Global Political Drivers

TRUMP TRADE WARS: FRIENDLY FIRE

Christopher Granville/ Constantine Fraser

- **US-instigated trade tensions may seem less scary with Europe than China. Standard geopolitical assumptions fuel such complacency: in contrast to the geopolitical fault line underlying the US-China stand-off, the historic US-Europe geopolitical alignment looks benign.**

- **Even before getting to geopolitics, the reality of the US-EU trade war threat – that went live last week – is far from benign.**

- **Beating the drums of (trade) war already appears to be delivering domestic political dividends for Trump; and with its undervalued currency, exorbitant external imbalances and, especially, the vulnerability of its relatively protected car industry, Europe offers him a fine new drum.**

- **Geopolitics aggravates trade war risk by prolonging tensions – producing this same result, from opposite starting points, in the European as in the Chinese case. This effect will be aggravated as far as European is concerned by further irritants, related to Iran and the WTO.**

- **The crucial point is that regardless of whether tensions eventually subside with Trump declaring victory (as we assume he will), elevated trade war threats for the next six months at least will inhibit (I) the capex growth required to sustain global reflation and (II) euro appreciation, aggravating the risks to the global economy and markets from dollar strength.**

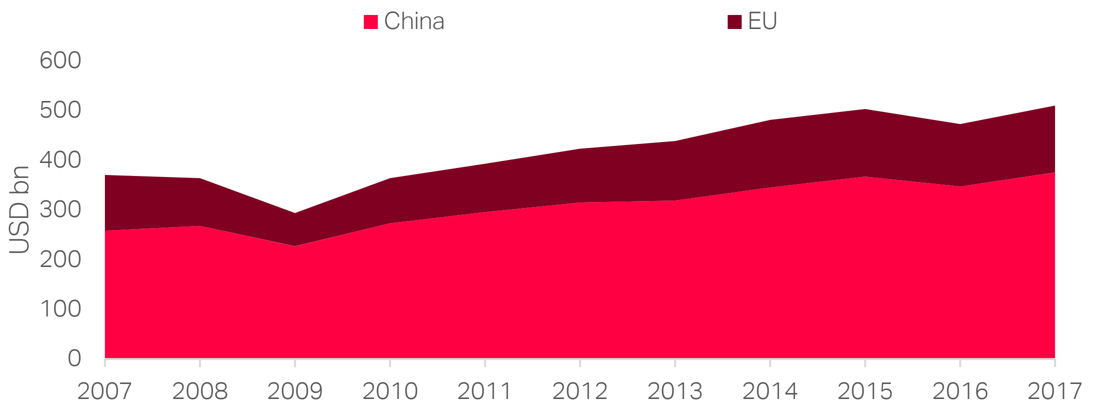
What is a trade war between friends?

Trump has opened trade hostilities against Europe and Canada. China has so far been the main focus of the 'Trump trade war' theme. On that main China front, we have noted the important and aggravating geopolitical driver. Now, with its decision not to prolong beyond 1 June the temporary waivers on protectionist steel and aluminium tariffs previously granted to 'friendly' countries, the Trump administration has opened serious hostilities on the western front – i.e. North America (Canada and Mexico) and Europe. Now is the time, therefore, to consider the effects of the geopolitical driver in this theatre. We concentrate here on Europe. Do the geopolitics of US-Europe trade disputes mitigate or – as in the China case – aggravate risks?

European 'war' seems less risky than China

The US-China geopolitical does not apply to Europe. As regards this geopolitical angle of trade wars, Europe may seem at first sight to come out well from a comparison with the China case. While Trump's stated immediate goal is to reduce America's bilateral goods trade deficit with China, the far more contentious dispute in reality revolves around US complaints about China's "acts, policies and practices" in the areas of technology transfer and intellectual property protection. Those complaints are underpinned by US geopolitical anxieties about the threat to US global hegemony from China's bid for leadership in a range of advanced technologies as advertised in the 'Made in China 2025' initiative. Such geopolitical concerns are inapplicable to America's oldest allies in Europe.

