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## Trump and Trade: What are the Risks?



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- President Trump has been an unabashed protectionist for decades, so it is no surprise that he has appointed the most hawkish trade team since Smoot-Hawley. Further, we believe Trump's China-bashing team, which will be led by trade hawks such as Robert Lighthizer (U.S. Trade Representative), Peter Navarro (National Trade Advisor), Wilbur Ross (Commerce Secretary) and several others with equally brazen views, should be taken literally and seriously.
- Protectionist actions may begin shortly after Trump's full trade team is confirmed. It is unfortunate, but D.C. is overflowing with China critics, so we envision China-bashing emerging as one of the few bi-partisan initiatives. If Trump's trade team does indeed deliver on its protectionist promises, China's retaliation will likely be immediate, forceful and in-kind. (They have studied our pressure points.)
- An acceleration of tit-for-tat protectionist measures is one of the biggest risks to the global market outlook. In terms of scenarios, we believe it is 15% likely that no protectionist measures are implemented during 2017–2018, 60% probable that moderate trade frictions occur, and 25% likely that a full trade war ensues. This would imply a greater-than-even chance of a global recession.
- Countries most at risk from Trump's policies include China and Mexico, followed by Japan and Germany. However, Japan aims to preempt such measures by investing a considerable sum in the U.S., increasing its defense spending and discussing a bilateral trade deal. The sectors most likely to be targeted include steel, aluminum, chemical products, tires, other auto-related products, and various types of manufactured goods.
- Finally, and in spite of all this, we believe the case for globalization remains overwhelming (although more needs to be done for those who have been negatively affected) and that President Trump's perspective reflects an erroneous, zero-sum view of trade. Displaying disdain for comparative advantage, which is one of the most profound and powerful concepts in economics, will ultimately hurt innovation, productivity, and employment.

“Patriotism, Jobs and Trade” is the pithy expression that best encapsulates President Trump's economic priorities. Similarly, his guiding principle on policy formation can be best expressed by the rather straightforward question: Is it friendly to U.S. businesses? By bringing this pro-business perspective into the executive branch, the November election was clearly

a real game changer and one that has elicited an understandably positive reaction from markets. However, in our view, many investors have been overly focused on the candy (tax reform, deregulation and infrastructure), while paying scant attention to the spinach (protectionism and “the big rewind”). We have already written extensively on the latter issue (see our December 15, 2016 white paper “The Big Rewind”, which explains how higher interest rates could drive a reversal of the multiple expansion experienced since 2012). This Insight examines the risks associated with the acutely protectionist views of Trump’s trade team.

**FIGURE 1: TRUMP WITHOUT THE BAD STUFF – INVESTORS ARE TOO OPTIMISTIC ABOUT THE CANDY, WHILE NOT PAYING ENOUGH ATTENTION TO THE SPINACH**

ECONOMIC IMPLICATIONS	
POSITIVE	NEGATIVE
Tax Reform	Protectionism
Deregulation	“The Big Rewind”
Infrastructure	

Source: Epoch Investment Partners

**TRUMP’S TRADE TEAM: THE UNDOING PROJECT**

While the China-bashing trade team will be led by Robert Lighthizer (U.S. Trade Representative), Peter Navarro (National Trade Advisor) and Wilbur Ross (Commerce Secretary), it is crucial to remember that the mercurial President has been an unabashed protectionist for decades. Although his policies on some issues may appear fluid and tactical, his views on trade have been remarkably consistent and vigorous. In fact, Trump has been calling for protectionist measures for at least the last three decades, back to 1987, when he used \$100,000 of his own money to take out full-page ads in the *New York Times*, *Washington Post* and *Boston Globe* attacking U.S. trade policy and demanding significant tariffs on Japan and “other nations that have been taking advantage of the U.S.” More recently, Trump has viewed China as the great offender, believing its mercantilist approach is embedded into its economic system at a fundamental and profound level. While some of his campaign rhetoric was undeniably excessive and perhaps offensive (“We can’t continue to allow China to rape our country”), his threat to levy a punitive 45% tariff on goods imported from China (35% from Mexico) should be taken seriously. This thunder represents a big club and an integral feature of his plan to “bring back our jobs from China, from Mexico, from Japan, from so many places.”

