PERSPECTIVES

Three Things to Think about When It Comes to Trade

June 12, 2018

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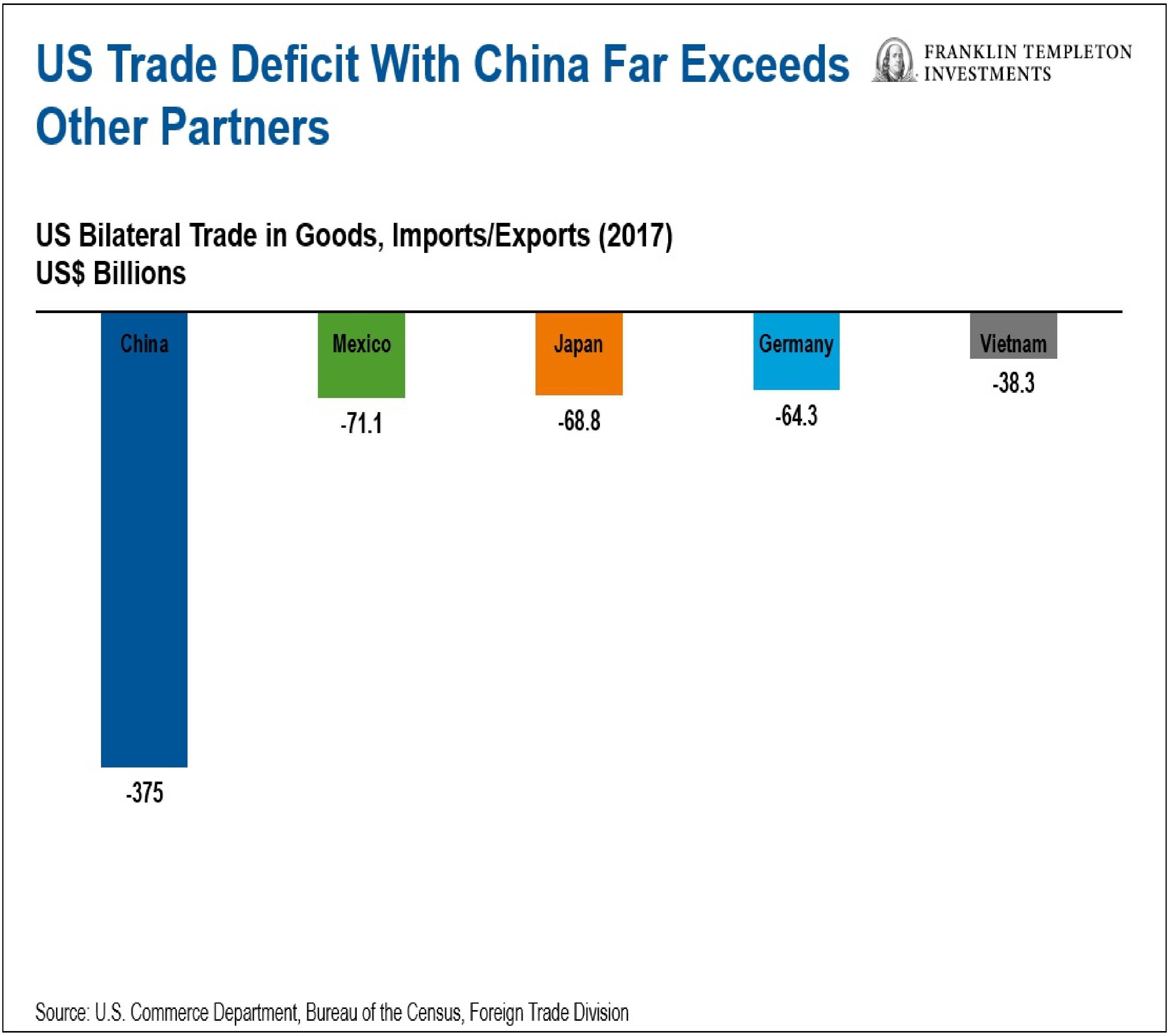
As the Trump administration continues to threaten tariffs targeting a variety of imported goods, from electronics to washing machines to automobiles, many market commentators have suggested the US-led trade skirmishes could turn into a trade war.

