3
Citi	-0.8	-1.0	-1.0	-0.7	-0.7

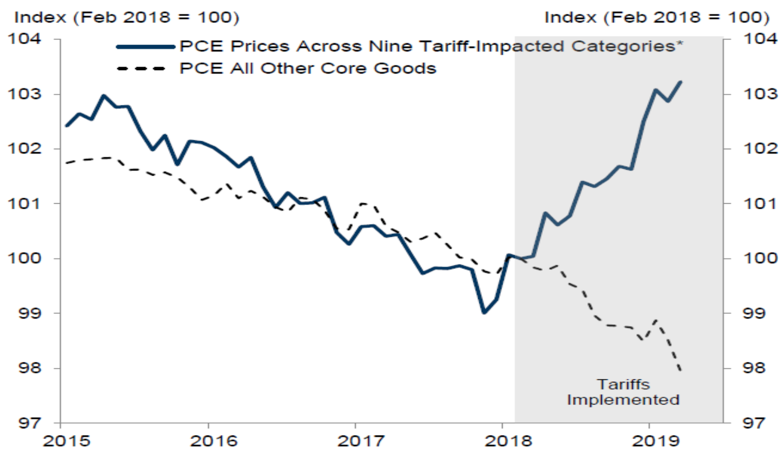
Note: Capital Economics - GDP impact by the end of 2020; Goldman Sachs Investment Research – GDP impact over 3 years; Citi Research – GDP impact by Q3 2020

Source: Capital Economics, Goldman Sachs Investment Research, Citi Research

- It is evident that the US has significantly trimmed its imports from China
  - During this trade conflict, US imports appear to have redirected to countries like Taiwan, South Korea and more specifically Vietnam appears to have benefited the most
  - However, the US recently imposed punitive duties of more than 400% on steel imports from Vietnam, due to businesses opportunistically rerouting products to evade trade levies between the US and China
- GDP impact estimates are significant but expected to be manageable; however the follow-on effects could cascade through several channels, including financial markets, labour markets and business and consumer confidence

US INFLATION IMPACT

Impact of Tariffs on Consumer Prices



Source: Department of Labour, Department of Commerce, Goldman Sachs Global Investment Research

Forecast of Trade Impact on US Inflation

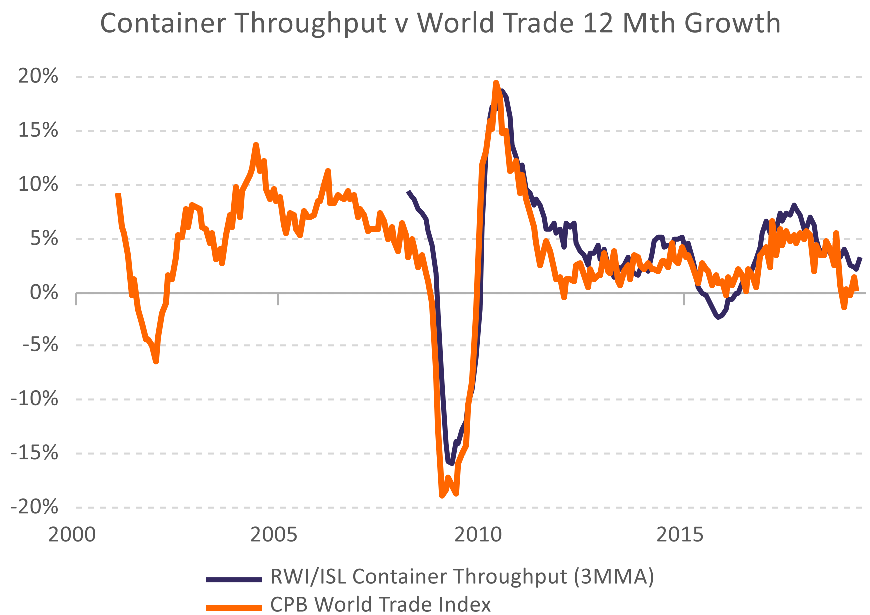
Estimated one-time impact of tariffs on China on US inflation

Forecast by	Impact on 2019 US inflation	Resulting from
J.P. Morgan	0.1% - 0.2%	• Latest hike to 25% on $200bn in Chinese exports
Federal Reserve	0.1% 0.4%	• Tariffs imposed in 2018 • Across the board 25% tariff on all Chinese goods
Bridgewater	0.2% 0.4%	• Partial escalation • Full escalation
Goldman Sachs	0.2% 0.6% 0.9%	• Tariffs imposed in 2018 • Across the board 25% tariff on all Chinese goods • 25% on China plus autos

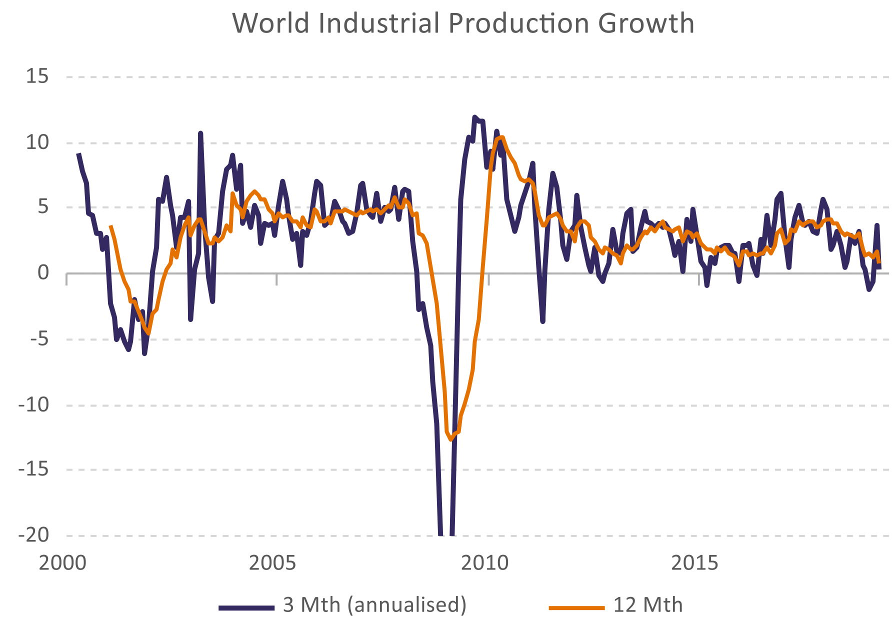
Source: JP Morgan

- With the initial tariffs in place for sometime now, it is evident that consumer prices in tariff-impacted categories have risen much more than other core goods
- Multiple sources estimated that the one-off inflation impact of the recent tariffs imposed will be modest. Nevertheless, estimates show that in a full escalation scenario, the inflation impact could double and even peak as high as 0.9%
- The US Federal Reserve is unlikely to respond to higher inflation if the inflation impact is transitory. However, it creates an additional uncertainty for Central Banks when considering future monetary policy

