ACTIVE
VIEWPOINT

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THE LONG-TERM IMPACT OF TRADE WARS ON INVESTMENT RETURNS

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Executive summary

The US and China are embroiled in an explicit trade war, but at the same time an underlying technology-driven cold war. Capital market investors have clear views of the short-term implications, allowing for straightforward decision making on that time frame. However, the longer-term impacts are less visible and the degree to which value chains and decision-making processes are permanently disfigured appears to be underappreciated. The inescapable conclusion is that the world is moving inexorably towards another extended period of political and economic divergence, with some similarities to the original Cold War, but in many ways more invasive and more dangerous for investors. The unintended consequence will be a three-track world, with a generalised return to heightened state intervention. Ultimately, this could lead to three distinct 'camps' (US-led, China-led and the 'Old World Order') of increasing economic and political interdependency and limiting investment outcomes. This approach will likely result in an acceleration of the adoption of certain new technologies, but at a higher risk of permanent dislocation of trade routes and long-lasting prejudice to investment returns.

In this scenario, the fragmentation of the world into three main camps will become entrenched. As a result, inflation and interest rates will rise, fuelling inequality. Consequently, state intervention will increase as populations become more vocal about their deteriorating living standards. Investors may not be able to maintain their current freewheeling status, as first public-sector plans and then large corporate asset owners could find themselves being channelled into restricting investment exposure to markets in the 'other' camps.

Trade drives foreign policy, drives military doctrine/ action

Historically, there has been a persistently strong relationship between trade policy, foreign policy and military doctrine. In practice, the primary motivation was trade interests, rendering foreign policy and military doctrine the subordinate, supporting role. For example, Rome invaded Egypt in 30 BC at least partly to ensure a good supply of grain for its growing population. Investors in the British East India Company enjoyed significant profits as the company effectively directed British foreign policy in Asia in the 17th century, based on trade interests. Fast forward to today and the world looks much more complex.

What can we learn from historical precedent?

One problem for investors today is that the last trade war was in the 1980s, between the US and Japan, the rising Asian economic power of the time. That was over 30 years ago and most investors active today did not experience it. Japanese firms had acquired Firestone, Rouge Steel (Ford's steelmaking subsidiary), the Rockefeller Centre in New York and other trophy real estate assets. Six Hitachi executives were arrested in an FBI sting relating to IBM technology, the UAW (United Autoworkers Union) encouraged people to smash up Japanese made cars and Hollywood produced a ream of movies where Japan and the Japanese were portrayed in a negative light. That dispute took 12 years to resolve, even though Japan was clearly the weaker country, wholly dependent on the US for its geopolitical defence.

The parallels to the current trade war are limited. China is the second (for now) largest economy in the world, with a resilient population, a stable, unchallenged leadership and a famously long policy horizon. As for the entertainment industry, China's movie theatre market is bigger than the US and as a result does not suffer from unflattering Hollywood depictions – at least for now.

Given consensus in Washington is currently so uniformly negative on China's perceived unfair practices, the likelihood of a resolution, now or in the future, is extremely low – the best the markets can hope for is an uneasy truce, perhaps best described as a relationship of mutual discomfort.

Some believe the earth is flat

It is almost universally accepted that strong trade flows encourage foreign direct investment (FDI). In turn, strong FDI flows are beneficial to the destination economy, by creating jobs, capital investment and increasing output and efficiencies. The investing company benefits by gaining access to higher concentration of specialist skills, or higher production efficiencies, or a significant overseas market and their customers gain by access to more affordable goods.

Clearly this is the paradigm of globalisation and many of us grew up with it. In the aftermath of World War II, the creation of GATT (General Agreement on Tariffs & Trade) effectively became a catalyst for increased global trade and economic growth. In 1995, GATT was replaced by the WTO (World Trade Organisation), which expands the scope to include services and intellectual property and cements the rules-based framework for international trade that most countries use today.

