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ECONOMIC AND MARKETS RESEARCH

The danger of elevated trade frictions

Authors

Jean Boivin
Global Head of Research,
BlackRock Investment Institute

Elga Bartsch
Head of Economic and
Markets Research,
BlackRock Investment Institute

Tara Rice
Deputy Head of Economic
and Markets Research,
BlackRock Investment Institute

Contributor

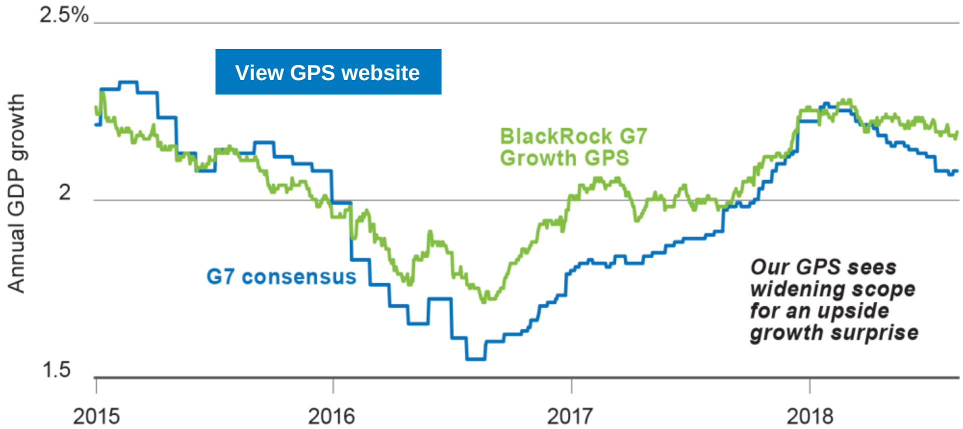
Simon Wan
Economic and Markets Research,
BlackRock Investment Institute

Elevated trade protectionism marks the greatest downside risk to the global expansion and is a prime driver of heightened macro uncertainty, in our view. The US trade conflict with China is at the heart of higher trade tensions. We find that trade tensions have likely served as a drag on risk assets, even if it is unclear if the measures taken so far have hurt global trade activity much. This leaves the global economy in an uneasy equilibrium. Yet amid the uncertainty, the BlackRock G7 Growth GPS below points to upside risks relative to the consensus. A major escalation of trade tensions or signs that prolonged tensions are hurting confidence would make us negative on the growth outlook. Highlights:

- Most model-based estimates of trade actions so far suggest the direct impact of tariffs on trade activity should be modest. Yet many of these simulations do not account for deeply integrated global value chains – and these value chains can greatly magnify the negative effects of trade actions. A sharp fall in private sector confidence, along with modestly tightening financial conditions outside the US, could also further damage activity and risk assets.
- Growth in the volume of global trade has slowed this year, but it is not clear that tariffs are the main driver. Our new daily trade "nowcast" points to global trade expanding at a steady but subdued 2% annual pace in the near term – softer since last year but on par with global GDP growth.
- We find some signs that the heightened macro uncertainty sparked by US trade policy is likely holding back equities and may be a key factor in this year's emerging market (EM) volatility. We find this lingering "uncertainty effect" weighing on risk assets as trade conflict headlines still dominate the news.
- We would become wary on the global growth outlook if there were a significant increase in tariffs and other trade barriers or if confidence were being hit. On the flip side, any easing of trade tensions – particularly between the US and China – could boost risk assets and some EM currencies. Still, we see these tensions as a part of a broader strategic standoff between the US and China that will likely persist.

Economic snapshot

BlackRock Growth GPS vs. G7 consensus, 2015-2018



Sources: BlackRock Investment Institute, with data from Bloomberg and Consensus Economics, October 2018. Notes: The GPS in green shows where the 12-month consensus forecast may stand in three months' time for G7 economies. The blue line shows the current 12-month economic consensus forecast as measured by Consensus Economics. Forward-looking estimates may not come to pass.

