INVESTMENT INSIGHTS · GLOBAL EQUITIES
NOVEMBER 2018

Where Are the Trade Winds Blowing?

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Recent tariff increases have pushed the average US tariff rate to levels not seen since 1971. While the US economy is less open than other countries, it is three times more exposed to international trade today than the last time tariffs were at this level. This makes it harder to estimate the impact on the economy and corporate earnings.

Most economists estimate the drag from tariffs will only be around 10 to 20 bps of US GDP due to offsetting improvements from expansionary fiscal policy, the oil sector, resurgent manufacturing, and recovering retail employment.

While a benign impact on the US economy seems reasonable, we believe the market may be underestimating the probability of an outcome that is either much better or much worse. We also feel the China impact may be greater than currently estimated, while countries like Vietnam and Mexico could profit from the conflict.

The Netherlands Bureau for Economic Policy Analysis published a study[1] on the economic consequences of the current trade conflict that analyzes the long-term impact of various trade policies on GDP. The results of the analysis are shown in Exhibit 1.

We believe scenario three is the most realistic scenario. The data show that both the US and China stand to lose in a direct trade conflict. US losses are limited to 0.3% due to their lower share of exports in total GDP and lower relative exports to China. China, however, would experience an asymmetric loss of 1.2% of GDP.

In contrast, countries that can fill the void left by lower Chinese exports to the US will benefit. According to the research, Mexico and Japan stand to gain the most from US-China trade sanctions.

The initial shake-out from the first round of US tariffs in early July provides early evidence in support of this thesis. China lost 18% market share (from 7.3% to 6.0%) in the affected categories from just July to August. Canada, Germany, and France picked up most of the lost share, with lesser gains going to Mexico and Thailand.

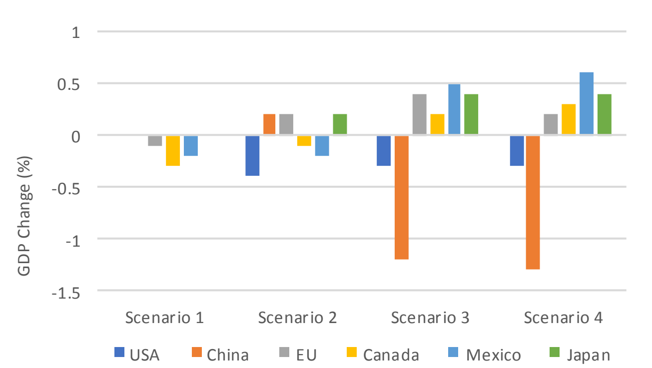
Should the US proceed with tariffs on an additional $200 billion of imports, Canada, Korea, and Taiwan are well-positioned to gain at the higher-value end of the spectrum while Mexico, Vietnam, and Thailand could pick up market share on the lower-value end.[2]

Upside and Downside Scenarios for the US Economy

In an out of consensus call, UBS is calling for a 100 basis point GDP loss with the expectation of supply chain disruptions and indirect impacts to consumer spending from layoffs. As start-ups and smaller companies have been the engine behind a resurgent manufacturing sector, there is a risk these companies are less able to absorb a tariff driven cost shock.

On the other hand, the outcome for the US economy could be more benign with rapid substitution of suppliers. Should companies have production facilities in countries not subject to tariffs, the disruption to supply chains and the impact on the US

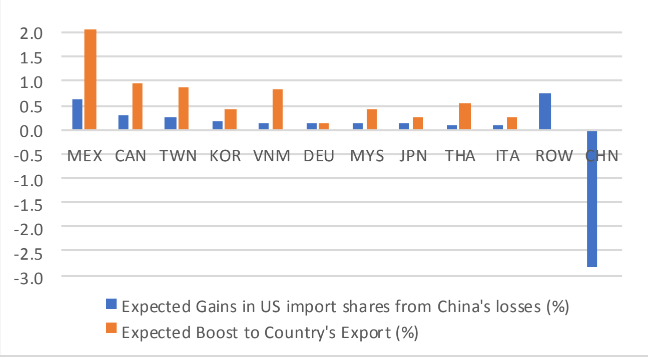
Exhibit 1: Impact of Trade Scenarios on GDP



