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Trade Update: Communication breakdown

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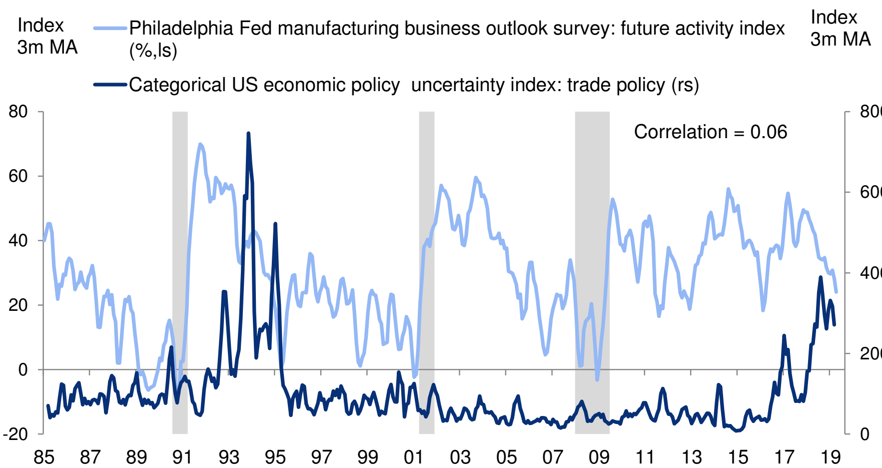
As we anticipated at the beginning of the week (see "Trade Update: Raising the stakes"), the US administration has raised the tariff rate on $200 billion (bn) of imports from China from 10% to 25%. President Trump has also maintained his threat to levy 25% tariffs on the roughly $340 billion of Chinese imports not currently being penalized. We remain of the view that the two sides will eventually reach an agreement without another material escalation given strong interest from both sides to avoid further tensions. But this week's breakdown in discussions indicates that the market reaction and negative impact on economic data may need to intensify before the two sides are willing to compromise on the remaining key structural disagreements.

In terms of the impact, we had already built an escalation of tariffs on imports from China into our forecast last summer (see "US outlook bends but doesn't break as trade stakes rise"). We assumed an increase to 25% on $200bn of goods that would last for several quarters, which we concluded would subtract around one-tenth from US growth over a year and add a similar amount to core inflation. These assumptions are unchanged.

Given the fluidity of the situation, we see the June 28 G-20 meeting in Japan as an upcoming possible date to provide an off-ramp to diffuse tensions. In the meantime, details from this week's talks and China's retaliation should provide some insights into the near-term trajectory of the negotiations. As our colleagues in Asia noted (see "US hiked tariff. What's next?"), China will likely retaliate by increasing tariffs on $60bn of US exports to China. It announced this list of goods last year but the tariffs were not fully implemented. In the coming days and weeks we will also be closely watching the performance of risk assets and business sentiment indicators to gauge whether either side should face greater incentive to compromise on key sticking points.

As Figure 1 illustrates, news-based measures of economic uncertainty have risen materially over the past year. The last time trade tensions were this elevated was 1993 - 1995, when the US was preparing to ratify the NAFTA agreement. Note that the Philadelphia Fed survey on the outlook for business activity fell notably over this period. While tax reforms and the boost from fiscal stimulus likely dulled the impact of rising trade tensions last year, the buffer from these policies is now smaller and could be less effective going forward.

Figure 1: Business sentiment deteriorated meaningfully the last time trade policy uncertainty was elevated



Source : PolicyUncertainty.com, Philadelphia Fed, Haver Analytics, Deutsche Bank

While recent events have raised the risk of adverse developments beyond the latest increase in tariffs, we continue to see only a small probability of the US implementing tariffs on the remaining portion of imports from China not currently subject to tariffs, which are skewed heavily towards consumer items. Similarly, we do not anticipate an increase in global auto tariffs that ensnares Europe and Japan. As a reminder, Saturday, May 18 is the deadline for a Section 232 action related to autos (see "Trade Update: A progress report and rough timetable for action"). In our view, the most likely outcome is that President Trump will delay any action on the Section 232 auto investigation by at least several months – newsflow has suggested six months – as negotiations continue with China, the EU and Japan. Along with an unfinished USMCA deal, a breakdown on any or all of these fronts could materially dent the US and global growth outlook (see "If the crosscurrents strengthen, how far could global growth fall?"). If financial markets and the data continue to hang in well, however, the US administration could feel emboldened to escalate tensions on these additional fronts.

For the Fed, Chair Powell noted in his prepared remarks at the May FOMC meeting that "there are reports of progress in the trade talks between the United States and China." Fed officials, who have uniformly emphasized data dependence in recent months, would likely want to await any fallout on financial conditions and US data from an escalation of trade tensions and not act pre-emptively. We anticipate they would be willing to look through the "transitory" boost to inflation and focus instead on the possible negative shock to global growth. A more severe deterioration in the negotiations, however, could impact financial conditions and/or sentiment by enough to warrant Fed action.

Appendix 1

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