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Major macro risk

A trade war is the biggest risk to the US-led economic expansion, we believe. The US is shaking up the post-war system of free trade, particularly with tariffs on a wide array of Chinese goods. The trade skirmishes between the US and China are part of a more confrontational rivalry over geopolitical dominance and technological leadership, in our view. The BlackRock Geopolitical Risk Indicator (BGRI) for global trade tensions remains elevated along with its counterpart for US-China relations. This signals increased market attention to these risks and underpins our view that the US-China conflict is at the heart of trade concerns. See the *Trade anxieties* chart.

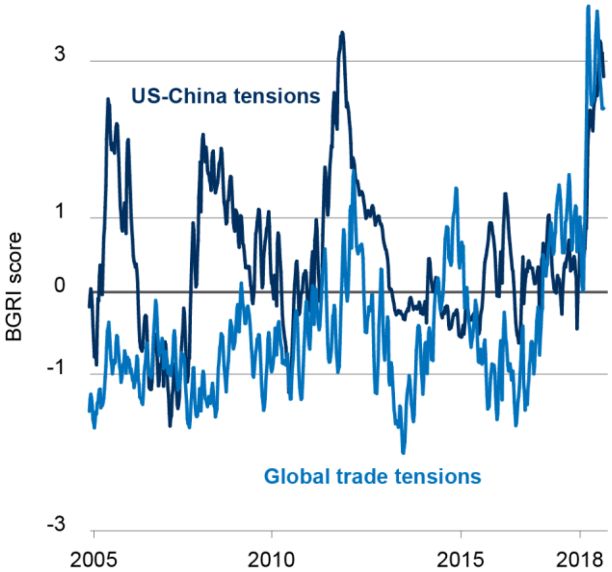
So far, neither side has shown much willingness to compromise. China has opted to retaliate in an almost tit-for-tat response. Yet it will need to explore other strategies because the US buys much more from China than China buys from the US. The White House has (temporarily) calmed other trade conflicts, such as renegotiating the North American free trade deal and agreeing to a truce with the European Union. If the tariffs on $250 billion of US imports from China are raised to 25% at the start of 2019 from 10% now, as planned, the effective US tariff rate would rise to a level not seen since the 1970s. Even if auto tariffs are excluded, the rise is significant. See the *Back to the future* chart. Largely due to the US moves, average global tariff rates would rise to the levels of the early 1990s – just before the launch of the World Trade Organisation. Such revived protectionism arrests a long-term decline in tariffs and intensification of international trade since World War Two. The absence of any change to US tariff levels in recent decades makes the macro impact of the current trade actions hard to estimate.

The trade conflict has ramifications that go far beyond the bilateral trade channel between the US and China. The damage to the global economy could be much worse for a number of reasons, including how global value chains (GVCs) are affected: International trade relations have become far more complex and entwined over past decades. Many macroeconomic models fail to capture the potential for a much bigger hit to global activity as trade barriers disrupt supply chains or sales via foreign affiliates.

The estimates of the fallout from heightened trade tensions can vary materially depending on the exact shock to trade and the retaliation assumed. We believe many models used to simulate a trade shock have drawbacks. They differ in how they consider the policy response – whether monetary or fiscal – and the effect on financial conditions. For example, models such as the International Monetary Fund's Global Integrated Monetary and Fiscal model (GIMF) do not explicitly account for deeper trade integration via GVCs – and shows only a modest direct impact for that reason. We believe the fallout could be much larger than these estimates. The indirect growth impact via GVC channels can be more than twice the size of the direct drag from tariffs if input-output matrices are anything to go by. Multinational companies may switch production towards the US, adding to the pressure on exporting nations. There are potentially very large spillovers at play depending how these trade tensions unfold – feeding the persistent macro uncertainty.