Turning to his trade team, we start with the views of Wilbur Ross, Trump’s nominee for Commerce Secretary. During his confirmation hearings on January 18, Ross referred to China as “the most protectionist country,” emphasizing that “It’s one thing to talk about free trade. We would like

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our trading partners also to practice free trade.” He stated, again with a clear reference to China, that “Countries that resort to malicious trading practices need to be severely punished.” Ross would also like to prioritize renegotiating NAFTA.

### DEATH BY CHINA?

Another senior member of the trade team is Peter Navarro, who has provided much of the detailed criticism of China and heads Trump’s National Trade Council. As a firebrand economist, most famous for his book, “Death by China: One Lost Job at a Time,” there isn’t much room for nuance in his views. A couple of his quotes serve to illustrate: “Let’s set the record straight. Trump will impose countervailing tariffs not just on China, but on any American trade partner that cheats on its trade deals,” and “China’s 2001 entry into the World Trade Organization opened America’s markets to a flood of illegally subsidized Chinese imports, thereby creating massive and chronic trade deficits. The global trading order is riddled with trade cheaters. China is both the biggest trade cheater in the world and the country with which the U.S. runs its largest trade deficit.” Wow, there you have it, as clear a view as you’re ever likely to see from an economist.

Additionally, Navarro has spilt much ink detailing and exaggerating China’s elaborate web of unfair trade practices, including illegal export subsidies, theft of intellectual property, currency manipulation, forced technology transfers and its widespread reliance upon both “sweat shop” labor and pollution havens. In his view China also engages in the massive dumping of select products such as aluminum and steel below cost. Navarro argues that Chinese leadership will quickly understand they are facing strength on the trade issue rather than the weakness that characterized previous presidencies. He somewhat naively expects Beijing to rein in its mercantilist impulses, in an acknowledgment of Trump’s resolute insistence that China relax the numerous non-tariff barriers now blocking U.S. exports across a wide range of products, including autos, agricultural commodities, fertilizers, and telecommunications equipment.

Equally strident is Robert Lighthizer, Trump’s nominee for U.S. Trade Representative (USTR). He was deputy USTR under Reagan, has represented numerous large U.S. corporations in trade disputes, and has been a consistently harsh critic of China and the WTO. To understand his views, its best to read his congressional testimony to the U.S.-China Economic and Security Review Commission. It is his opinion that Chinese mercantilism poses a serious threat to the U.S. economy and it is past time for our government to become more aggressive. He argues that China’s economic and political system is fundamentally incompatible with our conception of the WTO and that the WTO’s dispute settlement process is not designed to address the type of systemic non-compliance practiced by China.

Further, Lighthizer believes the U.S. trade deficit is catastrophic and unsustainable, which leads him to advise considering all options available. His laundry list includes: aggressive interpretations of WTO provisions; aggressively enforcing and strengthening our trade laws (including anti-dumping and countervailing duty laws); restricting the quantity or value

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of merchandise permitted to be imported; and a sweeping challenge to China's system under article XXIII (the WTO's rules and procedures for settling disputes). Lawyers choose their words carefully, and he uses the term "aggressive" fourteen times in his testimony and "crisis" ten times. He forcefully argues that U.S. policymakers must have the will to implement such measures in an energetic and determined manner, and concludes that, "We need strong leaders who are prepared to make tough decisions, and who will not be satisfied until this crisis has been resolved."

### CHINA'S GREAT FIREWALL

Aside from members of Trump's trade team, there are a host of unofficial advisors and lobbyists, as well as trade experts at conservative think tanks such as the American Enterprise Institute (AEI). For example, last month AEI's Claude Barfield (who worked at the USTR under Reagan) published an article on China's digital trade barriers that has garnered much attention. He argues that China's digital Great Firewall, particularly the new security and cybersecurity laws passed in November 2016, threatens vital high-technology sectors of the U.S. economy. Referring to this as only the latest in a series of highly destructive mercantilist policies adopted under President Xi, he emphasizes that China has effectively replaced foreign information and internet providers with Chinese companies. Barfield also notes that China currently bans 8 of the world's top 25 web-sites, including those of Google, FaceBook, Twitter, YouTube and Apple (as well as the NY Times, Time and the Economist), and that in many cases these bans are thinly disguised elements of discriminatory industrial policy.

