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WEEKLY INVESTOR RESEARCH

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Trump's trade policies: sacrificing long-term gain for short-term pain

By Jan Dehn

Last week's imposition by the US of fresh tariffs on Mexico shows that the Trump Administration is willing to mortgage the trust placed by other countries in American leadership. Trump's willingness to replace long-term global political planning in favour of short-term political opportunism marks a departure from 70-odd years of US foreign policy. In a nutshell, what is happening is that a long line of US presidents worked hard to build up global political capital and the Trump Administration has now decided to spend it. What does this mean for investors and policy makers in other countries, including EM?

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.8	–	1.24%
MSCI EM Small Cap	10.0	–	1.63%
MSCI Frontier	9.1	–	1.43%
MSCI Asia	11.5	–	0.06%
Shanghai Composite	10.0	–	1.76%
Hong Kong Hang Seng	7.6	–	-0.14%
MSCI EMEA	9.0	–	2.79%
MSCI Latam	11.2	–	3.97%
GBI-EM-GD	6.06%	–	0.60%
ELMI+	5.93%	–	0.00%
EM FX spot	–	–	0.07%
EMBI GD	5.99%	382 bps	0.17%
EMBI GD IG	4.17%	197 bps	0.63%
EMBI GD HY	8.13%	599 bps	-0.27%
CEMBI BD	5.56%	349 bps	0.15%
CEMBI BD IG	4.22%	216 bps	0.42%
CEMBI BD Non-IG	7.50%	542 bps	-0.22%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	14.9	–	-2.44%
1-3yr UST	1.91%	–	0.34%
3-5yr UST	1.91%	–	0.64%
7-10yr UST	2.13%	–	1.22%
10yr+ UST	2.58%	–	2.66%
10yr+ Germany	-0.20%	–	1.65%
10yr+ Japan	-0.09%	–	0.66%
US HY	6.57%	433 bps	-0.51%
European HY	4.43%	484 bps	-0.64%
Barclays Ag	1.64%	-49 bps	0.55%
VIX Index*	18.71	–	1.79%
DXY Index*	97.70	–	0.08%
EURUSD	1.1172	–	-0.20%
USDJPY	108.25	–	-1.16%
CRY Index*	175.36	–	-1.55%
Brent	61.2	–	-12.72%
Gold spot	1312	–	1.78%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

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Without warning or provocation, and in complete disregard of the terms of a recently agreed trade deal that was painstakingly negotiated in the first two years of his term, US President Donald Trump last week imposed tariffs on Mexico.

Mexico and the world were caught by surprise. Yet, this is just the latest in a long line of actions taken by the Trump Administration to unilaterally break agreements between the US and individual countries or groups of countries, including the Iran Nuclear Accord, the Global Climate Accord, TPP, NAFTA, etc. The fact that the US reneges on deals should therefore not surprise anyone. The fact that it does is revealing. The world, it seems, remains far too complacent about US risks. There is widespread denial about the fundamental policy shift, which is taking place in US, the deeper cause of the shift and its full implications for the world.

The fundamental shift taking place in US foreign policy is that the Trump Administration has decided to mortgage the trust placed in American leadership by other countries. This trust was won by successive US administrations since World War II. The shift replaces long-term global political planning with short-term political opportunism. In effect, after building up global political capital for decades the US has now decided to spend it. It is a break with 70-odd years of US policy.

This about-face in US policy is happening for two reasons. First, the US is no longer an unrivalled global leader able to achieve everything it sets out to accomplish. The end of the Cold War, rising living standards due to unprecedented economic convergence across vast swathes of Emerging Markets (EM), the rise of very large EM economies, such as China, as well as the formation of the European Union have all taken chunks out of America's ability to lead single-handedly. It is less fun to lead, when not everyone is willing to follow. Second, Americans have voted into power a leader, who seems perfectly willing to sacrifice the trust and respect, which came from positive American leadership in favour of the fear that, for a time, can be engendered, when a large country, such as the US throws its weight around. In other words, the leader has turned into a bully.

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Most countries around the world remain woefully unprepared for this change in direction of US policy. Many governments remain in complete denial. They are still hugely exposed to the US economic, financial and legal systems. It is precisely this dependence, which confers upon the Trump Administration a power, wielded through unilateral action, to inflict significant damage on other countries in the short run. Trump enjoys exercising this power, because it creates an impression of unrivalled US might, which has clear political benefits with a domestic US audience in the grip of heighted angst about globalisation and the rise of rival powers.