WORLD TRADE & GROWTH



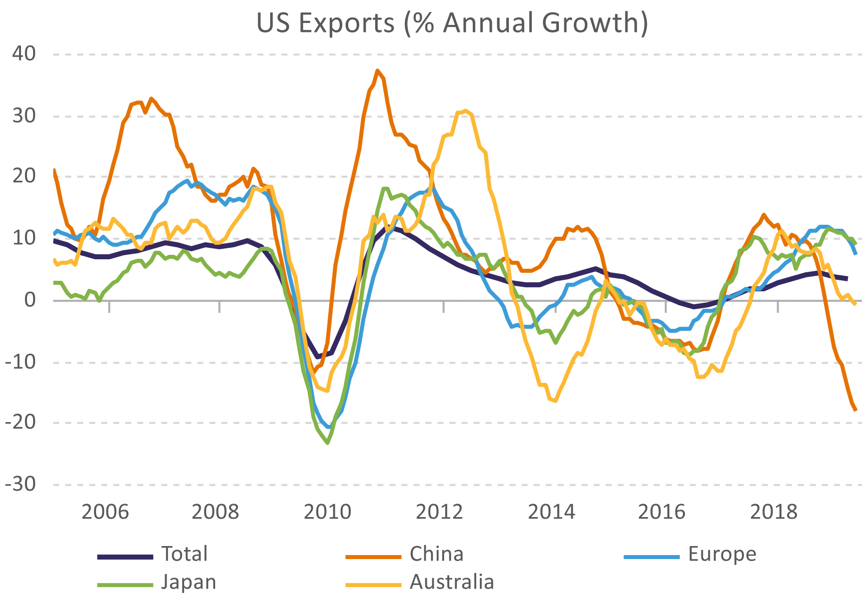
Source: Refinitiv Datastream



Source: Refinitiv Datastream

- There was a sharp downturn in global trade and industrial production in Q4 2018
  - Partly impacted by tactical approaches around implementation of tariffs
- It is difficult to specifically quantify the contribution of trade restrictions
  - China deleveraging slowdown is also a key contributor to the global economic growth slowdown

US EXPORTS



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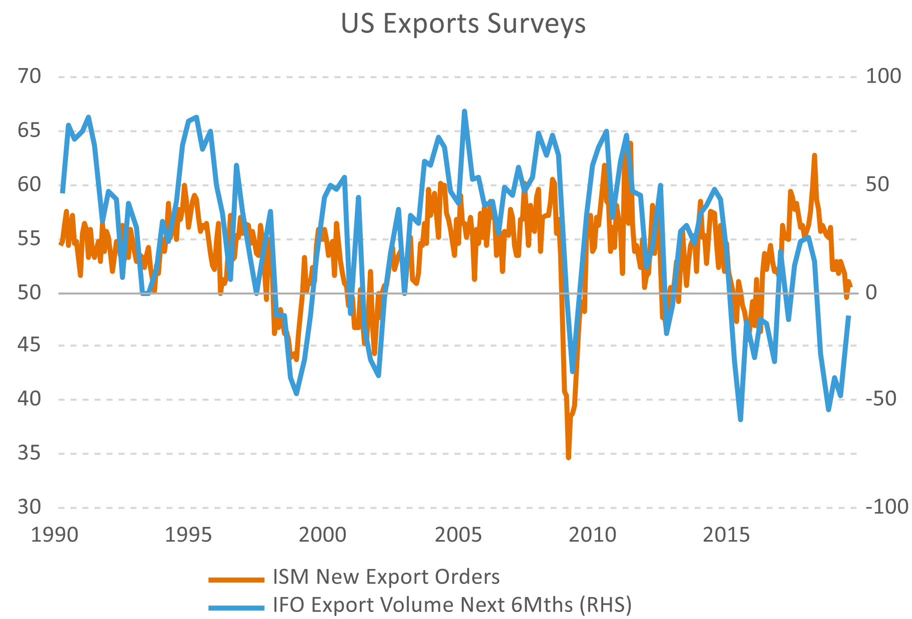
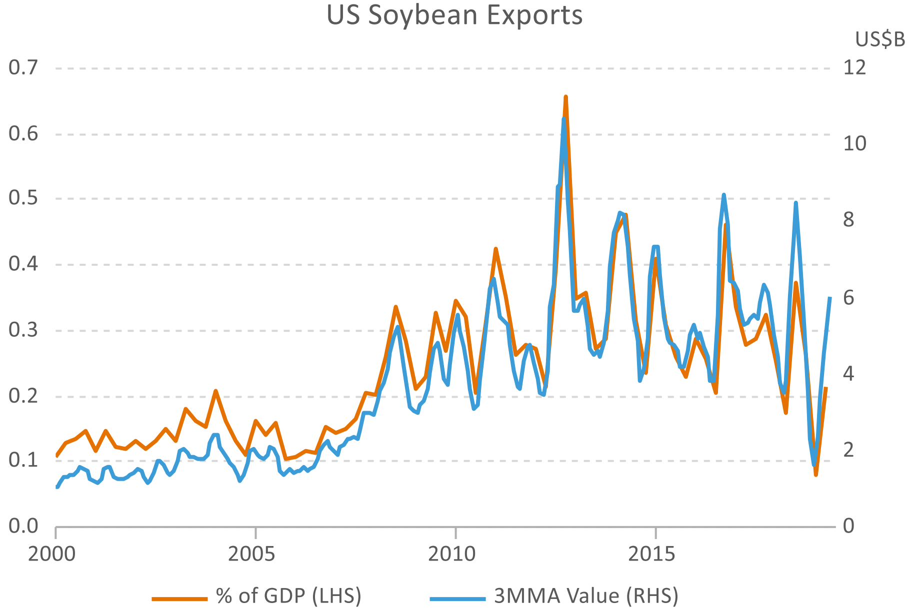


Source: Refinitiv Datastream, ISM, IFO World Economic Survey

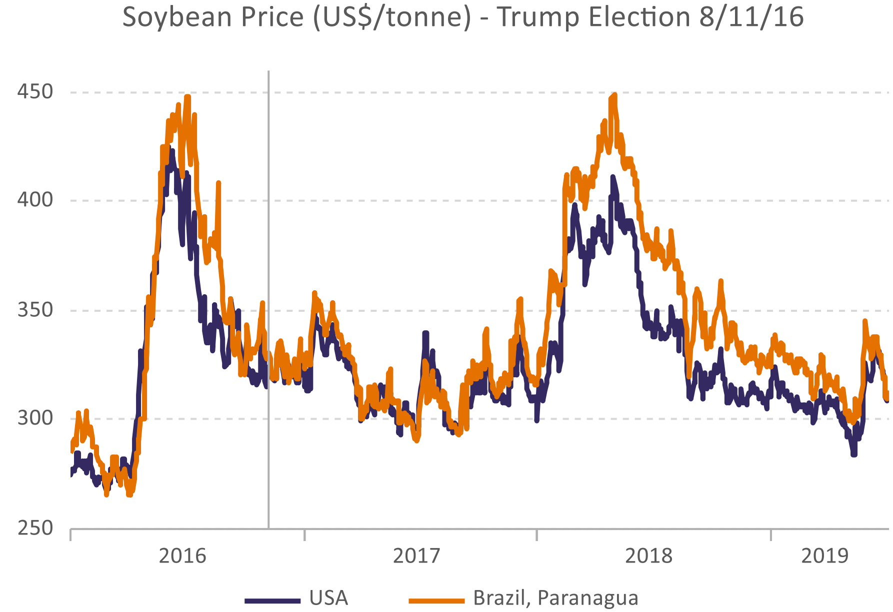
- There is a clear impact on US exports to China
- Leading indicators suggest ongoing weakness in US export trade is likely

