Tariffs, Trade Wars, and Geopolitical Rhetoric:  
A fundamental turning point or temporary speedbump?

Back in December of 2016 when I wrote our “7 for 2017” year ahead market outlook, I identified 7 fundamental catalysts that would affect markets. Catalyst #5 in that piece was the Trump Administration’s fiscal policy focus. And out of 8 pillars of Trump’s platform he ran on in the 2016 election, we identified the two we thought would have the greatest impact on markets in the future – those two pillars were Taxes and Trade. So far, those two pillars are currently the two primary pillars driving markets.

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<th>Growth boosting policies proposed by Trump</th>
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<td>Massive stimulus-at least double’ Clinton’s 5-year $275 billion infrastructure plan.</td>
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<td>Create many jobs in construction, steel manufacturing and other sectors with special focus on transportation, water, telecom and energy.</td>
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<td>Protectionist stance: introduce tariffs / duties</td>
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<td>Tough on China: 45% tariffs, label as FX manipulator, bring trade cases against China, both in the U.S and at the WTO</td>
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<td>Renegotiate NAFTA, reject TPP, unlikely to support T-TIP</td>
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<td>Corp.: slash tax rate from 35% to 15%, one-off offer to repatriate foreign profits at 10%, move from worldwide to territorial tax</td>
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<td>Personal: collapse current seven tax brackets to three tax brackets, cut top rate, repeal estate tax</td>
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<td>•Reduce regulatory burden, repeal parts of Dodd-Frank</td>
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<td>•Eliminate most intrusive regulations, like the Waters of The U.S. Rule, scrap the EPA’s Clean Power Plan which will cost $7.2 billion a year</td>
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<td>•Tough stance on immigration: build Mexico wall, end birthright citizenship</td>
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<td>•Protect economic well-being of lawful immigrants by curtailing uncontrolled foreign worker admissions</td>
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<td>•Repeal and replace Obamacare with Health Savings Accounts (HSAs)</td>
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<td>•Establish high-risk pools to ensure access to coverage for individuals unable to maintain continuous coverage.</td>
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<td>•Allow people to purchase insurance across state lines, in all 50 states</td>
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<td>•Maximize flexibility for states via block grants to design innovative Medicaid programs for low-income citizens</td>
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<td>•Create a dynamic booming economy that will create 25 million new jobs over the next decade.</td>
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<td>•Accelerate growth to average 3.5% per year with potential to reach 4% growth.</td>
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<td>•Make the U.S energy independent. Unleash $50 trillion in untapped shale, oil, and natural gas reserves</td>
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<td>•Eliminate barriers to energy production, creating at least a half million jobs a year, $30 billion in higher wages, and cheaper energy.</td>
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<td>•An additional federal investment of $20 billion towards school choice, provide low-income households an Expanded Earned Income Tax Credit in the form a Childcare rebate and a matching $500 contribution for their savings accounts.</td>
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<td>•Minimum wage determined at state / local level</td>
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Specifically as it relates to trade, I said the following back then:

“Trade Policy - The primary components of the Trump’s trade policies are:
- Protectionist stance: introduce tariffs / duties
- Tough on China: 45% tariffs, label as FX manipulator, bring trade cases against China,
- both in the U.S and at the WTO, Renegotiate NAFTA, reject TPP, unlikely to support T-TIP

Headwinds do exist, namely potential significant effects to US GDP growth and corporate profitability due to domestic policy focus and isolationist protocol and their impact from trade sanctions / isolationism with China and other global trade partners (think TPP / T-TIP / NAFTA).”
In my opinion, much of the rhetoric coming from President Trump and his administration is nothing more than an attempt to follow through on his pre-election campaign promises of both renegotiating NAFTA and being “hard on China.” Unfortunately his approach to addressing these perceived issues came out not only clunky and not well thought through, but also smelling of US Protectionism.

Below for ease of reading, I’ve summarized my “Bottom Line” views on all of this, but also try to provide you deeper factual content via a Q&A as well as a timeline of events that have transpired to date.