Trade anxieties

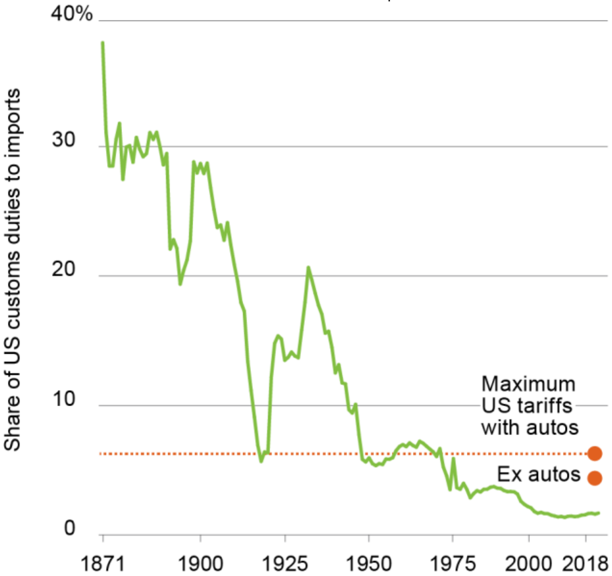
BGRI for global trade and US-China tensions, 2005-2018



Sources: BlackRock Investment Institute, with data from Thomson Reuters, October 2018. Notes: We identify specific words related to these geopolitical risks and use text analysis to calculate the frequency of their appearance in the Thomson Reuters Broker Report and Dow Jones Global Newswire databases as well as on Twitter. We then adjust for whether the language reflects positive or negative sentiment, and assign a score. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average. The BGRI's risk scenario is for illustrative purposes only and does not reflect all possible outcomes as geopolitical risks are ever-evolving.

Back to the future

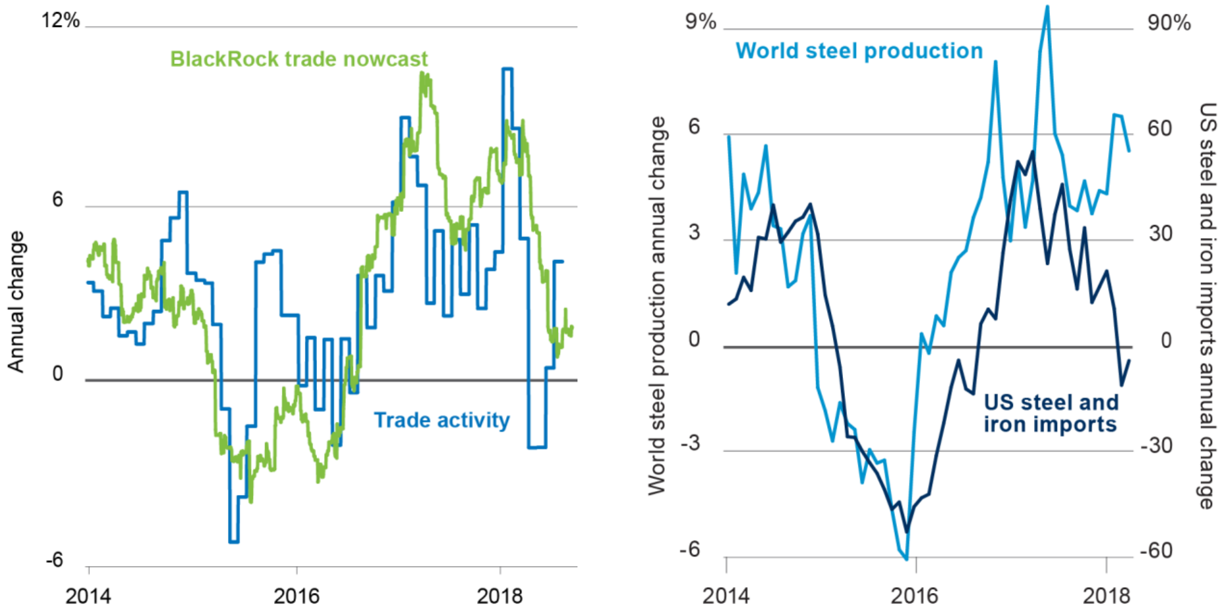
Share of US customs duties to imports, 1871-2018



Sources: BlackRock Investment Institute, US Bureau of Economic Analysis (BEA) and the National Bureau of Economic Research, with data from Thomson Reuters, October 2018. Notes: This chart shows the US federal customs duties as a share of total imports. The two dots represent estimates of where this effective tariff rate would go to if the maximum of threatened US tariffs were implemented, including tariffs on washing machines, solar panels, steel and aluminium, $45 billion of Chinese imports and autos globally.