For more than 70 years, the established doctrine of the US was to champion these organisations as they facilitate trade, which in turn stimulates demand for the freedoms and values enjoyed by democracies. All of that abruptly changed in 2016. Today, ideology is driving US policy, not economic considerations. The world view that is built on the belief that the trade deficit is the key data point, is driving the current tariff war, on the assumption that the other side will be brought to heel in short order. It would be disingenuous of me to ignore the fact that both assumptions seem to be misguided. Put simply, tariffs are a blunt instrument that essentially raises a tax on the economy and are inflationary over the longer term, hurting both sides in the process. Strangely enough, no US automaker was clamouring for protection from imports in 2016.

VALUE CHAINS – THE FORMULA HAS CHANGED AND THE IMPACT IS REAL, IMMEDIATE AND PERMANENT

Since the 1980s, as communication costs decreased and new software and digital platforms emerged, companies could choose from a much wider universe of suppliers, coordinate effectively, and track shipments anywhere in the world in real time. The internet enabled the restructuring of global production lines, with countries and companies specialising in specific parts of different industry supply chains. This resulted in the optimisation for quality, price and reliability.

It should be stressed, however, that value chains are in perpetual evolution, responding to changes in conditions, the implementation of new technologies and the fast-increasing demand from the developing world. The practice of arbitrage of unit labour costs is now outdated, but differentiation of service and knowledge intensity is key. This process should lead to further polarisation between countries and companies, across the developed and emerging asset classes.

What changes all of this, is the injection of politics into the formula. This can only have a destabilising and detrimental effect on costs, margins, reliability, business confidence and ultimately, investment returns. But perhaps equally importantly, it upsets the relative clarity of expectation regarding the likely winners and losers going forward. So, trade, industrial and economic policy designed based on the 'old world' view of optimisation of the value chain are unlikely to bear fruit. The new policies must consider politics and foreign affairs as well as service capabilities, workforce skills and digital infrastructure.

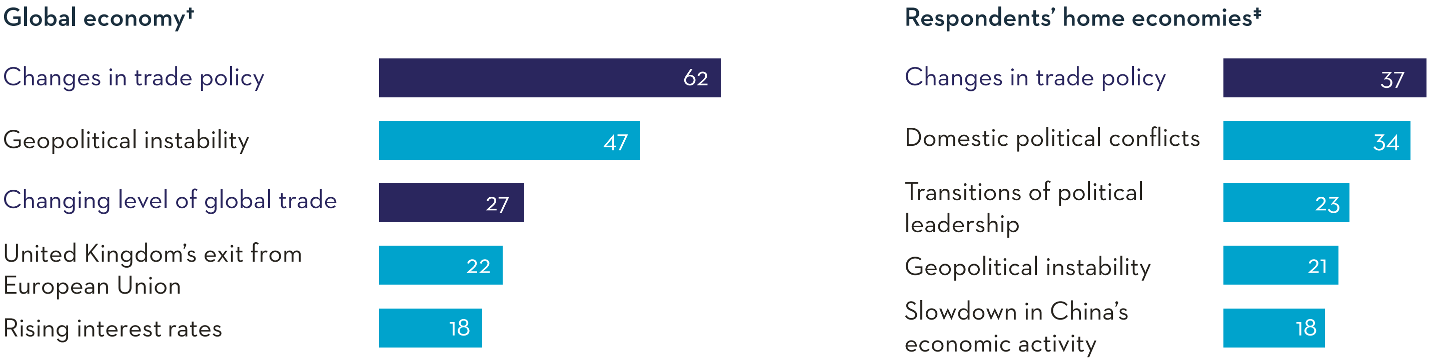
How have companies responded?

The second-largest exporter of Chinese-made cars to the US (after General Motors) was Geely, via its Volvo brand. To more effectively service the US market, Geely had opened a US$1.1 billion plant in Charleston, South Carolina. Originally, the company expected to export 50% of its production to China. Those plans are now changing as China's retaliatory tariffs render American-made cars less economical, with more production shifting to Chinese plants owned by Geely. Clearly, this represents a missed opportunity for the US manufacturing sector.

BMW has reacted the same way, cutting its production targets from the South Carolina plants and mulling increased production onshore in China instead.

Trade-related risks still predominate as top risks to global and domestic growth*

Potential risks to economic growth, next twelve months, % of respondents



Source: McKinsey Economic Conditions Snapshot Survey, September 2018.