FRONTIER ADVISORS

US SOYBEANS



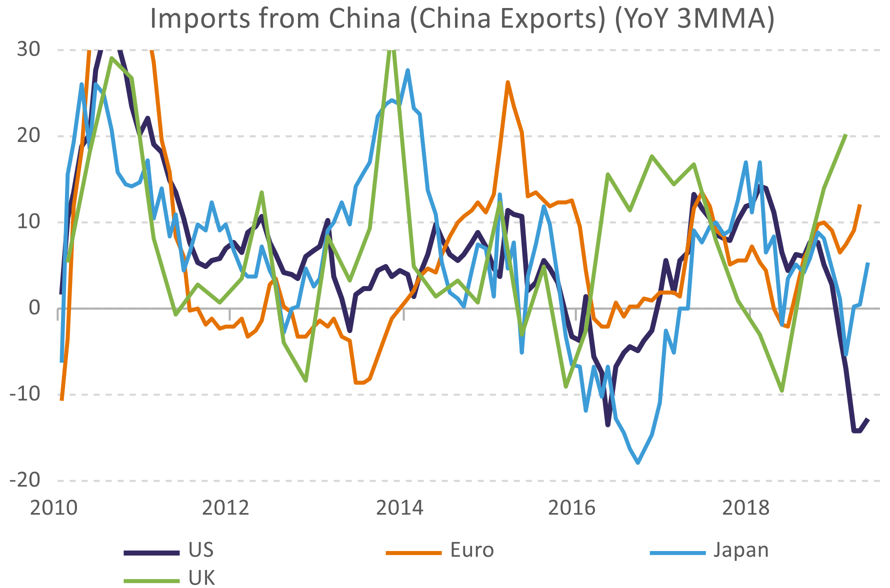
Source: Refinitiv Datastream



Source: Refinitiv Datastream

- The US soybean market has been impacted significantly with a large fall in exports and price due to Chinese tariff response
- Soybeans are a small part of total US trade, but it is the largest US agricultural export sector and constituents of key political consideration
  - Charles Evans, President Federal Bank of Chicago, noted multiple times the impact and sensitivity of the soybeans market at the Credit Suisse Asian Investment Conference that Frontier attended earlier in the year

CHINA EXPORTS



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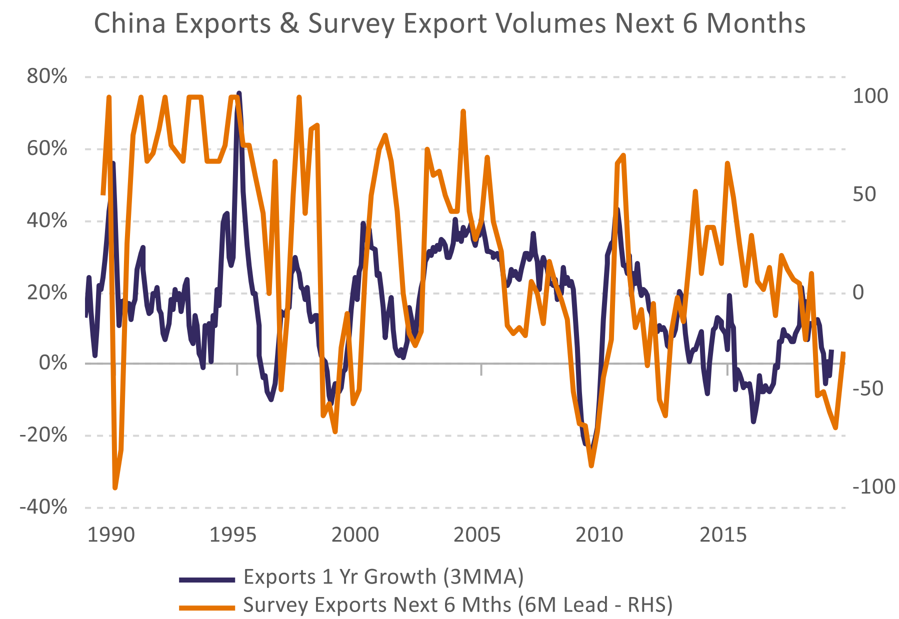
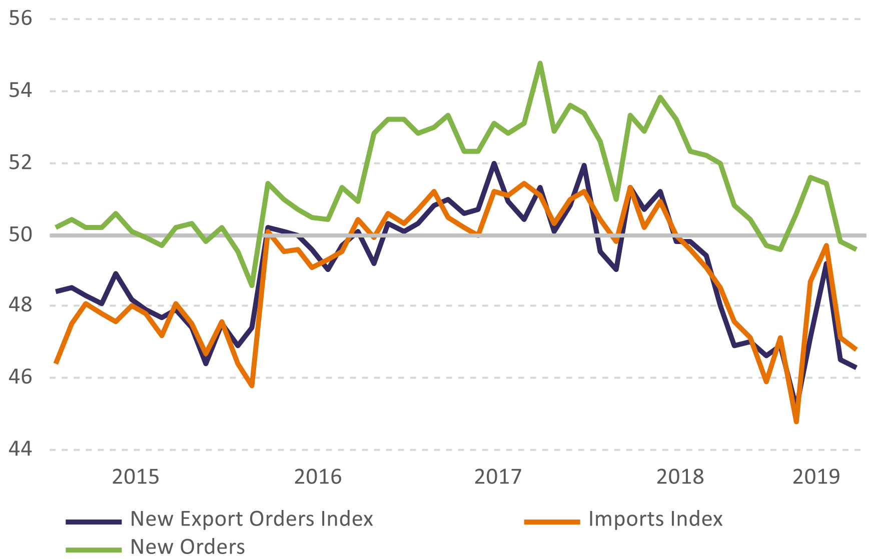


Source: Refinitiv Datastream, IFO, China Customs

- Sharp slowdown in Chinese exports
  - Biggest decline in exports to US (tariff driven)
  - Declines in exports to other countries more related to global economic slowdown but signs of improvement most recently
- Leading indicator suggests continued weakness in the Chinese export market is likely

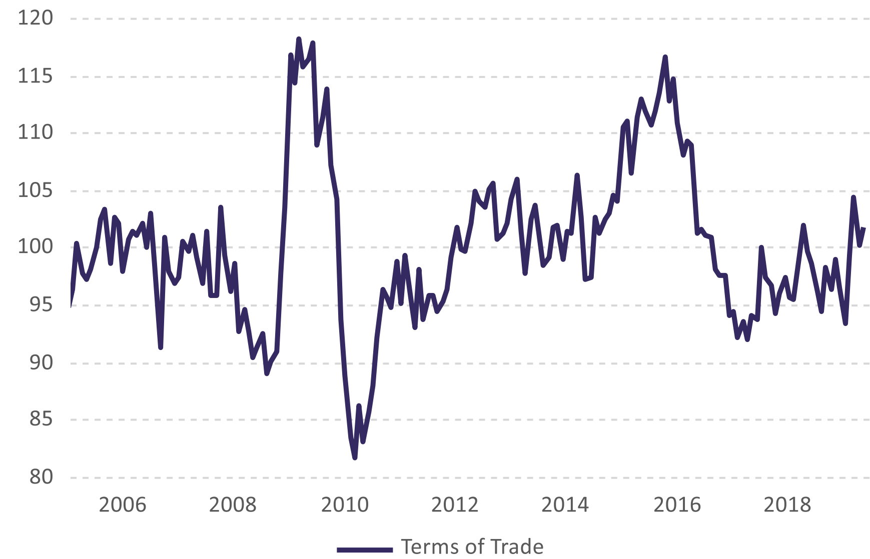
CHINA TRADE PMI

China NBS Manufacturing PMI (Trade Components)