However, the benefits of bullying are pyrrhic. The new US policy mix is already inflicting economic costs not just overseas, but also at home. Take tariffs for instance, they are taxes, which are paid for by Americans. As such, they increase costs, undermine real incomes, cause the Dollar to become overvalued, increase incentives to rent-seek and sow uncertainty. They are already hurting the stock market, growth and business confidence. However, the larger costs may ultimately accrue from the pivot of America's foreign partners. As they reluctantly come to the conclusion that the US is a source of risk rather than reassurance, they will begin to develop alternative systems to reduce their exposure to the US. They will write contracts in other jurisdictions; they will funnel payments and settlements outside the US banking system; they will diversify away from trading and keeping their reserves in Dollars; they will establish other institutions for global governance without US veto powers. For example, Europe is moving away from relying on NATO and going it alone with respect to Iran and maybe even Russia.

As a populist with a very short time horizon, Trump is naturally not concerned about risks to America's standing in the world over the long term. In fact, the Trump Administration's focus rarely extends beyond the latest move in the stock market. However, both policy-makers overseas and institutional investors are likely to be a bit more forward-looking. They know that Trump's myopic policies will accelerate the erosion of America standing in the world. What are the costs associated with loss of leadership for America?

To start with, one must realise that US global leadership was richly rewarded. In exchange for modest contributions to global governance institutions and taking on the risks associated with being 'out front', the US achieved unparalleled influence within the world's governance institutions, which helped America shape the entire global financial, legal and economic framework in accordance with its own preferences and to its own benefit. Through its pivotal role in global defence alliances, the US was able to access more information and exercise more clout in global security matters than any other nation. Most importantly, the special status of the Dollar, hinging critically on trust, meant that the US had the world's most awesome macroeconomic insurance policy: access to almost limitless finance in periods of crisis, when most other countries around the world typically scramble even to maintain a foothold in global capital markets.

All these benefits are now at risk. The US is not pre-ordained to remain the global hegemon; it has to earn this coveted status every single day. The willingness of other countries to tie their fortunes to the US boils down to trust and efficiency. Other countries need to trust that the US exercises global leadership in a responsible fashion. They need to trust that the US will defend free and fair markets, democracy and global security. They need to trust that the US will take the lead in dealing with global challenges, such as underdevelopment, security issues, financial instability and climate change. They see the efficiency of being part of a single US-sponsored system with one currency for international trade and finance, one legal system for global contracts, one banking system for settling transactions, but the efficiency of the system means nothing to them if the sponsor of the system is an abuser.

By breaking the trust vested by others in America, the Trump Administration is therefore cutting off the branch it is sitting on. But does the Trump Administration care? Probably not. As such, between now and the November 2020 Presidential election, there is certainly a risk that the US Administration doubles down on its current hostile stance towards the rest of the world. However, there is also a hope, which we share, that the economic consequences of Trump's inept policies turn out to be so bad for the domestic US economy that change becomes necessary. That is exactly what happened last year. When the US economy began to slow in response to Trump's declaration of trade war with China his Administration soon turned tail and began to seek a deal with China. The recent return to hostility took place after the US racked up 3.2% real GDP growth in Q1 2019, but growth and stock markets are now once again turning south, so a deal with China – and possibly one with Mexico too – may well be on the cards despite the high levels of hostility at the present moment. Assuming, of course, that Trump is rational enough not to gamble away his re-election chances in 2020.

Even if Trump U-turns again, however, the underlying reality of declining American leadership and the challenges to US economic hegemony will not go away. Low productivity, high levels of debt, an overvalued currency, inability to reform and a worrying surge in populism in the US are not the pillars upon which global leaderships is re-established. Besides, America needs to come to terms with the fact that the growth of other nations and the eventual loss of global leadership are the very fruits of successful global leadership. Granted, this is not easy to internalise. Consider the UK. More than 70 years after Indian independence, which marked the beginning of the end of the British Empire, and despite continuing prosperity, Britain is still struggling immensely to come to terms with its decline as global hegemon in a larger, richer and ultimately better world. The US may well face similar challenges in coming to terms with the success of others.