*1 = 1.158 †Out of 13 risks that were presented as answer choices. ‡Out of 16 risks that were presented as answer choices.

THE ANATOMY OF A TRADE WAR

Trade wars are not quick and easy to win. They are not glorious, adrenaline-pumping cavalry charges. They are more akin to energy sapping, trench warfare. Everyone gets hurt and the countries that prevail tend to be those whose populations have the highest pain threshold, because governments need popular support to last the course.

In many ways, the United States has important structural advantages in a trade war. It is the biggest economy in the world, it has a lot of resources, it is an attractive market and it has both human and financial capital to bring to bear. But it also has weaknesses. The biggest is its transparency. It means that it is a 'target-rich environment' making it easy for the counterparty to identify areas of the economy where each counter strike will do the maximum damage, as we have recently seen with soy bean farmers' record bankruptcies. The evidence of economic pain being inflicted on sections of both economies makes it plain that trade wars do in fact hurt both sides.

Further, strategists place a great deal of focus on perceived 'windows of opportunity' for their plans to take effect. In the case of the US, the electoral calendar and the loss of control of congress in the midterms would seem to be 'closing' the window to demonstrate the effectiveness of this trade war. Beijing meanwhile has policy and leadership continuity, so could potentially outlast this US administration.

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THE LAW OF UNINTENDED (AND INTENDED) CONSEQUENCES

Leaving aside the relative merits of the base assumptions, let's examine the impact of the policies on investment.

The usual motivation for tariffs on end products is to trigger import substitution. Tariffs on intermediate goods make import substitution less likely, because they cloud the calculations. Steel is a great case study: steel tariffs served to help the US domestic steel producers and their steel workers, but this benefit has come at a cost. As soon as the tariffs went on in March 2018, the US steel producers raised their prices to meet the tariff and the foreign producers did not reduce their pricing. In the US auto sector, GM has been a good corporate citizen, historically committed to buying 80% of its steel from US producers. By doing this 'national service', GM has been penalised as if it were sourcing 100% of its steel requirements from overseas, pushing up costs by around US$1 billion[1] according to market estimates. In October 2018, GM offered voluntary redundancies to 18,000 workers and in November, the company announced its intention to close five North American plants (four of which were in the US).

In a recent study[2], Amiti, Redding and Weinstein (2019) found that the impact of the trade war in 2018 has been a complete pass-through of the tariffs into domestic prices of imported goods. Overall, they found that the full incidence of the tariffs fell on US domestic consumers, with a reduction in US real income of U$1.4 billion per month by the end of 2018.

Another study[3], by Fajgelbaum, Goldberg, Kennedy & Khandelwal (2019), found that there was an intriguing geographical and political pattern to the trade war. Essentially, the US tariffs were most beneficial in those counties with steelworkers where the Republican Party has not been historically dominant, in states like Michigan, Ohio, Pennsylvania, Wisconsin, whereas the prejudicial impact of foreign retaliation has been disproportionately felt in traditionally Republican counties in Iowa, North & South Dakota and Nebraska, where agriculture is concentrated. Naturally, this impact is a result of careful and deliberate targeting by China and the other countries hit by tariffs on steel and aluminium. The authors conclude that the aggregate welfare loss was US$7.8 billion, but extremely focused geographically.

There is always a trickle-down effect on consumers as goods become more expensive. Industrial policy is not usually helped by tariffs on intermediate goods. If you want to promote manufacturing growth you should keep the cost of intermediates and components low, by putting tariffs on end products, to keep the competition out. By putting tariffs on these intermediate goods, you are obliging your domestic companies to pay more for their intermediate goods; this makes them automatically less competitive on the world stage. Ideally, parts and components should be tariff free.

[1]Source: GM, Form 10-Q, United States Securities and Exchange Commission.

[2]Amiti, Mary, Stephen J. Redding, and David E Weinstein "The Impact of the 2018 Trade War on U.S. Prices and Welfare," CEPR Discussion Paper 13564, May 2, 2019 http://www.princeton.edu/~reddings/papers/CEPR-DP13564.pdf

[3]Pablo Fajgelbaum, Pinelopi Goldberg, Patrick Kennedy, Amit Khandelwal 'The return to Protectionism', March 10th, 2019 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3350407

Preparing the ground for corruption?

