

Protectionism intensifies: country and sector selection to mitigate its effects



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- **Our view:** As a base case, we expect limited tariffs will be implemented on different fronts with relatively controlled macro impacts while talks continue. Although talks have become more contentious, we do still see space for negotiation among the various parties. This is the main difference vs a proper “trade war”.
- **Economy:** The risk of a global trade war may impact GDP growth well before a war begins. We have already seen a deterioration in business confidence, and uncertainty could possibly weigh on investments. If the base case materialises, we expect the impact of protectionist measures on world trade to remain contained and that global economic expansion will continue in 2018 and 2019. If talks and negotiations break down (trade war), we would expect to see deeper recessionary effects on the economy, especially for the countries more exposed to the targeted sectors (i.e., Automotive). A scenario of downward pressure on growth could lead to a more accommodative monetary stance. Potential pressures on inflation, on the other end, could further increase uncertainty on Central Banks’ action.
- **DM Equity:** Amid the current trade concerns, on a regional basis, among Developed Markets, we prefer the US to Europe, and, in Europe, the UK. We identify three global themes to play in this context: 1) domestic assets; 2) quality factors and 3) defensive and rate-sensitive domestic stocks if tensions escalate.
- **EM Equity:** Trade tensions are negative for Emerging Markets, as they tend to push global inflation and US rates higher, reduce the willingness to invest, and could negatively weigh on the exports of some countries. We like stories that will likely remain relatively insulated from such concerns or can counteract potential negative impacts with effective policy actions (i.e., Russia, oil exporters, China on flexibility on policy, Mexico on US interaction, Greek banks).
- **Multi-asset:** A multi-asset investor can generally implement a prudent stance at different levels: 1) maintain cautious asset allocation exposure to countries that are highly involved in the global value chain; 2) opt for defensive sectors (Telecoms, Utilities); and/or 3) at the stock-picking level, seek companies that are diversified across global value chains.

Do you see higher risks of escalation regarding current trade disputes?

D. Borowski: After several months of hesitation, President Donald Trump finally decided to implement some of his protectionist threats, first against the EU, Canada and Mexico (with a rise in tariffs on steel and aluminium on 1 June); then, more recently, with China, with a threat to raise taxes on USD 200bn of imports from that country. China immediately announced retaliatory measures. This may in turn provoke announcements of further tariff increases (from the US) on other products. President Trump also openly threatens to increase taxes on auto imports, with the hope of rebalancing the US bilateral trade balance with Europe and Japan. Our central scenario remains that tariffs will be implemented on a limited basis on different fronts with relatively controlled macro impacts while talks continue. Although talks have become more contentious, we do still see space for negotiations among the parties, and this is the main difference vs a proper trade war. However, recent developments, plus the high approval rating of President Trump, which encourages him to remain “offensive” on trade, have increased the tail risk, which relates to the potential breakup of talks. This could result in a serious spiralling path of retaliation, with significant negative effects on global trade, financial markets and, therefore, the world economy.

What could be the implications on the current economic outlook of the protectionist threats? What if a trade war were to materialise?

D. Borowski: The risk of a global trade war could impact GDP growth well before a war begins. Trade tensions between the US and most of its partners have already begun to weigh on business confidence (particularly in Germany, the most exposed European country to world trade) and on trade momentum. Uncertainty now risks weighing on business investment, even before global trade is affected by measures, some of which may never be put in place. That said, in our central case scenario, we continue to believe that the impact of protectionist measures on world trade will be modest and that global economic expansion will continue in 2018 and 2019. The worst-case scenario (outright trade war) would likely lead to recessionary pressure on the world economy.

World trade momentum



Source: World trade momentum: last 3-month average volume on preceding 3-month average volume. Source: Amundi, CPB World Trade Monitor, April dataset. As of 22 June 2018.

“The domestic bias and the sectorial mix of an economy will contribute to determining its resilience to trade shocks.”

“Despite short-term noise, Trump’s protectionist pressures might lead to a deeper integration of China with other EM that are keen to diversify risk”.

Protectionist measures have a negative impact on the global economy, including on the country imposing them. US auto exporters, for instance, would likely suffer from a reduction in the demand (European retaliation) and higher input costs (tariffs on materials). The strength of the impact would be initially proportional to the size of tariffs implemented, but above a certain threshold, the impact would be more than proportional as a consequence of implicit/not official measures adopted.

How would you identify the potentially more resilient countries in that context?

