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Trade Dispute with China

The calm, steady climb higher for stocks in 2017 has been replaced by the reemergence of volatility driven by a continuous stream of headline-grabbing events. Although most are of little consequence to the long-term growth and prosperity of global economies, the recent back-and-forth between the U.S. and China on trade policies and tariffs is worth a closer look.

The fear of a "trade war" between the U.S. and China first arose when the Trump administration proposed new tariffs on the import of aluminum and steel. These tariffs, which have yet to be enacted, would tax steel and aluminum imported into the U.S. from China at rates of 25% and 10%, respectively. The Chinese government responded by threatening tariffs on 128 products its country imports from the United States. Most of the products, 120 of the 128, will receive an import tax of 15% with the remaining 8 products subjected to a 25% rate. The products receiving the higher 25% rate include seven types of pork products and aluminum scrap. The 120 products to be taxed at 15% represent approximately $977 million of US exports to China while the remaining 8 products make up nearly $2 billion. This compares to approximately $50 billion worth of Chinese goods that would be subject to the new US import tariffs if or when enacted. Unsurprisingly, global stock markets reacted negatively to these initial actions, pushing volatility higher as the back and forth escalated between the world's two largest economies.

Although action to enact these tariffs has yet to occur, during the first week of April, President Trump requested that the US Trade Representative identify an additional $100 billion of Chinese imports on which to impose tariffs. Trump's request followed China's announcement that it would expand its tariffs to include an additional 106 products it imports from the U.S. Trump holds the position that China receives unfair advantages through the World Trade Organization (WTO) because of its status as a developing economy while the U.S. is put at a disadvantage. It is the president's position that China is large and influential to the level of a developed economy, and as such, should be treated as one. This would negatively impact the favorable treatment China currently receives as a developing economy by the WTO. To put China's trade advantage into perspective, according to the US Census Bureau, during 2017, the US exported about $130 billion of goods to China and imported about $506 billion. China is our largest total trading partner, third largest export market, and the trading partner with which we have the largest trade deficit.

Following weeks of what appeared to be progression toward an inevitable trade war between the U.S. and China, Chinese President Xi Jinping addressed the media at the Boao Forum for Asia on Tuesday April 10 in a speech that sent markets higher. Xi's remarks were interpreted as more accommodative than those previously released, providing details on specific efforts by China to reduce its overall trade surplus through increasing imports, increasing access to its markets, opening up its financial markets, and increasing protections of intellectual property rights. Xi reiterated China's wishes to achieve greater balance in its current account through increasing imports. Actively increasing imports also aligns with China's desire to transition from its dependence on its manufacturing and exporting based economy, to a more consumption-driven market. Xi believes that this will bolster China's economic growth in the long run. Specific initiatives toward this end are expected to include materially lower tariffs on imported automobiles and allowing greater ownership of the industry within country. China currently charges a 25% tariff on U.S. made cars versus the 2.5% tariff charged by the U.S. on Chinese cars. This should be helpful to U.S.-based car companies, which already count China as one of the top sales markets.

China views financial services as a critical component to its future growth, and therefore will continue to work to reduce regulatory constraints faced by financial services firms seeking to establish a presence in China. Regulations will be reduced in an effort to increase foreign investment in banking, securities, and insurance as well as provide greater access and development of its financial markets for global investors.

Likewise, critics of Chinese economic policies have highlighted the need for better controls around the piracy of intellectual property (IP) rights. Xi addressed this by stating that China will increase the enforcement of IP rights by devoting more resources to protection as well as increasing the punishments. This has been a contentious issue for a long time, particularly with the U.S.

As the U.S. has moved away from manufacturing and toward the creation of IP through the engineering and design of new technologies, and the development and distribution of content, China has become notorious for stealing the IP and creating forgeries. This has been a particularly troubling issue in technology hardware in which companies must share their designs so that offshore, and often Chinese, manufacturers can produce the end product. Among U.S. businesses that could benefit from tighter controls and regulated intellectual property transfers would be aviation, machine learning, semiconductor design and manufacturing, and in some cases software. These efforts would also serve to improve data security as companies expand their services in the Chinese market.

Skeptics immediately responded to the release of the transcript of Xi's speech, claiming that there was virtually no new information provided, and what was described could be characterized as incremental at best. Critics suspect that this was an attempt to alleviate current trade tensions and calm President Trump, but will not curtail what they suspect will be a long, drawn-out trade dispute. The concern is that much of what was stated has been discussed in the past and hasn't resulted in any meaningful action. Furthermore, Xi's remarks did not specifically address the reciprocity issues currently plaguing trade relations between the U.S. and China.

On the same day as Xi's speech, China filed a complaint to the WTO contesting Trump's tariffs on imported steel and aluminum. The complaint stated that China has requested 60 days of consultations with the U.S. on the steel and aluminum dispute. If that effort does not produce an acceptable result, then Beijing could request a ruling from a panel of trade experts.

What will actually come of Xi Jinping's speech cannot be predicted, but it appears to be a step in the right direction. Global markets, businesses, and individuals benefit from open markets and globalization. Trade restrictions or tariffs of any kind simply create unnecessary friction in the movement of goods and services across political borders. They act to increase the cost of products and services, which ultimately shrinks the market for them. This means fewer sales for business, reduced affordability and availability for consumers, and ultimately slower growth for everyone. Although open markets and globalization can create short-term dislocations within local economies, in the aggregate, and in the long run, we all benefit. Open markets create a tailwind for capitalism, an economic system that we believe in because it has generated unprecedented amounts of wealth globally.

We remain optimistic on the long-term growth and prosperity of the United States, as well as other global economies, and believe maintaining strategic portfolio allocations is critical to capturing this growth. The best course of action in this environment is to focus on long term objectives, which do not change due to short-term, headline-grabbing events. Our model portfolios are constructed to weather volatility and stock market declines in a manner that should mitigate extraordinary loss. This, in turn, allows us to collectively focus on long-term goals and improve your overall investment experience.

If you have any questions or concerns regarding your portfolio, the financial markets, or the economy in general, please do not hesitate to contact us. We are here to be a steady hand and responsible steward of your wealth. Thanks again for your confidence in our firm.

Sincerely,

Craig Blanchfield

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Portfolio Manager