One of the main concerns investors should have because of this injection of politics into what was a very transparent, economically driven decision tree, is the high likelihood of corruption permeating trade, with clearly undesirable effects. The World Bank Economist R. Gatti's, (1999) research[4] uses empirical evidence to demonstrate that, across countries, the very existence of a variety of tariffs, diversified by country and product, results in the growth of corruption.

The simplest rationale is the inevitable change in the level of empowerment of customs officials. Logically, the application of different tariffs on products or components means that officials have a menu of tariffs to charge and the importer could potentially be forced into paying a bribe, to avoid having their merchandise erroneously categorised, thus attracting a higher tariff.

If this were to play out, it would result in the cost of the goods rising and the demand for them falling, prejudicing global trade.

WHERE IS THE EXIT?

Historically, trade wars usually only last one round. Both sides think again and understand that they are both hurting, so further escalation only serves to raise the cost. Given the amount of political capital expended and the economic damage sustained after round one, typically both sides find a face-saving deal and submit to WTO rules. In this case, it looks unlikely that WTO will be an avenue used, given the White House's aversion to multilateral bodies. It appears more likely that the US administration signs a deal with Beijing which can be presented as a victory, but in fact is nothing more than an uneasy truce. China will be motivated to go along with it, recognising the value of the US electoral calendar, alleviating pressure on its own economy and preparing for the inevitable round two in the future.

A THREE-TRACK WORLD

The unintended consequence of this trade war will be an increased divergence in the benefits of trade, between and even within countries. Consumers will end up paying higher prices, fuelling inflation. Countries, regions and municipalities prejudiced by the trade war will lose investment, revenues and employment, putting further strain on local government finances. Budgets for infrastructure maintenance and municipal services will be restricted. We have seen the prejudicial intergenerational impact of these developments before.

If the trade wars continue at this pace, they may end up dragging others into it, as they retaliate against tariffs imposed on them. This escalation will probably lead to a generalised return to increased state intervention, as voters demand more action from their governments. This interventionist approach will become more widespread, even in countries that have liberal, capitalist traditions, as politicians begin to enjoy having more levers at their disposal. The positive impact will be an acceleration of the adoption and promotion of certain new technologies, but at a higher risk of permanent dislocation of trade routes and long-lasting prejudice to investment returns. Countries that have a long tradition of state intervention will adapt quicker and show benefits in the very short term. Those that don't will inevitably risk stunting future growth and eroding their institutions if they go too far.

Ultimately, this could lead to three distinct 'camps' ('US-led', 'China-led' and the 'Old World Order') each one leading to increasing economic and political interdependency and limiting investment outcomes.

1. **The China-led grouping**, primarily made up of countries involved in the Belt and Road Initiative and signatories of RCEP[5], the Chinese sponsored multilateral trade group. Covering most of Asia and the western Pacific. This group will enjoy continued growth of volumes and value of trade, while becoming ever more closely aligned to Beijing in the geopolitical sphere. On completion, RCEP will be staggering in size and breadth. It covers 3.5 billion people and 33.3% of world GDP, building on WTO rules[6].

2. **The remnants of the Old World Order,** Japan, the EU and some of the Southeast Asian and Pacific countries, via the Japan-EU Economic Partnership Agreement[7] and the 11 members of the CPTPP[8] (Comprehensive and Progressive Trans Pacific Partnership). The Japan-EU EPA puts the UK at a significant disadvantage post Brexit. It covers 638 million consumers, 28% of the world economy and over a third of world trade. CPTPP accounts for 753 million consumers, 15% of the world economy[6] and now places non-members at a clear competitive disadvantage to the members; US companies will now be at a disadvantage to Canadian, Mexican, Japanese and Australian competitors in these markets. Thai, Korean and Taiwan-based firms will lose out to Malaysian, Vietnamese and Japanese competitors.

3. **The US**, which is a relatively less trade intensive economy[9] in any case, with a reduced number of non-aligned countries, which become less relevant as trade partners over time, as their ability to compete with technological developments erodes due to their weakening capacity. One candidate for this group is the UK in the event of a 'hard' Brexit, where it loses the benefits of cooperation with the EU on technological research but cannot measure up to the US in that field.

