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Strategy Update

US Equities And The Trade War: -$5 Trillion And Counting

Binky Chadha
Chief Strategist
+1-212-250-4776

Parag Thatte
Strategist
+1-212-250-6605

Christian Arita
Research Associate
+1-212-250-2964

The direct impacts of tariffs on the overall economy are widely estimated to be small. This is not surprising as bilateral merchandise trade flows represent a small proportion (2%) of combined US and China GDP. Changes in tariffs or taxes on a small portion of overall activity will necessarily be small. Symmetrically though, any long term gains stemming from or to such a small proportion of overall activity, are also likely to be small. The costs of the trade war in our view are about its indirect impacts. Arguably the largest of these has been the huge (-$5 trillion) cost in terms of foregone equity returns. The bulk of equity returns comes from equity price appreciation and over the course of this recovery the S&P 500 has risen in a clear trend channel with price appreciation at an annual rate of 12.5%. But equities have been in a range for 17 months now, coinciding with the beginning of the trade war. While other factors also arguably played a role, the trade war has been key in preventing a recovery in global growth and keeping US equities range bound. Foregone US equity returns from price appreciation (12.5% ar) for 17 months are worth $5 trillion. The current episode is fast becoming comparable to the impacts of the European financial crisis and the dollar-and-oil shocks on US equities. The foregone equity returns are already worth 12 years of the bilateral trade deficit with China.

The direct impacts of tariffs on the overall economy are widely estimated to be small

An argument for incurring the short term costs from a trade war is that the longer term gains justify them. Indeed most estimates of the direct impact of the implemented and proposed tariffs on GDP and inflation find them to be small, ranging from a tenth to a third of a percentage point of GDP (DB: US Outlook Bends But Does Not Break, Peter Hooper, Aug 2018). After all, the size of the US economy as measured by GDP is $21 trillion; the Chinese economy, at market exchange rates, $14 trillion; and combined $35 trillion. Bilateral merchandise trade flows on the other hand (US imports plus exports) are around $700bn or just 2% of that. So tariffs, i.e., taxes imposed on bilateral trade flows, fall on a very small proportion of the overall economies and any estimate of the direct impact of changes in them will necessarily be very small in the aggregate. Adding in the sales of US companies' subsidiaries in China of $220bn, which could be subject to retaliatory measures, would raise the proportion of overall activity impacted, but only to 2½% (DB: US Business Interests In China, Zhiwei Zhang, Mar 2018). Finally even if one were to assume that the costs were to paid entirely by only one of the countries, say the US, as is the consensus of economists for the tariffs implemented so far and what the empirical evidence suggests, this would raise the proportion of overall activity impacted but to a still modest 4.4% of US GDP.

But if the direct impacts on overall activity are small, the same logic also suggests that the direct long run gains in the aggregate will likely be small, and any economic justification has to be distributional

The back-of-the-envelope calculations above illustrate that the incidence of tariffs falls on a base which is a relatively small share of overall economic activity. But symmetrically this implies that the gains accruing to, or from, changes to what is a small proportion of overall economic activity will likely also be small. There are of course other possible justifications such as distributional consideration, i.e., certain segments of the economy or groups that are losers in the status quo traded off against the winners.

The costs of the trade war in our view are really about its indirect impacts. Arguably the largest of these has been the huge (-$5 trillion) cost in terms of foregone equity returns

Most observers understandably throw up their hands in estimating the indirect impacts and costs of the trade war on the economy. The spectrum of possibilities for the effects of uncertainty created for investment spending and the costs of relocating supply chains is wide. But the equity markets are a discounting mechanism for pricing the longer term gains versus the short term costs and where the impacts of uncertainty and expectations of such costs and implications for economic growth should arguably be immediately evident. What are the equity markets saying? Equity markets hit new highs last month and so far are down about -5.5% from their peak. This is only slightly outside the range of typical pullbacks of 3-5% that have historically occurred every 2-3 months. It is tempting therefore to conclude that equity markets are complacent or even pricing in the long term gain relative to the short run pain. We would disagree strongly:

- **The bulk of equity returns (75%-85%) comes from equity price appreciation.** The proportion of total equity returns coming from price appreciation historically have been 75% to 85%: since 1900, outside recessions (76%); since 2010, excluding the sharp increase following the overshoot during the GFC (82%); and since the Trump election (80%).
- **Equities have been range bound for 17 months now, coinciding with the beginning of the trade war.** Since this economic recovery began in 2009, the S&P 500 has risen in a clear trend channel with 12.5% price appreciation at an annual rate. For the third time in this recovery, equities have become range bound for an extended period. The beginning of the current range bound period coincided with the imposition of tariffs on first washing machines and then Steel and Aluminum in January 2018. While the recent new peaks in equities were widely heralded, it is worth noting that the recent peak was only 2.5% above last January's peak and 0.5% above last September's peak. We would grant that other factors such as the slowing in global growth for other reasons such as Brexit and other political risks in Europe, and the slowing in China would have likely happened anyway. But in our view the trade war played a key role in exacerbating global growth in manufacturing and in preventing a recovery from these factors. As we noted last year, beginning in May and through September US equity markets saw a severe defensive rotation that coincided with the escalation of the trade war.
- **Foregone equity returns from price appreciation (12.5% ar) for 17 months are worth $5 trillion.** The Russell 3000, a broad measure of equity markets,

