11 December 2018 Special Comment

Trump's tariffs: Detecting some early winners among the many losers

The Trump administration's tariffs will do more than make trade more expensive. Expect the displacement of China-based supply chains and related infrastructure, higher US consumer prices and short-term changes in freight rates and cargo-aircraft values.

Scope Ratings says these immediate economic consequences of Washington's muscular new trade policy, regardless of whether it is appropriate or not, could turn out to be more complex than expected. In the near term, not all them are necessarily negative. Their overall impact will prove long lasting.

Over several months in 2018, President Donald Trump announced hefty tariffs on Chinese goods that will have an impact on several hundreds of billions of dollars of imports from China to the US. China retaliated with its own set of tariffs. Talks to strike a new US-China trade arrangement have broken down more than once, only to restart, making it hard to judge whether any early and timely resolution of the US-China trade conflict is likely. If put in place, Scope does not expect the tariffs to be a short-term phenomenon. Long and difficult negotiations will be needed to reduce or eliminate them, as well as the strongly asymmetric trade relationship that led to the trade dispute in the first place.

Trade wars are economically wasteful and inefficient. The imposition of tariffs ultimately leads to higher consumer prices and distorted markets. In that sense everyone loses. Any permanent increase in trade barriers has the potential to lower economic growth, add to inflationary pressures which could lead to tighter monetary policy than otherwise would have been necessary through accelerated interest-rate increases. Even if tariffs prove temporary, the willingness of the US administration to revisit existing deals in conjunction with its focus on bilateral rather than multilateral agreements may increase business and financial-market uncertainty and hence, lower investment and real GDP growth. China and the US will feel just such an economic impact.

Some sectors, however, have already benefited from a temporary increase in activity. One is maritime shipping as US-based companies draw shipments forward to beat tariff deadlines at the same time as they benefit from the seasonal upswing for goods aimed at servicing Christmas retail demand. The recent spike in Asia-US maritime shipping spot rates underscores this. Air freight companies are also benefiting.

Chain reaction: The tariff impact on China

While hard data is not yet available, anecdotal evidence points to US companies with significant portions of their supply and value chain in China (A+/Negative) already starting to look at alternatives to avoid sharp tariff-related price increases[1]. Scope anticipates supply chains, starting with basic manufacturing and moving up the value curve over time, to relocate to countries with similar comparative advantages to China.

China will feel the macroeconomic impact of such shifts. A drift in investment away from China risks leading to slower-than-expected growth, prompting government intervention to avoid unemployment in affected industries. Government support for export sectors to support Chinese price competitiveness and avoid loss of market share is problematic: it opens China to further accusations of price-dumping[2] and are not infinitely sustainable; shifting workers affected to alternative industries may be difficult, given the broad range of tariffs to be imposed; devaluating the yuan—a move which would also open China up to more accusations of unfair competition—is not expected; domestic demand will not be able to compensate fully for declining exports. As a result, the tariffs will have a punishing effect on the Chinese economy.

[1] For one example see: http://epagepub.com/publication/?i=541015#{%22issue_id%22:541015,%22page%22:9}
[2] EU geht gegen Chinas Seidenstraße vor, Handelsblatt, 21 Nov 2018, s. 10

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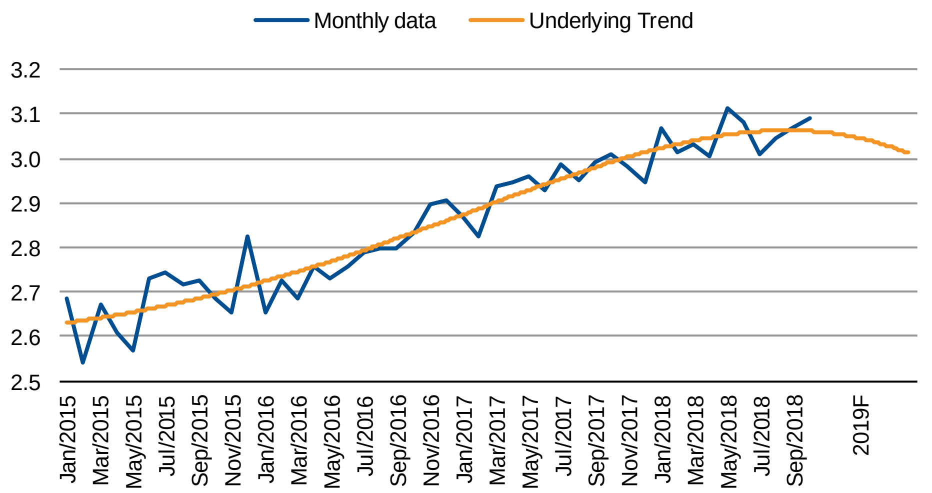
Figure 1: Foreign Trade Goods Transportation in Major Chinese Harbors (SA,100 Mil.Metric Tons)



Source: Haver Analytics, Scope Rating GmbH calculations

The introduction of tariffs coincides with a delicate moment for China's credit markets, with any extra trade-related slowdown in the economy exacerbating mounting corporate bond defaults in China, already at a cumulative 67.4 bn yuan in the year to date and up over 4 times from the same period of 2017. Contagion risks here should not be underestimated, as large cross-guarantees are in place amounting to nearly 4 tn yuan in 2017. This is being addressed in the recent move by banking regulators to require one-third of new lending to go to private companies, currently less than a quarter of bank's outstanding debt in September 2018[3]. This is the first time China has set such formal goals.