While the fear of a potential trade war has heightened market volatility, our investment leaders haven't been overly concerned that the trade disputes will derail the global economy—at least not yet.

Here, we highlight three things for investors to think about when it comes to global trade and the markets.

1. China is the US' Largest Trading Partner

While there are a lot of misunderstandings about global trade, the fact is, China is the largest US trading partner in terms of goods, with $636 billion in bilateral trade during 2017.[1] And, as the chart below shows, the US trade deficit with China stood at $375 billion, as of 2017.[2] This imbalance—far larger than with other US trading partners on an absolute basis—is often cited as a reason for tariffs.



While perhaps the bigger global economic threat is a rise in protectionism, trade can't simply be shut off between China and the United States, as Franklin Templeton Emerging Markets Equity's Sukumar Rajah noted recently:

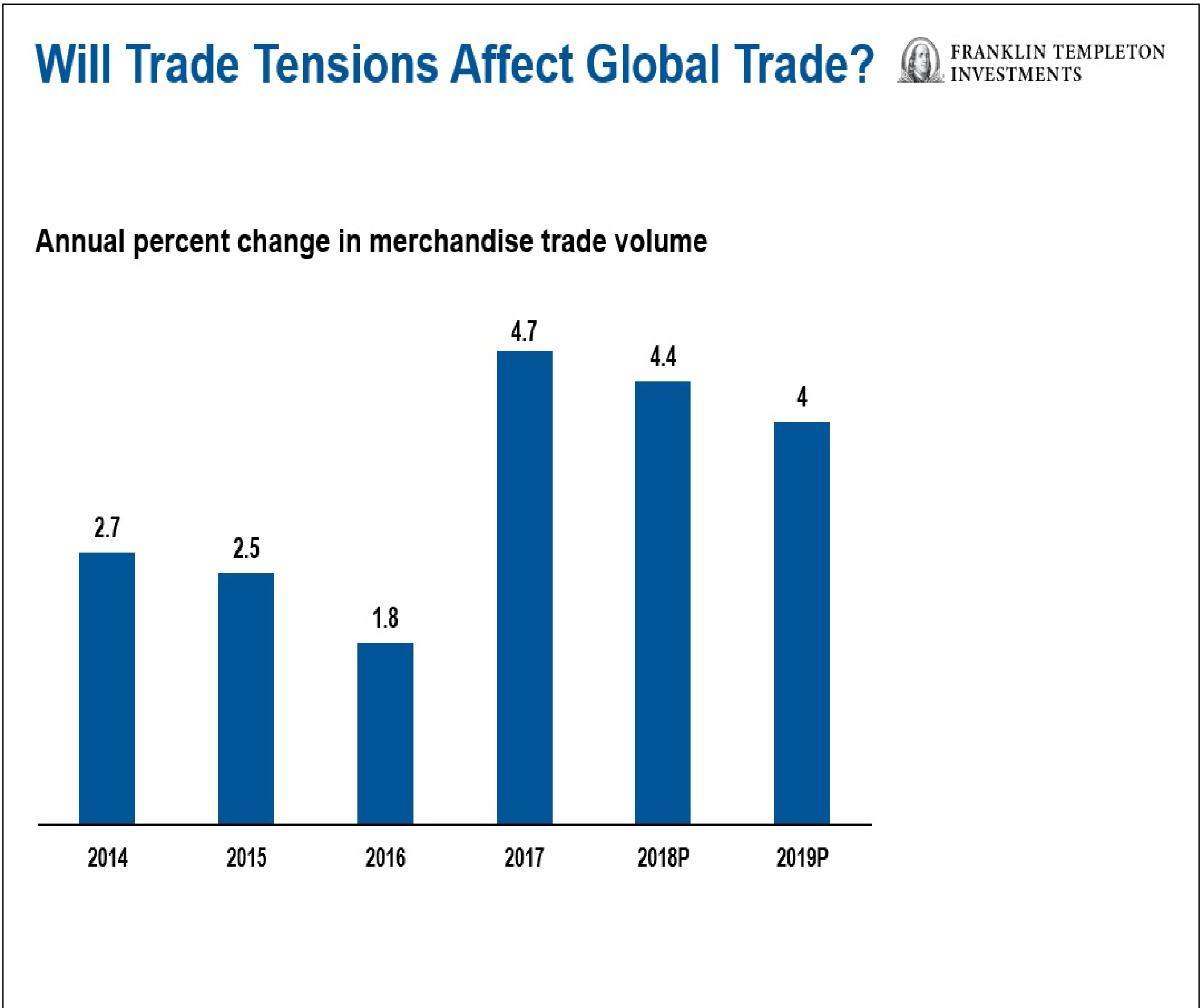
> "This issue is another example of a trend of rising protectionism globally that remains a potential risk facing the markets. But despite the tit-for-tat measures we've seen between United States President Donald Trump and Chinese officials, we don't think this war of words will affect China in the long term. In our view, the importance of bilateral trade for both sides should ensure they maintain stable relations. Without stable relations, it would be more difficult for Chinese or US companies to navigate complex international supply chains."

