LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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A STEP BACK ON TRADE

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KEY TAKEAWAYS

The United States has raised tariffs to 25% on $200 billion of Chinese goods.

Even in the worst-case scenario, we don't expect a significant impact on the U.S. economy.

Raising tariffs could put upward pressure on consumer inflation.

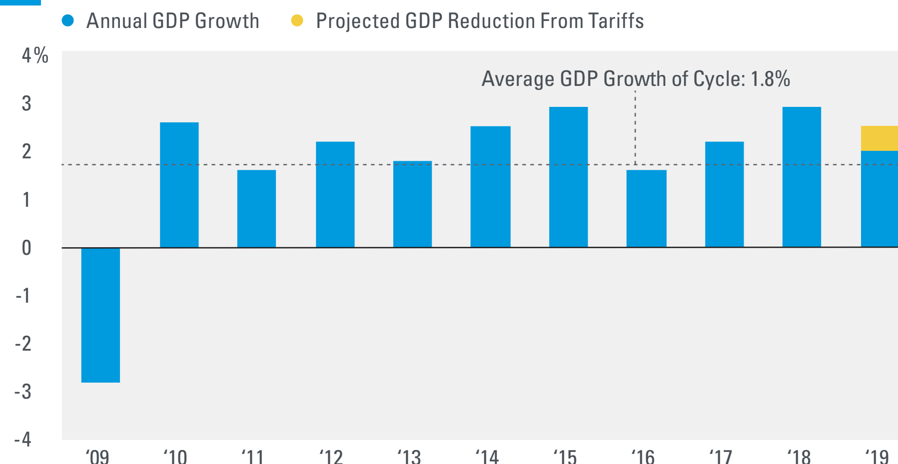
Investors aren't quite out of the woods yet with trade tensions. On May 5, President Trump threatened to raise tariffs to 25% (from 10%) on $200 billion in Chinese imports, surprising investors who thought the United States and China were close to a deal just a few weeks ago. Five days later, the U.S. announced it would impose higher rates on that swath of goods, and China announced its own tariff increase on $60 billion in U.S. goods. Now, the U.S. is considering higher tariffs on all Chinese imports.

Financial markets have struggled to process the rapid back-and-forth between both countries. The S&P 500 Index fell nearly 5% over six trading days before paring about half those losses through the end of last week. As the stock market swings, we suggest investors step back and consider the fundamental implications of increasing tariff rates. Higher tariffs can weigh on economic activity, but we don't expect an escalation to derail this expansion [Figure 1].

MANAGEABLE IMPACT

The United States and China have been engaged in a year-long squabble over trade relations as the U.S has attempted to negotiate greater protection for

1 SMALL HIT TO GROWTH IN WORST-CASE TRADE SCENARIO



Source: LPL Research, Bureau of Economic Analysis 05/17/19
GDP= Gross Domestic Product
The 2019 annual GDP growth is LPL Financial Research's projection.

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domestic intellectual property. While an agreement would be beneficial over the longer term, getting to a compromise has involved some short-term risks.

Any direct economic impact from these new tariffs should be small, although the secondary impacts on sentiment and financial markets remain a concern. The United States' decision to hike rates on $200 billion in Chinese imports adds about $30 billion in costs per year (on top of existing tariffs). U.S. importers pay the direct cost, and some of those costs may be passed on to U.S. wholesalers or consumers. Chinese exporters can also choose to lower prices, but the evidence points to minimal movement in that direction so far. If the U.S. takes the next step and decides to implement a higher tariff rate on all Chinese imports, the U.S. economy would bear about $80 billion in additional costs over a year, which is about 15% of our gross domestic product (GDP) growth projection this year. While this is still a possibility, it would be an unusually aggressive step after several weeks of progress in trade talks. In either case, we expect the fiscal stimulus tailwind alone to overpower any negative effects.

Of course, the past several months have shown that the intangible effects from trade uncertainty can also be significant. Trade tensions have had a chilling effect on consumer and business confidence, and the U.S. economy has only recently begun to overcome a noticeable hit to spending and demand. Growth in capital expenditures is a key part of our economic outlook this late in the business cycle, and prevailing uncertainty could impede this source of future growth.

We continue to project GDP growth near 2.5% in 2019. In the worst-case scenario, we suspect this latest round of tariff increases could lead to a 0.5% reduction in that projection. If that happens, GDP growth would be closer to 2% this year, largely consistent with the average pace over the last decade.

2 CHINESE TARIFFS MORE LIKELY TO IMPACT CONSUMER PRICES

Top 5 U.S. Exports to China in 2018	Top 5 Chinese Exports to U.S. in 2018
1. Aircraft ($18 Billion)	1. Electric Machinery ($152 Billion)
2. Machinery ($14 Billion)	2. Machinery ($117 Billion)
3. Electrical Machinery ($13 Billion)	3. Furniture and Bedding ($35 Billion)
4. Optical and Medical Instruments ($9.8 Billion)	4. Toys and Sports Equipment ($27 Billion)
5. Vehicles ($9.4 Billion)	5. Plastics ($19 Billion)

Source: Office of the United States Trade Representative 12/31/18

INFLATION IMPLICATIONS

Logically, tariffs should be a catalyst for higher inflation, as higher costs should boost price growth. So far, we've seen the opposite happen. Import price growth has slowed considerably: In April, import prices (excluding petroleum) fell 1% year over year, the biggest drop in nearly three years. Consumer price growth has moderated as well, fueling calls for a Federal Reserve (Fed) rate cut to give inflation an extra nudge. So far, the negative impact of slower global growth on inflation has outweighed any broad price impact from tariffs, although inflation has been rising on goods facing tariffs [Figure 2].

Many of the current tariffs are on intermediate goods, and U.S. businesses have struggled to pass along higher input costs to the end consumer, especially amid weaker spending and activity. The U.S. dollar's recent climb has also helped curb costs for importers. Even if prices rise on Chinese imports, a strong dollar can offset that increase.

Given these moving parts, it's tough to predict how the latest tariff increases will affect U.S. inflation. On balance, though, we think higher tariffs could eventually fuel higher consumer prices, especially if the U.S. ends up raising rates on the other $300 billion in Chinese goods. If the dollar weakens, we could also see some added inflationary pressure.

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Economic fundamentals also point to building pricing pressures. We believe wage growth greater than 3% should eventually stoke higher consumer inflation, as wages constitute about 70% of business costs. Consumer inflation was near the Fed's 2% target for most of 2018, and we expect a return to these levels once trade uncertainty is resolved.

CONCLUSION

U.S.-China trade negotiations are in a delicate stage, and we expect more brief bouts of increased uncertainty as the two sides tackle difficult remaining issues. Still, we don't think trade tensions will materially dent U.S. economic growth.

While there is increased uncertainty, we still expect a deal over the next several months. Late stages of negotiation can be the most challenging as both sides push for final concession, but we still largely view this as part of the negotiating process and not a fundamental change in intent. The bottom line is that a deal is clearly in the best interest of both parties. President Trump wants re-election and a strong economy, China wants growth, and neither party wants to materially roil global financial markets. But U.S. companies doing business with China do need to come away with greater enforceable protection of intellectual property. Tensions are high, but we believe a path to compromise still exists. ■

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