[4]Source: Roberta Gatti (1999), Corruption and Trade Tariffs, or a Case for Uniform Tariffs. Policy Research Working paper, World Bank. http://documents.worldbank.org/curated/en/223751468741371712/pdf/multi-page.pdf

[5]RCEP Regional Comprehensive Economic Partnership is China's answer to the TPP. There are 16 members: Australia, Brunei, Cambodia, China, India, Indonesia, Japan, Lao, Malaysia, Myanmar, New Zealand, Philippines, Singapore, South Korea, Thailand and Vietnam. Together, they account for $25trn of GDP.

[6]Source: Martin Currie, The World Bank.

[7]EU-Japan FTA came into force in February 2019, eliminating 90% of customs duties between the countries.

[8]CPTPP came into force in December 2018. Members are Canada, Mexico, Peru, Chile, New Zealand, Australia, Brunei, Vietnam, Malaysia, Indonesia, Singapore and Japan.

[9]Trade (as measured by imports+exports) represents 25% of US GDP; hence the country is not particularly trade dependent. For China, trade is 36% of GDP. Source: World Bank Database https://wits.worldbank.org/countrystats.aspx

WHO WINS?

Vietnam

Foreign direct investment usually comes in waves, typically led by manufacturing firms chasing production efficiencies. However, the location decision is not simply driven by labour costs; if that were the case, Haiti would be the manufacturing powerhouse of the western hemisphere. Vietnam is significantly behind China in terms of its ability to attract FDI, but in this climate, the fact that it is not China is more important. Hanoi is playing its cards very adeptly, by remaining a founder member of CPTPP (Comprehensive and Progressive Trans Pacific Partnership) and committing to the standards of intellectual property protection, dispute resolution and market access. So, no surprise that it is the biggest beneficiary of the recent moves to reposition supply chains in Asia. Result: a substantial boost to GDP over the next decade.

Industrial automation – 5G value chain

The trade disputes are serving as a catalyst for renewed momentum in the development of industrial automation, as a way of sidestepping tariffs and sanctions. For companies reviewing their existing value chain arrangements, the decision on the deployment of robots, 3D printing and generally enhanced automation of industrial processes just got easier. The single most important enabler is technology, in the shape of 5G deployment. As detailed in our recent paper '5G – The Confluence of Technology and Geopolitics' (March 2019), this technology is a prerequisite for the successful deployment of all aspects of industrial automation, machine learning and ultimately, artificial intelligence (AI). As a result, the clear winners will include the high specification chip makers, TSMC, Samsung Electronics, SK Hynix and Qualcomm. Other winners will likely be the specialist consultants and software solutions developers, like EPAM or TCS and finally, those civil engineering companies involved in the necessary capital expenditure items for building new plants and logistics centres.

Artificial Intelligence firms

Increasingly the US Senate and the House of Representatives have become more accepting of the view, held by many in the intelligence and defence communities, that China represents the single most important economic, military and virtually existential threat to US national interests. And AI is the field where China appears to be gaining the advantage. So, it's clear that if ever there was a time when governments around the world felt an urgency to create national champions, this is the field of primary focus. Every credible firm in this field will be offered access to finance and protection from foreign takeovers.

Trade lawyers

The more unstable, the more uncertainties around trade policy, the better for this subset of the legal profession, which for a long time was viewed as a quiet backwater…

WHO LOSES?

The Unverified list[10]

The United States Department of Commerce's Bureau of Industry and Security exercises the right to directly intervene by effectively blacklisting foreign companies who, in their opinion, are not *bona fide* organisations and could represent a security threat. Just recently[11], the Bureau of Industry and Security (BIS) published a list of 51 companies that have recently gone onto this Unverified list. 37 of these companies are Chinese, seven are from Hong Kong, one is Indonesian, two are Malaysian and four are based in the United Arab Emirates. There is an immediate impact as all US and many non-US companies rush to cut commercial links with those on the list, on the basis that they want to avoid the suspicion of guilt by association.