Source: Refinitiv Datastream

China Terms of Trade

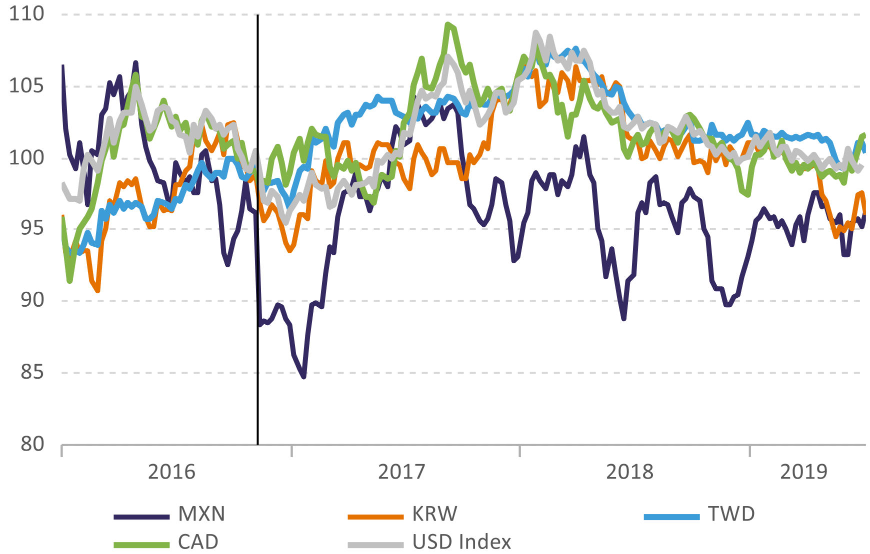


Source: Refinitiv Datastream

- Chinese trade PMIs have been volatile in reaction to news flow on the ongoing trade negotiations
- Overall it has had a negative impact on business conditions in China

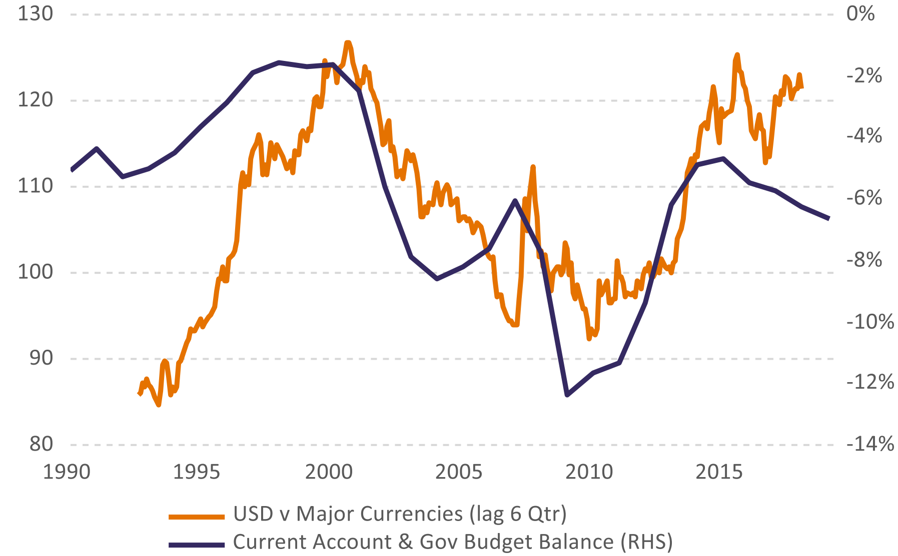
CURRENCY

Currency/USD (Trump Election 8/11/16)



Source: Refinitiv Datastream

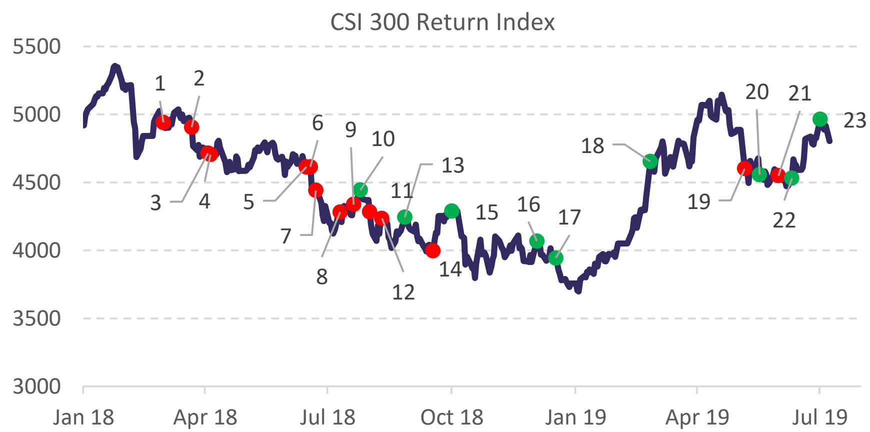
USD vs Current Account & Government Budget Balance (% of GDP)



Source: Refinitiv Datastream

- US trade exposed currencies have depreciated over the last year, broadly consistent with the general appreciation of the USD
  - Mexican peso movement has been driven by more specific domestic events
- Long-term deteriorating government and current account balances would be expected to put downward pressure on the USD

