HEALTH WEALTH CAREER

TRADE WARS 2: ENTER THE DRAGON

AN AUSTRALIAN INVESTOR'S PERSPECTIVE

DECEMBER 2018

MERCER MAKE TOMORROW, TODAY

"East is East, and West is West, and never the twain shall meet.

When two strong men stand face to face, though they come from the ends of the earth"

– Rudyard Kipling (1865-1936)

INTRODUCTION

The rising tide of nationalistic and anti-globalisation sentiment is leading to fundamental shifts in international relations, not just popular demands in Europe for greater sovereignty, but also diminishing support for the arrangements that have underpinned the post-World War II liberal economic order (including open goods and capital markets, multilateralism, and large scale immigration). "Brexit", and more recently, US President Trump's rejection of various multi-lateral trade agreements, along with his implementation of a range of protectionist measures, are the most vivid examples. From a US perspective, moreover, the country's position as the sole global superpower is under increasing challenge from the steady rise of China, which in turn justifies curtailing the 'unfair' trade practices that have hastened China's economic and military development.

For investors, an added complication is that all these developments are emerging in the more mature phases of economic cycles in much of the developed world. After many years of low inflation and running highly accommodative monetary policies, central banks in the developed economies are slowly withdrawing monetary stimulus. Australia is caught in the middle of these complicated relationships.

This paper examines the potential impact of recent US trade policy changes on the Australian economy. It would seem Australia is stuck in the middle between China and the US as two of its three biggest trading partners. A second stage of trade wars and possible escalation of protectionist steps could impact international trade across a broad range of industries. But is this really going to be the case and what is an investor in Australia to make of all this?

POTUS – PUTTING AMERICA FIRST

President Trump's threats and actions, reflecting an agenda of populist, protectionist and anti-globalist ideas, have challenged the settled consensus on a range of foreign and trade policy issues. There is considerable scepticism about the US President's commitment to uphold the post-1945 liberal international order crafted under American leadership. Closer to home, Trump has alarmed Australia given his early decision to withdraw from the Trans Pacific Partnership, along with his antipathy towards multilateral institutions including the United Nations and NATO, at a time when Russia and China are increasing global presences. In contrast, Australia has remained part of the Trans-Pacific Partnership trade agreement after the US pulled out, and in 2015 finally committed to a China-Australia Free Trade Agreement.

Using national security grounds, the US Administration began to implement its protectionist agenda in early 2018. In March 2018, President Trump imposed a 25% tariff on steel imports, and a 10% tariff on aluminium imports, although excluding those from Canada, Mexico and Australia and several other countries. The President continued to attack the 'unfair' trade practices of the EU, but also continued to demand a broader renegotiation of NAFTA.

As 2018 has unfolded, however, it is fair to say the US has increasingly turned its attention towards China. Indeed, President Trump has increasingly adopted a more conciliatory tone towards the EU (under pressure from US manufacturers?), and in September agreed to replace NAFTA with the new US-Mexico-Canada Agreement (USMCA).

In the meantime, however, the US Administration announced in April it was considering imposing a 25% tariff on a further $50 billion of merchandise imports from China.

On 6 July 2018, Trump's tariffs went into effect on $34 billion of Chinese imports. In retaliation, China levied a 40% tariff on US autos. On 10 July 2018, the Trump administration announced plans to impose tariffs of up to 25% on another $200 billion of Chinese imports. On 17 September 2018, the US imposed a 10% tariff on $200 billion of Chinese imports, rising to 25% in January 2019. China announced 5% to 10% tariffs on $60 billion of US exports in retaliation. Trump warned that if China takes retaliatory action against US farmers or industries, tariffs on approximately $267 billion of additional imports will be considered (effectively applying tariffs on all US merchandise imports from China).

Following the G20 Summit in Argentina on 1 December 2018, China and the US agreed the US will leave tariffs on $200 billion worth of Chinese imports at 10% at the beginning of 2019, agreeing to not raise them to 25%. China agreed to purchase a not yet agreed upon amount of agricultural, energy, industrial, and other product from the US. Both countries aim to have this transaction completed within the next 90 days. If this does not happen the 10% tariffs will be raised to 25%.

Prior to the G20, the US Administration increased a number of other measures aimed at hampering trade between the US and China (see the box 'Beyond trade wars'). At the G20, the two leaders agreed to start talks on structural changes with respect to forced technology transfers, intellectual property protection, non-tariff barriers, cyber intrusions and cyber theft.