Trade and tariffs

BlackRock global trade activity nowcast and US steel imports vs. world production, 2014-2018



Sources: BlackRock Investment Institute, CPB World Trade Monitor, US BEA and World Steel Association, with data from Thomson Reuters, October 2018. Notes: The chart at left shows the three-month annualised percentage change in real global goods trade volume (in blue) and a real-time "nowcast" (in green) of where that trade volume may stand in three months' time. The nowcast uses principal component analysis based on 50 indicators to track global trade activity. Forward-looking estimates may not come to pass.

Tracking trade

Trade tensions are here to stay. To get a live read on how trade dynamics are evolving in the face of protectionism, we have developed a real-time indicator of trade growth. The reported global trade data typically have a lag of one quarter. Our trade nowcast incorporates live information from 50 publicly available time series that are related to international trade, including business surveys, timely Asian trade data, freight volumes, technology sector activity and capital spending orders. We aggregate this information to get a glimpse on the near-term outlook for trade growth.

Trade growth has slumped from last year's remarkable pace of around 5%, but in our view it is not clear that trade tensions are the main culprit. Our nowcast suggests that trade should grow at an annualised pace of 2% over the next few months, a subdued level given the strength of global growth. See the left chart above. For the past few months, the reported data were trailing our nowcast but have now rebounded. Trade growth at a 2% pace for the remainder of 2018 would result in a full-year growth rate of around 3.5%. That's just below the IMF's October 2018 forecast for this year and next – but in line with global GDP growth and better than recent PMI data on export orders have suggested.

Tariffs are likely a factor behind this trade slowdown, even if they are not the main drag. Tariffs are frequently mentioned in business surveys such as PMIs and central bank reports. Yet the current pace of trade growth looks more normal than the spike we saw in 2017 and early 2018 – a bounce back from the global industrial slowdown in 2015. While it's intuitive to link this global trade slowdown to rising trade tensions, our work doesn't find a statistical connection. We looked at two models to assess global trade growth – one based on its own past history and one that brings in global industrial production. In both cases, the slowdown cannot be fully explained – nor can the run-up in activity last year. Even incorporating the BGRI on trade tensions does not find any meaningful link. The cooling of trade activity also preceded the implementation of tariffs – not what would be expected given the likely front-loading of import demand to avoid duties. The best we can conclude is that circumstantial evidence suggests that tariffs can partially explain the slowdown. If more tariffs are put in place, the impact may be clearer. For now, our trade nowcast points to a steady but subdued growth rate of global trade growth relative to last year.

The tariff fallout is more noticeable at the micro level. US steel imports slumped as tariffs dented demand for foreign steel. See the right chart above. Other products that have been hit include washing machines and solar panels. Yet global semiconductor sales – a useful proxy for the health of the global tech trade – have not slowed. We also believe any price effects from renewed trade barriers will be contained at the micro level – such as washing machines in the US – and not have material effects on broad CPI or PCE inflation.

Long-term consequences

The impact of rising tariffs goes far beyond bilateral trade relations. The high degree of global interconnectedness – of economic drivers and financial markets – could be amplifying the knock-on effects of shocks from one region to another. The outlook could get murky even without further trade actions. Why? The longer uncertainty around trade lingers, the higher the risk that private sector confidence starts to suffer.