Sukumar Rajah, April 23, 2018.

2. Trade as a Driver of Global Growth

While global growth has been strong in the last few years, escalating trade tensions could have a detrimental impact. In a commentary in April, the World Trade Organization (WTO), the intergovernmental organization that regulates international trade between countries, warned of the impact of restrictive trade policies on global growth.

As the chart below shows, the WTO projects world merchandise trade volumes to increase by 4.4% in 2018. However, it said economic activity would likely “take a hit from escalating trade restrictions, which could result in more negative scenarios being realized.”[3]



Source: World Trade Organization, “Strong trade growth in 2018 rests on policy choices,” April 12, 2018. There is no assurance that any projection, estimate or forecast will be realized. For illustrative purposes only.

> "The strong trade growth that we are seeing today will be vital for continued economic growth and recovery and to support job creation. However, this important progress could be quickly undermined if governments resort to restrictive trade policies, especially in a tit-for-tat process that could lead to an unmanageable escalation. A cycle of retaliation is the last thing the world economy needs."

World Trade Organization, April 12, 2018.

In a recent video, three of our senior investment leaders addressed how trade tensions could affect their outlooks for global growth. They say the global economy seems healthy enough to weather the trade disputes.

Here's what Franklin Templeton's head of Equities, Stephen Dover, had to say:

> "In our view, the underlying earnings growth we anticipate from the US tax cuts this year and going forward, along with falling interest rates in some countries, are likely to be bigger near-term influences [on global growth] than trade."

Stephen Dover, April 12, 2018.