US goods trade deficit by partner



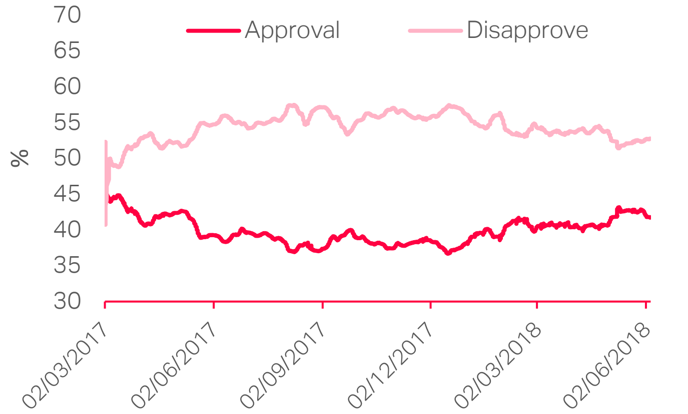
Source: Eurostat, US Department of Commerce, TS Lombard.

Europe's trade surplus is smaller than China's, and less live a political issue. The comparison with China looks benign for Europe in other respects too. China's bilateral trade surplus with the US matters more than the EU's not only because it is considerably larger (see chart above) but mainly because EU trade is only a secondary theme in Trump's rousing speeches about the loss of secure and well paid US manufacturing jobs to unfair trade. In the perspective of Trump's political platform and base, China rather than Europe is the main culprit for the economic setbacks experienced in the American heartlands.

Not so fast

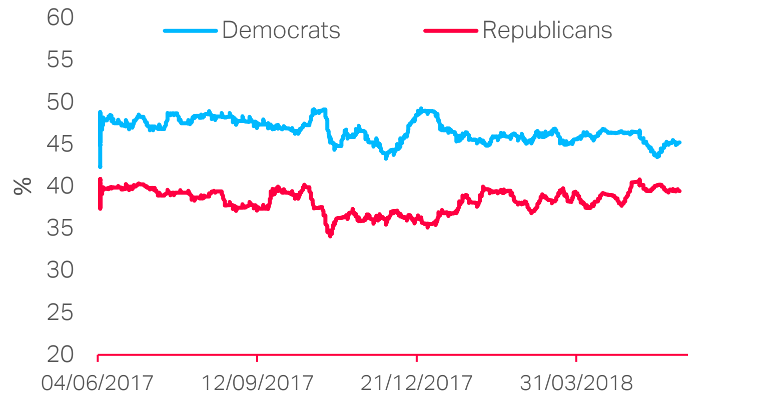
Talk of trade wars has coincided with recovering Republican polling. Nasty surprises – the wages of complacency – could nevertheless lie in store from the US-Europe trade tensions. The US domestic political driver for 'trade wars' may not stem from Europe, but Europe may yet provide useful fuel for the fire. The period since Trump dusted off his protectionist agenda (that had lain dormant during his first year in office) has coincided with notable recoveries in his own public approval rating and, more important for now, Republican prospects looking forward to the mid-term elections in November (charts below).