What to do about this? Barfield demonstrates that the President has been granted surprisingly broad authority by Congress, and persuasively argues that the U.S. needs to challenge China's digital trade barriers, by establishing digital economic and security issues as a top priority. He contends that the U.S. needs to take reciprocity-based trade and investment retaliation, and to escalate when necessary. He also warns that China's intransigence may force the Trump administration to take even bolder actions, especially given the potential obduracy and over-reaching of President Xi's government.

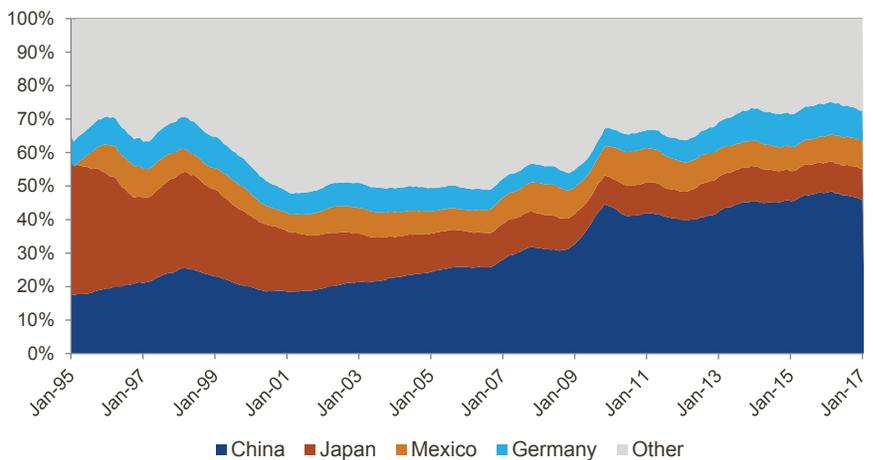
To finish up our discussion of trade hawks, investors need to be cognizant that, well beyond the White House and conservative think tanks, D.C. is overflowing with China critics. For example, even though the Senate employs less inflammatory language, it believes that during recent years China has been closing rather than opening its markets, and has displayed a general lack of reciprocity. In spite of President Xi's recent pro-globalization speech in Davos, the general view in the Senate is that China is becoming more nationalistic and mercantilistic. Further, they are hearing an increasing number of complaints from U.S. companies, who are becoming ever more frustrated with China. These developments are truly disconcerting and have led us to conclude that China-bashing is likely to emerge as one of the few bi-partisan initiatives in D.C. this year.

### WHICH COUNTRIES ARE IN THE BULLS-EYE?

The easiest way to identify countries most at risk from U.S. protectionist measures is to examine which account for the largest slices of the U.S. trade

deficit. Ever since its accession to the WTO in 2001, China has claimed the top spot and currently accounts for 46.1% of the U.S. trade deficit. It is followed by Japan at 9.2%, Germany at 8.8% and Mexico at 8.4% (Figure 2). Of the remaining 27.5%, roughly half represents petroleum (13.7%). In addition to explaining the focus on China, this perspective provides some insight into President Trump’s thinking about energy deregulation and the importance he places on increasing domestic production of fossil fuels. Further, it seems unlikely that he will begin his protectionist program by taking action against other countries that account for a smaller percentage of the U.S. trade deficit (such as Italy, France and Switzerland in Europe, or Vietnam, South Korea, India, Malaysia and Thailand in Asia). That said, Trump has a well-deserved and self-coveted reputation for being unpredictable, and success against a smaller country could provide leverage and establish a precedent that would be useful when wrangling against the big four.