A more aggressive escalation of US-China trade frictions could lead to a number of possible scenarios: rising US inflation as import prices continue to increase (at a time when the US economy is close to full employment); stagflation as rising import price inflation is accompanied by greater business and consumer uncertainty and slower economic growth; or even a full blown China/emerging market crisis.

Unlike a financial crisis, or emerging market crisis, there is no comparable historical period on which to base a specific trade war scenario. For example, the Smoot-Hawley tariff (which raised average US tariffs to 60% in the 1930s) led to a period of deflation, rather than inflation, as it exacerbated the Great Depression.

At this stage, financial markets appear to be discounting relatively small direct and indirect impacts on global growth, although they clearly remain sensitive to the risks of the US following through on all the foreshadowed measures.

The sections below discuss the results of modelling by the International Monetary Fund (IMF), estimating the potential impacts on global and regional growth of the various tariff measures and retaliatory actions.

Trade Wars 2: Beyond trade wars

In September 2018, the US put sanctions on the branch of China's military responsible for weapons procurement. The 2017 US law which created the economic sanctions was put in place to punish Russia for aggression in Ukraine. In the same month, the US announced the sale of $330 million worth of military and aircraft parts to Taiwan, which led to strong opposition from China. China has since refused entry of a US carrier group to Hong Kong, challenged US warships nearing the Spratly Islands and cancelled a meeting with the US Defence Secretary.

In October, the US banned technology exports to a Chinese micro-chip manufacturer in Fujian, on national security grounds. Fujian Jinhua is currently locked in a legal dispute with main rival, US chip maker Micron Technology over IP theft. The "likely US-origin technology" to be produced at the new Fujian plant would threaten "the long term economic viability of US suppliers of these essential components of US military systems." In October, the CFO of Huawei was arrested in Canada for potentially breaching US trade sanctions against Iran. A number of countries, including the US and Australia have already banned the use of Huawei technology for 5G networks.

ENTER THE DRAGON

China recently approved the removal of the two-term limit on the presidency, effectively allowing President Xi Jinping to remain in power for life. He has amassed power the likes of which has not been seen since Chairman Mao Zedong. His position strengthened, Xi continues to support globalisation, pledging to allow foreign companies greater access to China's financial and manufacturing sectors, and signalling lower tariffs on cars in a move to neutralise the damaging trade dispute with the US. At the same time China is expanding its global trade and military presence through the One-Belt, One-Road initiative.

China has unique abilities to do what is required because of the central role of the government in dealing with issues such as debt restructuring, capital market restructuring and the balance of payments.

President Xi has also been clear about his focus on shifting China's economy from a credit-intensive, infrastructure and property-led growth model to something more sustainable. Focusing more on consumption and technological innovation, China is committed to bolstering research and development spending to a total of 2.5% of gross domestic product by 2020.

"Made in China 2025" is investing $US300 billion of government money, to make China self-sufficient and a global leader in 10 high-tech industries. Areas such as robotics, autonomous and electric cars, artificial intelligence, biotech and aviation are subsidised, and will gain access to low-interest loans, rent-free land and tax breaks to become world leaders. This represents an industrial policy of unprecedented ambition. Communist leaders aim to make China a world leader in AI by 2030. Already, Chinese companies including Tencent Ltd. Baidu Inc. and Alibaba Group are spending heavily to develop artificial intelligence for consumer finance, e-commerce, self-driving cars and other applications.[1]

1 Presumably this innovation flows through to profits and (foreign) shareholders as the MSCI China is opening up. In the past, growth in the MSCI China's market capitalisation was mainly driven by privatisation of state-owned enterprises.

Fasten your seat belts! The road to world domination

China's "One Belt, One Road" (OBOR) initiative seeks to improve China's linkages to other countries by creating a "Silk Road Economic Land Belt" that includes countries on the original Silk Road through Central Asia, Western Asia, the Middle East and Europe.

- The Land Belt will be established by a network of rail, road and energy infrastructure investments.
- The Road refers to establishing a 21st Century Maritime Silk Road which links China's port facilities with Africa, the Middle East and Europe.