**Our Bottom Line Views:**

- Going back over the last several years, virtually every geopolitical speedbump was resolved in the market’s view, and global markets continued to make new highs. This pattern specific to the Trump Administration is no different – come on hard, then walk back/ back off. We, and likely the markets, expect more of the same.

- As I detail out below, both trade relations and financing relations (China buying our debt) between the US and China are very large and significant. Both nations have a vested interest in making this work. Neither can afford strained relations that affect both trade and fiscal financing. The cost of either or both is, in my opinion, far too great for either nation to bear.

- The US is currently slated to impose tariffs of 25% on $34 billion of Chinese exports beginning on July 6. The remaining $16 billion of the original product list will undergo further review in a public notice and comment process, the timing of which is set to be released in the coming weeks. Should tariffs on another $200bn of goods be considered, they would be subject to the same process, which would ostensibly take two to three months. Thus, we see little prospects for a near-term settlement.

- Analysis done this week via Deutsche Bank indicates that a further escalation of the trade dispute to include $200bn of imports could reduce real US GDP growth by roughly -0.2 to -0.3 percentage points. In addition, the effective $32.5 billion “tax” on imported goods could have the effect of boosting core PCE inflation by roughly 0.15 percentage points (0.15%)\(^4\).

- Our base case remains that the trade conflict with China will be settled before it progresses significantly beyond the initial imposition of tariffs on $50bn of imports in both directions. However, recent events have clearly increased the risks that the conflict will begin to have measurable negative economic effects. If things do go further, we are guessing that the stock market correction could get into the -5% to -10% range. If a settlement is then negotiated quickly, the stock market could recover and the risks to GDP mitigated. However, if a trade war gathers further momentum, it could well induce the next recession.

- **Positive points that are easy to overlook right now:**
  - It’s easy to forget that US markets (Russell 3000) are up 355% and global markets (MSCI ACWI) are up 249% from the end of the Great Financial Crisis through last month. In 2017 you made 21% and 25% respectively in those markets, and year-to-date through 6/22/2018, are up 4.7% and 1.1%. If we are worried about markets now, we’ve got bigger problems related to expectations vs. the reality of markets\(^1\).

  - US economic data through May remains very strong across both hard and soft economic data.
As of June 19th, Atlanta Fed GDPNow data point to a whopping 4.7% real GDP growth for Q2 2018.

Recent global PMIs for May for developed international markets have ticked materially back up showing there’s more left in the tank for International markets.

Corporate earnings in the US, Eurozone, and Japan broke records last quarter, and early views into Q2 look equally strong.

**Bottom Line:** Whether or not significant tariffs come to pass or trade wars ensue or don’t ensue is not really the point. The most concerning event to me is the massive change in tone and positioning the US has taken with the rest of the world. The tone of protectionism and isolationism throughout history regardless of time period and geographical location has NEVER played out in a positive way. I fear if the US continues down this path with our international partners, it could cause potentially irreparable damage to global relations or at the very least take the US years if not decades to repair.

**So what should you be doing about all of this?**

So what do you do about this most recent global speedbump? You read my most recent piece titled “Market Volatility: How NOT to be eaten by a Bear”, and run through this checklist:

1. What amount of cash do you need over the next 5 years that is not covered through your family’s collective paychecks, or other passive/active income? Set that amount aside; revisit your financial plan and asset allocation that aligns to your greater than 5 years goals.

2. Remind yourself that you **WILL NOT** properly time getting both out, and conversely back in to the market this time around or any other time in the future, so stop even thinking about it (c’mon, I know you are).

3. As it relates to asset allocation and portfolio positioning, we are evaluating our positions every day and making prudent changes every quarter. Please let us do our job. You are emotional about your money - we are actively prudent and methodical about your portfolio’s success.

**What is happening and why?**

The US has slated broad-sweeping tariffs or taxes on various international partners, with a targeted focus on China.