BAD TRADE NEWS GOOD FOR US STOCK MARKET?
TRADE CONCERNS MORE NEGATIVE FOR CHINESE EQUITIES THAN THE US



1. 1 March 2018: Trump announces steel and aluminium tariffs; 7 March 2018: EU announces its planned retaliatory response; 8 March 2018: Trump issues formal steel and aluminium tariff proclamations but exempt Canada and Mexico
2. 22 March 2018: Trump issues revised formal steel and aluminium tariff proclamations, further exempting the EU, South Korea, Brazil, Argentina and Australia
3. 3 April 2018: Trump administration releases its $50bn list of Chinese products under consideration for tariffs; 4 April 2018: China publishes its list as retaliation for Trump's tariffs
4. 5 April 2018: Trump instructs trade officials to consider whether an additional $100 bn of US imports from China should be subject to new tariffs
5. 15 June 2018: Both US and China release an updated list of products subject to tariffs
6. 18 June 2018: Trump threatens another $200 bn of tariffs if China retaliates again
7. 22 June 2018 EU announce retaliation on iconic American goods
8. 10 July 2018: USTR releases a list on $200 bn of imports from China to be subjected to new tariffs
9. 20 July 2018: Trump threatens tariffs on all imports from China, which totaled $504 bn in 2017
10. 25 July 2018: Trump and EU announce deal to avert escalation of trade tensions
11. 1 August 2018: Under Trump's direction, the USTR considers a 25% tariff rate rather than 10% on the list of $200 bn of imports; 3 August 2018: China warns it could add duties of 5 to 25% on $60 bn of US goods following Trump's threat to raise proposed tariff rates on $200 bn of Chinese goods; 7 August 2018: The Trump administration releases a revision to the second phase of its $50 bn list, announcing that $16 bn of imports from China will be subject to a higher 25% tariff rate; 8 August 2018: China revises the second tranche of its list of $50 bn of imports from the US with which it planned to impose 25% tariffs
12. 10 August 2018: Trump announces he will increase the steel and aluminium tariffs on Turkey
13. 27 August 2018: President Trump and President Enrique Pena Nieto of Mexico announce a preliminary US-Mexico trade agreement that would potentially replace the NAFTA. Trump also threatens to impose tariffs on Canada's cars
14. 17 September 2018: Trump finalises the list products on $200 bn of imports from China that will be subject to a 10% tariff rate that goes into effect on September 24 and also announced the rate will increase to 25% on January 1,2019; 18 September 2018: China finalises tariffs on $60 bn of US goods
15. 1 October 2018: Trump announced new USMCA deal with Mexico and Canada
16. 1 December 2018: President Trump and President Xi announce a deal to halt the escalation of tariffs that were expected in January (leave the tariffs on $200 bn worth of product at 10%, and not raise it to 25% at this time)
17. 15 December: USTR announces that scheduled date for tariff rate increases from 10% to 20% on $200bn of China goods has been deferred from 1 January to 2 March. China purchases US soybeans for first time since trade war started, and temporarily reduces tariffs on US car imports from 40% to 15%
18. 24 February: President Trump announces via Twitter that he will delay the tariff increase on $200 bn of imports from china that had been scheduled to go into effect on 1 March, 2019. The 10% tariffs would have been raised to 25%
19. 5 May 2019: In sudden reversal during the US-China trade negotiations, President Trump tweets that the US will increase the 10% tariff on $200 bn of imports from China to 25% on May 10,2019. He also indicates he will shortly impose 25% tariffs on the rest of US imports from China not yet targeted with his Section 301 tariffs; 13 May 2019: China announced that on June 1, it intends to increase the tariff rate covering some of the $60bn of US exports it had already hit in September
20. 17 May 2019: President Trump delays auto tariffs for 180 days to pursue negotiations with Europe, Japan and other nations. The United States agreed to remove steel and aluminum tariffs on Canada and Mexico on 21 May, 2019
21. 31 May 2019: President Trump announced that he will impose a 5% tariffs on all imported goods from Mexico beginning 10 June, 2019; the tariff would be raised to 10% on 1 July, 2019, and then by an additional 5% each month for 3 months. Tariffs will then remain at 25% until the illegal immigration issue is remedied
22. 10 June 2019: Trump says he is suspending the scheduled tariffs against Mexico after reaching a "signed agreement" with the country to reduce or eliminate the illegal immigration
23. 29 June 2019: President Trump and President Xi declared a trade truce to resume trade talks. Trump confirmed he would hold off adding tariffs on $300 bn worth of Chinese goods and would allow US companies to resume sales to Huawei Technologies

US STOCKS WITH INTERNATIONAL EXPOSURE

US International/Domestic Sales Relative Performance

Source: Refinitiv Datastream, Goldman Sachs

US China Exposure Index Relative Performance (since Trump Election)

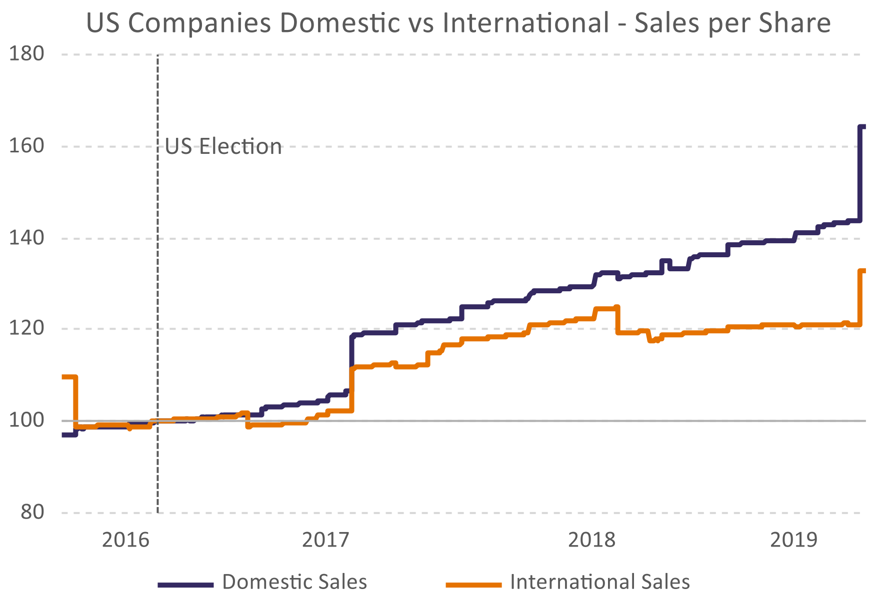
Source: Refinitiv Datastream, Fathom Consulting

23 US-listed stocks that derive more than 15% of revenues from China

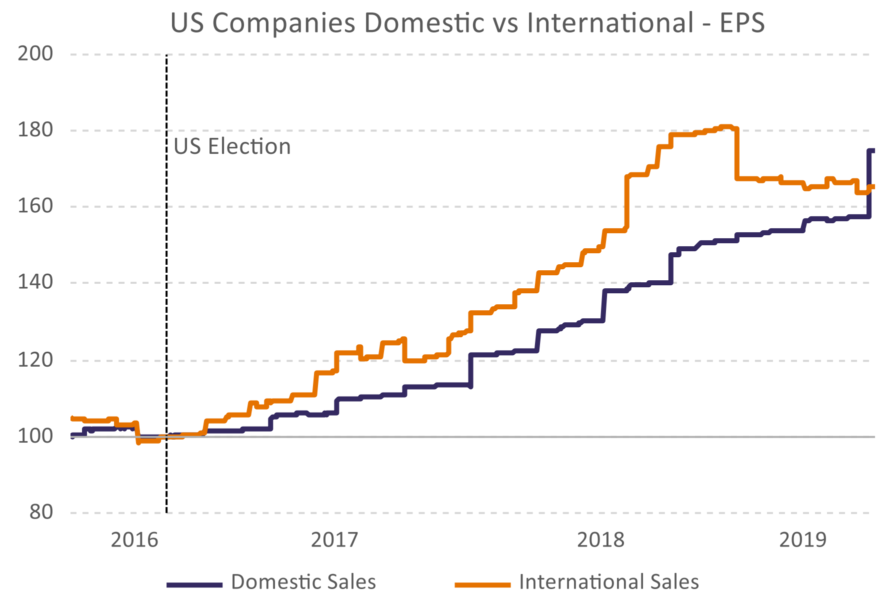
Note: The Goldman Sachs International Sales basket identifies 50 S&P 500 stocks across 11 sectors with the highest international sales. The analysis is based on the geographical breakdown of sales reported by firms in their 2017 10-K filings. The median stock in the basket derives 71% of its revenues from sales outside the US compared with 29% for the median S&P 500 stock and 30% for the S&P 500 in aggregate.