OBOR will accelerate development in a number of developing countries and extend China's political and economic influence. China is aiming to include over 60 countries, 4.5 billion people and capture 40% of global GDP. OBOR will be funded by China's financial resources, State Owned Enterprises and by Asian controlled development institutions such as the Silk Road Infrastructure Fund, Asian Infra Investment Bank and the New Development Bank.

In contrast, the US Marshall Plan for rebuilding allied countries in Europe after World War II was helped by the United Nations, the World Bank and the International Monetary Fund. OBOR will broaden China's economic linkages with the rest of the world and diversify their food and energy security.

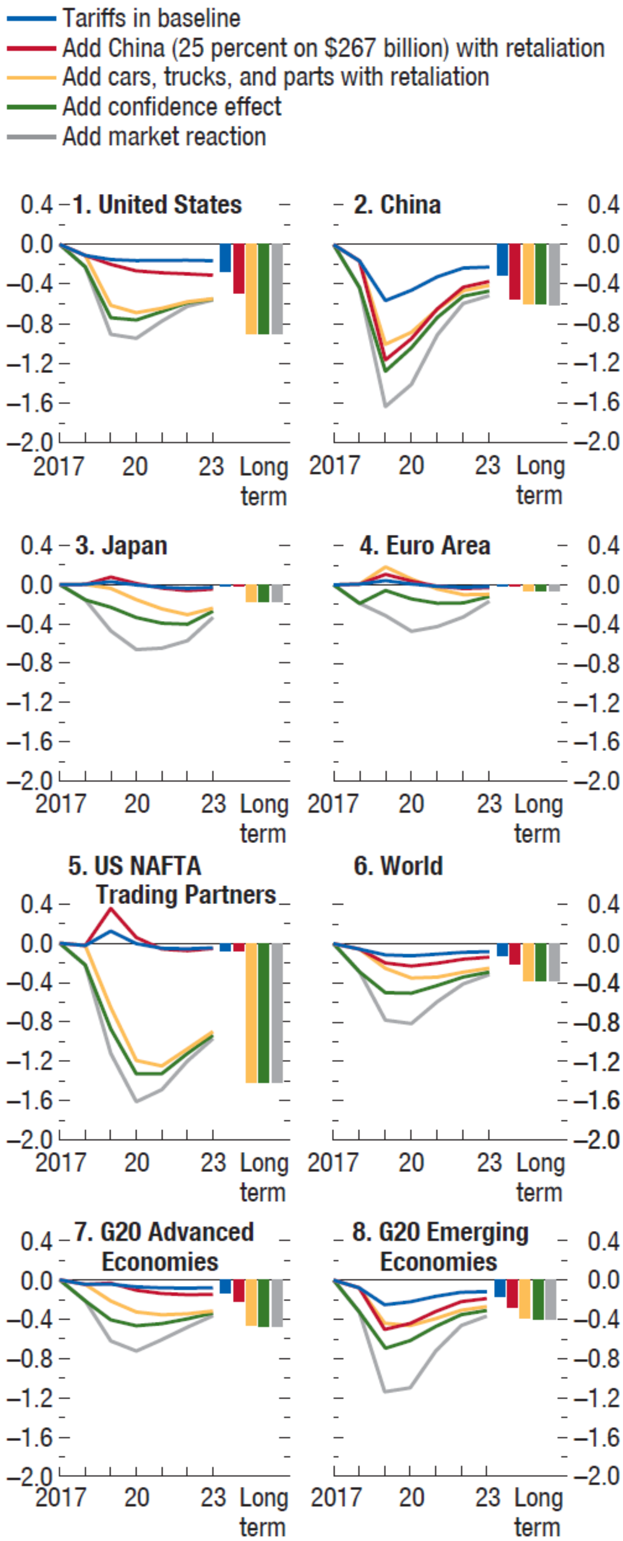
TRADE WARS: ESTIMATED IMPACT

It is not clear from economic theory whether increasing US tariffs on Chinese imports will necessarily reduce the US trade deficit. More certain is that higher tariffs act as an indirect tax on domestic producers and consumers and lead to slower productivity growth.

Figure 1 shows the IMF's estimates of the potential impact on the global economy, with China and the US NAFTA trading partners the hardest hit in a worst case scenario.

Estimates in Figure 1 suggest these actions could lead to a 0.2% to 0.5% overall loss in World GDP by 2020, or close to 1% including the indirect effects. This is similar to estimates provided by the World Bank.[1] The measures are also projected to have small adverse impacts on inflation.