The United Kingdom

Around 1,000 Japanese firms like Nissan and Honda and their suppliers built factories in the UK in the 1980s, driven by a desire to access the EU market, from a country with lower social costs and lighter labour regulation than other European countries. After the Japan-EU free trade agreement and in the wake of Brexit, these companies can, and have, relocated manufacturing back to Japan. The UK has lost its usefulness for them.

At the time of writing, the range of possible outcomes of the Brexit debate remains too wide to justify conclusions on probable end states. Suffice to say that regardless of the position held, investors must see that any outcome that rescinds membership of the EU is less good in trade and economic terms, than before. The rationale is not just limited to the fact that Britain is a middle-sized economy that will be outgunned by larger countries in negotiations, it is that the requirements of other countries for a trade deal with the UK would prove, in my opinion, toxic to the debate. In the case of the US, the UK would have to allow direct private sector participation in the NHS (National Health Service), chlorine-washed chicken and GM (genetically modified) crops, all issues that have repeatedly proved to be red lines with the voters. In the case of India, the ask would be visa-free entrance for Indian citizens and free movement of people, which 'Brexiters' do not countenance.

Low and semi-skilled humans

One of the repeated lessons of history is that in any society, the benefits of automation tend to flow to a small minority of workers, principally the highest skilled and best paid. This phenomenon acts as a driver to further inequality. Countries with strong and credible commitments to improving public education and training are already better placed to deal with this. Those that are unprepared or even oblivious, are clearly going to struggle. For investors, there is a clear implication that due diligence in these countries requires, at the very least, an informed judgement on the likely social and political stability of the country in question.

The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were or will prove to be profitable.

[10]Source: US Department of Commerce https://www.govinfo.gov/content/pkg/FR-2019-04-11/pdf/2019-07211.pdf

[11]April 10th, 2019.

Which countries are on the danger list?

As investors, we must be dispassionate and clear eyed about the relative merits of different countries; fortunately, the data is (mostly) available. My conclusion is that the worst placed are those countries that display a confluence of already high levels of inequality, fast-growing populations, young demographics, poor education, higher youth unemployment and an imbalance between the sexes. For example, in 2017 Pakistan was struggling with the combined pressures of a large, young, fast-growing and mainly rural population. There were 22.8 million children (5 to 16-year-olds) out of school. For those students who stay the course, the standards of education remain relatively poor, there is little hope for enough meaningful employment and there are 105.6 men for every 100 women. Faced with this situation, it is hard to see what policy can start to redress the scale of the problems.[12]

Country	R&D as % GDP	Human Capital Index[13]	Population mm	Pop Growth	Median Age (years)	Urban pop.	Tertiary Education[14]	Males to 100 Female	Youth Unemployment (official)
Egypt	0.7%	0.49	99.4	2.2%	24	42.7%	34.4%	102.2	17.0%
India	0.8%	0.44	1,296	1.4%	29	40.8%	27.4%	107.6	10.6%
Indonesia	0.1%	0.53	262.8	1.4%	28	54.6%	16.1%	101.5	15.9%
Pakistan	0.3%	0.39	207.9	2.3%	22.5	36.4%	6.9%	105.6	7.7%
Nigeria	NA	0.34	203.5	2.6%	17.9	49.5%	10.2%	102.6	13.7%
Morocco	0.6%	0.50	34.3	1.3%	28.3	61.9%	33.7%	97.9	17.9%
Kenya	0.78%	0.52	48.4	2.5%	18	26.6%	11.7%	99.6	26.2%

Sources: Martin Currie, World Bank, OECD, and UNESCO.

Countries with kevlar jackets

Australia – Security vs Economy

Australia has long developed the skills of a tightrope artist, in the sense that in geopolitical matters, the country has been an unwavering US ally, even sending troops to the Vietnam war, when Britain refused to. However, in economic terms, Australia is inexorably tied to China. According to the Department of Foreign Affairs and Trade[15], China is the biggest destination for exports, accounting for 31% of the total, eclipsing the US, which accounts for 5.3% of Australian exports. Ostensibly, there is nothing to stop the government from continuing to walk the tightrope, although clearly the decision to ban Huawei from the country's 5G network induced a significant wobble in the relationship. Trade accounts for approximately 40% of GDP[16], implying that exports to China represent 5% of Australian GDP, but the benefits are very concentrated in certain industries and regions, while the promise of trade relations with China lies in their future growth. Inevitably, Australia is firmly in the Old World Order camp, but remains well placed to benefit from growing volumes of trade with the CPTPP and the Chinese-promoted RCEP going forward.

