Trade falls into the category of political phenomena that the market would rather ignore until it absolutely 100% can't anymore. [1] When the U.S. announced tariffs on steel and aluminum, many market participants were able to dismiss them because of the numerous exemptions. When those exemptions expired, it was still possible that the tariffs would only be on a limited set of goods. Now that view is becoming less tenable. The European Union and China have both announced retaliatory tariffs on imports from the U.S. NAFTA negotiations have deteriorated along with U.S./Canadian relations. The administration has talked of adding $200 billion in tariffs on Chinese goods. [2] Markets finally reacted, but the move was fairly modest.

Many people overestimate the significance of trade on the economy. Commerce in the U.S. is still very domestic, and trade is not a large percentage of GDP. Still, U.S. multinationals are dependent on global supply chains to produce their goods and deliver their services. Markets are dependent on the international flow of capital. A full blown trade war would probably affect markets even more than the underlying economy and could result in more significant market moves.

The reason market reaction has been so tame is probably that markets have moved from the view that there won't be a trade war to the view that any trade war will be resolved quickly and in a satisfactory manner. This is not irrational. Many commentators point to the negotiations with North Korea as evidence that tough talk by the administration is just a negotiating tactic to get to a positive outcome.

The negotiations with South Korea offer an even better case. After calling the previous South Korean trade deal “horrible” and a “one-way street,” President Trump agreed to changes that won’t drastically alter the trading relationship between the two countries. [3] Granted, this may have been a geopolitical concession, but it may also be an indication of the kind of agreements we’ll see in the future.

Unfortunately, this outcome is not inevitable. Right now the most important thing to look at is how China and other countries respond. [4] The proposed $200 billion in tariffs would make it impossible for China to counter in kind because it doesn't import enough from the U.S. This means China would have to take alternative measures. [5] Some folks have suggested that China could purposely disrupt supply chains, cutting off U.S. companies and stopping production. This would lead to the messiest of trade wars, as the U.S. could respond by cutting off agricultural exports. [6] It would be a very aggressive and risky approach, and would probably lead to an unfavorable response from markets and potentially a sell-off in global equities. Another possibility is that China could try to hurt U.S. markets by selling Treasury bonds, as others have suggested. This would be the least logical response. China would generate massive losses on its own portfolio, and it isn’t clear that higher Treasury yields would be all that damaging to the U.S. economy.

If China sold its Treasuries and repatriated the money, it would likely strengthen the yuan. This is exactly the opposite of what a country in a trade war wants. Weakening the yuan would be a far more logical policy. A weaker yuan could offset some of the effects of the tariffs by artificially making China more competitive. China has shown the ability to control its exchange rate, something that is difficult for the U.S. to counter directly. The U.S. could label China as a currency manipulator, but that would be mostly symbolic. However, a currency devaluation would have costs. It could lead to higher inflation in China and encourage capital flight. For markets, it would probably result in dollar appreciation against emerging market currencies, but not against developed currencies. The euro and the yen could benefit from the search for alternatives to the dollar. [7] When the yuan fell sharply in 2015, those currencies held up well. [8]

Another possibility is that countries could weather the tariffs without giving in, but also without any major retaliation. Instead, they would work on deals with each other at the expense of the U.S. China, for example, could allow European countries access to its markets. At the same time they could make it more difficult for U.S. companies to renew permits. Markets would probably ignore this subtle response in the short run, but it could lead to underperformance of U.S. assets in the longer term. It might be difficult for countries to take such a measured approach if the U.S. continues pressuring them with new tariffs.

Commodities have been a good barometer of market sentiment on tariffs. During the first few days of this week, both agricultural commodities and base metals fell. [9] Even though tariffs increase the prices of consumer goods, they tend to reduce demand for commodities. For base metals, to the extent tariffs disrupt sales of goods, they reduce demand for materials to make those goods. As far as agricultural products, if U.S. exports of soy or grains are disrupted then the U.S. could be left with large excess stockpiles. The effects on oil are less direct. If a trade war slows global growth, it should reduce demand for oil, but otherwise oil may hold up better than other commodities.

The tariffs will probably remain an issue in the near future. The market may move from not expecting a trade war, to expecting a short...
trade war, then to accepting a long trade war. Right now it seems market performance will depend on how the rest of the world reacts. It may play out slowly and lead to some gradual trends. Markets seem to want it all to work out so they can go back about their business. This is reasonable to expect, but it is certainly not the only possible outcome.

What We Are Watching

Turkish Election (Sunday) In the aftermath of a failed coup attempt two years ago, Turkey has been in an official state of emergency that has allowed President Erdogan to exercise unusually broad powers. Last year, a constitutional referendum passed narrowly which formalizes the centralization of power in the hands of the presidency and will take full effect after the upcoming election. This Sunday, the Turkish electorate will vote in the first presidential and parliamentary election under the new system. Erdogan leads other presidential candidates by a wide margin, but polls suggest he may fall short of the 50% support needed to avoid a second round. If polls are correct, he would face the second place candidate head-to-head in early July. The outcome in parliament is also uncertain, as Erdogan’s coalition has the strongest support in most opinion polls, but may fall short of a majority. Indeed, the outcome in parliament may hinge on the technicalities of Turkish electoral rules, which require a party to receive at least 10% of the vote to participate in parliament. A small opposition party, the HDP, is polling right around that threshold and could be excluded from parliament, in which case Erdogan’s coalition will almost certainly win a majority of seats. Volatility in Turkish markets has been elevated in recent weeks, in part due to concerns about President Erdogan’s influence over the central bank and other economic policymakers. While some tempering of his political power might assuage these concerns, a divided government could lead to additional uncertainty in the near term, perhaps keeping markets on edge.

U.S. Durable Goods Orders (Wednesday) The monthly durable goods report from the Census Bureau provides policymakers and market participants with a timely update on demand for capital goods, such as machinery or computers. Orders for capital goods picked up significantly last year, but momentum appears to have slowed somewhat since the start of the year. Durable goods orders for May will be watched closely to see if capex activity is in fact losing steam, or whether the last few months merely represent a temporary soft patch. A positive result would likely cause economists to mark up their forecasts for second quarter GDP growth, which is already on track to look quite strong.

Canada Business Outlook Survey (Friday) The Bank of Canada’s quarterly Business Outlook Survey has historically been a key input to the central bank’s views on the Canadian economy. The BoC may give particular weight to the survey right now as potential changes to U.S. trade policy are creating an uncertain environment for many Canadian firms. The BoC will be on the lookout for signs that this uncertainty is leading to reductions in capex or hiring activity. If this appears to be the case, it could lead the central bank to tone down its guidance for future rate hikes.

[1] This category gets bigger every week.
[3] **“South Korea to allow more U.S. autos, ship less steel as part of trade deal,” USA Today, 3/27/18.**
[4] And how the U.S. responds to that. And how China responds to the response. And so on and so on and so on, like the shampoo commercial.
[6] It would be very difficult for China to replace soybean imports from the U.S. quickly.
[8] After China devalued its currency on August 10, 2015, CNY fell 3.0% against the USD over the next five trading days through August 17, 2015. The EUR rallied 0.5% and the JPY rallied 0.2% against the USD. Source: Bloomberg.
[9] From the close last Friday, June 15, 2018, to the close on Wednesday, June 20, 2018, front month soybean futures have fallen -2.1%, front month corn futures have fallen -1.8%, three month forwards on copper have fallen -3.5%, three month forwards on zinc have fallen -2.8% and three month forwards on nickel have fallen -1.4%. Source: Bloomberg.