- The “why” is based on a belief that “unfair” trade practices exist not only between US and China, but also broader Europe, Mexico and Canada. There is also a belief that China is stealing intellectual property from technology companies.
Are there actually unfair trading practices going on between nations, or the actual stealing of intellectual property? Well, like everything in life, it’s all in the eyes of the beholder and it depends on which side you’re speaking with. Below is a chart that details the extent to which countries around the world have instituted national “interventions” or rules of how the trade game is played. As you can see from the graph, all nations to some degree play this game and more importantly, none of this is new and has been going on for decades.

Does China really steal our intellectual property on a regular basis, or are the laws in China that require ANY company outside China to form a JV or Joint Venture with a Chinese firm damaging to global businesses?

Does China engage in technological espionage and steal or intercept information? Yes, but so do we and every other nation in the world. To think otherwise would be woefully naïve. That’s unfortunately the high-tech world we live in now. What I really want to address is the significant misunderstanding and misinterpretation of Chinese law related to required corporate partnerships, or Joint Ventures. Let’s discuss this simply:

1. China is one of the fastest growing economies in the world and has the largest population of consumers on the planet.

2. Companies like to make money and sell things. They very much want to tap into the potential China and other emerging market nations provide.

3. China wants to develop and westernize both their securities markets and economy, and decided that requiring ANY company outside of China – not just US companies – to engage in a mutually beneficial partnership with Chinese companies to sell their goods and services will benefit both China and that respective company.
4. **Most importantly** - If U.S. or other international companies truly felt like they were being harmed they simply wouldn’t participate, and/or they would balance harm vs. added profitability of selling in China. It’s that simple. You might not like it, or think it’s unfair but that’s not our decision to make – it's China and global corporations decision to make – not the US Government.

Let’s turn this discussion around and look at this from another nation’s perspective. What if another country reached out to the US and said “Hey, I don't like your rules/laws related to xyz. You need to change them because we've decided we don't like them and we believe they're harmful to our nation and our companies.” What do you think we would say? Yeah, I know exactly what you’re thinking and what you might say, and it likely wouldn’t be polite. In a global world, we all must mutually coexist and respect each other. Unilateralism or a dictatorial approach rarely ever works and it certainly won't work this time either. Diplomacy and respect, more often than not, has proven to be the best recipe and if this Administration can muster the intestinal fortitude to do so, they might actually be surprised by the result. But don't count on it happening.

**What are tariffs and are they broadly good, bad, or indifferent?**

Before I get into what has transpired relative to the Trump Administration's trade policy actions, I wanted to compare and contrast the differences between tariffs and quotas. Tariffs simply stated, are taxes on imported goods from other countries; i.e. they affect prices. Quotas on the other hand are curbs on the quantities of certain imported goods from other countries. Even more simply stated tariffs drive price inflation for the consumers of those goods, while quotas affect the supply and demand balance of a good, which in itself may or may not affect the aggregate pricing of said good. Research by the OECD highlights that developed and developing nations that reduced tariffs amongst each other lead to higher levels of aggregate GDP, significant economic expansion, and bettered mutual relations between nations that engaged in reductions, vs. ones that did not.

**Why is this conflict important?**

Before we get into any detailed conversation, let’s put the US/China trade balance into perspective. Looking at 2017 actual data per the US Census Bureau, the US exported approximately $130 billion worth of goods to China which represents 16.4% of total US exports in 2017. Per the World Trade Organization (WTO), China exported approximately $506 billion worth of goods to the US, which accounts for 21.8% of their total global exports. China is the US’ number one exporting partner. The US is China’s number one exporting partner. China and the US combined account for 26% of total global imports and 24% of total global exports. Not to quote Apollo 13 astronaut Jim Lovell and NASA command Control Leader Jack Swigert’s famous (but erroneously adjusted) quote, “…Houston, we have a problem.”

