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New Tariffs Complicate but Don't End Trade Talks

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Key takeaways

» *An eventual agreement still seems likely but may be more limited in scope than we previously expected.*

» *The new round of U.S. and Chinese trade tariffs again raise the risk that the two sides may add further rounds of trade restrictions.*

What it may mean for investors

» *The additional uncertainty requires some patience but may prove to be another opportunity to add to allocations in risk assets.*

On May 10, President Trump raised tariffs from 10% to 25% on $200 billion of U.S. imports from China. He also initiated steps to levy a 25% tariff on another $325 billion in Chinese imports, although implementation may take until mid-August. Then Beijing announced early today that it would retaliate by raising levies to between 5% and 25% on $60 billion of U.S. goods. Before he left Washington last week, China's head negotiator was open to another round of talks. If (or when) talks continue, their next goal could be to announce progress when the U.S. and Chinese presidents are scheduled to attend the June 28-29, 2019 Group of 20 Countries meeting in Tokyo.

China also could impose non-tariff measures, including more onerous customs inspections or restrictions on U.S. investment in China. Beijing could influence North Korea to complicate U.S. efforts to denuclearize the Korean peninsula. North Korea conducted short-range missile test launches twice after the U.S. threatened new tariffs on May 5.

Next steps for the U.S. and China, and market implications

Our long-standing view is that each side wants a deal and that significant risk of economic damage will drive an eventual deal. Our work suggests that further escalation will have stronger negative economic consequences than the rounds of tariffs applied so far. Even for the two sides to publish an agreement on a subset of the main issues could help break the cycle of escalation. An eventual agreement still seems the most likely outcome, although political miscalculation is a rising risk.

However, differences on key issues and in negotiating styles may spark more market volatility ahead. The two sides have conflicting demands and work from different

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negotiating styles. China still wants to subsidize industries to compete globally and seems willing to bargain patiently. The U.S. wants to retain some tariffs to enforce compliance, wants China to drop the subsidies, and wants the talks to move faster.

The latest tariffs do not appear large enough to change our balanced economic outlook for the U.S. and emerging economies. We believe economic growth should moderate toward our year-end forecast, and inflation may tick temporarily higher. Reduced U.S.-China trade may spill over into the trade-oriented economies of Japan and Europe, but we have been expecting additional downside risk in those economies—less so in emerging economies, where domestic consumption is stronger than in the European and Japanese economies.

Even with market volatility along the way, the new U.S. levies also may increase the chances for capital markets to hit our year-end targets. For the S&P 500 Index, our target range remains 2900-3000 (and 3000-3100 by May 2020). Transitory, tariff-related U.S. inflation is unlikely to move the Federal Reserve to higher interest rates but may help lift long-term yields towards our targets (2.50%-3.00% for the 10-year U.S. Treasury yield and 2.75%-3.25% for the 30-year Treasury yield).

Currency exchange rate volatility was subdued last week. We still expect modest 2019 dollar depreciation. The main risk to that view is that the dollar gains against emerging-market currencies, in the unlikely case that U.S.-China trade talks break down altogether. A stronger dollar could adversely affect U.S. corporate overseas revenue and make dollar-denominated debt more expensive to refinance in emerging economies.

The main risk has been a breakdown in trade talks, but we now add the risk of political miscalculation that produces more escalation. Those risks seem unlikely but, if realized, could undercut global economic growth. Prolonging this dispute also could provoke uncertainty about U.S. congressional approval of the recently renegotiated North American free trade pact and about possible U.S. tariffs on European autos. Last week underscores that the U.S. and China seem prepared to face impasse rather than capitulate. Political miscalculation is still possible.

What we believe investors should do now

We anticipate a deal, even a simple one that may not solve all the issues, and we favor the balanced economic and market outlook implied in our current targets and forecasts. On pullbacks in equity markets, we will focus on areas with stronger fundamentals, such as U.S. large caps, which we rate as neutral, and emerging market equities, where we carry a most favorable rating. If a chance emerges to add to equities, we will look to use cash set aside earlier this year.

More broadly, our strategy is to look for opportunities to rebalance when markets move significantly in either direction. On pullbacks, we will look for opportunities to allocate cash in global equities. But if markets rise steadily, we expect to trim positions toward long-term target allocations. This is rebalancing, and it is a way to maintain those allocations, which we believe are the foundation for an investor's long-term plan.

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