- Underperformance of US stocks with international sales exposure through 2018 as trade conflict escalated
  - Difficult to quantify how much was driven by slowing global growth
- Relative performance rebounded with more positive news on trade discussions

SALES & EARNINGS



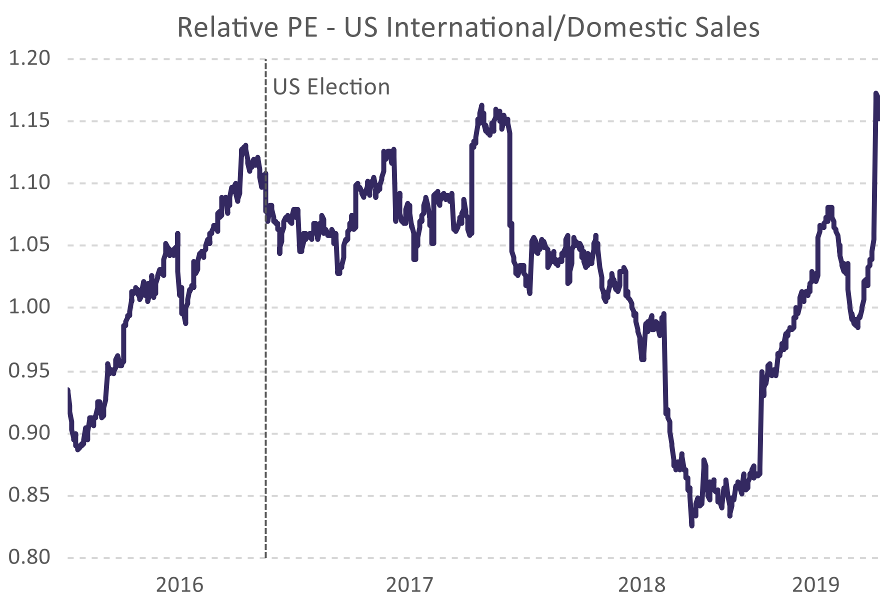
Source: Refinitiv Datastream, Goldman Sachs



Source: Refinitiv Datastream, Goldman Sachs

- Sales and earnings performance of US stocks with international sales exposure has deteriorated since 2018
- Again, it is difficult to quantify the split between the impact of trade restrictions and general global economic slowdown

VALUATIONS



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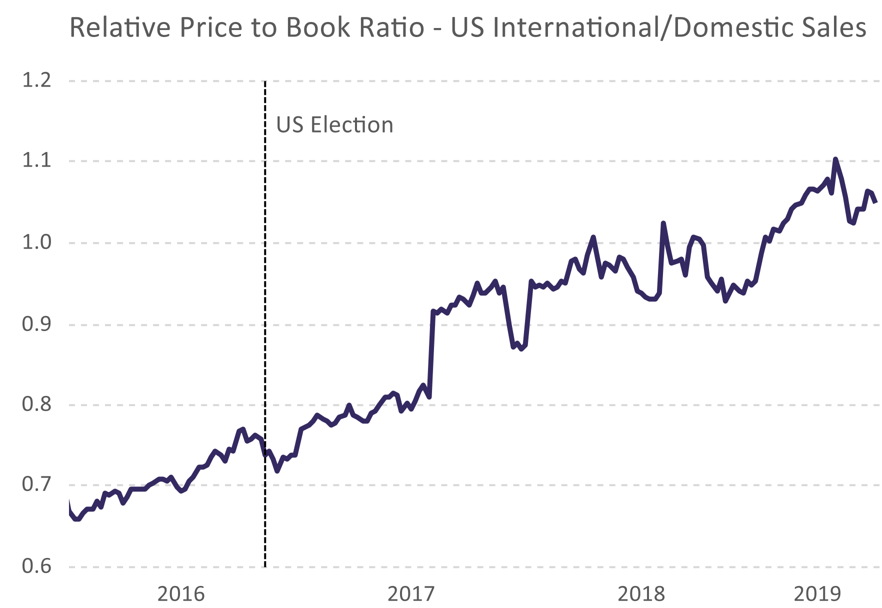
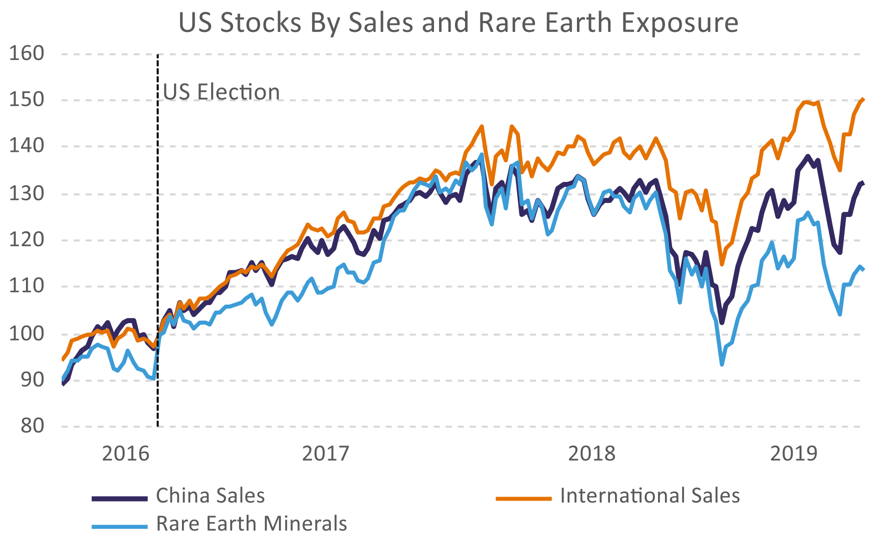


Source: Refinitiv Datastream, Goldman Sachs

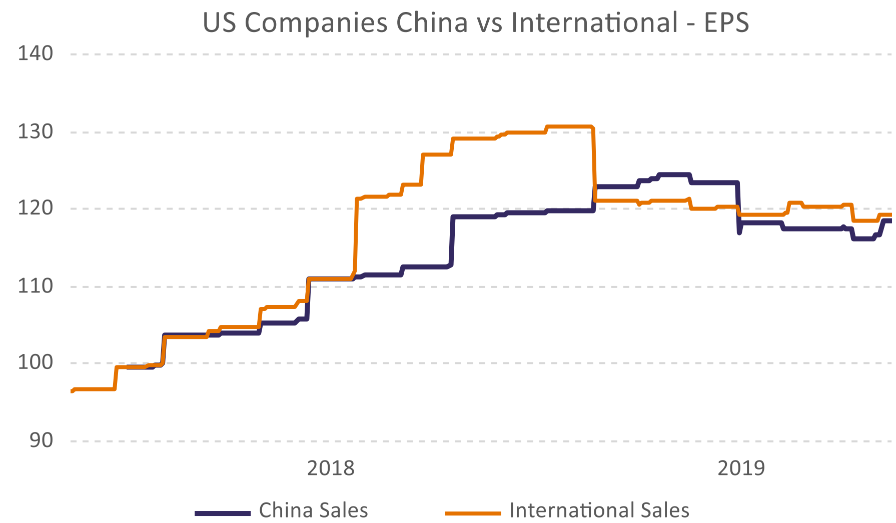
- Relative valuations suggest a premium is currently priced in US stocks more exposed to trade
- Relative P/E shows that stock valuations have the potential to expand on positive trade news; but compared to late 2018, a lot of positivity for trade is priced into the market

