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# US Turns to Tariffs for Border Security; Supply Chains, Larger Economic Concerns to Grow

- Last night, President Trump said the US would impose escalating tariffs on all Mexican exports, beginning at 5% on June 10, rising to as high as 25% on October 1. This is unless Mexico takes actions to "dramatically reduce or eliminate" illegal migration across the US border.
- **Financial markets have not come around to a clear consensus that the negative trade impact must inevitably be felt and worsen. While no one can be certain, that leaves markets vulnerable to a negative "overshoot."**
- **We reiterate our call to hedge portfolio risks from these unpredictable political developments. While we see US recession risks rising, particularly if the trade war spreads globally, we still can't argue that a shock is unavoidable.**
- More news that the US will use tariffs to enforce non-trade disputes will strongly add to suspicions that the US sees higher tariffs as a potential permanent substitute for dissatisfactory cooperation on trade and other matters. (Political analysts believe this mixing of "trade and security" makes reaching trade agreements more difficult. Just yesterday, the US Trade Representative moved to finalize details of the USMCA to spur action in Congress).
- The potential imposition of wide-ranging tariffs on a free-trade zone partner will create greater concerns about supply chains involving the US. While the direct economic impact of tariff increases on the US are equivalent to moderate tax increases, the potential hit to business confidence presents a larger risk. (We do not believe Fed easing can pre-empt or offset these concerns.)
- To scale the impact, 25% tariffs on Mexico's imports would equate to $85 billion in added US customs duties vs $135 billion for all Chinese goods imports at the same tariff rate (paid by US importers). While there is no certainty the tariffs will be imposed. If they are, we would expect much larger negative effects on Mexico's smaller, more US trade dependent economy than on China's. (Mexico exports to the US are 30% of Mexican GDP vs about 4% for China).
- The global autos sector is at greatest risk, as cross border autos trade accounts for 24% of gross US/Mexico trade (US autos and parts equities are off more than 4% today). The news may also impact sentiment regarding future US autos tariffs, potentially applied globally.
- The Mexican peso fell about 3% today which will cause Mexican import prices to decline further in USD terms. The Mexican peso is significantly less managed than China's currency, which is both a strength and a weakness for asset prices ahead.

## US Turns to Tariffs for Border Security; Larger Economic Concerns to Grow

Yesterday, the US Trade Representative sent final text to US Senate committees to help spur action replacing the North American Free Trade Agreement before the Congressional recess in August. The same day, the US announced escalating tariffs against one of NAFTA's two treaty partners to spur action on border controls.

These dueling actions must inevitably raise concerns regarding an important factor in the outlook for markets and the economy. The Mexico tariff news comes after national security questions were escalated over China's telecom gear maker Huawei. Trade talks between President Trump and Chinese President Xi are presumed to be ahead. On May 24, President Trump noted that a solution for Huawei could potentially be included in a trade accord with China.

**US national emergency declarations allow for wide-ranging actions on trade. Financial markets, however, are still finding great difficulty coming to grips with the uncertain new US approach**. Many see the actions as a hopeful spur to speed up trade action from the usual very long path required to reach agreements (see figure 1). Against this hope, however, **we are inclined to take President Trump at his word that the tariffs could serve as a permanent alternative if accords are not reached.**

As we noted in recent bulletins (and May 6th, May 13th, and May 21st) last year's reports (July 3rd, September 18th, December 3rd), the issue has a potentially large impact on US and global corporate profits. Mexico tariffs of 25%, if imposed, would more than double current tariffs on China. Mid-June US trade hearings, however, could raise US tariffs on Chinese merchandise much further. Summing these maximum tariff collections together – but leaving out what appears to be increasingly likely global autos tariffs – it amounts to 17% of large capitalization US corporate profits (please see our discussions of Autos and USMCA).

**Figure 1: Historically Trade Agreements Have Taken Years of Negotiations**

| Enacted Trade Agreements | First Proposed | Implemented |
|---|---|---|
| Canada-United States Free Trade Agreement | 1985 | 1988 |
| Israel-United States Free Trade Agreement | 1984 | 1985 |
| North American Free Trade Agreement | 1980 | 1994 |
| Jordan-United States Free Trade Agreement | 1996 | 2001 |
| Australia-United States Free Trade Agreement | 1945 | 2005 |
| Chile-United States Free Trade Agreement | 1992 | 2004 |
| Singapore-United States Free Trade Agreement | 2000 | 2004 |
| Bahrain-United States Free Trade Agreement | 1999 | 2006 |
| Morocco-United States Free Trade Agreement | 2003 | 2006 |
| Oman-United States Free Trade Agreement | 2004 | 2009 |
| Dominican Republic-Central America Free Trade Agreement | 2002 | 2012 |
| Panama-United States Trade Promotion Agreement | 2006 | 2012 |
| United States-Columbia Free Trade Agreement | 2004 | 2012 |
| United States-Korea Free Trade Agreement | 2006 | 2012 |

Source: Citi Private Bank as of May 30, 2019.

## Taking Chances With US Expansion Again

The notion that tariff actions can be isolated from larger economic spillovers is increasingly difficult to make. Owing to low inflation and relatively cautious US consumers, the US economy appears unusually sound for a period so far off from the last recession, with 10 years of uninterrupted economic growth in reach this coming month.

Historically, financial markets have been "magnifiers" of both boom and bust periods. Late last year, we believed financial conditions were becoming incompatible with continued US expansion. Yet the largest source of the stress – US monetary policy – reversed course. However, the Fed's 9 rate hikes and only gradual end to quantitative tightening leaves the US somewhat more susceptible to shocks than many other measures might suggest.

