BREWIN DOLPHIN

Are we heading for a global trade war?

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We have been hearing more about protectionism. What is happening?

Trump has announced the imposition of tariffs. This in itself is not unusual. There are many tariffs in the world at the moment. We should disabuse ourselves of any notion that the world was tariff free before Donald Trump became President. We in the UK, and our partners in the EU, are protected by the Common External Tariff (a tax on all imports into the customs union where there is no alternative free-trade agreement). In fact, one of the reasons that China is relatively unaffected by the recently announced steel and aluminium tariffs was that their exports to the US were already captured by so-called countervailing tariffs. These were introduced by President Obama to protect the US from dumping (selling at a price which has been manipulated by subsidies to undermine competition). What is different is not what President Trump is doing, but rather how he justifies it.

President Trump described the tariffs as being essential for US national security. These were directed at all trading partners although subsequently they have been softened to exclude, Canada, Mexico, and later the UK and European Union (but not Japan).

What is contentious about this is that while WTO rules do permit countries to assess their national security requirements and protect industries if they feel it is necessary, certain passages in the World Trade Organisation (WTO) rule seem to limit that provision to either explicit military-related goods or a broader range of goods during wartime. It is dangerous to conclude that a broader range of goods could be considered essential to national security because the same interpretation could be made by many industries and governments, in which case decades of work reducing tariffs through multilateral negotiation could be undone.

In the worst-case scenario this trade dispute could cause long-standing international agreements to unravel. For example, if the US were to leave the WTO it would have implications for the 60% of US two-way trade not covered by free trade agreements. Currently this is conducted under the WTO's most favoured nation terms. Ceasing membership of the WTO would mean that every country could set its tariff levels (or other forms of protectionism) with the US with discretion, making it easier to apply tariffs on goods where the US is very competitive.

The most obvious advantages of this are that each country treats all its peers equally. That makes for a more competitive environment which brings benefits to consumers. It also avoids the need for lots of bureaucracy which otherwise has to identify the point of origin for goods that might have components from many different companies, each with their own bilateral tariffs with the US. Finally, the WTO makes it possible for smaller, less developed countries to compete in the global market. This advantage for developing countries is not, however, a disadvantage for developed economies like the US because as those less developing economies grow they become more profitable markets for US firms to sell into (larger markets for iPhone for example).

The Trump Administration's imposition of steel and aluminium tariffs on national security grounds could also be seen as worrying given that many of the countries included were NATO allies.

Since the steel tariffs were announced their impact has been greatly reduced through negotiation. Japan was still included which may hasten the revision of its pacifist constitution. Japan relies informally on the US and its NATO partnership for defence. The US has military bases in Japan. Yet if the US considers aluminium and steel tariffs a national security necessity then Japan should surely be reconsidering whether its own security arrangements are robust.

Whilst announcing the finalised set of steel tariffs President Trump was already announcing a second set of measures under section 301 of the US trade act. This was a specific sanction against China seeking reparations for the Chinese insistence upon intellectual property being transferred to Chinese firms when US firms invest in China.

Section 301 now compels him to seek the removal of that barrier.

What are the economic effects of these actions?

These tariffs are taxes on imported goods and their imposition will raise prices in, for example, the US. That either means that the government gets the revenue from the tax or, if the tariff is set high enough, the goods don't get imported and more expensive domestic goods are sold instead. In either case this tariff is largely paid for by whoever consumes the goods (the supplier might accept a little less mark-up as well). That ultimate consumer could be US households or businesses. Imposing a tariff means taxing one part of your society to support another. If the victim is US consumers at large then the impact will be spread and they are unlikely to notice – tariffs can seem like a bit of a victimless crime which is why President Trump describes them as good and easy to win.

Unfortunately, at this stage it gets more complex because if a tariff raises the price in the US, it effectively lowers the price everywhere else. Goods which might once have been sold in the US are no longer competitive there, so the trade is deflected to other regions. They have the choice of raising their own tariffs, or seeing their own industry undermined. This is one way in which trade disputes can escalate and broaden.