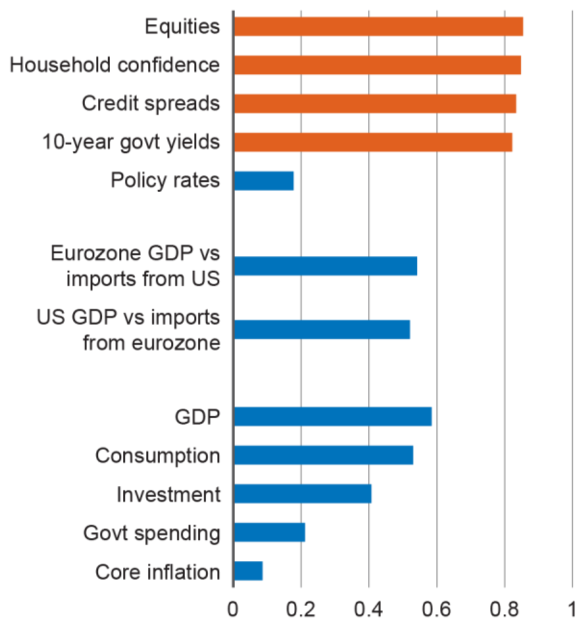
The IMF's GIMF model suggests confidence can have a much bigger impact than shifts in trade dynamics. We studied correlations between economic and market indicators for the US and the eurozone. See the *Confidence channels* chart on the left. There has historically been a roughly 60% correlation between GDP growth for the two regions. Bilateral trade linkages are part of the story. Yet this is not the most powerful transmission channel because trade is a relatively small percentage of GDP growth. Financial and confidence indicators are even more strongly interlinked across the two regions. See the orange bars below. The correlation between equity markets and household confidence measures is typically above 80%, though it has been weaker this year.

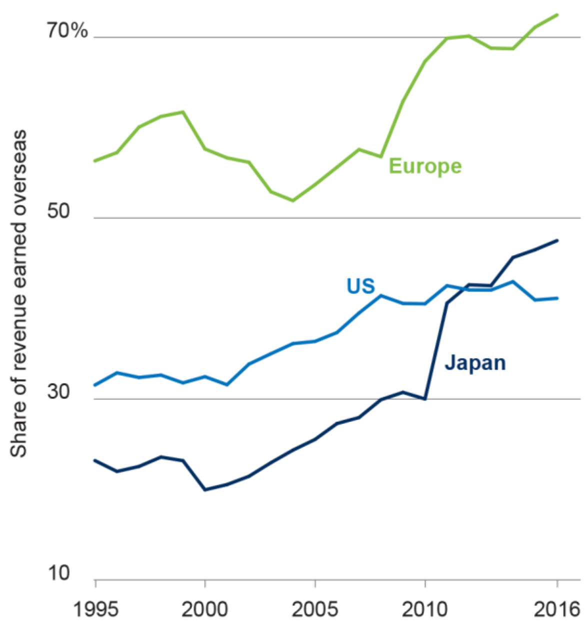
Global factors are responsible for an ever-rising share of the variation in macro variables, especially via financial markets, as a June 2018 OECD study on economic shocks and spillovers shows. Financial conditions play an important role in globalising shocks, in our view. Cross-border linkages between financial markets have risen. US and eurozone equity markets, for example, are highly correlated over longer-term periods. The one-way opening up of global trade over several decades has increased the share of revenue multinationals derive from outside their home markets. See the chart at right below. Rising protectionism means any damage to animal spirits can be widespread, propagated across financial markets and through other interlinkages.

