ECONOMIC COMMENTARY:
THE TARIFF WAR'S CURRENT AND FUTURE IMPACT

Q&A with Robert DeLucia

How has the decline in world trade affected other export-led economies?

Most foreign economies have been impacted more profoundly than the U.S. by the sharp slowdown in world trade. Because of their greater reliance on both manufacturing and exports, Germany, Japan, Korea, China, Australia, and emerging market economies have suffered far **more severe GDP weakness** over the past 12 months. World GDP slowed to an annual rate of 2.5% in the quarter, the slowest pace in more than a decade.

What is the current state of real final sales?

Slower growth in inventory investment reduced GDP by nearly one full percentage point as businesses cut output to better align inventories with final sales. Capital formation was also weak as heightened uncertainty surrounding the future of trade policy undermined business confidence. **Real final sales** — defined as GDP excluding the effects of inventory destocking — increased at a solid 3% annual rate.

What is the overall economic impact of tariffs?

In their most fundamental form, protective tariffs act as an excise tax on domestic companies and consumers, with an obvious adverse effect on purchasing power. Tariffs also negatively impact **economic growth** and **corporate profitability**.

How would the U.S. economy and financial markets have performed in 2019 in the absence of the tariff war?

- Hypothetically, U.S. economic growth during 2019 would be stronger, especially the manufacturing and capital goods sectors.
- U.S. GDP in 2019 would be expanding at an estimated rate of 2.75% — somewhat slower than the 3% growth in 2018 but faster than the current 2% trend. World GDP growth would be 3.5% versus the current 2.5% growth rate.
- Business investment spending would likely be considerably stronger. It is clear that businesses have postponed long-term investment projects because of enormous uncertainty associated with tariffs.
- U.S. Treasury yields would be closer to 2.75%, well above the current 2.12% but still lower than the 3.25% peak in 2018.
- The Federal Reserve would likely be raising its key policy rate during 2019 and 2020, after holding rates steady during the first half of this year.
- Corporate profits would be stronger in the absence of the current tariff war. The equity market would be higher on the basis of both stronger earnings and more generous valuations.

In short, it seems reasonable to hypothesize that economic and profit growth as well as interest rates and stock prices would be higher in the absence of current trade tensions.

How have tariffs increased the risk of a global recession?

My focus remains on typical end-of-cycle catalysts that could undermine economic growth and trigger the next recession. However, a new variable has asserted itself over the past year, namely an increasingly aggressive tariff policy on the part of the Trump administration, which has **greatly increased** the risk of a global recession. The focus of my forecast is centered squarely on the following two factors:

- » **Forecast Adjustment:** I have recently adjusted my forecast for U.S. economic growth to allow for the increased uncertainty associated with U.S. trade policy. The escalation of tariffs over the past year has adversely impacted the U.S. economy, and the impact will become **more intense** and widespread the longer the tariffs remain in effect. Because of these trade tensions, my forecast now assumes slower GDP growth over the next several quarters. The current odds of recession within the next 12 months have risen but remain comfortably below 50%. However, the probability of recession will increase should trade tensions escalate.

- » **Monetary Policy:** The statement following the June 19 FOMC meeting signaled a clear shift in tone from the Federal Reserve, significantly raising the probability of one or more rate cuts during the second half of this year. My forecast assumes a rate cut at the July FOMC meeting and another in September, implying a federal funds rate of 2% at year-end. The implications for the economy are **favorable for growth** in 2020 and 2021, but potentially unfavorable in 2022 and beyond because of an increased risk of an overheating economy.

Do you see an extended expansion cycle?

My new forecast assumes that the business expansion cycle will be sustained for a longer period, which implies a postponement of the recession until 2022 or later. The rationale for this assumption of a longer expansion cycle is discussed below, but depends importantly on a **resolution** to the current trade conflict prior to year-end.

Can you explain "slower now, faster later" thinking?

Under the scenario of "slower now but faster later," the current slowdown phase should relieve supply pressures in the short term, thereby leaving the economy with more room to grow. The key point is that an interim period of slow growth would lay the foundation for a **longer expansion cycle**, beginning in 2020.