US consumers will have a price to pay; more gradual impact on rest of world

US (AA/Stable) import prices are set to increase for a significantly wider selection of goods, directly affecting industry and increasingly consumers who will feel the difference in their pocketbooks. The effects of higher import prices on US inflation will be moderate given relatively low inflation in the US (core CPI of 2.1% is slightly higher than the Fed target).

However, increased prices for consumer goods will negatively impact consumption, especially for lower-income groups least able to afford them. Scope expects this will be mitigated to a certain degree in the near term by pre-tariff inventory building among US companies, keen to maintain price positions after new tariffs are imposed.

One catch for US importers is that while increased inventories provide a buffer against price increases, the time required to move supply chains away from China may prove to be significantly longer than inventory coverage. In other words, it can only be a stopgap measure to delay having to pass on higher costs to consumers.

Regardless of the temporary effects, Scope anticipates any new trade equilibrium will bring permanently higher prices, placing real-world negative effects on US consumers, with the risk of faster-than-anticipated interest-rate rate rises if tariffs are permanent even though the potential for economic growth deteriorates.

The impact of the US-China trade conflict will be felt more gradually by the rest of the world. Countries such as Cambodia, Vietnam, Indonesia and Bangladesh should benefit

[3] https://www.bloomberg.com/news/articles/2018-11-09/china-banks-drop-after-regulator-sets-targets-for-private-loans

from declining US dependence on China for imports. A new global trading equilibrium developing will likely bring economic expansion via new factories and employment to these countries.

Cargo companies benefit at least for now from tariff impact—but for how long?

The recent spike in Asia-US maritime shipping rates (these broke through the USD 2,000/FEU barrier in August 2018, up 10.5% YoY) illustrates the near-term demand for container space as economic actors anticipate the coming tariffs in addition to the typical pre-Christmas, seasonal pick up in freight traffic.

Whether this increase signals a longer-term improvement in maritime shipping rates is less obvious. The price mechanism in maritime shipping is not a simple case of supply meeting demand with clear price-building. The coming year may well bring rate increases regardless of supply and demand effects, reflecting a long-needed price correction from the low prices of recent years that resulted in challenged maritime shipping profitability. A large supply overhang, coupled with relatively inelastic demand, led the industry into a negative price spiral after the Great Financial Crisis. The sector's fundamentals have since improved, in part due to industry consolidation. Scope expects shipping companies to push to make price increases permanent, driven in no small part by the fact that without higher prices, increased environmental rules and fuel costs will otherwise lead to further profit and possibly service disruptions in 2020 and later. The industry can point to some genuine capacity restraints: Numbers and types of ships cannot be easily expanded to meet strong short-term upswings in demand on specific routes[4].

The short-term effects of tariff imposition are already benefitting the air freight industry. While most US-China trade is moved by sea, the increased volume and resulting relative lack of capacity during the short lead-in time (before January 2019 when tariffs will be imposed) has already seen a shift to air shipping to ensure that high-value exports reach their destinations, largely the US, before tariffs are imposed. The companies profiting the most are Asia-Pacific carriers, which showed robust growth in 2017 leading to strong operating margins (up by 11% in 2017, against the industry average of 7.5%). Scope expects this to continue, reflecting the increasing market share of these carriers, already the largest in terms of market volume, with favorable load metrics and strong growth. Air freight alone, before any tariff-related effects, was expected to increase from 2017 to 2022 at an average compound rate of 3.9% for Asia to North America and 4.0% from Asia to Europe[5]. Air freight volume appears already to be rising beyond expectations in Southeast Asia, with Thailand reporting international air freight volume up by over 6%, Cambodia up by 24% and Vietnam expecting growth to be up by 18%. While these increases are not primarily caused by the US-China trade rift, they point to shifts in trade reflecting changes in supply chains.

Scope anticipates that the market value of cargo aircraft will rise at least in the short term to reflect increased demand, little spare capacity, and relatively long delivery times. One danger is that if aircraft manufacturers, in response, increase output of freight aircraft too strongly, that could lead to an overhang in the used freight aircraft market when the current upswing in demand slows or reverses. Long delivery times and relatively easy cancellation of options on new planes might mitigate the problem. Certainly, for now, the outlook for the market value of freight aircraft looks bright.

[4] https://splash247.com/how-will-the-container-industry-recover-60bn-in-higher-fuel-costs/
[5] https://www.iata.org/publications/economics/Reports/freigh-forecast/Forecasting-air-freight-demand.pdf

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