Figure 1. Estimated impact on world GDP



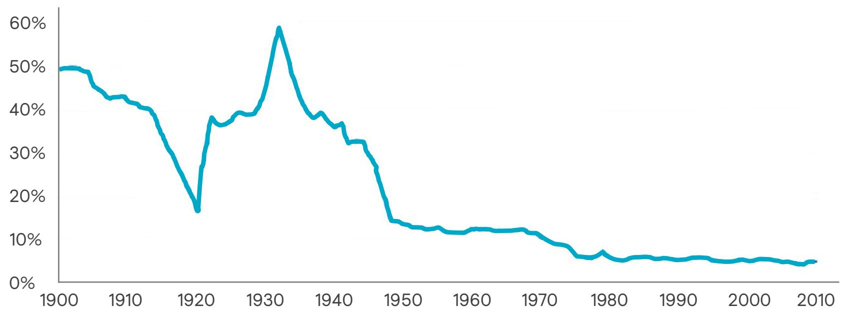
Source: IMF World Economic Outlook, October 2018

1 World Bank: *The global cost of protectionism*, December 2017

Figure 2 shows that successive rounds of multilateral and bilateral trade liberalisation agreements since World War II have pushed the US average effective tariff rate down to less than 5% in 2017, and compared with close to 60% following the Smoot-Hawley Act of 1930.

However, approximately one third of all US merchandise imports will be subject to tariffs in the event the Administration implements all the foreshadowed measures (with a significant proportion at 25%), suggesting a large increase in the overall or average tariff rate.

Figure 2. History of US trade tariffs
Average tariff on dutiable imports



Source: US Department of Commerce

More positively, Chinese retaliation has been measured to date and appears designed more for political impact than for economic impact, targeted primarily at imports of US agricultural goods and US autos. In the meantime, in mid-April President Xi announced significant other measures aimed at opening foreign access to China's domestic markets, as well as relaxing controls of forced IP transfers from foreign direct investors in China (and which has been a major sore point for the US).

CAN AUSTRALIA PLAY THE TRUMP CARD IN THE GLOBAL TRADING GAME?

Whereas the US runs a trade deficit with China, Australia runs a trade surplus. The main long-term effect of a more globalised world is higher productivity through specialisation, and protectionism reverses some of these benefits. Uncompetitive producers may be hit, but there will be re-allocation of resources and trade to the producers which are able to specialise in industries in which the country has comparative advantages.

While Australia could potentially suffer from an increase in US tariffs, in line with other developed markets, there are a few points worth considering.

- Australia was one of a handful of countries granted an exemption from US tariffs on imported steel. In the event, annual exports of steel and aluminium products to the US are about $500 million (or 0.3% of Australian GDP), so the direct impact would have been relatively small.
- While Australia is a large exporter of iron ore and coal to China, most of the subsequent processed steel is consumed in China's domestic market. It has been estimated that only one third of all Australian exports to China are processed domestically and then re-exported, not all of which to the US.
- There is some risk that merchandise exports blocked by the US and Chinese measures could be re-directed or 'dumped' into other markets (as a result of a global supply glut). Again, however, Australia has moved to strengthen anti-dumping measures in recent years.
- Australia is among the better placed countries to reap the gains of trade diversification. For example, Australian beef producers will be more competitive exporting to China as their American competitors have to grapple with the 25% tariff.
- On the other side, as China raises tariffs on soybeans, Australia could buy this product more cheaply from US farmers keen to find new distribution channels.
- The same goes for all other products appearing in the US and Chinese hit lists on both the export and import sides of markets.
- Australia has a natural advantage due to the ease of access to maritime routes across the Asia Pacific, and the US and China are already its two largest trading partners.
- There could be some concern if the US extends tariffs to beef, other meat products, aircraft parts, pharmaceuticals and alcoholic beverages. These goods comprise the top five Australian exports to the US and account for considerably larger trade volumes than steel and aluminium. Yet there is no reason to expect tariffs will suddenly be imposed on these major exports, given the provisions of the Australia–US Free Trade Agreement. This agreement comprehensively covers trade in goods and services, as well as investment flows, between the two nations. It eliminated many of the pre-existing tariffs affecting trade.