While **we believe US monetary policy could be *reactive* to an expansion-threatening shock, we do not see it as the source of the current set of risks, or the cure for them**.

As figure 2 shows, US small business optimism fell late last year, as have large business confidence readings and sector-level (manufacturing) confidence. The small business sector's confidence remains among the highest of these readings. In recent months, the drop in confidence has reversed some. Yet with international supply chains widely cited as a significant pain source by US producers, new pressures are likely to emerge. Sustained drops in US business confidence would weaken hiring intentions, with fewer job openings reaching completion.

Meanwhile, as figure 3 shows, financial markets can change the economics of tariffs quickly. Today's 3% drop in the Mexican peso will reduce Mexican import prices. However, the negative impact on Mexico's economy would easily outweigh such adjustments both sides of the border.

**Figure 2: US Small Business Optimism and Job Openings**

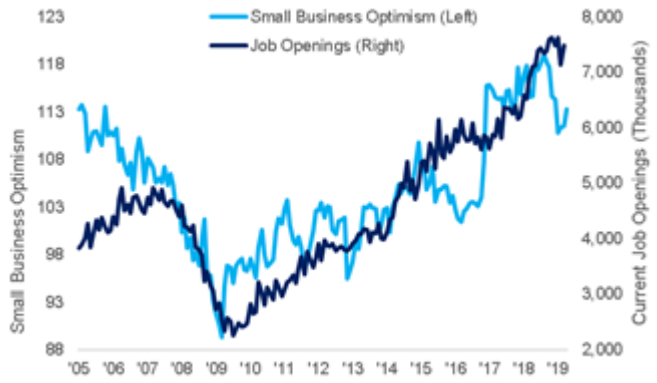
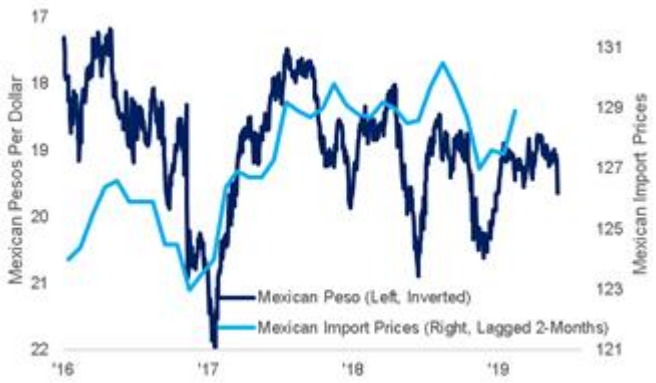



**Figure 3: Mexican Peso and US Import Prices from Mexico**




Source: Haver Analytics as of May 31, 2019.

As we noted in recent bulletins, markets are moving swiftly, but reactively to unpredictable trade policy news. This argues unusually strongly for outright risk hedges, particularly given how hedges are priced and the scope for greater than usual market movements (for discussion, please see Quadrant).

Notably, investor sentiment has quickly worsened (see figure 4). This poses downside risk for markets, but raises the potential for "violently strong" rallies if risks are alleviated by policy actions. (One has only to look to the performance of markets in December/January for a recent example). At the same time, we have to acknowledge greater downside risks to asset prices, and we rely on high quality fixed income holdings in our asset allocation as a ballast.

Meanwhile US shares seem a relative safe haven within global equities. Yet as figure 5 shows, the US equity market has reached 55% of world equity index market capitalization, well above the 23% share of world GDP measured in USD. It has reached this strong point through globalization, and trade risks pose a threat to US profits.

**Figure 4: S&P 500 and Investor Sentiment**

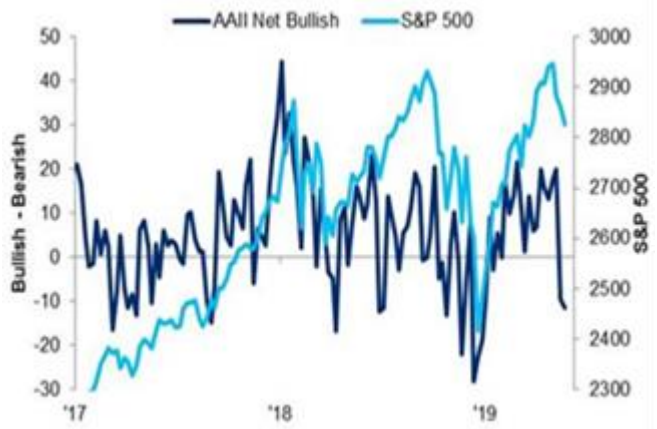
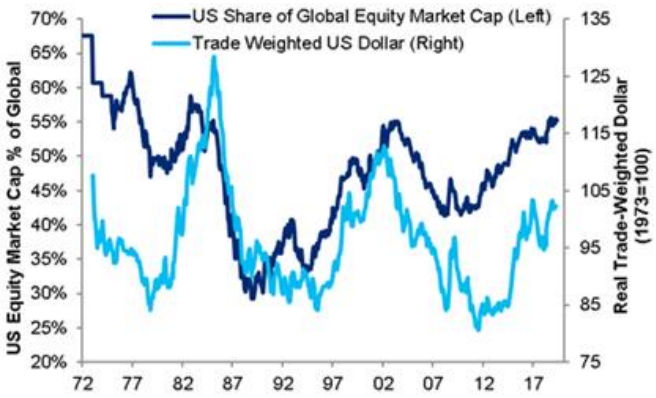



**Figure 5: US Share of Global Market Cap and Trade Weighted Dollar**




Source: Factset and Haver Analytics as of May 31, 2019.

Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

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