Investment News

Monthly Bulletin from the Insurance & Investment Team

April 2018

Last Month in Brief

On 13th March the Chancellor of the Exchequer, Philip Hammond presented the first Spring Statement to Parliament. In this statement it was announced that an Office for Budget Responsibility (OBR) forecast suggests public borrowing will start falling as a share of GDP beginning next year. This improvement, however, is judged by the OBR to be a cyclical effect in the economy rather than a reflection of an underlying structural improvement in public finances.

In the second half of the month the Dow Jones dropped by around 5% as news of potential tariffs on US goods fuelled investors' fears of a potential trade war. The Dow Jones recovered throughout the remainder of March, dropping again in early April as China increased tariffs by up to 25% on 128 products in the US. At the start of April, the European Central Bank stated that their analysis suggest that a 10% tariff on all U.S imports and exports would cause a 1% shrinkage in the global economy.

The Federal Reserve has announced an interest rate rise from 1.5% to 1.75%. Economists are also expecting two further increases to the rate this year, and the Federal Open Markets Committee have revised the December forecasts of a 2.5% growth rate to 2.7%.

Chart 1: Equity Indices
Equity markets fell over March

Chart 2: Sterling Credit Spreads
Credit spreads on weaker rated bonds rose over the month

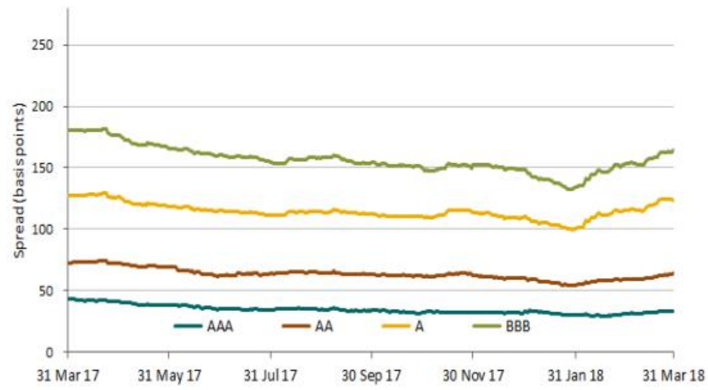


Chart 3: Gilt Yields
Short term nominal yields were stable over the month, other yields fell.

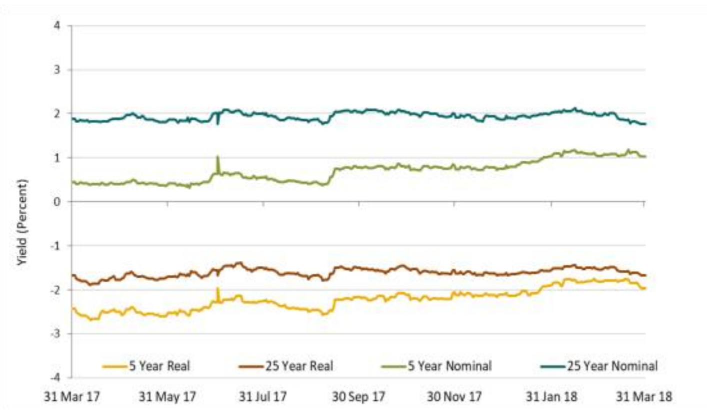
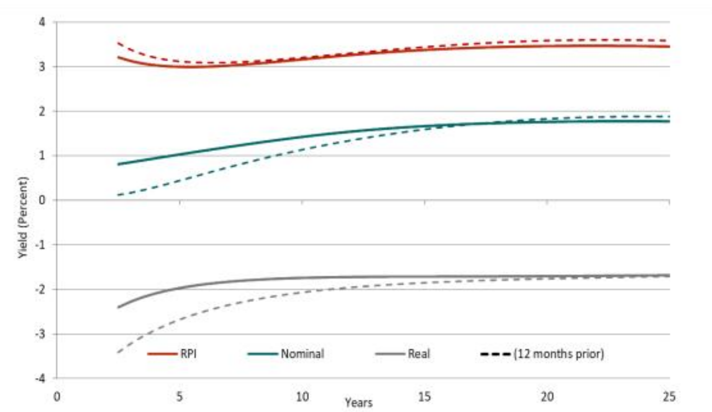


Chart 4: Gilt Spot Curves
The yield curves were stable over the month



Source: Bloomberg, Business Insider, MSCI, Merrill Lynch Bank of America and Bank of England.