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It is not just UK and US which struggle to define their new roles, other countries around the world do so too. In a world where a defensive US is becoming a source of risk, other countries must increasingly take responsibility for their own affairs. A good place to start would be simply to accept reality. It is time to stop blindly entrusting financial, legal and economic matters to the US system. South Africa, India, Mexico, Turkey, Russia, China and many other countries have already found themselves on the receiving end of Trump's desire to Make America Great Again. Others will surely follow. When sufficiently enough countries have been burnt surely the momentum will increase to build new global institutions, which rely less heavily on US involvement.

Until that happens, however, the world will continue to operate within a system, which simply gives too much power to the US and so too much power to Trump. This means, in our opinion, that in today's world the US remains the single largest source of global volatility. Europe is not yet ready to replace the US as global leader due to internal weaknesses, while the world is not yet ready to accept China's destiny as global hegemon due in the main, we believe, to sheer prejudice. Prudent investors should expect more beggar thy neighbour policies and rising costs of doing business well into the medium term.

What makes things even worse is that markets are abysmal at pricing in risk in developed economies, especially the US. Every single major global risk aversion event in the past twenty years – as measured by spikes in the VIX index – has emanated from developed economies, not EM. The mere fact that the risks are never adequately priced in for developed countries makes them riskier than EM countries. In addition, after years of hyper-easy monetary policy stimulus, asset prices are sky-high, while the fundamental backdrop is clearly worsening, both economically and politically. A sober assessment of these facts argues for a decisive program of diversification away from exposure to US markets at this point.

- China: The Chinese government is compiling a list of foreign companies that it deems to be unreliable. We highlighted this risk in last week's Weekly. Trump's decision to restart trade hostilities with China have given the Chinese an excellent opportunity to identify, which firms turn tail and which ones remain loyal to China in times of stress. Armed with this knowledge, China will be able to award future contracts only to those companies, which did not betray the Middle Kingdom. Any ambitious company other than the most myopic will take note. There is no doubt, in our view, that China will have a great deal to offer in terms of growth, reforms and potential to expand markets in the coming decades. By contrast, the US offering will suffer from diminishing returns due to debt, declining productivity, inability to reform, extremely overvalued markets and populism. In other news, official manufacturing PMI softened to 49.4 in May versus 49.9 expected, but the Caixin manufacturing PMI held its own at 50.2, unchanged from last month. Services PMI was also unchanged at 54.3. Manufacturing is typically more sensitive to sentiment shifts than services due to larger fixed costs in production.

- India: Newly re-elected Prime Minister Narendra Modi announced his Cabinet, which the market received well. The appointment of Nirmala Sitharaman to the post of finance minister is particularly welcome news. She is a former Defence Minister, Commerce Minister and junior Finance Minister. She has formal training in economics and gained private sector experience in London. She will be busy immediately. The Indian economy decelerated in Q1 2019, racking up 'only' 5.8% real GDP growth, but May got off to a good start with the Nikkei PMI rising to 52.7 from 51.8 in April. Businesses probably curtailed private investment in the run-up to the election, but now that the political uncertainty is over we expect business confidence to recover. The new Administration is also likely to shape an economic program to get activity going again. Besides, inflation remains low, so rate cuts from the Reserve Bank of India are a distinct possibility. In other news, the Trump Administration removed India from the list of countries eligible for tariff free trade with the US under the Generalised System of Preferences (GSP). A total of USD 5.6bn of trade will be affected.