Scenario 1: US Unilateral steel and aluminum tariffs
Scenario 2: Retaliation over US steel and aluminum tariffs
Scenario 3: US-China Trade sanctions
Scenario 4: US tariffs on motor vehicles

Source: CPB Netherlands Bureau For Economic Policy Analysis, July 2018

Exhibit 2: US Tariff Winners and Losers



Source: UBS, DuPont Capital

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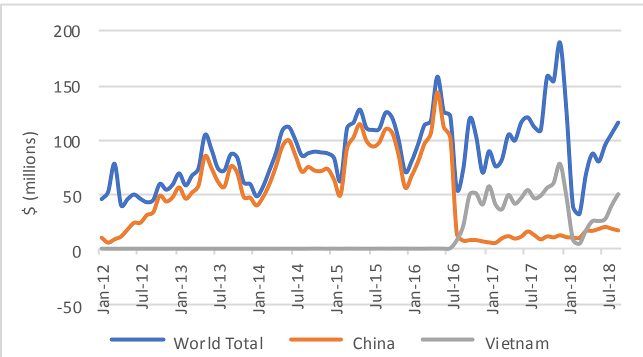
economy would be minimal. Such was the case when the US imposed punitive tariffs on imports of Chinese washing machines in 2016. China lost nearly all of its 70% market share in the US while Vietnam picked-up a 40% share from near zero (Exhibit 3).

Exhibit 3: Washing Machine Imports Into The US



Source: Census, UBS, DuPont Capital

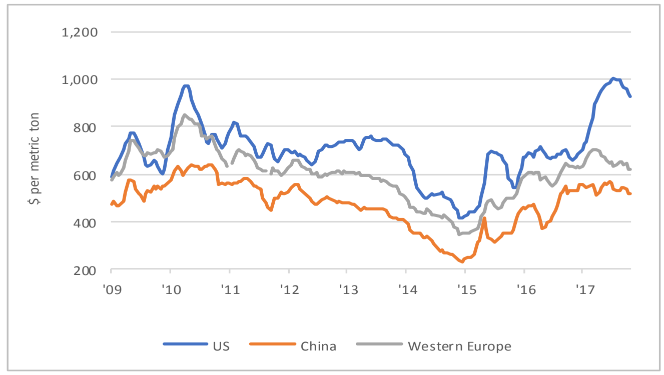
The success of other Chinese supply chain partners (Japan, Taiwan, Korea and Germany) in taking US import share will be contingent on whether their exports are substitutes or compliments to China's exports (demand for complimentary goods decreases with tariffs).

Sectoral and Equity Market Impacts

While the Dutch research suggests the impact on the US economy will be more muted, we believe sectoral impacts could be significant. Secondary effects will likely surface from sub-optimal resource allocation and higher priced consumer and intermediate goods. We have seen evidence of such from companies like Harley Davidson, which moved production to Europe to avoid European tariffs, and Ford, which is facing a billion dollar cost increase on the back of a tariff-induced rise in domestic steel prices (Exhibit 4).

During third quarter earnings, investors were keenly focused on how trade related issues, including supply chain disruptions and

Exhibit 4: Hot Rolled Band Steel Prices



Source: Steelcatcher.com, DuPont Capital

price impacts on raw materials, were impacting operating margins and returns on capital. This is important because margin developments have become a key driver for the markets while share buybacks and earnings growth have become less influential.

Research from UBS on initial third quarter earnings releases shows that EBIT margins have started to disappoint. Earnings expectations and operating margin developments are two of the main reasons why strong macro-economic data are not translating into strong equity markets. Time will tell whether this portends a cautionary tale for the market outlook.

Over the last two quarters, trade tariffs have added a new level of uncertainty to macro-economic and earnings forecasts. We expect this will result in greater return dispersion and require a more selective approach at the country, sector, and company level.

Sources:
[1] Trade War: Way out of consensus, critical to follow (UBS, 1 October 2018)
[2] Trade Wars: Economic impacts of US tariff increases and retaliations (CPB Netherlands Bureau for Economic Policy Analysis, July 2018)
[3] APAC economic perspectives: Trade War: China's loss, whose gain? (UBS, 6 November 2018)

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