Trump approval rating



Source: fivethirtyeight.com estimate, TS Lombard moving average

Generic party preference for midterms

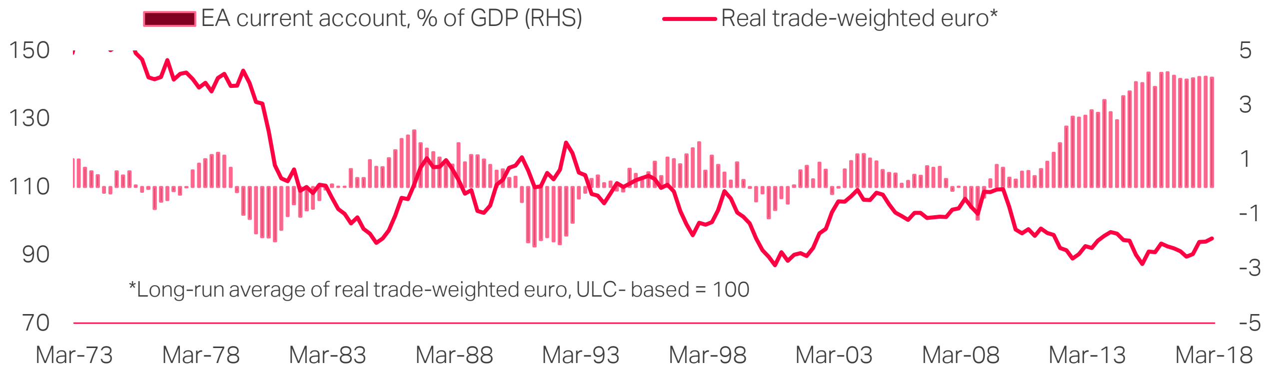


Source: fivethirtyeight.com estimate, TS Lombard moving average

So Trump will continue on his protectionist course at least until the end of the year. It is safe to assume that Trump will see these gains as a case of cause and effect. Given the domestic election timetable, it follows that he will continue beating protectionist drums at least until the end of the year. This timing point itself adds to the risks; but before getting to that below, we can simply note for now that Europe offers another drum.

US grievances with Europe are anyway well-founded. The European trade drum is a good instrument. Turning from domestic US politics to the substance of the trade dispute with Europe, US grievances are better founded than in the Chinese case. In contrast with China's current account moving close to balance and the RMB exchange rate no longer being artificially depressed, the euro remains chronically undervalued and the economic upturn in the EA has barely dented its sky-high current account surplus (chart below).

The euro disconnect



Source: Datastream, Eurostat, TS Lombard

German cars are a longstanding bugbear for Trump. It may be objected here that Trump is not motivated by any such substantive arguments. One answer to that objection is that he will anyway have a political interest in noisily beating the European trade war drum. A second, and more important, answer is to remember another lesson of Trump's track record: he sticks firmly to his long-held fixations. First among these (outranking even the aspiration of "getting along better with the Russians") is protectionism in general. A firm feature of Trump's protectionist mental map appears to be German cars.

The 'German car' threat

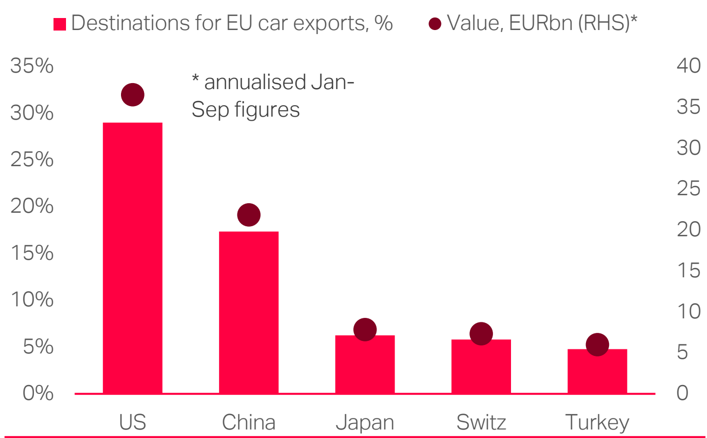
He immediately mentioned this topic in reaction to the EU's promise of retaliating against the hike in US import tariffs on steel and aluminium with increased duties on imports from the US originating from politically sensitive states (orange juice from Florida, bourbon from Kentucky and Harley-Davidson motorcycles form Wisconsin). Trump warned that the US would respond to any such moves in the following round of tit-for-tat by raising import tariffs on European cars.

He is already laying the groundwork for car tariffs. The groundwork for any such move is being laid in the form of the US Commerce Department investigation into the automotive trade under Section 232 of the Trade Expansion Act of 1962. Similar enquiries on steel and aluminium initiated in April 2017 resulted in the metals tariff hike announced this March, and the Secretary of Commerce now has until mid-February 2019 to submit his automotive findings to the president for possible action.

And Europe is more vulnerable than China. This enquiry highlights various aspects of Europe's fundamental vulnerability to US-instigated trade wars. Put another way, in a debate on Trump's thesis that "trade wars are easy to win", Europe would supply some of the best supporting evidence. There is more to this case than just the relative openness of the European economy (with goods exports accounting for 19.7% of 2016 Eurozone GDP versus 7.8% for the US). This is an area where the comparison with China does not work to Europe's advantage. The supply chains of many major US industry sectors, starting with technology and communications, are deeply enmeshed in China.

