*current*PERSPECTIVES

Trump, Tariffs and Trade Wars

How serious is the risk of a trade war to markets?

When Donald Trump was elected U.S President in November 2016, our initial assessment was that markets would respond positively. This was largely due to his campaign promises to decrease corporate taxes, roll back regulation and stimulate the economy through infrastructure spending. This narrative, of course, is what has largely unfolded over the past 15 months. However, from the outset, we also recognized that a counter narrative was possible – one based on opposition to free trade – that markets would find unsettling. In recent weeks, this story line has been gaining the upper hand. So how do we assess the risks posed to markets by the recent developments on trade?

The background

On some issues, President Trump's views have changed over time. On free trade, however, his antagonism has been long standing and consistent. He has stated that he views the U.S.' trade deficits, with Mexico and China particularly, as evidence that those countries are "cheating" on trade. During the election campaign Trump characterized the North American Free Trade Agreement (NAFTA) as the worst trade deal in history. Since then he has repeatedly voiced his concern that China has outmaneuvered the U.S. on trade, which he claims represents a threat to U.S. economic interests, and particularly its supremacy in the area of technology. Likewise, two of his key advisors on trade, Robert Lighthizer and Peter Navarro, have both argued for many years that the U.S.' trade relationships with China and Mexico are deeply problematic and need to be altered. On trade, in other words, President Trump and his key advisors firmly believe that NAFTA and the current trading relationship with China are damaging to U.S. interests.

Recent developments

While the market has been aware of these views since the election, there has been little impact until recently. This was partly due to the positive impact of tax reform, deregulation and the strong global economy, all of which have driven exceptional corporate earnings growth. However, it is also likely that the market viewed many of the harder line views of the administration as negotiating tactics that were unlikely to result in significant policy change. But markets are now beginning to react, with some of the key reasons outlined below:

- NAFTA negotiations have dragged on against the backdrop of continued risk that the U.S. may trigger the six-month advanced notification of its intention to withdraw from the treaty.
- Gary Cohen, Chief Economic Advisor to President Trump and a well-known supporter of free trade, resigned from cabinet.
- The Trump administration imposed tariffs on steel and aluminum imports from many countries. Canada has been excluded - for now.
- President Trump announced his intention to impose tariffs on $50-60 billion of Chinese imports, which in turn, triggered a relatively mild Chinese response.

The market reacts to such developments because the ability of companies to move capital globally to maximize efficiencies and profitability in recent decades has been an important driver of earnings growth. A change in direction on this front is likely to cause volatility as earnings growth is called into question. It is also particularly unnerving to investors that this recent spat involves the two largest economies in the world.

Our view

A deterioration in global trading relationships has been and remains at the top of our list of concerns. However, it is important to remember that within the U.S., there remain many supporters of free trade within Congress, state governments and corporations, and that dramatic changes to NAFTA or the U.S. trading relationship with China are not a foregone conclusion. We will continue to monitor developments carefully as they unfold.

In the meantime, from a portfolio perspective, it's important to reiterate some key themes that should help investors navigate the current market environment. We continue to focus on companies we believe to be at the high-end of the quality spectrum, particularly those that generate substantial free cash flow, who return that cash to shareholders through rising dividends over time. In addition, we would advocate holding some cash as "dry powder" so that investors can potentially take advantage of volatility by buying high quality stocks that are oversold on trade war news. Finally, for Canadians, we continue to advocate having exposure to global markets and the U.S. dollar as the Canadian dollar may experience weakness if trade continues to come under pressure.

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