A. Berardi: As global value chains are highly integrated, it is common knowledge that there is unlikely to be a winner in a global trade war. However, some countries could prove more resilient than others: the most domestic-oriented economies; countries that have benefitted from the recent sweet spot of global expansion to adjust their imbalances and to increase the most productive public expenditure; countries that implemented reforms to improve their business environments (domestically and externally); countries less externally vulnerable with an effective mix of policies (monetary and fiscal). For a limited period of time, we do expect that commodity exporters will benefit more than manufacturing exporters: in fact, supply dynamics will tend to support commodity prices; a slowing global cycle could cool down expectations of manufacturing exporters and restrain investment decisions. Then, we do expect countries more exposed to sectors hit by tariffs (especially Automotive) to suffer more among DM and EM. As far as EM are concerned, looking at the two critical areas - the Automotive sector and China/US tensions - the most impacted regions should be Eastern Europe and Asia, due to sectorial and geographical integration. However, pencilling in a stronger-than-anticipated slowdown in China, this will affect some very open economies of commodity exporters in Latam too (Chile, Peru).

What would you expect from US-China talks?

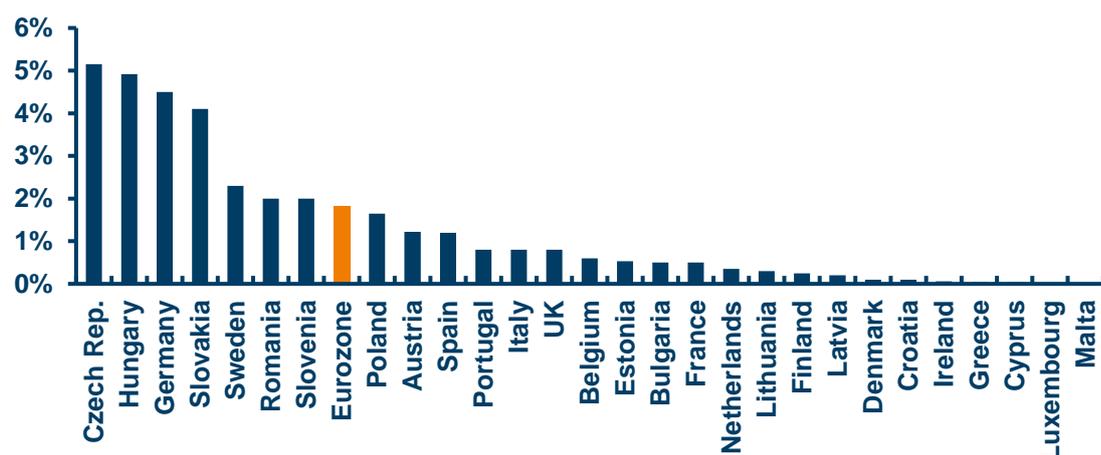
Q. Wang: We expect, as a central case, limited tariffs to be implemented, with relatively mild macro impacts while talks continue. From China's perspective, policy has been relatively consistent, delivering some reforms and further openings (cut to import tariff on autos and some consumer goods and opening of Auto and Financial sectors to foreign investors). Moreover, China's policy stance is expected to be further fine-tuned to guard against a moderate slowdown. Despite short-term noise, on a medium-term perspective, it appears that President Trump's protectionist pressures might lead to deeper integration of China with other EM that are keen to diversify risk away from the uncertainty related to US policy and to embrace China's Belt & Road initiatives. With regard to tail risk, should disputes escalate, the damage to global trade and China could be significant. As a rough estimate, we believe that the 25% tariff on USD 50bn of products would knock around 0.1pp off China's GDP growth (while a 10% tariff on USD 200bn could shave off an additional 0.2pp). Nonetheless, there is still the chance that the US and China could reach certain deals which could result in a decline in concerns about potential tariffs and other protectionist measures.

What could be the implications of car export tariffs for Europe?