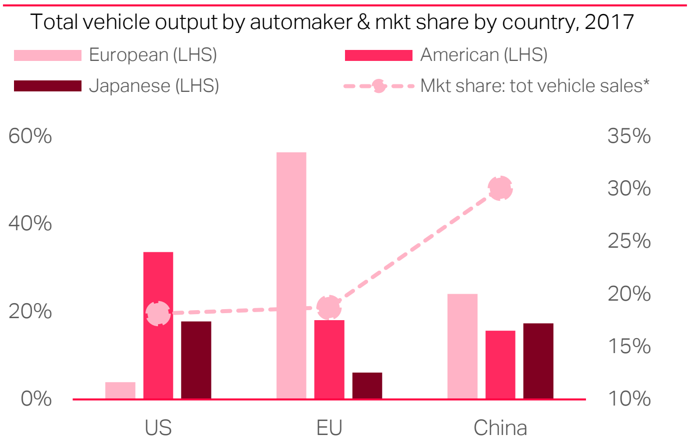
A trade war with China would therefore entail much more self-harm for the US than with a trading partner like Europe, which is competing more in finished product markets. In this respect, Europe today resembles Japan in the 1980s. Trump imbibed his protectionist credo in that period when the Reagan administration put heavy trade pressure on Japan – and, completing the analogy, with a similar focus on the automotive sector.

EU car "imbalance" - 1/2



Source: ACEA, TS Lombard

EU car 'imbalance' - 2/2



Source: OICA, TS Lombard

The European automotive sector is particularly vulnerable. This short note by our Europe economist Davide Oneglia explains why the automotive industry is so economically sensitive for the EU, with complex integrated supply chains forming the backbone of the continent's manufacturing and high employment multipliers. Specifically as regards the US, 10% of the EU's bilateral goods trade with the US is automotive-related, while vehicles account for over a fifth of the US trade deficit with the EU (these data points, shown in the left-hand chart above, are for 2016). Given the importance of the US market for the European vehicle manufacturers, only a small fraction (4%) of European production is localized in the US (right-hand chart above).

This last point recalls part of the solution to the US-Japan trade dispute of the 1980s – that is, the substantial localization of Japanese car making inside the US. In any event, this present picture will furnish the Commerce Department's report on the sector with well-founded complaints against Europe, in the same way that the US Trade Representative's 'Section 301' report on Chinese industrial policies (IP theft etc) teed up the Administration's announcements of punitive tariffs against China. Regardless of Trump's personal grasp on the details of the transatlantic automotive trade, recent tweets with wild references to auto tariff differentials suggest that the EU's import tariff on cars (10% vs America's 2.5%) is firmly imprinted on his mind as a spur to action.

Geopolitical angle: Falling out

With apparently lower geopolitical stakes, the Europeans could try to wait out the storm. With all the above background in mind, it is easier to gauge the effect of the geopolitical driver. As noted, the initial impression is benign. America's historic European allies with a massive stake in the US-led alliance might be expected to batten down the hatches, waiting for the Trump storm to pass and his successor to normalize US trade policy. Such assumptions may prove complacent: however long Trump's political career lasts, he could well be survived by the protest vote from those in the US heartlands who have lost out from globalization.

They will deploy a mix of protest, retaliation and appeasement. However that may be, the outlook for now from the EU is a combination of public protest (on sharp display at the annual G7 Summit process last and next weekend) and formal retaliation. This may be accompanied less publicly by a policy of appeasement – especially on the part of Germany, driven to a considerable extent by the above-mentioned vulnerability of its core automotive sector.

Once again, not so fast

Lower perceived geopolitical costs could mean a harder line from Trump. Here again, however, closer inspection highlights the risk of complacency. We have already noted how in economic terms, the US has less to lose from escalating trade tensions with Europe than with China. The same might apply to the political sphere. For Trump, the domestic political dividends of trade-related sabre-rattling arguably have a lower geopolitical cost against friendly targets. As an anonymous blogger put it this week:

No matter how much Trump humiliates them, most of America's allies will always stick around. He know that he owns them because for many US allies, an alternative alliance with China and/or Russia is a total non-starter.