To sum up where we are bluntly (and you can see the detailed timeline of events below), is we collectively have a lot of guns pointed at each other but no one has yet to pull the actual trigger. Given that the only so far enacted tariffs go into effect on July 6th, and equate to less than 2% of trade between the two nations, this fight is very young and at this point, very small. What can get lost in this headline-grabbing war is the reality of this potential impact vs. the fiscal stimulus generated via the US’s Tax Cuts and Jobs Act. It is likely that this trade war dialogue is not going away anytime soon, but we must keep it in context.
Other areas of concern related to China, specifically fiscal financing

Below is an extract from my Q1 2018 write-up on fiscal financing of US debt and China:

“Risks I see from current fiscal policy actions

One very significant area of concern I see in the not too distant future is the confluence of massive governmental spending and higher US interest rates. With Congress’ passage on March 23rd of $1.3 trillion worth of spending to keep the government and the military open for business, coupled with the estimated $1.4 trillion1,2 in costs from the Tax Cuts and Jobs Act, the US will be adding a massive amount of debt quickly. Here are the problems I see:

1. The US government will have to finance nearly $3 trillion for these new initiatives over the coming years, let alone refinance the over two-thirds of all outstanding US debt maturing inside of five years3 that needs to be rolled.
2. As I mentioned in Catalyst #3, the path forward for interest rates over the next two and a half years is almost certainly up. Higher interest rates and thus higher borrowing costs will drive up the aggregate costs to this spending and refinancing (re-rolling) on us and future generations.

3. **Question:** Who is currently the largest buyer of US debt in the world? **Answer:** Well, that would be China. How do you think China feels right now about our approach to diplomatic relations? Imagine you're a business that desperately needs financing to stay afloat and you willingly snub your nose at your biggest and most reliable financier. Smart? Probably not. The US needs to tread a little bit more carefully with its #1 financing buddy, lest it may find itself on the fat end of a big stick. China need only sell a couple hundred billion of treasury bonds from its sovereign stash (aimed primarily at maintaining its currency peg to the US dollar), or worse, decide to significantly reduce the amount of future purchases. While both of these outcomes are draconian in nature and unlikely to occur, rhetoric from the Chinese insinuating either or both would potentially send the cost of US financing (i.e. interest rates) significantly higher.”
Below is a detailed timeline of trade war rhetoric\(^1,^2,^3\) from its beginning back in March:

**March 1\(^{st}\)** President Donald Trump's trade war began almost four months ago when he announced steep tariffs on steel and aluminum that would take effect the following week.

- The 25% tax on steel and 10% tax on aluminum coming to the U.S. from abroad was applied broadly at first, with no specific targets and no quotas. The president announced them despite being seemingly at odds with some of his key advisors. Former economic policy director Gary Cohn quit the administration over it.
- The global reaction was swift and fierce, with condemnation coming from European and other foreign leaders, members of Congress and even leaders of U.S. industry. Canada, which exports more steel and aluminum to the U.S. than any other country, threatened to retaliate even as it was in the middle of renegotiating the 24-year-old North American Free Trade Agreement with Mexico and the U.S.

**March 8\(^{th}\)** Trump signs the tariffs into effect. Trump exempted Canada and Mexico and gave other countries the chance to argue why they should also be exempted. The S&P 500 rose 0.45% and 1.74% on March 8 and 9 before beginning a four-day slide the following week.

**March 22\(^{nd}\)** Trump signed retaliatory tariffs on up to $60 billion of Chinese imports, including components used in the aeronautics, technology and energy industries. The S&P 500 shed 2.5% that day and 2.1% the next day and then rebounded 2.7% on March 26.

**March 31\(^{st}\)** The list of the exempted would grow to include members of the European Union, Argentina, Australia, Brazil and South Korea.

- That day, there was word that South Korea had made concessions on imports of American cars, what some called Trump's first major trade deal.
- China responded to the U.S. tariffs in kind, announcing new taxes on American imported meat, wine, fruit, nuts, ethanol and other products, not great news for American farmers, who shipped $20 billion in products to China last year. On Monday April 2nd, the S&P 500 fell 2.2%.

**April 3\(^{rd}\)** Trump raised the ante. The U.S. Trade Representative released a list of 1,300 product categories covered by the 25% China tariffs. It includes parts used to make a variety of household products, from flat-screen televisions to dishwashers, snow blowers and even vaccines. The stock market appeared to take it all in stride. The S&P 500 closed up 1.2%.