T. Perrier: The next US action could be an increase of US tariffs on cars imported from Europe vs the current level of 2.5% to 20% or 25%. This is a threat that cannot be ignored. A key characteristic of such an action is that it would have very uneven consequences on Eurozone countries, with disproportionately negative effects on Germany and smaller countries (Slovakia in particular, but also a number of non-euro CEE countries) that are key players in German supply chains. According to ITC statistics, Germany's car exports (passenger cars only, other motor vehicles not included) to the US were worth EUR 20bn in 2017. That is 15% of gross German car exports, or 0.6% of German GDP (estimated at about 0.4% of German domestic value added). The second-hardest-hit large country would be Italy, whose gross car exports to the US were worth EUR 4.3bn in 2017 (26% of Italian car exports and 0.25% of GDP). The effect of a tariff on exports depends on the specific price elasticity of this sector in the US. Additional factors will come into play: the shock to investment as a reaction to concerns about a larger trade war; the political equilibria within the Eurozone could be challenged due to the asymmetry of the shock. On the other hand, there could be some mitigating impact from a presumably weaker Euro. Overall, if US tariffs of such a magnitude (20% or 25%) on European cars are indeed implemented, we would lower the Eurozone GDP forecast by 0.1pp for 2018 and 0.2pp for 2019, with most of the losses carried by Germany.

“An increase of US tariffs on cars imported from Europe would have very uneven consequences on Eurozone countries, with Germany being the hardest hit”.

European car industry as a % of value added



Source: Eurostat, Amundi Research, on data available as of 2 July 2018.

“US companies may regain some competitiveness over others, but there would also be a negative impact on input costs and margins”.

What could be the implications of a rise in trade-related issues on equity markets and what equity strategies/sector/markets could hold better?

E. Mijot: A real trade war is not our base case and would be painful for all stock markets. An escalation of tensions could indeed disrupt the chain of value creation which is currently very international. In theory, US companies may regain some competitiveness vs others, but there would also be a negative impact on input costs and margins. At the regional level, our preference in equities is still for the US. In Europe, the UK should do better than the Eurozone. Three global themes should emerge: 1) domestic assets: especially non-cyclical consumption (food retail, etc.) - small caps as well, but only as long as the cycle holds and volatility remains contained; 2) acceleration of the current move towards quality (which excludes some financials, despite their domestic characteristics); and 3) if the situation were to deteriorate further, a move in focus to more defensive and rate-sensitive domestic stocks (Utilities, Telecom, Real estate). Within EM, if global trade growth slows significantly, closed economies will suffer less. In EM Asia, we prefer India and Indonesia, both growth stories with good equity fundamentals. Also in terms of sectors, we think it is better to stay on the domestic side, i.e., with consumer sectors and even Financials - also in this case mainly in EM Asia, where the Chinese economic rebalancing between investment and consumption is continuing. Assuming that the dispute, at least in the short term, will mainly involve the US and China, in the short term, the countries most exposed to these two countries (Vietnam, Taiwan, Colombia, South Korea, Malaysia) could be more vulnerable. Oil is unlikely to be hit directly by tariffs and this protects oil exporters, at least initially.

“China, which exports the equivalent of 3% of its GDP to the US, has the capacity to take internal economic measures to mitigate the effects of trade tensions.”

What is your view on EM equity in the current environment of trade tensions?

P. Lemonnier: Trade tensions are negative for emerging markets as they tend to push global inflation and US rates higher, reduce the willingness to invest, and could negatively weigh on the exports of some countries. Within EM, China and Mexico are the main targets, but Western allies have not been spared. The extent to which emerging economies will be affected will ultimately depend on actual measures and potential escalations. But, we believe that China, which exports the equivalent of 3% of its GDP to the US, has the capacity to take internal economic measures (especially monetary) to mitigate any negative impact. Countries that are commodity exporters in EM are not directly affected. However, the strength of the US dollar, which is exacerbated by US trade sanctions, as well as potentially marginally weaker economic growth in EM could weigh on commodity prices. Regarding the Sino-US negotiations on trade, we do expect structural frictions, given increasing levels of competition on technology. Yet, both parties should at some point understand that they both may lose from departing too abruptly from the current order of global business. In any event, we believe the US will not be able to prevent China from becoming a global technology leader. The capacity of China to invest in R&D and to benefit from the large economies of scale, stemming from its huge market size, will continue to work in its favour in the medium term.

What areas/countries should be preferred in a phase of rising protectionism?