Barriers to trade could impinge on long-term drivers of productivity growth. Foreign direct investment (FDI), higher competition and technology transfers – key components of global trade and capital flows – spur productivity growth. These appear to be at risk. We could see setbacks from the US limiting technology sales to China, as well as any curbs on FDI into the US and possibly Europe. Curbs on US exports of technology to China could come next year. Developed market (DM) economies appear to be turning towards more export controls and restrictions on inbound investments - not fewer. Long-run productivity growth could be 0.2 percentage point lower annually if global trade as a share of GDP stagnates, according to OECD estimates. There are clearly bigger negative consequences at play if globalisation goes further in reverse. Our upbeat economic outlook relies on a further recovery in DM business investment. The close links between DM capex and EM growth take on added importance now as tighter financial conditions will likely weaken local investment spending in some EM economies. Protectionism can hurt sentiment and growth via financial markets and confidence channels. The uncertainty stirred by trade tensions has prompted investors to demand higher risk premia - especially in equity markets.

Confidence channels

Correlation between US-eurozone indicators, 1995-2018, and overseas revenue of G3 listed companies, 1995-2016

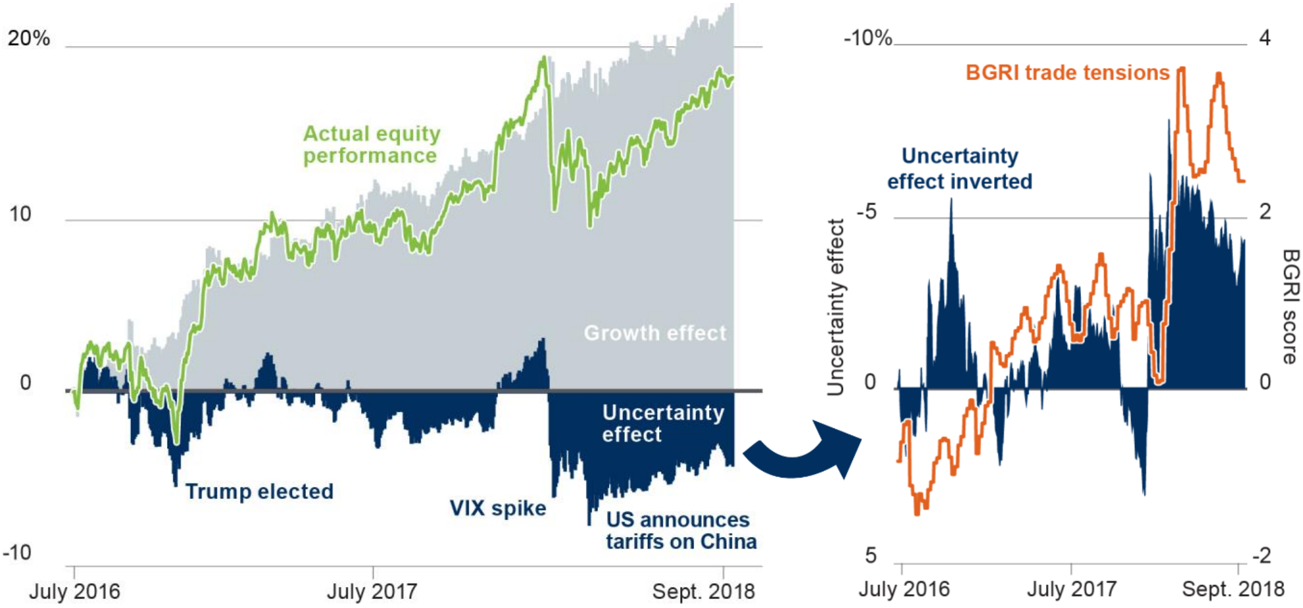




Sources: BlackRock Investment Institute, Eurostat, US BEA and Organisation for Economic Cooperation and Development (OECD), with data from Thomson Reuters, October 2018. Notes: The left chart shows the quarterly correlation of various economic and financial market variables between the US and the eurozone. The right chart shows the share of revenue earned overseas by the median company in major equity indices: the S&P 500 for the US, the STOXX 600 for Europe and the Nikkei 225 for Japan. The median shares are based on changing constituencies of the stock indices. For the Nikkei, the constituents from 2011 are used for the period 1995 to 2011. For STOXX 600, the constituents from 1999 are used for the period 1995 to 1999. For the firms considered as national within the euro area, foreign sales are sales outside the national area. What matters more is the change in the revenue share than the level.