How is trade policy the key to the economic outlook?

In the absence of cyclical imbalances, the overarching variable in the outlook is the direction of U.S. trade policy. The **tariff war** between China and the U.S. has been disruptive to the domestic economy, but the economic impact on the global economy has been much more severe. Export-oriented economies such as China, Japan, the eurozone, and emerging Asia have weakened considerably. Moreover, the impact on growth should be viewed as cumulative, not static, implying that continuation of the status quo in trade policy would likely have an increasingly negative economic impact as a function of time.

Why does a truce help both sides?

My assumption since the onset of the U.S.-China tariff war in 2018 has been that it would be in the interest of both parties to agree to a truce, sooner rather than later. This assumption seemed consistent with the notion of **game theory** — the dynamic process of modeling the most likely end result of a strategic interaction between two players in a situation containing set rules and outcomes.

The Chinese economy has been struggling for more than a year. Continuation of the tariff war would further undermine economic growth, raising the risk of rising unemployment, credit risk, social unrest, and political instability. In the U.S., President Trump should be highly motivated to end the tariff war far in advance of the **2020 election** to enhance his chances for re-election. Consequently, I continue to believe that the most likely outcome is that at least a partial truce will be reached prior to year-end.

Without a truce, what trade scenarios and economic implications could result?

In the best case scenario, a truce, U.S. GDP growth would bottom later this year around 2% and accelerate strongly in 2020. There are several **alternative scenarios** with respect to trade policy that would have negative implications for both future growth and the direction of financial markets. Here are the **most likely**:

1. Continuation of the **status quo** through year-end without a formal truce — economic growth would moderate further to a pace of only 1.75% in 2020, but avoid a recession. Corporate earnings would fall by 5% in 2020 as profit margins narrowed further.

2. Continued **gradual escalation** in tariffs in coming months — U.S. GDP growth would decline to 1.25% in 2020, but an outright recession would be averted. Company earnings would fall by 10% in 2020.

3. Trump **implements** all threatened tariff increases — An outright trade war, including 25% tariffs on all Chinese imports as well as on European and Japanese auto imports, would almost certainly culminate in a global recession. U.S. company profits would decline by 20% to 25% in 2020.

How have tariffs affected company profit margins?

Another consequence of the tariff war has been a mild compression in company profit margins, owing to an increase in operating costs associated with the disruption to global supply chains. A margin squeeze has also resulted from higher input costs on imported materials and components. At the same time, consumer inflation has remained surprisingly benign. It appears likely that intense global competition has **deprived business firms of pricing power**, so that these tariff-related cost pressures have been manifested primarily in narrower profit margins and not higher inflation.

What does this mean for the future of the extended business expansion cycle?

If my assumptions regarding trade policy are correct and a recession is avoided, prospects for economic growth in 2020 and beyond would become more favorable. Of greatest importance is the potential for a **postponement** of the next recession from 2021 to 2022 or 2023. The rationale behind this assumption is that the tariff war of the past year has disrupted the natural path of the business expansion by extinguishing the normal end-of-cycle catalysts. In the absence of **late-cycle pressures**, the odds of a dreaded boom/bust business cycle are reduced and the path of least resistance for the U.S. economy would be sustained growth:

- Various supply-side pressures that were building in 2018 have faded
- Slower job growth has partially relieved labor market tightness
- Wage growth has slowed from a peak of 3.4% to only 3.1%
- Core consumer inflation has slowed from 2% to 1.6%
- Instead of raising its policy rate, the Federal Reserve will likely be lowering rates
- Market yields of long-term Treasury bonds have declined from 3.25% to close to 2%

» Mortgage rates have declined from nearly 5% to 3.85%

» Crude oil prices have plunged from a peak of $66 per barrel to $52

» Labor productivity growth jumped to 2.4% versus only 1% one year ago

The key point is that the various impediments to sustained noninflationary growth that had developed during 2018 have greatly diminished, clearing the path for a **longer expansion cycle** and postponement of the next recession. However, this optimistic economic scenario is predicated upon a speedy resolution of trade frictions.