Figure 3. Top 10 exports for Australia

EXPORTS BY PRODUCT		
1.	Iron ore	16%
2.	Coal	13%
3.	Education	7%
4.	Gold	6%
5.	Natural Gas	5%
6.	Travel	5%
7.	Beef	2%
8.	Aluminium	2%
9.	Wheat	2%
10.	Professional services	1%
	Total	**59%**

EXPORTS BY COUNTRY		
1.	China	28%
2.	United States	6%
3.	Japan	12%
4.	South Korea	6%
5.	UK	5%
6.	New Zealand	4%
7.	Singapore	3%
8.	Thailand	1&
9.	India	4%
10.	Germany	1%
	Total	**100%**

Source: Department of Foreign Affairs and Trade (DFAT), 2016

CONCLUSIONS

- There is no denying that a potential trade war puts additional pressure on a global economy which is facing late cycle dynamics as markets move from Quantitative Easing to Quantitative Tightening. A reduction in global growth could impact commodity prices which would hit Australia.
- Australia has solid and mutually beneficial bilateral free trade agreements with both China and the US and does not pose a direct threat to either, which gives more predictability to the country's trade and investment flows.
- Australia is relatively safe from any retaliatory action from the Trump administration thanks to preferential arrangements and a trade deficit with the US.
- In terms of impact on interest rates and currency there are of course potential indirect effects to consider. For example, higher US import prices could lead to higher US inflation and interest rates, which could impact funding costs for Australian banks and which could feed through to the highly leveraged household sector.
- However, the Fed policy will continue to be the dominant factor as the present measures are too small to have much impact.
- Similarly, China's RMB has been allowed to depreciate against the USD over the past year to offset the tariff increases.

In summary, we are still a long way from some of the doomsday modelling scenarios. However, it is fair to say that we need to be alert to the threat that US-China trade tensions continue to escalate. In addition, it should be clear that this is not just about a trade war started by the US, with protectionist sentiment gaining ground across much of the developed world. Nevertheless, it is also reasonable that financial markets could continue to price in the risk of a further escalation of protectionist measures, which at some point could feasibly tip the global economy into a period of much slower growth and higher inflation. In a late economic cycle, with interest rates slowly rising, in our view a cautious investment stance is warranted.

IMPORTANT NOTICES

'MERCER' is a registered trademark of Mercer (Australia) Pty Ltd ABN 32 005 315 917.

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.

This contains confidential and proprietary information of Mercer and is intended for the exclusive use of the parties to whom it was provided by Mercer. Its content may not be modified, sold or otherwise provided, in whole or in part, to any other person or entity, without Mercer's prior written permission.

The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed. Past performance does not guarantee future results. Mercer's ratings do not constitute individualised investment advice.

Any advice contained herein is of a general nature only, and does not take into account the personal needs and circumstances of any particular individual. Prior to acting on any information contained in this document, you need to take into account your own financial circumstances, consider the Product Disclosure Statement for any product you are considering, and seek professional advice from a licensed, or appropriately authorised financial adviser if you are unsure of what action to take

Information contained herein has been obtained from a range of third party sources. While the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential or incidental damages), for any error, omission or inaccuracy in the data supplied by any third party.

This does not constitute an offer or a solicitation of an offer to buy or sell securities, commodities and/or any other financial instruments or products or constitute a solicitation on behalf of any of the investment managers, their affiliates, products or strategies that Mercer may evaluate or recommend.

For the most recent approved ratings of an investment strategy, and a fuller explanation of their meanings, contact your Mercer representative.

Conflicts of interest: For Mercer Investments conflict of interest disclosures, contact your Mercer representative or see http://www.mercer.com/clients/conflicts-of-interest-mercer-investments.html.

Mercer universes: Mercer's universes are intended to provide collective samples of strategies that best allow for robust peer group comparisons over a chosen timeframe. Mercer does not assert that the peer groups are wholly representative of and applicable to all strategies available to investors.

Risk warnings: The value of your investments can go down as well as up, and you may not get back the amount you have invested. Investments denominated in a foreign currency will fluctuate with the value of the currency. Certain investments carry additional risks that should be considered before choosing an investment manager or making an investment decision.

This document is not for distribution to retail investors.

This document has been prepared by Mercer Investments (Australia) Limited (MIAL) ABN 66 008 612 397, Australian Financial Services Licence #244385.

For further information, please contact your local Mercer office or visit our website at:
www.mercer.com

MARSH & McLENNAN COMPANIES