- Mexico: President Andres Manuel Lopez Obrador (AMLO) reacted with restraint to US President Donald Trump's unprovoked announcement of escalating tariffs. Trump tweeted that he would impose a 5% tariff on all Mexican imports as a measure to curb illegal immigration starting on 10 June and that the tax rate applied to Americans importing Mexican products will increase by 5% every month until it reaches 25% by October, unless Mexico fixes the problem of illegal immigration. AMLO responded with a conciliatory (but firm) letter requesting that the issue be resolved via bilateral dialogue. He stated that Mexican officials are travelling to Washington to meet US representatives in person. Mexicans are excellent diplomats, so we would not be surprised if they eventually return with a bag full of US taxpayers' money for all kinds of projects to strengthen the border. Meanwhile, the Mexican peso obviously took a hit in response to the tariff news. This is because American companies and households now have to pay tax on goods from Mexico. This hurts their spending power and results in fewer Dollars flowing to Mexico. Meanwhile, Mexican exporters will be able to find new markets given the lower peso. Incidentally, nearly 70% of all US imports from Mexico involves intra-company trade and some 40% of imports are intermediate goods. In other words, American companies will certainly be hurt very badly by these tariffs. In other news, Mexican real credit growth was a solid 5.8% yoy in April and the rate of unemployment was 3.50% in April versus 3.57% expected. The former CEO of PEMEX, Emilio Lozoya, was arrested on charges of corruption. This is the first concrete manifestation of AMLO's stated objective of rooting out corruption in public life. We strongly welcome AMLO's fight against corruption. Similar anti-corruption movements are gaining ground in many other EM countries as the middle classes gain greater prominence.

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- **South Africa:** President Cyril Ramaphosa unveiled a slim Cabinet of just 28 ministries, down from 36 previously. Tito Mboweni, a former governor of the Central Bank, returns as finance minister. Pravin Gordhan, a graft-fighting former finance minister, remains in charge of cleaning up public enterprises. These are strong re-appointments. Ramaphosa will outline his policy priorities at the State of the Nation address on 20 June.

- **Africa:** Twenty-four out of fifty four African states have ratified the African Continental Free Trade Area (ACFTA), which took effect last week. ACFTA aims to move African countries towards a single market for goods, services, investment and people along the lines of the European Union. The agreement could increase intra-African trade by at least 50%, according to the UN Commission for Africa. In order to realise its full potential, African countries will also need to improve transport and communication infrastructure between countries.

Snippets:

- **Argentina:** Peronist Sergio Massa has entered into talks with the Alberto Fernandez/Cristina Kirchner duo to explore the possibility of forming a broad election alliance to face President Mauricio Macri in the presidential election on 27 October this year.
- **Brazil:** At BRL 6.6bn, the public sector primary surplus in April was more than twice as large as last year (BRL 2.9bn). Unemployment declined to 12.5% in April from 12.7% in March. The real economy expanded at a yoy rate of 0.5% in Q1 2019 with investment still a drag pending passage of the pension reform in parliament.
- **Chile:** The rate of unemployment ticked up to 6.9% in April against a backdrop of rising labour participation. In April, industrial production rose broadly for the second month in a row.
- **Colombia:** The central bank suspended its program to accumulate reserves.
- **Croatia:** Retail sales were up at yoy rate of 4.8% in May. The real economy expanded at a strong pace of 3.9% yoy in Q1 2019.
- **Czech Republic:** Real GDP growth in Q1 2019 was 2.6% yoy.
- **Hungary:** Q1 2019 real GDP growth was solid at 5.3% yoy. The Hungarian central bank left the policy rate unchanged at 0.9%. Malaysia: Exports were significantly stronger than expected in April, rising at a yoy rate of 1.1% compared to the consensus expectation of -2.1% yoy. The trade surplus was MYR 10.9bn.
- **Poland:** The real economy expanded at a firm yoy rate of 4.7% in Q1 2019, which was marginally above expectations (4.6% yoy).
- **Serbia:** Retail sales expanded at a solid pace of 6.7% yoy in April.
- **Slovenia:** The Q1 2019 real GDP growth rate was 3.2%, which is solid albeit slightly below expectations. Slovenian inflation was 1.4% yoy in May.
- **South Korea:** Exports were down 9.4% yoy on softer exports to China, a consequence of Trump's trade war. Still, industrial production surged 1.6% mom in April, well ahead of consensus (1.0% mom). Bank of Korea left the policy rate unchanged at 1.75%.
- **Thailand:** Private consumption and investment edged higher in April. The trade balance was in balance.
- **Turkey:** The economy is back in black. Real GDP expanded 1.3% in the first quarter after contracting 2.4% in Q4 2018. Fiscal stimulus aided the economy, but the wider macro economy remains out of balance so Turkey is not out of trouble.