FRONTIER ADVISORS

US STOCKS WITH CHINA AND RARE EARTH MINERALS EXPOSURE



Source: Refinitiv Datastream

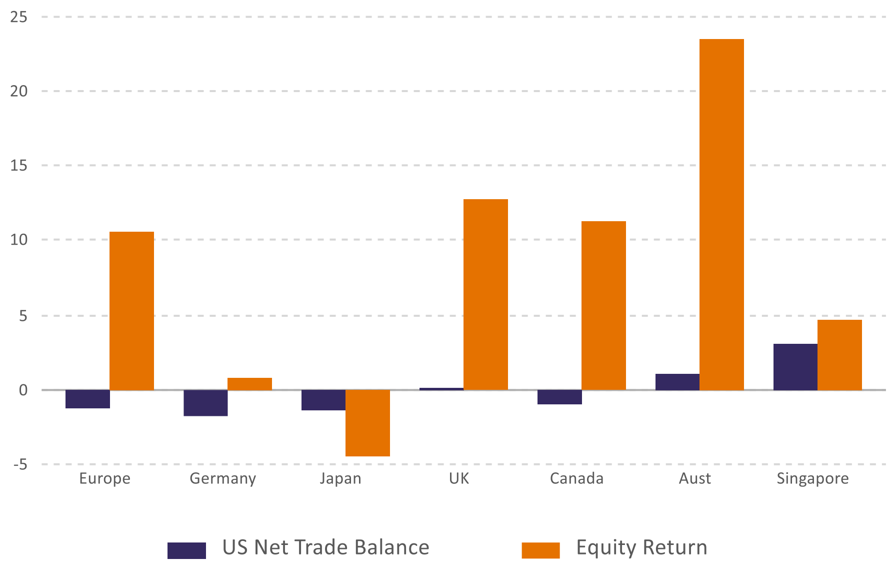


Source: Refinitiv Datastream

- US stocks with China sales exposure have further underperformed stocks with international sales exposure
- US stocks with disclosed rare earth minerals exposure have underperformed even more
  - Potential Chinese retaliation to US tariffs could be in the form of restrictions on rare earth minerals

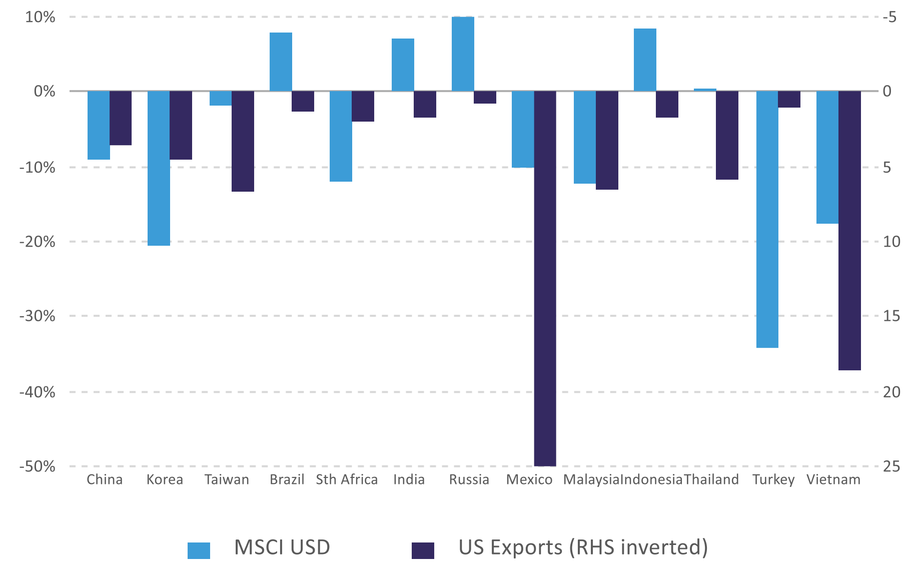
US NET TRADE BALANCE

US Net Trade Balance (% GDP) vs Equity Return 30 Mar-18 to 22 Jul-19



Source: Refinitiv Datastream

EM Equity Return 30 Mar-18 to 22 Jul-19 vs US Exports % of GDP

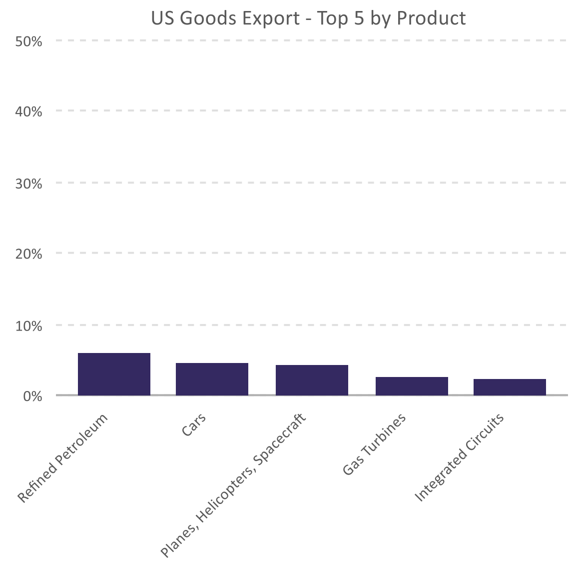


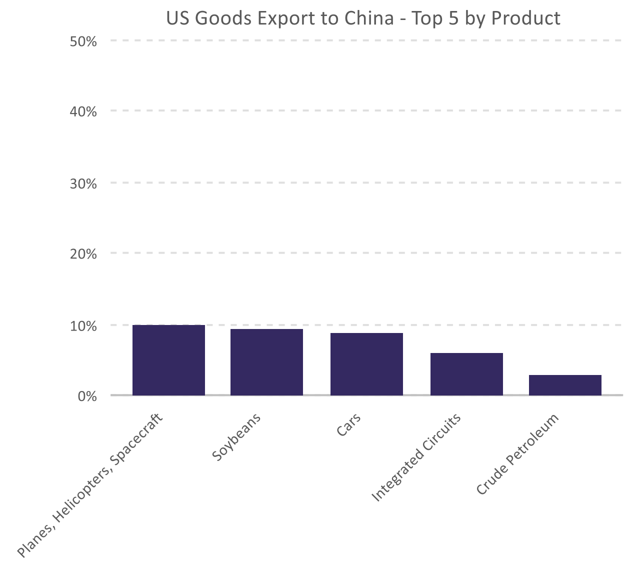
Source: Refinitiv Datastream

- Unlike Europe and Japan, the US is in net trade surplus with Australia
- Despite developments in trade and domestic issues, the Australian equity market has held up and outperformed other developed market countries
- Equity markets in emerging countries have generally underperformed during this period