**April 4\(^{th}\)** China answered with its own 25% tariffs on a still-longer list of American goods, including whiskey, cars and soybeans.

**June 15\(^{th}\)** June 15th, the Trump Administration via US Trade Representative (USTR) Robert Lighthizer's office imposed a 25% tariff (tax) on approximately $50 billion worth of goods slated to be imported to the US from China. The
move was a response to the USTR’s Section 301 investigation earlier this year that accused China of stealing US intellectual property in an effort to dominate the development of advanced technology.

- These proposed tariffs consist of 1,102 items and are broken down into two groups: 1) 818 items out of roughly 1,333 items originally identified and announced back on April 6th, and 2) a second set of 284 items newly identified by the interagency (of the USTR) Section 301 Committee as benefiting from Chinese industrial policies, including the “Made in China 2025” industrial policy.

- The tariffs we initiated in response to the USTR assertion that China’s unfair trade practices related to the forced transfer of American technology and intellectual property are materially damaging US interests. These targeted goods relate to “Chinese imports containing industrially significant technologies, including those related to China’s “Made in China 2025” industrial policy.” It generally focuses on products from industrial sectors that contribute to or benefit from the “Made in China 2025” industrial policy, which include industries such as aerospace, information and communications technology, robotics, industrial machinery, new materials, and automobiles. The good news for most of us is that this list does not include goods commonly purchased by American consumers such as cellular telephones or televisions. Per the US Office of Trade Representative to China, Ambassador Robert Lighthizer, this list was compiled based on “extensive interagency analysis and a thorough examination of comments and testimony from interested parties.”

- President Trump also vowed to impose additional tariffs on China in a quite staggering amount of $100 billion if China reciprocated with their own tariffs against the United States. Well, I’m sure you can guess what happened. China rapidly responded the same day with a pledge to impose reciprocal tariffs with “equal scale, equal intensity.” Their focus was directly at Trump’s base, focusing on soybeans, pork, aircraft and a whole host of other items. These barbs and jabs back and forth feel and sound more like grade schoolers on a playground rather than responsible and thoughtful world super powers.

- The first group of tariffs on the 818 items identified back in April takes effect on July 6th. The second group of 284 still has to be reviewed by the USTR and go through the public review process (which is nonsensical rubber stamp process the USTR and the Republican Congress will move rapidly on).

June 19th

The Trump administration responded to China’s intention to implement reciprocal tariffs on US exports with threats to impose 10% tariffs on an additional $200 billion of Chinese imports. Recall that the section 301 investigation determined U.S. damages of $50 billion annually from China’s unfair acts, policies, and practices. Hence, the latest threats are somewhat proportional to the perceived injuries from China’s trade policies.

June 24th

Via the Wall Street Journal, President Donald Trump, already embroiled in a trade battle with China, plans to ratchet commercial tensions higher by barring many Chinese companies from investing in U.S. technology firms, and by blocking additional technology exports to Beijing, said people familiar with administration plans...The Treasury Department is crafting rules that would block firms with at least 25% Chinese ownership from buying companies involved in what the White House calls “industrially significant technology.”

June 27th

President Donald Trump walks back the White House’s draconian approach and instead embraced legislation under consideration in Congress to strengthen the Committee on Foreign Investment in the U.S., or CFIUS, so it can prevent companies from violating intellectual-property rights of American companies. Trump didn’t single out Beijing or
even mention China in a statement Wednesday announcing his decision. The administration decided not to employ the International Emergency Economic Powers Act of 1977, or IEEPA, that would give the president broad authority to curb Chinese investments in the country.

More to come, I’m quite sure. If you have any questions or want to chat, please reach out to your FCB representative and we can arrange that. In a couple of weeks, I will be back at you with our 2018 Mid-Year Outlook that will delve into more detail on where we are, where the second half of this year ends up and what the next year or so might be shaping up to bring. Stay tuned.

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1 Bloomberg, Bloomberg News
2 Associated Press via CNBC
3 Wall Street Journal
4 Deutsche Bank Research
5 Atlanta Federal Reserve Bank
6 FactSet Research
7 Strategas Research

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