Is this a "rubber-band expansion" cycle?

Similar to the elongated expansions of the 1980s and 1990s, the current expansion has exhibited enormous resiliency and durability. A unique factor affecting the current cycle has been **widespread risk aversion**. The lingering trauma of the world financial crisis introduced a large element of fear and caution into consumer, business, and investor behavior, engendering a firm determination to avoid the excesses of previous cycles. In principle, **the biggest risks** to the sustainability of an economic expansion are complacency, excessive risk-taking, and a sense of euphoria.

To the extent that excesses and imbalances are minimized, the odds of an outright recession are also minimized. Similar to previous episodes earlier in this expansion cycle — most notably those in 2012 and 2015 — the current slowdown has been led by weakness in the **manufacturing sector**. An end of the current inventory drawdown and an easing of trade tensions would likely be followed by a solid rebound in industrial production and capital formation. The result would be a lengthening of the expansion, possibly throughout 2022.

What economic forecast assumptions can be made?

Diminishing inflationary pressures should also support a lengthening of the business expansion cycle. Core consumer inflation has declined from 2% one year ago to only 1.6%, and is likely to stabilize at its current pace through year-end at a minimum. Inflation is a **classic lagging indicator** and is unlikely to move higher until the second half of next year and in 2021, in lagged response to a cumulative strengthening in the U.S. and world economies. Continued low inflation implies that monetary policy is likely to remain accommodative for an extended period.

» **GDP Assumptions:** U.S. real GDP is likely to average 2% during the second half of this year, led by consumer spending and the broad services sector. Assuming a resolution to the trade conflict before year-end, the economy should **gradually strengthen**, with GDP accelerating to 3% by the middle of next year. Business capital investment and residential construction should stage a **solid recovery** in response to reduced uncertainty and the plunge in borrowing costs. My forecast assumes full-year growth of 2.75% next year followed by 2.25% in 2021. A major slowdown or recession is possible in 2022.

» **Corporate Earnings:** Company earnings peaked on a rate-of-change basis in 2018 but should continue to drift modestly **higher** in absolute terms. Earnings per share (EPS) were flat in the first half of this year but could increase at a 5% rate during the final six months of the year. EPS growth could accelerate to 10% in 2020 but then begin a long period of **deceleration** in both 2021 and 2022 in advance of the next recession.

How does China impact the world economy?

It's crucial for investors to understand the enormous influence of China on the global economy. Fearful of excessive growth in debt, policymakers implemented a severe tightening in monetary policy beginning in the second half of 2017. The result was a simultaneous slowdown in credit creation and slump in domestic demand, manifested in falling imports. Slumping Chinese imports immediately triggered **progressive weakness in global manufacturing** and world trade. Global GDP has been in a steadily declining trend since the early months of 2018.

How are China's imports Europe's exports?

Chinese imports play a crucial role with respect to global GDP and world trade. Chinese domestic demand has a large impact on the rest of the world, especially on **heavy exporters** such as Germany, Japan, Korea, and emerging Asia. In particular, manufacturing and export trade are the two most important economic sectors for Germany and other countries within the **eurozone economy**, which has weakened significantly since 2017. The eurozone has been a **tale of two economies** over the past 18 months: strong domestic demand and employment offset by profound weakness in manufacturing and export trade.

Is China an engine of growth for the global manufacturing sector?

A sustained rebound in the European economy is critically dependent upon a strong rebound in Chinese domestic demand and import growth. The strength of the Chinese economy, in turn, depends upon the success of China's monetary stimulus implemented over the past year. There are some preliminary signs that monetary stimulus is beginning to have a **positive effect** on China's economy, but the evidence has been spotty.

Much more so than the more insular U.S. economy, China is the crucial engine of growth for the global manufacturing sector. As such, investors should **closely monitor data** from China pertaining to credit growth, domestic demand, and imports, with a special focus on real estate investment.

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