**FIGURE 2: US TRADE DEFICIT APPORTIONED BY COUNTRY: CHINA ALONE ACCOUNTS FOR OVER 46%**



Source: Epoch Investment Partners, Bloomberg

By now, the four countries highlighted in Figure 2 are well aware of their vulnerability and most will respond appropriately. For example, Japanese corporate and political leaders have been concerned about a protectionist backlash in the U.S. for over three decades, and our understanding is that Japan aims to preempt such measures by investing a considerable sum in the U.S., increasing its defense spending and negotiating a bilateral trade deal. China also understands its vulnerability and is likely to follow suit by expanding its imports from the U.S. and increasing its investment, possibly accompanied by monthly announcements to demonstrate its seriousness and gain maximum publicity. While Japan’s actions will probably suffice, it is not at all clear that China’s will be enough to placate the hawks. Further, we are concerned that Germany will show less flexibility (especially given the upcoming elections) and thus, unwittingly attract the ire of Trump’s trade team.

A second way to identify countries most at risk from protectionist measures is to examine which countries the U.S. has previously investigated (Figure 3). China almost leaps off the chart on this score, and is followed by South Korea, India and Mexico. However, we recommend taking this ranking with

a hefty grain of salt, as previous administrations were much less aggressive and combative than Trump’s trade team is certain to be, so history might not prove such a useful guide.

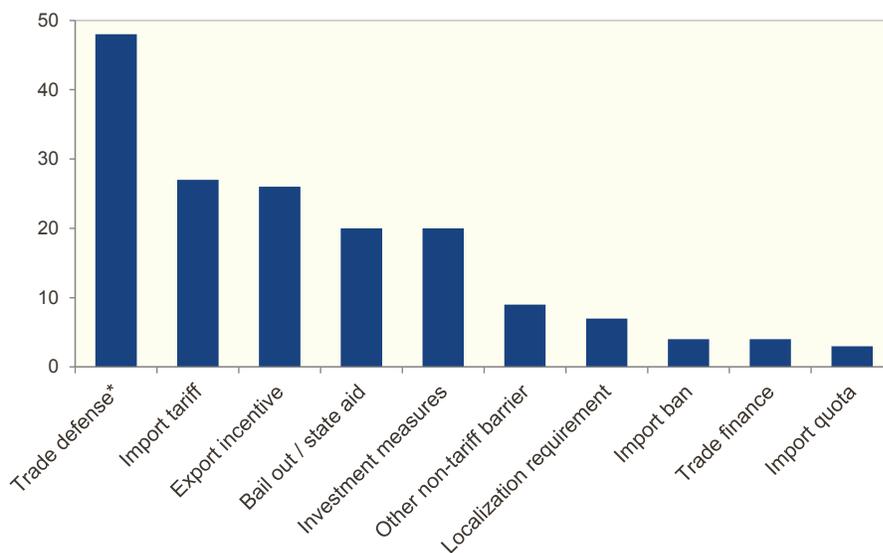
**FIGURE 3: U.S. DUMPING INVESTIGATIONS OFTEN FOCUS ON CHINA**



Source: U.S. International Trade Commission, Goldman Sachs

Regardless, the large number of investigations might make one ask if China is really the great offender or is it just a handy scapegoat, being picked on by China-bashers based in D.C.? For that reason we also follow research by Global Trade Alert (an independent academic and policy think-tank based in London, UK), which demonstrates that, although China is not the only culprit, it has implemented a distressingly large number of protectionist measures over the last eight years (Figure 4).

**FIGURE 4: CHINESE PROTECTIONISM – MEASURES IMPLEMENTED SINCE 2009**



Source: Global Trade Alert

\* Includes counter-vailing duties (anti-subsidy duties), anti-dumping measures and safeguards (to protect an injured domestic industry).

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## HOW LIKELY IS A GLOBAL TRADE WAR?

We believe an acceleration of tit-for-tat protectionist measures is one of the biggest risks to global markets over the next couple of years. We see three possible scenarios for 2017–2018:

- 1.** Status quo: Trump focuses on other issues (such as tax reform and ACA repeal) or China preemptively lowers some tariffs, so no major protectionist actions are taken. (15% likely)
- 2.** Moderate trade frictions: Trump continues the strong rhetoric, but just imposes selective tariffs that are largely symbolic on high-profile imports such as steel and aluminum. China adopts reciprocal, token actions. This would be similar to what happened in the 1980s between the U.S. and Japan, with retaliation remaining controlled and restrained, causing only minor hiccups. (60% probable)
- 3.** Full trade war: Trump's trade team delivers on their aggressive promises (say by imposing tariffs of 35% to 45% on a wide range of imports), with China's retaliation being immediate, forceful and in-kind. (They have studied our pressure points.) Measures escalate, calmer voices do not prevail, and a full trade war ensues. (25% chance)