Realistic as this seems (for now, at least), the emotional blowback from spurned allies should not be underestimated. In particular, weighing in the balance against Germany's economic incentive to appease Trump is the French 'Gaullist' tradition, now clearly enough visible in the style and policies of Emmanuel Macron. The same point that it is safe to annoy old friends since they have nowhere else to turn might be encouraging Macron and his government in their relatively hard line against Trump. In particular, Macron has threatened not to sign the final communiqué coming out of next weekend's G7 Summit unless the US is prepared to compromise on trade wars and Iran.

Further irritant #1: Iran secondary sanctions

Iranian secondary sanctions will coincide with escalating trade tensions. Mention of Iran brings us to the first of two further irritants in the US-EU relationship that will coincide with the trade dispute. The timings are important here. As we have noted, the trade tensions are set to last at least until the US mid-term elections in November and most likely until at least next February, when the Commerce Department's automotive industry report is due (at which point, a Trump decision to pursue his dream against German cars would spell a major new escalation). Slap in the middle of this timetable, European companies could face US extra-territorial sanctions related to Iran. When the US withdrew from the Iran nuclear deal last month, the US Treasury set deadlines of 90 and 180 days for winding up (respectively) financial and oil-related dealings with Iran.

Major European companies like Total have already indicated that unless granted a waiver by the US Treasury, they will comply – i.e. halt their operations in Iran rather than face secondary sanctions against their (more important) business interests in the US. But other, perhaps smaller companies, might be in the US firing line.

The rift with the EU will only deepen as a result. The EU currently seems set on the politically-charged response of passing a so-called "blocking statute", as they did in 1996 in response to US sanctions against Cuba and Iran. This would nullify the effect of the sanctions within the EU, make them illegal to comply with and unenforceable in European courts, and in theory allow European companies to apply to repossess assets from sanctioning entities to compensate for any fines they incur. In essence, these would force companies to choose between breaking European and US law.

In practice, the blocking statute is mostly symbolic: the associated fines are miniscule, there is plenty of scope for waivers, no company has ever been prosecuted under the regulation, and the chances of a European court confiscating US government property on the application of a sanctioned entity are roughly nil. So it would not dissuade any company at risk of heavy US sanctions from pulling out of Iran. Nevertheless, the blocking statute would send a strong political message, and mark a serious rift on foreign policy.

Sanctioning SWIFT could even lead to an unprecedented row. The transatlantic rift may be more than symbolic in the event that the US tried to enforce its desire to exclude the Iranian banking system from the SWIFT payments system. This was done once before – in 2012, when the US and EU were in agreement on Iran sanctions. That no longer being the case, and with SWIFT under *de facto* European control, the stage is set for possible US individual sanctions against the directors of SWIFT (representatives of major global banks) and even those banks themselves given their controlling relationship to SWIFT. Although that last possibility seems unrealistically extreme, this SWIFT question could lead to an unprecedented row.

Further irritant #2: WTO death agony

At the same time, the EU is coming to see the US as a threat to the world trading system. Brussels is becoming increasingly concerned at what it sees as the Trump administration's attempts to undermine the WTO. Not only is the US engaged in a series of bilateral confrontations, but it is also invoking a national security loophole in WTO rules in order to do so, setting a dangerous precedent. Moreover, Washington is holding up the appointments process to the WTO's top court, the Appellate Body, which as things stand will become inquorate and cease to function in 2019.

That would leave the WTO's dispute resolution mechanism toothless: it could remain a forum for consenting parties to seek arbitration, but in the absence of enforcement mechanisms its rules-based framework would quickly become rather pointless.

Investment Conclusion

We expect Trump to keep beating his trade drum until the midterms – potentially inhibiting capex. Relating this political analysis to the economic effects of trade wars, we would stress the time factor above all. Business investment is an important, arguably the most important, key to prolonging the present upward phase of the global cycle. There is already some evidence of trade wars inhibiting capex, and this effect will only increase on the safe assumption that the Trump administration will keep beating those war drums. Our house view – formulated specifically in relation to China– is that the noise will remain elevated in the coming months leading up to the US mid-term election, with Trump declaring victory either before or after those elections depending on where he sees more tactical advantage.