Canada and Mexico – Clause 32.10

Strangely, Canada and Mexico are potentially in the firing line. They are both signatories of CPTPP, so should intuitively be classified in the second 'camp' of the Old World Order, but they are also signatories to the United States-Mexico-Canada Agreement (USMCA). Assuming this is ratified by their respective legislatures, these countries will be locked out of free trade agreements with China for the duration of their membership of USMCA. This is due to clause 32.10, which states that participants can be expelled if they enter into a trade deal with a 'non-market economy'. This is clearly viewed as an anti-China clause. So, it is conceivable that at some point, these countries may have to choose between trading with the US and trading with China.

[12]Source: Pakistan Education Statistics 2016 – 7, Ministry of Federal Education and Professional Training, Government of Pakistan.

[13]The World Bank's Human Capital Index measures the amount of human capital that a child born today can expect to attain by age 18, given the risks of poor health and poor education that prevail in the country of birth. Maximum is 1.0. It is designed to highlight how improvements in current health and education outcomes shape the productivity of the next generation of workers, if children born today experience over the next 18 years the educational opportunities and health risks that children in this age range currently face.

[14]UNESCO's definition includes vocational training colleges as well as universities.

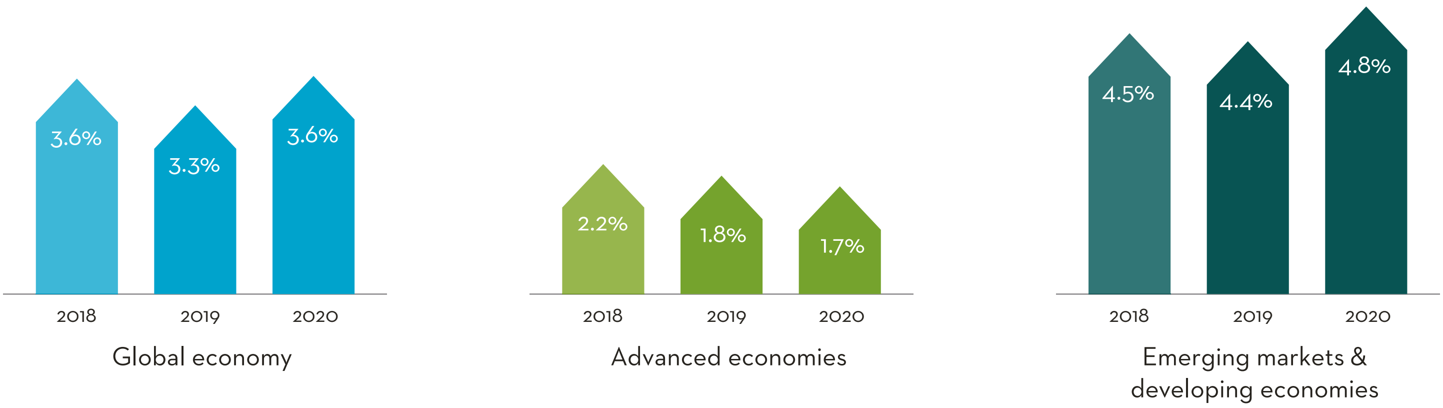
[15]Source: Australian Government, Department of Foreign Affairs and Trade: https://dfat.gov.au/trade/resources/trade-statistics/trade-in-goods-and-services/Documents/australias-goods-services-by-top-15-partners-2017-18.pdf

[16]World Bank database.

IMPACT ON GROWTH AND INVESTMENT RETURNS

The International Monetary Fund (IMF) has revised down its global growth estimates by 0.2% and 0.1% respectively in 2019 and 2020[17], citing trade tensions, coinciding with tightening financial conditions. The economy feels the reverberations, as can be seen in the chart below, which illustrates the IMF's latest estimates for global economic growth, downgraded because of weaker global growth and a deceleration in trade.

