Commentary – Quick Insight

May 2018

United States and China Trade Actions ... So Far

United States trade investigations, tariff actions, retaliatory tariffs and trade negotiations have been a major economic story this spring. In this quick insight, we bring clients up to speed on the topic and share the underpinnings of our current risk assessment, in which we see limited impact on our portfolio strategies. Trade remains a dynamic theme under the current Administration and we expect further volatility in news flow as markets absorb its unique brand of negotiating.

Trade Actions and Analysis –

Primary announced actions to date include the United States' January import tariffs and taxes on solar panels and washing machines and March's Section (§)232 (national security) steel and aluminum import tariffs. To date, China has retaliated with a small \$3 billion / 128-product tariff (pork, recycled aluminum, etc.) announced in late March. Also pending are the Unites States' §301 tariffs affecting ~\$50 billion of Chinese imports and China's threatened retaliatory tariffs also worth ~\$50 billion.

The United States has temporarily exempted most trading partners from the §232 steel and aluminum tariffs, excluding China. Canada is a very large supplier of the metals, at over 15% of U.S. steel consumption and 50% of aluminum, and its temporarily exempted status will likely be a lever in concluding NAFTA negotiations. Pork is an interesting target insofar as the world's largest pork producer and exporter to China has been owned by a Chinese company since 2013, meaning while U.S. jobs are implicated there would also be significant negative effects circling back to China.

On the larger §301 tariffs, the macro impact is expected to be modest, at 0.06% U.S. GDP and 0.1% China GDP. The primary U.S. goods with export exposure are aerospace, autos and soybeans; U.S. services exports are primarily travel and intellectual property (IP) licensing. U.S. multinationals operating in China have operating risk insofar as the potential for regulatory or other increased operating pressures, capital controls, et al.; however, China risks shooting itself in the foot by leaning too heavily on U.S. direct investment capital, so we don't expect a material policy change. In addition, the U.S. Bureau of Economic Analysis reports only \$17.3 billion of investment income flows from China, which seems manageable to us.

In addition to IP licensing business models that are near a crossroads due to China's industrial strategy, the potentially larger risk – to the extent it becomes underappreciated by negotiators – is in the workings of complex supply chains that may be disrupted, raising costs. These IP companies tend to be in the automotive, industrial machinery and electronics sectors and – to a lesser extent – clothing, footwear and textiles (however the §301 list was apparently refined to minimize impact to U.S. consumers). Second order impacts may be felt by other entities such as logistics and shipping companies, as well as agricultural sector suppliers and service providers.

Specific to aerospace, the largest impacted sector, we note that the proposed Chinese tariff is defined to exclude widebody airframes, which account for most of Boeing's China order book, so the impact should be muted unless the terms

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are changed (note: China has not yet set its tariff rates). Further, while a good target insofar as its importance to the U.S. economy, aerospace trade friction also has the potential to impact aftermarket and service aspects of existing Chinese air fleets, which China should want to avoid.

In the U.S., other impacts may be felt by importers and consumers of goods on the U.S. tariff list, including retailers and manufacturers whose costs and margins may be pressured to the extent tariffs cannot be passed on or re-sourced to an ex-tariff provider in short order. We note that for competitors with similar operating models, such cost increases should not present a material competitive disadvantage, though price may drag on market demand.

Focusing on China, it continues to be a negotiation with the two sides far apart in core areas – particularly U.S. demands are in conflict with China's core industrial strategy (Made in China 2025) – so we expect a bumpy path. Both sides have allowed time to negotiate and there's some room to maneuver: the U.S. §301 action is to follow a public review and comment period through May before the Administration announces an effective date and China has not set an effective date for its proposed retaliatory actions.

In terms of our portfolio views, relative both to direct export exposure (e.g. Boeing airframe exports) and to U.S. multinationals (e.g. Starbucks), the risks to single-name credits in our coverage universe are largely mitigated by business and geographic diversity (e.g., a Barclays report finds only 8% sales and manufacturing exposure to China by U.S. multi-industry companies). Portfolio diversification further mitigates the risk that may be introduced as this trade landscape evolves.

Author's Bio

Robert Boucher, Senior Managing Director of Credit Research, is responsible for the firm's credit research efforts. He chairs the Taxable and Tax-Exempt Credit Committees. In addition to managing the credit research team, Robert is actively involved in credit research within a number of sectors. Robert began his financial industry career in 1999. Prior to being named Senior Managing Director of Credit Research for the firm, Robert was a principal credit analyst with responsibility for credit research within the industrial sector. He was an active participant in the Taxable and Tax-Exempt Credit Committees and a key contributor to the firm's broader investment process. Before joining U.S. Bancorp Asset Management in 2010, Robert was vice president of private placements with ING Investment Management. Robert earned a B.S. in finance from Saint Cloud State University and an M.B.A from the University of St. Thomas. Robert holds the Chartered Financial Analyst designation and is a member of both the CFA Institute and the CFA Society of Minnesota.

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[See next page for additional sources and important disclosure information.]

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