3. Trade Issues Have Ripple Effects

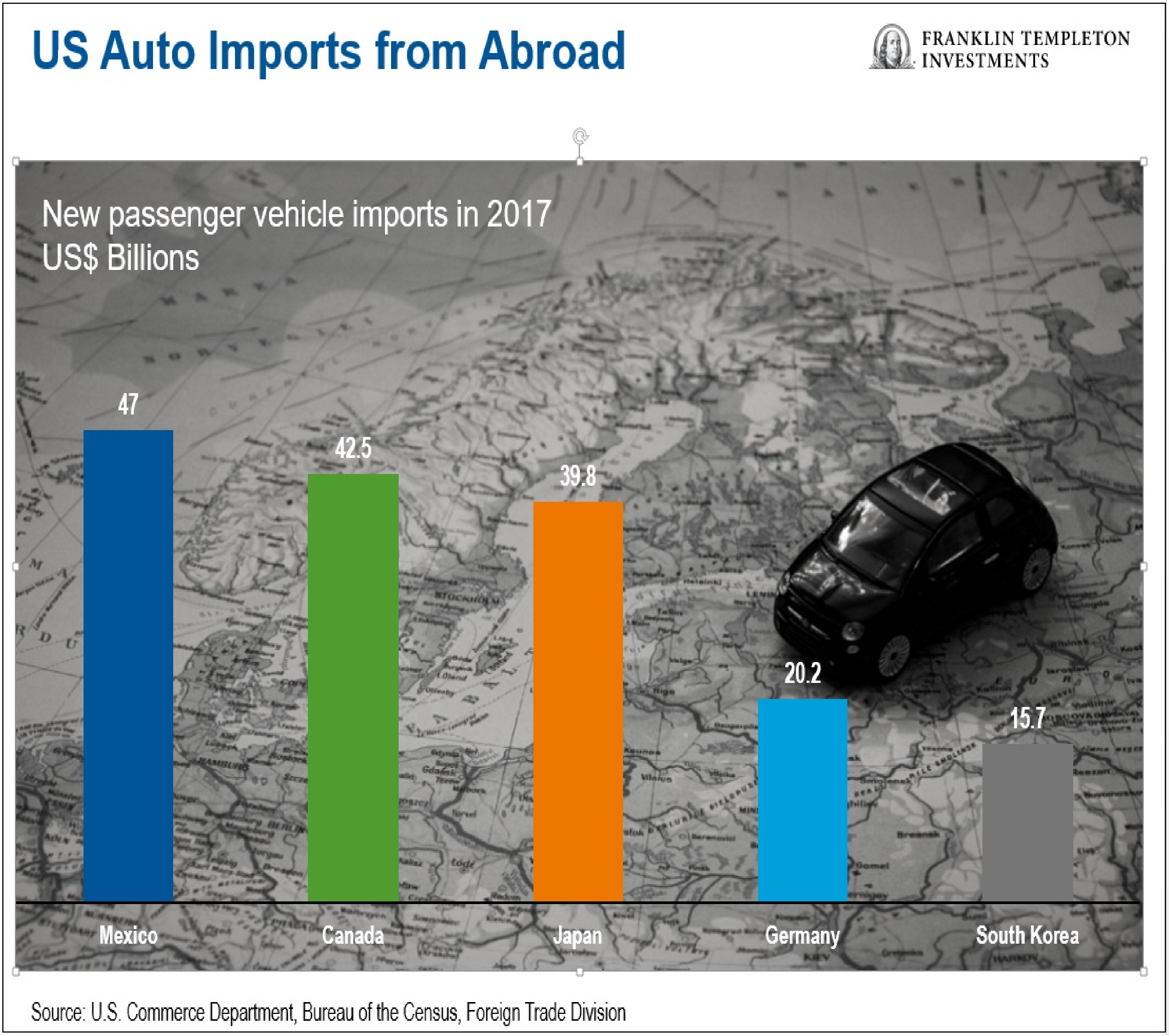
While most of the media focus in regard to trade so far has been on the relationship between the United States, its traditional allies and China, our investment professionals note there are many ripple effects on markets around the world.

In this article, Chris Siniakov, our managing director of Australian Fixed Income, explains why Australia's goods and services sectors depend on China.

> "So far, the net effect of Trump's ambit claim and China's response has been relatively mild. However, should trade-policy tensions escalate … then we would expect that China could respond more forcefully on services to offset a decline in goods exports and to maintain a net trade surplus."
>
> Chris Siniakov, May 2, 2018.

In addition, Franklin Templeton Multi-Asset Solutions' Stephen Lingard thinks the entire North American automobile industry would suffer if Canada and Mexico are forced to pay announced US tariffs on steel and aluminum.

As the chart below shows, as of 2017, Canada and Mexico are the top two US exporters of vehicles to the United States, so the industry is an important one for all three countries.



And who might pay the price of all these tariffs? According to Templeton Global Macro's Michael Hasenstab, the end result could mean a big dent in consumers' pocketbooks.

> "I think underpinning this is the Trump administration's view that these free-trade agreements were not good for the United States…I don't think it ends trade, but certainly the price of goods…that's going to be shifted from benefiting the consumer to maybe benefiting a narrower sector of manufacturers that make those [goods] within the United States. And so, prices go higher."
>
> Michael Hasenstab, February 15, 2018.

Franklin Mutual Series' Katrina Dudley thinks if companies can't pass on higher costs to consumers, it could lead to near-term margin pressures.

> "We think an outright trade war is a low-probability event, but it is a risk we continue to monitor. The imposition of trade barriers—and how they are implemented—is something we think needs to be considered, in particular the potential impact on supply chains."
>
> Katrina Dudley, June 1, 2018.

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1. Source: U.S. Commerce Department, Bureau of the Census, Foreign Trade Division, "Top Trading Partners – December 2017."

2. Ibid.

3. Source: World Trade Organization, "Strong trade growth in 2018 rests on policy choices," April 12, 2018. There is no assurance that any projection, estimate or forecast will be realized.