Pricing in uncertainty

Estimated uncertainty impact on DM equities and BGRI on trade tensions, 2016-2018



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Thomson Reuters, October 2018. Notes: The left chart shows (green line) the cumulative return performance in the MSCI World Index since July 2016. We break equity returns into growth (grey area) and non-growth (blue) components. Co-movements in DM real yields and equities are interpreted as the market pricing in a change in growth expectations – the growth effect. We call the non-growth change the uncertainty effect. The technique is similar to that used in this September 2014 IMF Working Paper. The events highlighted in the left chart coincide with the downward spikes in the uncertainty effect.

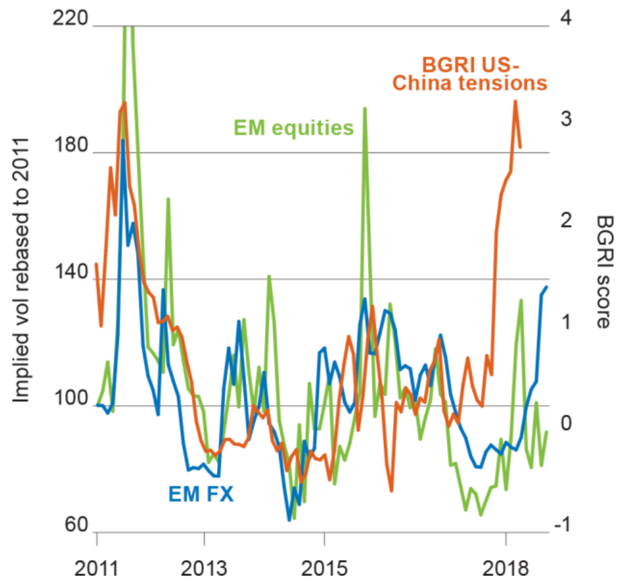
Reasons to be skittish

Investors have suffered bouts of skittishness over the course of 2018. Similar to our previous work, we looked at how financial markets are pricing DM economic growth and whether other factors are shaping such pricing. For much of the past two years, investor perceptions on growth appeared to drive the rise in DM equities. Since the VIX spike in February, non-growth factors – what we call the uncertainty effect – have played a bigger role. See the blue area in the *Pricing in uncertainty* chart. While other factors are also at play, this drag appears correlated with the surge in concern about still elevated trade tensions. See the inverted uncertainty effect compared with the BGRI index of trade tensions above. Trade tensions seem to be an key source of market uncertainty amid a solid global growth backdrop. The biggest drag from the uncertainty effect came in March when the US announced its first round of tariffs on China, and since then it has moderated. We see the trade tensions also playing a role in EM FX volatility. See the *Feeling the heat* chart. Yet the impact on EM equity volatility is less clear.

Our base case is for an ongoing uneasy equilibrium – global growth stays decent amid elevated risk premia. We would turn more cautious on the global growth outlook if the US presses ahead with its threat to impose 25% tariffs on all Chinese imports and auto tariffs become a possibility. Macro uncertainty could undermine corporate and household sentiment. Such a shift would also likely prompt the Federal Reserve to be more cautious in pushing ahead with policy normalisation. We believe US economic overheating also remains a risk barring a pickup in productivity. But the risks to outlook aren't only tilted to the downside. A thaw in trade tensions could cause investors to focus on the solid growth outlook and create some upside for risk assets if the uncertainty factor fades.

Feeling the heat

EM implied vol vs. BGRI on US-China tensions, 2011-2018



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, Chicago Board Options Exchange and JPMorgan, with data from Thomson Reuters, October 2018. Notes: EM FX vol is based on the JP Morgan Emerging Market Volatility Index and EM equity vol is based on the CBOE's Emerging Markets ETF Volatility Index, which is based on the implied volatility of the ETF EEM – the iShares MSCI Emerging Markets Index The implied vols are rebased to the start of 2011.

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