Aside from protectionist actions against China, it is also possible that Trump unilaterally imposes tariffs of up to 35% against Mexico. For example, TS Lombard Research emphasizes that NAFTA renegotiation will be lengthy and complex, so it is possible that President Trump will become impatient and behave impetuously. They estimate a 40% chance that Trump could act unilaterally in an attempt to speed up the process and rebalance trade flows. This seems reasonable, particularly given that Trump has referred to NAFTA (at least the Mexican component) as a “catastrophe” for U.S. workers and the economy.

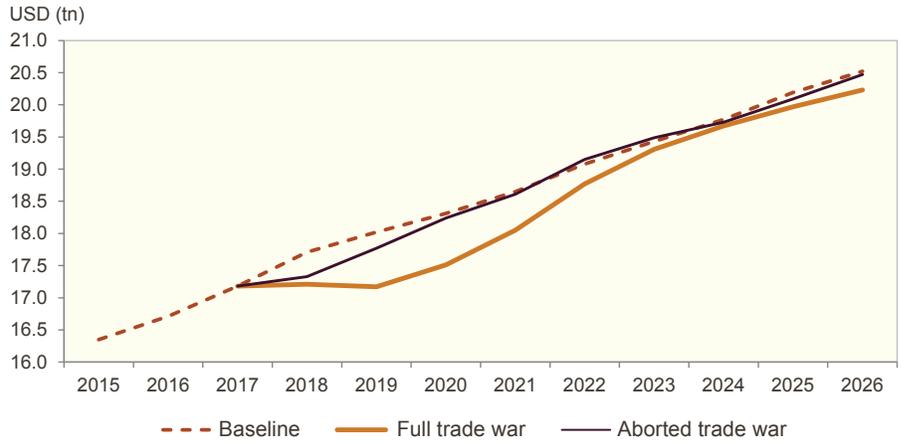
## LIKELY IMPACT OF A TRADE WAR ON THE U.S. ECONOMY

The most meaningful study we have seen on this topic was undertaken by the Peterson Institute, which is a D.C.-based research firm that is top-ranked for its analysis of trade and globalization issues. It presents a baseline case for the growth of the U.S. economy, as well as two scenarios (Figure 5):

- 1.** Aborted trade war: The U.S. imposes tariffs, but for only one year, as either an agreement is quickly reached or Trump's trade team hastily backs down.
- 2.** Full trade war: The U.S. imposes a 45% tariff on imports from China and 35% on Mexico. They respond symmetrically, resulting in a dramatic hit to economic activity (in the U.S. there would be a cumulative 3% hit to consumption and a 9% hit to capex by 2019).

**FIGURE 5: SMOOT-HAWLEY 2.0? A FULL TRADE WAR WOULD MEAN > 50% CHANCE OF A GLOBAL RECESSION BY 2019**

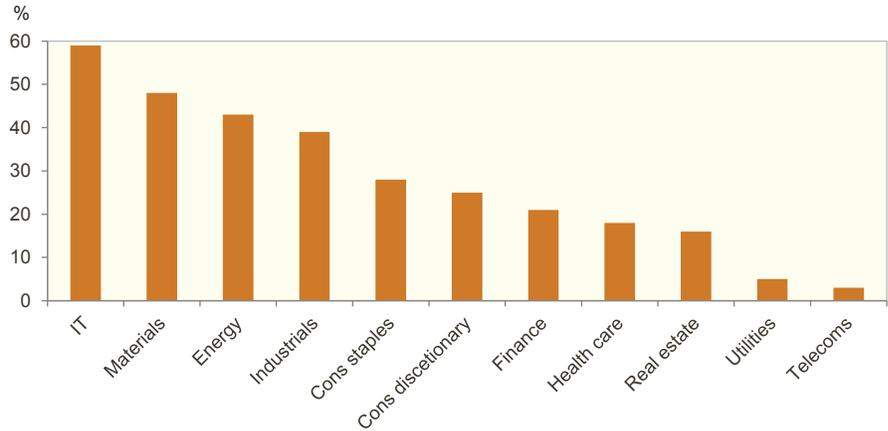
*Projected U.S. GDP (USD tn) under three scenarios (as explained on the previous page)*



