From a Tweet to a Trade War

After months of encouraging news surrounding the trade negotiations between the U.S. and China, the parties reached an impasse in early May. Taking to Twitter, U.S. President Trump tweeted that there would be an increase in tariffs from 10% to 25% on $200 billion of Chinese goods. To understand the impact of these tariffs, we should first consider what a tariff is and whom it affects. A tariff is a fee paid by an importer to the importer's home government. For example, suppose the U.S. government imposed a 25% tariff on t-shirts from China. If a U.S. company such as Walmart imports $100 worth of t-shirts from China, Walmart will pay their Chinese supplier $100 and the U.S. government $25. The Chinese pay nothing. In the end, one thing is for sure—Walmart is paying more for those t-shirts.

While Walmart could look for alternative suppliers locally or in a different country, import tariffs will generally result in lower earnings for U.S. companies or higher prices for U.S. consumers, with either case resulting in weaker economic growth. If these trade tensions persist, business and consumer confidence will likely decline and businesses will delay spending plans until they gain more clarity.

Triggered by Trump's surprise tariff increase, China took retaliatory tariff actions, and it hasn't stopped there with both the U.S. and China imposing or threatening further protectionist measures. With trade tensions rising, the unpredictability of President Trump leads us to believe that while he remains sitting in the Oval Office, any resolution with China will be met with skepticism since it could unravel with a tweet. In an already slow-moving growth environment, these trade issues have increased the odds of an even greater slowdown in the economy.

In other tariff news Canada and Mexico came to a deal with the U.S. to lift tariffs on steel and aluminum, a move that was expected to help clear the path towards the ratification of the new United States-Mexico-Canada Agreement (USMCA). Unfortunately the good news was short lived as President Trump threatened a 5% tariff (yes, another tariff) on all Mexican imports effective June 10th if migrant issues were not resolved. This tariff threat put plans for the ratification of the USMCA on hold amid this new U.S./Mexico conflict. Luckily, Mexico and the U.S. did reach a deal in time for tariffs to not be put in place. However, the U.S. is still using the threat of tariffs should Mexico not comply with U.S. demands.

While growth may be slowing and tensions persist, Canadian economic data has been encouraging as of late, including record employment numbers. Parts of the Canadian economy could actually benefit from the U.S. tariff tantrum as the U.S. could look to source goods from other countries. However, should the trade dispute significantly hurt U.S. economic growth it would likely have a negative impact on the Canadian economy. As the old saying goes, when the U.S. sneezes Canada catches a cold.

Over to our portfolio, we have been calling for a slowing but still growing economic outlook through 2019 with no recession. Recent trade tensions with the U.S. have increased the odds of a recession, although expansion is still our base case. Whether the trade dispute gets settled or not, damage has been done to the global economy that should bring corporate earnings expectations lower. This is not yet reflected in the market. As such, we lowered our equity weighting by 2% and put the money into short term investments. Although we continue to believe a recession is not in the near future, the odds are increasing due to the trade wars so we moved a little out of equities to protect capital.

We are becoming more cautious on equities, but this does not mean you should completely exit this asset class. It's important to stay invested and on plan. These shifts are meant to add value and lower risk within our current asset mix.

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