Growth projections: global growth is set to moderate in the near term then pick up modestly



Source: International Monetary Fund, World Economic Outlook, January 2019

Logically, a prolonged trade war is likely to escalate and involve more countries, resulting in entrenched positions and non-tariff barriers to trade. This is a permanent dislocation of global value chains and consequently, profit margins across most industries. As the secondary effects percolate through the economies, we see the return of inflationary pressures, triggering interest rate rises and further pressure on margins. Stock markets do not appear to have reflected the long-term and long-lasting effects on the corporate sector.

UBS has published a research report[18] on the impact on economic growth, inflation and financial markets, which finds that world GDP growth could be reduced by 1%, with the pain being taken primarily in the US (-2.45%) and China (-2.3%). Interest rates will suffer more than currencies and all equity markets look set to lose around 20%.

The Australian Productivity Commission has published a report[19] concluding that if all countries end up raising tariffs by 15%, global GDP would fall by 2.9%.

For a time, it seems logical to expect, most developed countries will continue to pursue multilateral trade deals, such as the Trans Pacific Partnership, RCEP, Japan-EU and Canada-EU. This would seem to gradually build up a volume of trade (independent of the US), large enough to begin to cushion them from potential tariffs from the US. That could work, until the point where they are forced to choose between camps.

What can break this trajectory?

It is, I believe, unrealistic to expect a return to the world of 2015. Current cross-party consensus in Washington, DC seems to be aligned behind the view that the US must be tough on China. Hence, even a Democratic President is unlikely to substantially change course. So, the best we can hope for is a weakening of the forces driving the new cold war. Perhaps a realisation that the outcome is more likely to be a painful stalemate than a glorious victory will do it. But how much further must we go down the line first?

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[17]Source: Source: International Monetary Fund, World Economic Outlook, January 2019.

[18]Source: UBS *'Trade Wars – What is the impact on growth, inflation and the financial markets? A Top Down View'*, 11 July 2018.

[19]*'Rising Protectionism: challenges, threats and opportunities for Australia'*, July 2017.

CONCLUSION

The great globalisation-driven international trade model built after World War II has officially ended, at least in the shape that some of us grew up with. The volumes of developed-emerging country trade look set to decrease, becoming replaced instead by a combination of increased automation, machine learning, AI and 3-D printing, facilitated by 5G adoption and spurred on by the increasing lack of clarity in government trade policies, as more and more developed countries are eventually dragged into the current trade wars.

Emerging Market to Emerging Market trade, however, accounts for 39% of world trade and has been growing at a compound annual rate of 2.9% over last decade. Advanced economies' trade growth has been pedestrian by comparison at 1.1% in the same period[20]. Given China's size, growth and the sheer scale of physical infrastructure built to facilitate trade with the 80+ countries of the Belt and Road Initiative, it seems conservative to expect intra-emerging market trade to overtake developed market trade by 2025.

In this scenario, the separation of the world into three camps will be complete and state intervention will increase as populations become more vocal about their deteriorating living standards, as inflation and higher interest rates fuel inequality. Investors may not be able to maintain their current freewheeling status, as first public-sector plans and then large corporate asset owners find themselves being channelled into restricting exposure to markets in the 'other' camps.

Finally, it must be said that all this pain is highly unlikely to achieve a reduction in the US-China trade deficit, or to derail China's development. Ultimately, a combination of single minded and stable leadership, economies of scale, an increasingly educated population and a dynamic domestic market ensures that Beijing probably accelerates the country's increasing technological sophistication.

THE GREAT GLOBALISATION-DRIVEN INTERNATIONAL TRADE MODEL BUILT AFTER WORLD WAR II HAS OFFICIALLY ENDED, AT LEAST IN THE SHAPE THAT SOME OF US GREW UP WITH. THE VOLUMES OF DEVELOPED-EMERGING COUNTRY TRADE LOOK SET TO DECREASE, BECOMING REPLACED INSTEAD BY A COMBINATION OF INCREASED AUTOMATION, MACHINE LEARNING, AI AND 3-D PRINTING

[20] IMF Direction of Trade Statistics database https://data.imf.org/regular.aspx?key=61013712

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