Source: Peterson Institute for International Economics

In the event of either an aborted trade war or a full trade war it seems reasonable to expect the sectors of the U.S. economy with greatest foreign exposure to be hit the hardest. These would include IT, materials and industrials, as well as consumer staples and consumer discretionary. Principally domestic sectors such as telecoms and utilities would be least affected (Figure 6). Regardless, given increasingly complex global supply chains, investors should expect significant disruption for many businesses.

**FIGURE 6: S&P 500 REVENUES BY SECTOR: FOREIGN AS A % OF TOTAL**



Source: Goldman Sachs

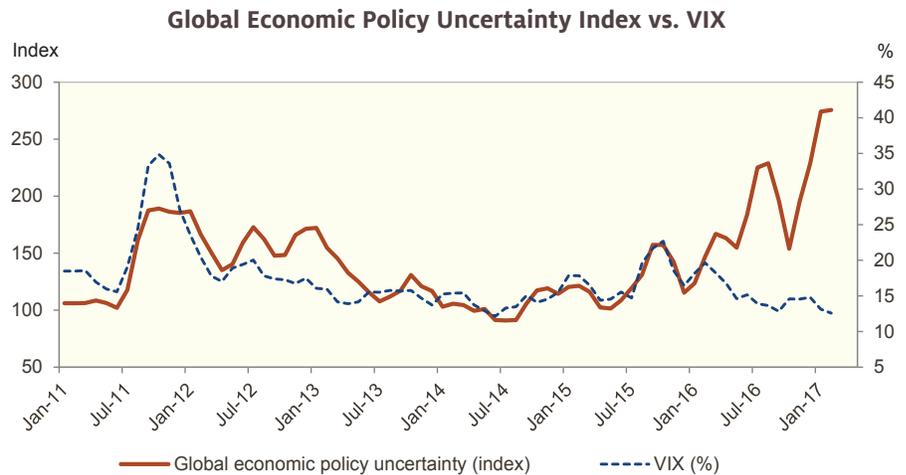
TS Lombard Research also emphasizes that a China – U.S. trade war would likely be deflationary. For example, if one avenue of retaliation involved letting the RMB depreciate significantly, Chinese authorities would be devaluing against the entire world, not just the U.S. In addition to significantly reducing global import prices, protectionism would also undermine investor confidence in Trumponomics, leading to a disruptive reversal of the reflation trade.

**ARE MARKETS PREPARED FOR THE LIKELIHOOD OF TRADE SPATS?**

We believe the short answer is no. To illustrate, global economic policy

uncertainty (using an index designed by Baker, Bloom and Davis, from Northwestern, Stanford and Chicago, respectively) is at the highest level experienced since its inception in 1997, while equity market volatility is close to a 10-year low (Figure 7). This suggests a high degree of complacency and a lot of room for investors to be disappointed in the second half of 2017. As this note has emphasized, we are particularly concerned about protectionism — while Smoot-Hawley tariffs might not have caused the depression, it certainly helped make it “great.”

**FIGURE 7: HEIGHTENED GEOPOLITICAL RISKS: BUT INVESTORS REMAIN COMPLACENT**



Source: Bloomberg, [policyuncertainty.com](http://policyuncertainty.com). January 2017

### MARKET OUTLOOK: HIGH SINGLE-DIGIT GAINS IN 2017, BUT WITH MUCH WIDER TAILS THAN NORMAL

The equity market has risen by over 8% since the November election, a trajectory that has significantly outperformed the post-WWII average when there is a change at the White House. Although we are moderately constructive on the outlook, we expect that delivering the much anticipated candy (tax reform, deregulation, infrastructure spending) is likely to prove more challenging than optimists envision. Further, we believe the market continues to pay insufficient attention to the spinach (the risks of protectionism, as well as the possibility of rising interest rates driving multiple contraction). As a consequence, our base case anticipates high single-digit gains this year, but with more uncertainty and a wider range of potential outcomes than normal.

*Canadian Disclosures:*

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