ESCALATING TRADE WOES

The introduction of punitive tariffs on Mexican imports is the latest sign of dangers ahead – not just to our macro forecasts

The current escalation in trade tensions is not in line with the macro forecasts as we have laid them out in our baseline scenario. Trade tariffs are increasingly becoming an all-purpose weapon, serving as instruments not only to promote fair trade, but now also e.g. to strengthen U.S. border security. Imposing punitive tariffs against Mexico to dim illegal immigration introduces a new quality in this trade dispute.

According to President Trump, the U.S. will institute a 5% tariff on imports from Mexico effective June 10, with the rate set to rise by 5% every month until it reaches 25% in October. However, the new duties will be scrapped again if "illegal migrants coming through Mexico, and into our country, STOP" as per his tweet. U.S. imports from Mexico amount to around $30bn of goods each month, of which roughly 30% are cars and car parts. Tariffs at 25% on that flow of goods, on top of the punitive tariffs on imports from China, would increasingly have a significantly negative impact on the U.S. manufacturing industry. So far, Mexico has stated that they will not retaliate while talks with the U.S. are ongoing. A swift de-escalation certainly remains possible. However, some damage to U.S.-Mexico relations has probably been done already.

Implications:

_ The initial tariffs of 5% would target all Mexican exports to the U.S. (starting on June 10th), and continue to increase unless and until the migration "crisis" is "addressed" by Mexican authorities. This seems to be difficult (if not impossible) for Mexico to comply with. If implemented, this new round of tariffs can be expected to be a material threat to profitability for the auto sector.

_ In addition, the move could derail another one of President Trump's goals: Revising the North American Free Trade Agreement with Canada and Mexico. Only last week, things looked quite promising after the U.S. administration announced the exemption of Canada and Mexico from global punitive tariffs on U.S. steel and aluminum imports.

_ With regards to China, the Huawei case has escalated to an extent that a face-saving agreement now seems hard to achieve. As things stand, we have to acknowledge the risks for the global economy are increasing by the day. China's official PMI sentiment index for manufacturing declined in May to 49.4 (from 50.1 in April). The details were not encouraging either: the employment component fell to the lowest level since the financial crisis, new export orders fell strongly. The import sub-component also fell visibly, which is bad news for China's trade partners. There might be a bit of comfort from the relatively robust sentiment in services and construction, leaving the non-manufacturing index at 54.3. However, given the substantial headwinds in manufacturing (trade escalation and an increasing "tech war") which are not likely to end soon, negative knock-on effects on the domestic sector must be expected. China retaliating by banning exports of rare earths to the U.S. is another risk and could cause production shortfalls along global supply chains.

While the end of the China-U.S. talks has already put the conflict on a new level, the Mexico tweet has added yet another layer of escalation. In order to get to our baseline scenario, which is built on the assumption that rational behavior will eventually prevail, we would need to see some evidence of that starting to happen in the coming weeks. Be it at the G20 summit, be it in light of the implementation of the announced China tariffs, or be it with regards to the new Mexico tariffs.

The timing is critical now for several reasons:

1. In May, the S&P 500 has seen its first decline this year. There have been some indications in the past that markets might serve as a corrective, however, recent events are undermining this assumption. We have raised the risk of a full-blown correction (with the S&P declining by more than 10%) to high (from moderate).

2. Tariffs on trade with Mexico would have even more immediate and detrimental consequences on U.S. businesses than the China tariffs. Hence, opposition from the Republican Party (GOP) should be more forceful compared to the China case. A lack of GOP reaction would be a negative sign.
3. The longer the China-U.S. conflict (at the current heat level) continues, the less likely it becomes that both parties will be able to find a face-saving compromise.
4. At some point, the conflict could unfold its own momentum, which none of the decision makers involved would then be able to contain.

While the fall-out is not yet visible in hard economic data, a further escalation on the path set by recent events may require a reassessment of our economic and monetary-policy forecasts. For the U.S. we would expect lower growth, higher inflation and most certainly an alternative path for monetary policy. For now, we expect the U.S. Federal Reserve to continue its "wait-and-see" approach, unless and until we see a sharp further deterioration in financial conditions. While we would expect only a minor impact on hard macro-economic data for the remainder of this year, a bigger impact would be visible in 2020. Sentiment indicators as well as financial conditions are likely to be hit earlier. We have to acknowledge that policy makers currently appear to be ready to pursue their policy objectives without caring much about the economic cost.

GLOSSARY

G20
The **Group of 20** are the largest industrialized and emerging economies in the world.

Inflation
Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Monetary policy
Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

North American Free Trade Agreement (NAFTA)
The **North American Free Trade Agreement (NAFTA)** is a trade agreement signed by Canada, Mexico and the United States, creating a trilateral trade bloc in North America, which came into force on January 1st, 1994.

Purchasing Managers Index (PMI)
The **Purchasing Managers Index (PMI)** is an indicator of the economic health of the manufacturing sector in a specific country or region.

Republican Party (Republicans)
The **Republican Party (Republicans)**, also referred to as Grand Old Party (GOP), is one of the two major political parties in the United States. It is generally to the right of its main rival, the Democratic Party.

U.S. Federal Reserve (Fed)
The **U.S. Federal Reserve**, often referred to as **"the Fed"**, is the central bank of the United States.

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