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TRADE CHECK-IN

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KEY TAKEAWAYS

So far, the global economy has avoided a trade breakdown, as exports and imports are growing steadily for both the U.S. and China.

Small cracks are forming from the indirect impact of trade tensions, however, and they could become more meaningful over time.

We still believe trade's economic impact will be limited, but the indirect consequences should be monitored.

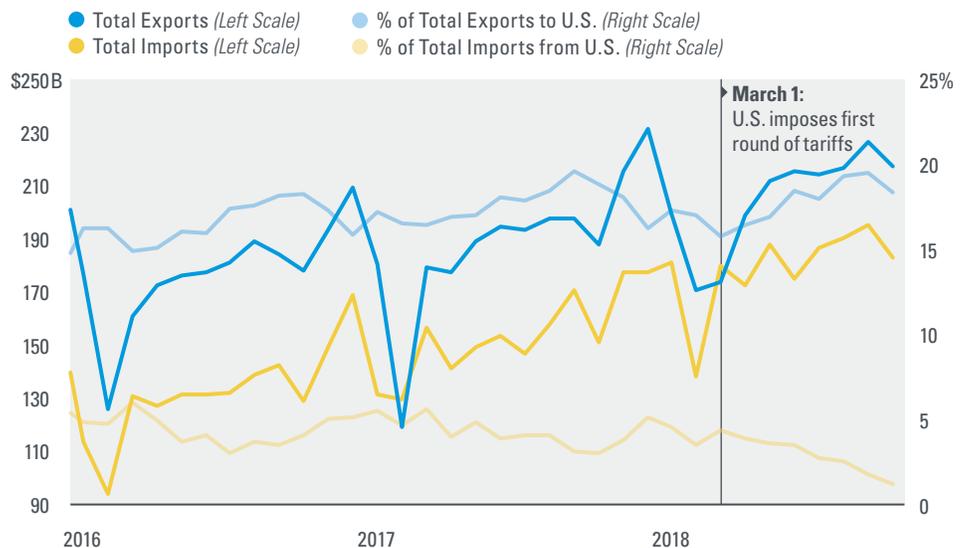
The U.S.-China trade dispute has carried on for about eight months, with no agreement in sight. To date, the U.S. has imposed tariffs on about \$250 billion in Chinese goods, representing about half of what the U.S. imported from China last year. In turn, China has retaliated with its own tariffs on \$100 billion in imported U.S. goods.

So far, the global economy has avoided a trade breakdown, as exports and imports are growing steadily for both the U.S. and China. However, small cracks are forming in the global economy due to the indirect impact of trade tensions, and leading trends show a prolonged dispute or more severe tariffs could exacerbate these effects.

SOLID TRADE FLOWS

Global trade itself has yet to weaken significantly. China's exports and imports have remained steady, even after the latest round of U.S. tariffs on \$200 billion in goods kicked in on September 24 [Figure 1].

1 CHINA'S DEPENDENCE ON U.S. IMPORTS DWINDLES AMID TRADE DISPUTE



Source: LPL Research, Customs General Administration (People's Republic of China) 11/09/18

Last month, Chinese exports jumped 15.6% in dollar terms, the strongest growth since February. Imports increased 21.4%, marking the strongest growth in three months. While China's exports to the U.S. were near a cycle high in October, U.S. imports comprised just 6% of China's imports, the lowest level going back to 1999. Solidly growing Chinese imports shows that total demand hasn't wavered significantly, and the country has found alternative sources for goods amid tariffs.

In September, U.S. exports grew 1.5% while U.S. imports rose 1.5%, both at the strongest pace since the trade dispute began in March. Also in September, U.S. imports (adjusted for inflation) grew at the fastest pace year over year since 2015 as consumer demand continued to strengthen. U.S. exports, which reflect the health of other regions, grew 6% year over year, a solid pace of growth and well above the 4.3% average growth in 2017.

Currently, strong global demand is outstripping any interruption from trade. To us, this demonstrates the interconnected nature of the global economy, with solid U.S. economic growth making an

increasingly heavy contribution to overall global growth. Trade worldwide also may be benefitting from a surge in activity earlier this year when firms rushed to beat tariffs' implementation dates. Some of this effect may still be having an impact, given that the U.S. has threatened to double the amount of outstanding tariffs and increase the rate on a significant portion of existing tariffs if no deal is reached by the end of the year.

SOME NEGATIVE EFFECTS STARTING TO APPEAR

However, economic cracks have started to appear, largely in leading indicators, as producers brace for a decline in demand and other unintended consequences of the trade dispute.

The most telling trend is the global decline in manufacturing activity, which is considered a bellwether for economic growth [Figure 2]. Ironically, China's shift to sourcing from other regions hasn't significantly lifted manufacturing in other areas. Manufacturing activity in the Eurozone declined to a two-year low in October. Markit's gauge of Chinese manufacturing health fell to 50.1 last month, on the brink of what Markit considers "contraction" territory.

China's industrial profit growth has also slowed for five straight months to near the smallest gain since December 2016. Declining manufacturing health could come from several sources, including political crises in Europe and emerging markets. The global economy also remains relatively fragile in its post-financial crisis "new normal."

U.S. manufacturing health remains the strongest of all global regions, but deterioration in the underlying data (off of meaningful strength) is spreading. Wholesale inventories have been climbing at their fastest pace since 2015, indicating companies' expectations for stronger consumer demand. However, unfilled orders for durable goods continue to increase with

2 INTERNATIONAL MANUFACTURING ACTIVITY DECLINES AMID TRADE TENSIONS



inventories, hinting at breakdowns in the supply chain as manufacturers and firms digest growing labor shortages and rising input costs.

Trade tensions have also had a chilling effect on U.S. businesses, some of which have delayed capital investments because of trade uncertainty. In September, growth in new orders for nondefense capital goods (excluding aircraft), our best proxy for capital expenditures, fell to the slowest pace in 18 months. Last month, the Institute for Supply Management's measure of new export orders fell to a 10-month low, while its gauge of new import orders has hovered around the lowest level in a year. New orders are viewed as a leading component for manufacturing and the economy (rising orders will typically lead to increased production), so the drop-off in new orders could forecast slower future manufacturing growth. The slowdown in investment is especially telling considering fiscal stimulus has incentivized firms to increase capital expenditures.

Financial markets have incurred the most damage from trade tensions. U.S. stocks have endured an increase in periodic volatility this year, spurred by back-and-forth threats between the U.S. and China.

In October, global stocks (tracked by the MSCI All-World Country Index) posted their worst month since May 2012, while the S&P 500 Index fell the most since September 2011. Most of these declines occurred after Vice President Mike Pence's October 4 speech, in which he accused China of trying to erode the competitive advantage of the U.S. in manufacturing.

CONCLUSION

Tariffs have yet to weigh on overall demand, and most of the economic impact is from the peripheral effects of uncertainty on manufacturing and business confidence. We still believe the U.S. and China will reach an agreement before significant damage is done to the global economy. We also think the path to a trade agreement with China may be shorter and smoother now that Congress is split between Republicans and Democrats. Both countries have agreed to discuss trade at the G-20 summit at the end of this month, so progress in trade talks could happen soon. Nevertheless, we will continue to monitor economic data for any clues of a tariff-related economic slowdown. ■

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Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

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