Appendix

US TRADE

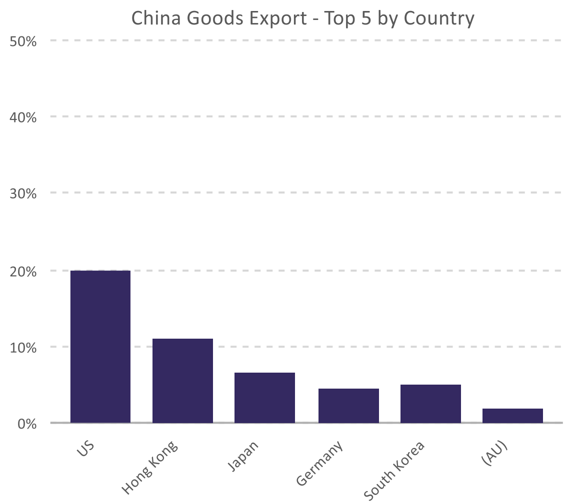


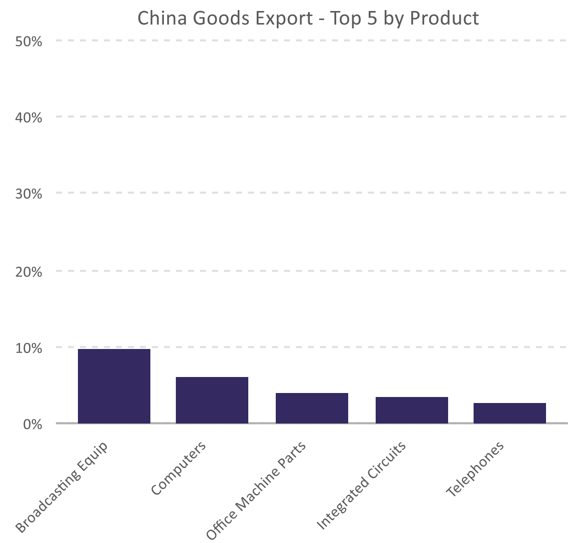


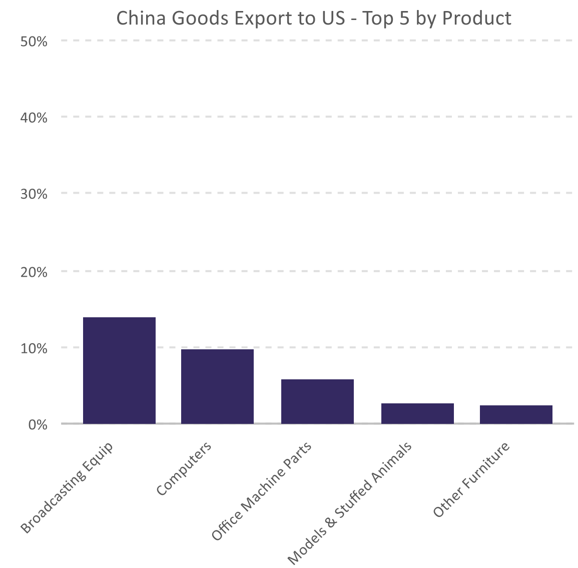
Source: Refinitiv Datastream, The Observatory of Economic Complexity, MIT

- The US has a fairly well diversified export base, both in terms of countries it exports to and by product
- The US has significant export trade with its two neighbouring countries – Canada and Mexico – followed closely by China (11% of total US exports)
- The US exports high-valued manufactured products to the world and China, as well as Soybeans
  - Soybeans are not a major <u>global</u> export product for the US (representing around 2% of total US exports), but they are an important part of US bilateral exports to China (nearly 10% of total US exports to China)

CHINA TRADE



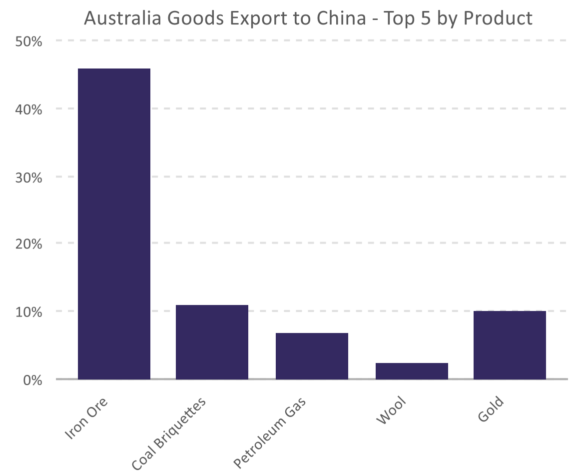


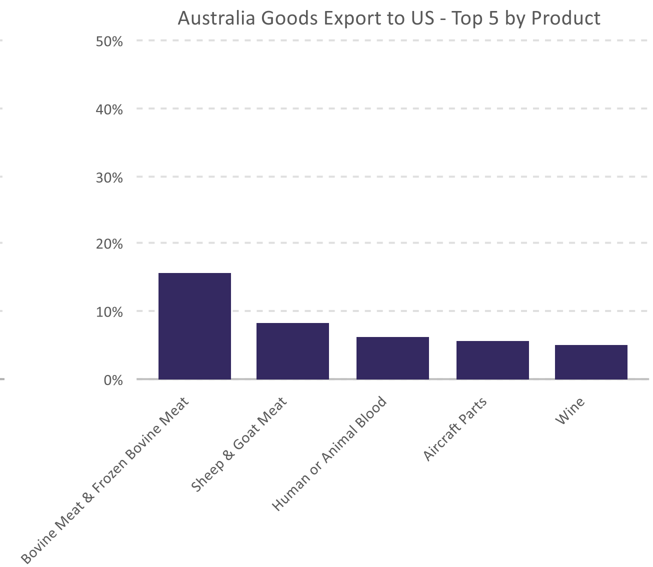


Source: Refinitiv Datastream, The Observatory of Economic Complexity, MIT

- China has significant export trade with advanced economies in the Asian region (22% of exports go to Hong Kong, Japan and Korea), with the US (20%) and Germany (4.5%)
- China's exports are mainly related to electronic equipment, such as broadcasting equipment (10%), computers (6%), office machine parts (3.8%) and integrated circuits (3.3%)
- Electronics are also the major export products China sells to the US

AUSTRALIA TRADE WITH CHINA AND THE US

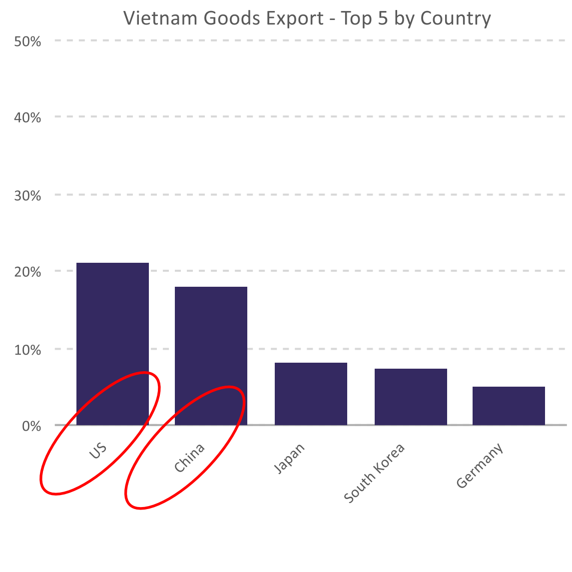




Source: Refinitiv Datastream, The Observatory of Economic Complexity, MIT

- Australia is highly reliant on its largest trading partner, China for exports (35% of total), whereas Australia has a relatively small export exposure to the US (3.5%)
- Australia's exports to China are dominated by iron ore and coal. Meat is Australia's major export to the US
  - At a global level, Australia accounts for 50% of total world iron ore exports and China accounts for 60% total imports
  - Arguably, iron ore and coal is more exposed to China's domestic conditions (property and infrastructure) rather than the export driven sectors

VIETNAM TRADE WITH CHINA AND THE US



Source: Refinitiv Datastream, The Observatory of Economic Complexity, MIT

- Vietnam has a high export exposure to the US and China (around 40% of exports are to those two countries)
- Compared to Australia, Vietnam is much more exposed to a change in export volumes as a result of a potential increase or decrease in bilateral trade between the US and China. This is because Vietnam exports similar products to what US and China sell with each other (electronic items such as integrated circuits and broadcasting equipment)

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