	Latest	Previous		Latest	Previous
CPI (annual change)	+2.5%	+2.7%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	95.6%	96.9%	**$/£ exchange rate**	1.40	1.38
Halifax house prices (monthly change)*	+1.5%	0.4%	**VIX (volatility) index**	19.97	19.85

** Halifax have recently changed their methodology for calculating the above figures so the figures may not be consistent with previous updates*

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

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Trade Wars

In recent weeks, the Trump administration has been publically reassessing the US' economic policy relating to trade. The US has introduced tariffs on foreign imports in a move that is likely to damage the trading relationship between the US and China. As concerns grow of a trade war between the two world superpowers, in this article we examine the nature and history of trade wars and the events specific to America and China in this situation.

What are trade wars and how do they happen?

Trade wars are economic conflicts between two or more states which impose restrictions on the movement of goods in order to protect domestic trade. These restrictions are normally tariffs, a type of tax on goods entering the country, but can also be in the form of quota restrictions, a restriction on the number or value of goods that can be exported during a particular period. These restrictions may be imposed for a number of reasons:

> To promote and protect domestic producers, particularly promising infant industries, at risk from foreign competition.

> To prevent the dumping of materials at below market value in the domestic economy by foreign competition looking to monopolise the market.

> To ensure strong domestic employment prospects by protecting struggling domestic industries against international competitors.

Historically, America has imported relatively low levels of Chinese steel, despite China's position as a global producer. The US imposed steel tariffs on Chinese steel in 2016 under the Obama administration and similar tariffs were also imposed under Presidents Bush and Clinton. However, the current trade dispute has led to world leaders and policy experts warning of a simmering conflict that could result in damaging consequences for the US and wider global economy.

The US trade deficit

A trade deficit is simply the amount by which the value of a country's imports exceeds the value of its exports. In recent years the US has had a large trade deficit meaning that the value of the US' imports has exceeded that of its exports. China is America's largest trading partner and trade between the two countries is the cause of a significant proportion of the total US deficit in goods. This deficit has been cited as a reason for the imposed tariffs.

Figure 1: America's Growing Trade Deficit with China
Source: US Census Bureau

Figure 1 shows the growing trend in US trade deficit over the past 30 years. This deficit is driven by high imports of consumer products and automobiles with exports in the service industry creating a surplus which partly offsets the deficit. A key cause of this large growing deficit over the last 3 decades was due to the U.S. economy growing faster than the economies of America's major trading partners. This meant Americans were buying foreign goods at a faster pace as these were cheaper than domestic goods.

In 2016, the US recorded an all-time high trade deficit of $737 billion. In 2017 this had increased to $796 billion. Economic theory suggests a persistent large trade deficit is synonymous with a country living beyond its means and accumulating too much debt. This can have a negative impact on the nation's economy and employment levels and devalue its currency. The protectionist measures introduced by the US are aimed at reducing this deficit.

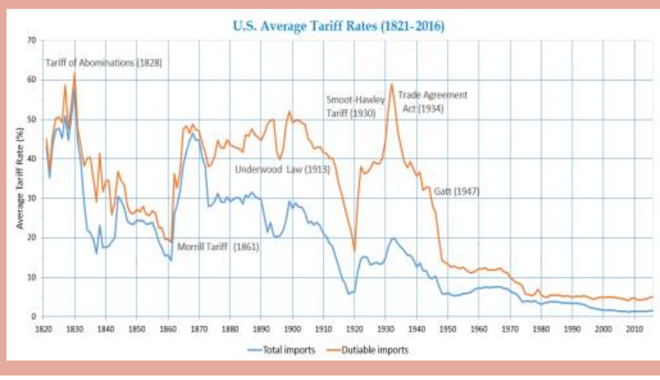
In a two-week period, President Trump ordered an estimated $50 billion in tariffs against China and other countries with tariffs of 25% and 10% respectively on Chinese steel and aluminium imports. China, meanwhile, later retaliated with tariffs on $3 billion of 128 US products.

Can trade wars be won?

As well as the obvious political repercussions, the impacts of trade wars affect many other sectors. Despite some US steel firms' share prices rising in the wake of the President's announcement, the Dow Jones suffered a dip and Asian stocks tumbled. Many people in the US are employed in industries such as auto manufacturing that import steel and a rise in tariffs is likely to trickle through to rising prices for the consumer.

In 2002, when President Bush raised steel tariffs, it is estimated US GDP declined by around $30 million and an estimated 200,000 jobs were lost. Perhaps the most notorious trade war occurred in the 1930s when the Smoot-Hawley Act hiked tariffs by around 20% (as shown in Figure 2), initially to protect American farmers before other industries lobbied for protection. Global trade significantly decreased as countries imposed more trade barriers and the Act is widely considered as a factor that slowed down the economic recovery after the Great Depression.

Figure 2: US Average Tariff Rates (1821—2016)
Source: US Department of Commerce dataweb.usitc.gov



General consensus suggests that whilst it might be possible to achieve political benefits from a trade war, the associated costs are typically less visible and economic benefits rarely emerge.

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