And that's bad, because any trade restriction will raise prices on aggregate which means people are willing to buy less. The measure may be about protecting employment in one region but it will be at the expense of employment in another region and if other countries use safeguards or countervailing measures (retaliatory protectionism) then quite possibly there is no benefit to anyone, only costs.

The EU immediately planned its own safeguards following the initial announcement of the US steel tariffs, to protect against steel being deflected from the US and flooding the market. As it stands these seem to be unnecessary because the US has since exempted the EU from the protection.

The same could occur when the US announces its tariffs on specific Chinese exports.

How worried should we be about that?

At the moment the scope of this protectionism is incredibly narrow; steel and aluminium which amounts to a very small fraction of US imports and around a tenth of US imports from China. The direct effects should be minimal and China's planned retaliation is currently limited to a fraction of the US measures. More significant are the US measures that have not been announced yet. That will happen within the next fortnight. After that there is a period of public consultation of 30 days. This provides ample time for the measures to be watered down or an agreement to be reached, rendering them unnecessary.

We know these discussions are going on between US Treasury Secretary Steve Mnuchin, US Trade Representative Robert Lighthizer and their Chinese counterparts. The US team are seeking easing of tariffs on US car imports, more Chinese purchases of US semiconductors and greater access to the Chinese financial system for US firms. That follows comments during the month from China's commerce minister, Zhong Shan, that the authorities are seeking to lower duties on vehicles, consumer goods and industries such as telecoms, education and care. Premier Li Keqiang also pledged to open up its manufacturing sector and to end the practise of requiring technology transfer by foreign companies.

It seems very likely that these tariffs are never implemented and that, in fact, the global car market in particular becomes an incrementally freer market as a result of President Trump's announcement. Whether that was the intended effect or not is unclear, certainly the approach to the problem has been unorthodox. The golden rule when negotiating trade is normally to talk tough behind closed doors as you are almost always trying to balance the effects of different domestic public interest groups. It can frustrate the chances of reaching a deal if public threats are made. That said, perhaps the announcement was made to show the Chinese how serious Trump's team are.

What are the implications for investors?

The direct effects of the current trade skirmish are unlikely to be substantial. If they were then the political pressure to ease them would mount quickly. It may seem intuitive to believe that smaller companies are insulated from protectionism because they trade predominantly within their domestic market, but that conclusion is a dangerous one. In the UK, for example, smaller companies still seek around half of their revenues from overseas. But even that misses the point that they may very well depend upon any number of imported components. This is the real challenge of trade related policy. It is very difficult for policymakers in Whitehall or Washington to protect or punish one sector without inadvertently interfering with the workings of other businesses and households.

Sectors provide some protection against a reversal of free trade. Less cyclical sectors, such as utilities, or those which have their entire cost structure contained within individual geographies such as telecoms, are safer areas. In general, emerging markets as a block are particularly sensitive to any disruption to trade.

Will tariffs lead to inflation and higher interest rates?

There will be an impact on inflation, but it is unlikely to repeat so policymakers will probably ignore it. A very significant retracement of globalisation could lead to whole industries escaping the ravages of global competition, becoming less competitive as a result and therefore charging higher prices. But we think that well in advance of any such eventuality it would have become clear that rolling back free trade was mutually harmful.

We would not urge radical revision of portfolios in the face of recent trade rhetoric.

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Guy leads Brewin Dolphin's Research team ensuring that a rigorous and exhaustive investment process is employed. He also provides recommendations on tactical investment strategy to Brewin Dolphin's investment managers and strategic recommendations to the group's Asset Allocation Committee. Before joining Brewin Dolphin in 2006, Guy was an Investment Director at Hill Martin (Asset Management). Guy has a Masters in Finance from London Business School. He is also a CFA charterholder, holds the CISI Diploma, and is a member of the Society of Business Economists. Guy frequently discusses financial issues with the written and televised media as well as presenting to the staff and clients of Brewin Dolphin.