P. Lemonnier: Allocation in a GEM equity portfolio does not depend exclusively on global trade risks, even if it is an important issue at this juncture. EM equity allocation is also linked to internal political issues (such as elections), markets and FX valuations, interest rate cycles, internal economic trends, stock picking opportunities, etc. In this environment, we maintain our preference for Russia, which looks to be quite insulated from the global trade issues. Oil exports are not in danger. We are cautious on commodity sectors, where a metal price correction may materialise. We continue to prefer, in spite of the trade issue, China given its flexibility in terms of economic policy. We are still positive on Mexico, where we believe that, even if NAFTA were to end, President Trump would negotiate a bilateral agreement that would suit both parties in order to preserve the deeply rooted US business interests. We would look at Greece, where banks are an idiosyncratic investment that does not depend on global trade. In terms of stock picking, this phase is supportive of companies with earnings in US dollars, which have suffered together with their countries of quotation as trade and political issues have increased.

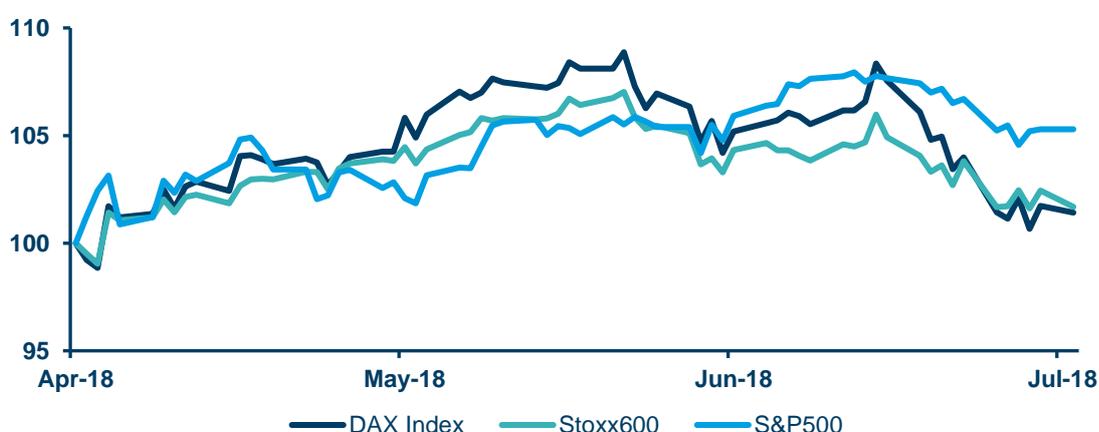
“We like stories that look to be relatively insulated from global trade issues: Russia (oil), China (flexibility) Mexico (entrenched US interests), Greece (banks)”.

In terms of trade tensions, what is currently priced in by market? Which asset class could be the most affected/favoured in a phase of escalating trade tensions?

“We tend to prefer defensive domestic sectors; a depreciation of the EUR vs the USD could help to compensate for the Euro area GDP loss from potential tariffs on car exports”.

F. Sandrini: At the time of writing, we can see that European equities are suffering; it's difficult to attribute such an effect only to the trade war theme, given the already ongoing deterioration of European activity indicators. However, it is worth noting that German DAX underperformed the Stoxx600 index and automobiles names, within consumer discretionary sector, are hit very hard. The impact of an increase in US car tariffs to 25% on Euro area GDP could be very significant indeed, given the already compressed forecasts for 2019. Checking global value chain data, it's no surprise that the most exposed country is Germany. A broader tariff rise beyond cars could materially harm Euro area GDP. It's not that easy today to quantify both the impact on capex intentions and the measure of possible EU retaliation, as the situation across the EU is extremely heterogeneous. Thus, it is difficult to conceive a single political response. We believe investors should prefer defensive domestic sectors in which the exposure to global trade can be more contained. We think that appreciation of the USD vs the EUR in a range of 5-10% would be required to compensate for such losses in terms of GDP. Hence, a constructive position on the USD seems advisable under the current circumstances.

Equity indices



Source: Bloomberg, rebased at 100 at 2 April 2018. Data as of 2 July 2018.

How can risks of trade tensions be managed with a multi-asset approach?

F. Sandrini: A multi-asset investor can clearly implement a cautious stance at different levels, from maintaining defensive exposure to countries that are highly involved in the global value chain (e.g., Taiwan, Germany across key sectors such as Tech and Auto), to maintain exposure to the USD and the yen that can perform in a phase of sell-off whereas the current fears could include global growth and capex. At a sector level (second level of asset allocation), we think a rather defensive allocation (e.g., Telecoms, Utilities) might be best, keeping in mind that the rates dynamic might have an effect on some of the more highly levered plays. At a stock-picking level, we think it will be important to carefully screen for companies that are diversified across global value chains and are not so exposed to political factors targeted at specific sectors.

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