Geopolitics will string out the trade war threat. The geopolitical driver matters by contributing to this economically negative stringing out of the trade war threat. This same undesirable result beckons in both the Chinese and European cases from opposite starting points.

- On China, there is no possible negotiating fix for American geopolitical anxiety. While it has already signalled its readiness to increase imports from the US and level the investment playing field, China will never compromise on state support for 'Made in China 2025'. This reality will make it politically easy – even necessary – for Trump to spin out the 'trade' tensions with China, until one fine day when he decides the time is ripe to pocket Chinese concessions and declare victory.
- As for Europe, the close geopolitical alignment with the US creates the impression of lower stakes, perversely encouraging a long drawn-out episode of elevated trade-related tension. The geopolitical irritants discussed above have strong potential to make this transatlantic dispute all the more bitter and protracted.

Prolonged trade tensions will hit the euro – risking the global reflation story. The conclusion on Europe is that to the extent that the low perceived geopolitical stakes make first Trump and then 'Brussels' less inhibited about escalating the trade dispute, the stakes for financial markets might prove uncomfortably high. For prolonged trade tensions – especially with the threat of their spilling over into the automotive sector – would exert downward pressure on the euro against the dollar, which, regardless of the euro, will in any case be supported by 'safe-haven' inflows. As Dario Perkins argues in his latest Macro Picture, dollar strength should be regarded as a core risk to the global reflation story and source of market volatility.

GLOBAL POLITICAL DRIVERS – OUR THEMES

Theme	Why it matters	Recent views	Risk
The squeezed middle	Squeezed lower/middle income households in DM countries might be inclined to look for radical solutions – whether to the left or the right.	Corbyn's Labour is interested not so much in redistribution, but in ideologically-driven supply-side changes. The new Italian government could be an unexpected safety valve for discontent.	⬆
Great Power conflict: East Asia	North Korea's nuclear drive threatens to spark conflict in a region that already possesses its share of large-country tensions.	Kim Jong-Un's "Gorbachev gambit" raises the possibility of a geopolitical realignment.	
Trump Risk	Donald Trump has cultivated a reputation for unpredictability –from military intervention to trade disputes.	The new US National Security strategy implies a world of zero-sum competition. The US-China "trade war" has a key geopolitical component.	⬆
Great Power conflict: Middle East	The Middle East is a flashpoint for conflicts – with potential for spillovers that could affect the oil price, European security or Israel – a key American ally.	The US withdrawal from the Iran nuclear deal will be self-defeating, but it also spells escalating regional conflict.	⬆

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GLOBAL POLITICAL DRIVERS: DEFINITION AND BENEFITS

Political and social developments are for the most part inseparable from economic drivers of risk and opptortunity in the global economy and financial markets. But there are times when purely political factors play a decisive role. Global Political Drivers is a new component of our macro research service that will identify and analyse such factors. As the title suggests, the selection criterion will be the scale of the potential impact – that is, large enough to make the theme relevant for global asset allocators. The detailed insights on the subject matter of many themes should also offer value to portfolio managers and analysts focused on particular geographies and asset classes.

What are these drivers?

The drivers fall into two broad categories:

Geopolitical:

The risk of great power conflict in:

- Western Eurasia
- East Asia
- The Middle East

Domestic politics:

- Voter revolts in Europe
- Trump risk

Publication content and cycle

At any one time, we expect to have around six themes under active coverage. While we will only focus on political drivers that we assess to be globally important, we will occasionally challenge a consensus view on the high importance of some topic that, in our view, is less risky than widely believed.

GPD notes will be published every other Thursday (alternating with Macro Picture). Each note will lead on a particular driver, while noting more briefly any marginal changes in the risk profile of other topics on the service's current roster.

Core team

The service will be led by Christopher Granville, a former UK diplomat who has two decades of experience providing political economy analysis for investors on Russia and the rest of the former Soviet Union. The other lead analyst will be Jonathan Fenby, the Chairman of LSR's China Research service and the author of several books on Chinese history and contemporary China. The core team will also include Marcus Chenevix and Constantine Fraser, specializing respectively in the Arab world/wider Middle East and Europe. The team will draw systematically on the insights of our senior economists and market strategists.

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