

# The trade war drags on ... and on, and on

News from the financial markets

**The trade dispute between the US and China has escalated. By hiking the already existing tariffs and introducing trade restrictions for key companies, Donald Trump is demonstrating his willingness to accept a hit to the US-economy in return for the achievement of a strategic goal: The protection and exclusive use of American intellectual property. Apparently, the policy is not just about balancing the trade deficit with individual countries. What significance do punitive tariffs have for companies and consumers, and what do investors have to keep in mind in this uncertain environment?**

Punitive tariffs are a blunt sword. In a nutshell, the imposition of such tariffs results in a loss of prosperity for all countries involved, as is enunciated by three scientists from the American National Bureau of Economic Research in a recent study. The US administration's trade policy weighs on prices as well as on the overall prosperity of American households. Based on tariff hikes introduced in 2018, the authors have ascertained that the added costs are being passed through to consumers almost directly, with the result being a monthly negative effect on U.S. real income of about USD 1.4 bn. Similarly, they note that in the effort to avoid higher tariffs, a trade volume of some USD 165 bn was lost or directed elsewhere internationally.

The introduction of protective tariffs of 20 to 50 % on washing machines in the US at the beginning of 2018 offers a prime example of how companies are reacting to new import restrictions. American household appliance manufacturer Whirlpool had sparked the move after having complained for years about unfair trading conditions. Due to fierce competition, especially from LG and Samsung, washing machine prices had been falling steadily since 2013. Whilst good for American consumers, this trend posed a strong economic headwind for the US producers. The countermeasures already taken by the Obama administration had proved ineffective. Trump's tariffs, though, were a boon for Whirlpool, which immediately hired 200 new employees. A year later, prices for washing machines in the US rose by an average of 12 % – but alas, fewer washing machines were sold.

## Companies are adapting opportunistically

This washing machine example shows how companies are responding to the tariffs:

**Tendency for tariffs to be passed on to consumers:** The Whirlpool case demonstrates that – whenever possible – companies are simply tacking on the added costs to their

selling prices. The same effect was observed in wood and wood products from Canada: along with the increase in import tariffs from 15 to 21 %, construction costs for single-family homes rose by around 7 % as a result. Higher tariffs on steel and aluminium have also been passed on.

Goods affected by US punitive tariffs

Spring 2018: USD 50 bn

53 % Intermediate Goods	42% Capital Goods	5% Others
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September 2018: USD 200 bn

50 % Intermediate Goods	25 % Capital Goods	24 % Consumer Goods
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Announced: USD ~280 bn

15 % Intern. Goods	44% Capital Goods	40 % Consumer Goods
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Source: Peterson Institute for International Economics

**Domestic companies are profiting:** Customs duties on imported washing machines last year generated USD 82 mn in additional tax revenues, but consumers had to fork out a total of USD 1.5 bn. The reason for this is not just the price increase on imported washing machines; rather, because all domestic competitors without the burden of additional import duties took the opportunity to raise their prices by between 5 and 19 %. All in all, US consumers are being burdened much more heavily, and Donald Trump's brinksmanship on trade policy is proving to be a disservice.

**Some manufacturing is being moved elsewhere:** A number of importers have reacted by shifting their supply chains to other countries. As a result, they can avoid the higher import tariffs and, ideally, reduce added costs. Examples of this are LG and Samsung. To avert competitive disadvantages, they have relocated parts of their washing machine production processes to the US, thereby creating almost 2,000 new jobs there. At the same time, they are also profiting from higher domestic US sales prices. Apple's crucial supplier Foxconn has acted similarly by shifting some of its manufacturing capacities from China to Vietnam.

**Other trade partners are selected:** So long as there are locations where production costs are as cheap as in China and which are not affected by the new customs duties, manufacturers and suppliers will avoid China. Almost half of all imports into the US subject to punitive tariffs are so-called intermediate goods. In this segment, if relocations are no longer possible, the result can be a

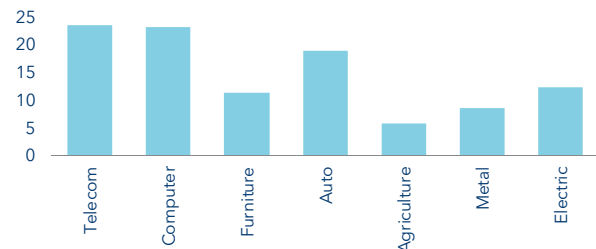
switch of subcontractors. Whilst exports from China to the US fell by almost 7 % last year, imports from other countries such as Taiwan, Vietnam, Japan and South Korea increased. Ultimately, the overall volume of trade hardly changed as demand in the US remained steady.

**Market squeeze-out is under way:** The more that American companies remain dependent on China for the production of their goods and no possibilities exist for any substitution of that manufacturing capacity, the harder they will be hit by the real economic damage. Especially in highly competitive markets, profit margins are generally low. Gary Shapiro, head of the Consumer Technology Association, estimates the forgone profits to date for the US technology sector to be in the vicinity of USD 1 bn per month. In this regard, small and medium-sized enterprises have been disproportionately affected and are struggling to survive.

### Technology is at the epicentre of the trade war

It is not surprising that the US has its eye mainly on the technology sector in this dispute. Aside from issues relating to agriculture and the auto industry, high tech and its many intellectual property aspects are the highest priority in terms of trade with China. For both countries, technology is key to their future growth. Chinese telecom giant Huawei is at the forefront in the area of 5G mobile communications. The company is also the world's largest customer of semiconductor technologies and is the global number three in mobile phone sales. Under the pretext of national security, the US is now subjecting the company to specific trade restrictions. As a result, key suppliers have been forced – at least temporarily – to discontinue their cooperation with Huawei, namely Alphabet (Google), Intel, Qualcomm and other global companies which use US technologies in their products. The ultimate effects of this extreme measure are currently difficult to assess. For the suppliers, this means a loss of sales; the worst case for Huawei would be a temporary cessation of production. However, America's high-tech industry is heavily dependent on Asia: for example, chip manufacturer Intel generates 27 % of its sales in China, competitor Qualcomm 67 %. But the US Department of Commerce does not want to leave it at that – the focus is also on three other Chinese technology giants, namely Zheijang Dahua, Hangzhou Hikvision and Iflytek, which have a leading position in the field of video surveillance, face and voice recognition.

Segments affected by US punitive tariffs (in USD bn)



Source: US Int. Trade Commission (USITC) Dataweb

### Long-term investors can be relaxed

The trade skirmish with China is primarily a dispute over the protection of intellectual property and the fair usufruct of key technologies. The US administration is conducting this battle with tremendous resolve and is prepared to accept any consequential economic fallout. The related increase in government revenues pales in comparison to the greater burden that consumers are now forced to bear, but enterprises have developed very dynamic adjustment processes.

The way things are going at present, it is entirely possible that the observable negative influences could intensify even further. It is unclear as to what extent the potential sales shortfalls, declining profit margins and higher costs will find their way into financial statements of companies. Ergo, the increased forecasting uncertainty can be expected to result in valuation markdowns, and wider price fluctuations for the affected companies need to be taken into account. In this regard, the technology and automobile sectors are likely to be hit the hardest. Consumer electronics would only be significantly affected if the tariffs were extended to all imports from China.

The adaptability of today's companies suggests that these impairments are but temporary annoyances, whereas the short-term impact on the equity markets can be significant. Be that as it may, the current phase of uncertainty can open up interesting windows of opportunity for long-term investors. The shifts in production bases and trade flows that are essentially under way today are certainly unnerving in the short term, but they should have little if any effect on the future value creation attributable to the strong and ongoing industrial trends.

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