Global backdrop

In a welcome outbreak of rationality, EM outperformed US markets last week. EM stocks racked up 1.24% return, while US stocks declined 2.44%. EM currencies were marginally stronger than the Dollar, despite the big shift lower in the Mexican peso. EM local currency bonds delivered a solid 60bps return. The difference between EM yields and US/European yields is now extremely enticing. US stocks and Treasury bond yields declined mainly in anticipation of serious negative consequences for the US economy from President Donald Trump's inept economic policies, especially on trade. In Europe, Euro-area economic sentiment improved 1.2 points to 105.1 and German job growth was strong at roughly 1% per month. Eurozone credit growth recorded the strongest month in this cycle so far, but Italian real GDP growth was softer than expected (0.1% qoq versus 0.2 % qoq consensus).

In the UK, a new poll from YouGov showed that the Liberal Democrats, which until recently were roaming around in the political wilderness, would obtain 24% of the votes if a general election took place today. They would be followed by Brexit Party with 22% support. The mainstream Conservative and Labour parties would only get 19% each. In other words, the UK political landscape is currently completely transformed. This is because voters have wholeheartedly rejected the inept handling of Brexit by both main political parties.

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Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	-7.23%	-5.26%	4.16%	-8.36%	10.34%	2.17%
MSCI EM Small Cap	-4.90%	-4.69%	2.72%	-14.43%	5.24%	0.34%
MSCI Frontier	2.23%	2.19%	9.25%	-1.09%	6.28%	-1.28%
MSCI Asia	-8.51%	-6.77%	3.89%	-10.86%	10.42%	4.27%
Shanghai Composite	-5.56%	-5.92%	16.61%	-4.08%	2.03%	9.77%
Hong Kong Hang Seng	-9.12%	-7.81%	3.62%	-9.54%	10.72%	4.30%
MSCI EMEA	-3.64%	1.39%	7.06%	-0.89%	8.13%	-1.72%
MSCI Latam	-1.99%	-1.55%	6.26%	8.57%	12.99%	-0.85%
GBI EM GD	0.30%	0.12%	3.04%	0.35%	4.37%	-1.32%
ELMI+	-0.66%	-0.59%	0.88%	-0.69%	2.96%	-1.01%
EM FX Spot	-0.96%	-1.17%	-0.91%	-5.75%	-1.98%	-7.31%
EMBI GD	0.41%	0.66%	7.65%	7.46%	5.46%	4.67%
EMBI GD IG	1.31%	1.90%	7.98%	9.42%	4.97%	4.29%
EMBI GD HY	-0.46%	-0.54%	7.43%	5.54%	6.07%	4.88%
CEMBI BD	0.49%	1.27%	6.49%	7.38%	5.39%	4.52%
CEMBI BD IG	1.05%	1.78%	6.64%	8.39%	4.50%	4.09%
CEMBI BD Non-IG	-0.27%	0.58%	6.26%	6.07%	6.88%	5.05%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	-6.35%	-2.56%	10.73%	3.78%	11.71%	9.64%
1-3yr UST	0.74%	0.94%	1.94%	3.49%	1.32%	1.10%
3-5yr UST	1.48%	1.57%	3.18%	5.46%	1.59%	1.83%
7-10yr UST	2.99%	2.54%	5.48%	8.63%	1.83%	2.96%
10yr+ UST	6.54%	4.64%	9.52%	11.02%	3.01%	5.39%
10yr+ Germany	3.58%	2.20%	7.75%	10.56%	3.46%	7.21%
10yr+ Japan	1.48%	0.83%	4.16%	4.78%	0.58%	4.81%
US HY	-1.19%	0.22%	7.49%	5.51%	7.04%	4.40%
European HY	-1.68%	-0.34%	5.28%	2.23%	4.11%	3.74%
Barclays Ag	1.35%	1.05%	3.28%	3.09%	1.86%	0.90%
VIX Index*	0.00%	36.47%	-26.40%	39.00%	38.90%	57.62%
DXY Index*	-0.05%	0.42%	1.58%	3.76%	3.90%	21.28%
CRY Index*	0.00%	-4.56%	3.28%	-13.06%	-7.05%	-42.51%
EURUSD	0.02%	-0.40%	-2.59%	-4.50%	-1.72%	-18.02%
USDJPY	-0.03%	-2.35%	-1.32%	-1.42%	1.61%	5.60%
Brent	-5.12%	-10.53%	13.74%	-20.32%	23.27%	-43.77%
Gold spot	0.49%	1.51%	2.29%	1.54%	5.44%	5.37%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.

Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.

Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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