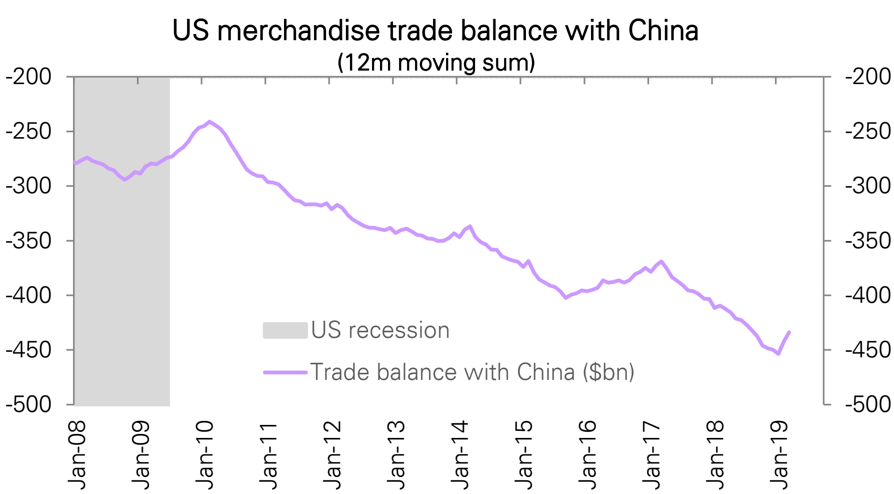
had a capitalization of $28.7 trillion at the start of 2018. Foregone equity returns for 17 months (12.5*17/12) are thus worth $5 trillion.

- **The current episode is fast becoming comparable to the impacts of the European financial crisis and the dollar-and-oil shocks to US equity markets.** The previous two episodes of extended range-bound behavior were (i) in 2011-2012 around the US debt downgrade and then the European financial crisis; and (ii) following the dollar and oil shocks of 2014-2016. In terms of duration, the current episode is still 5-6 months short of those two episodes. But it is notable that the current episode has occurred in a context of significantly stronger US macro and earnings growth and a lower unemployment rate.
- **The foregone equity returns are already worth 12 years of the bilateral trade deficit with China.** While we subscribe to the consensus view that US trade deficits reflect macro and not micro factors and trade policy initiatives are unlikely to have any impact on them, the point is that even if one did take the opposite view that the bilateral trade deficits are bad and that trade policy would fix them, the cost in terms of foregone equity returns is already worth 12 years of that bilateral merchandise deficit.

Figure 1: As US merchandise imports from China have risen more than exports in dollar terms …

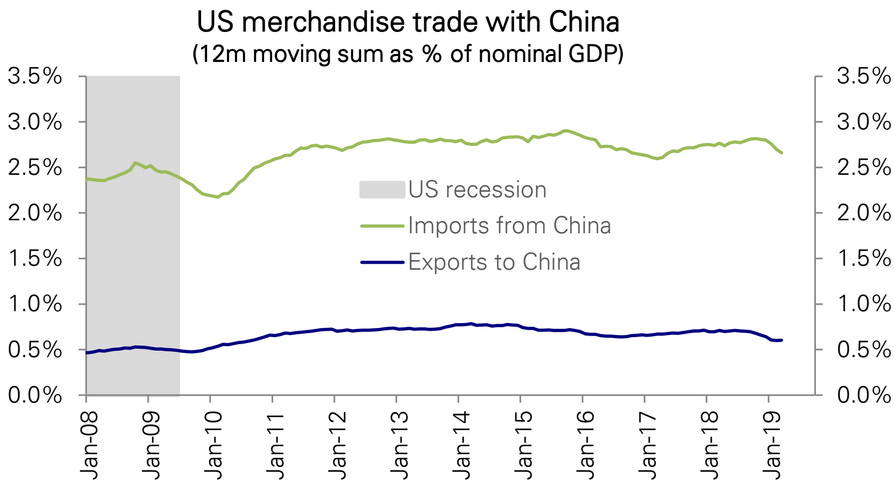
Source : BEA, Haver, DB US Equity Strategy

Figure 2: … the bilateral trade deficit in dollars has widened



Source : BEA, Haver, DB US Equity Strategy

Figure 3: But as a ratio to US GDP, both US merchandise imports and exports to China have been flat. This suggests macro growth has been the main driver of the widening in the bilateral trade deficit in dollars

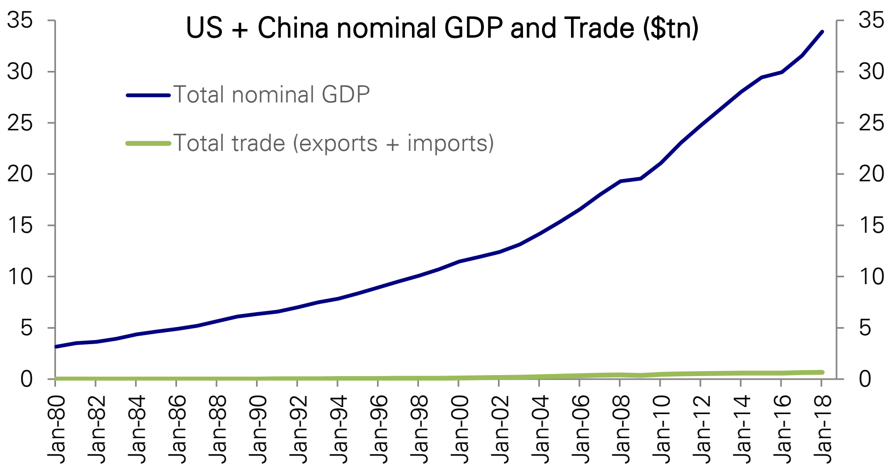


Source : BEA, Haver, DB US Equity Strategy

Figure 4: The US's bilateral trade deficit with China as a ratio to GDP has fluctuated in a relatively narrow range

Source : BEA, Haver, DB US Equity Strategy

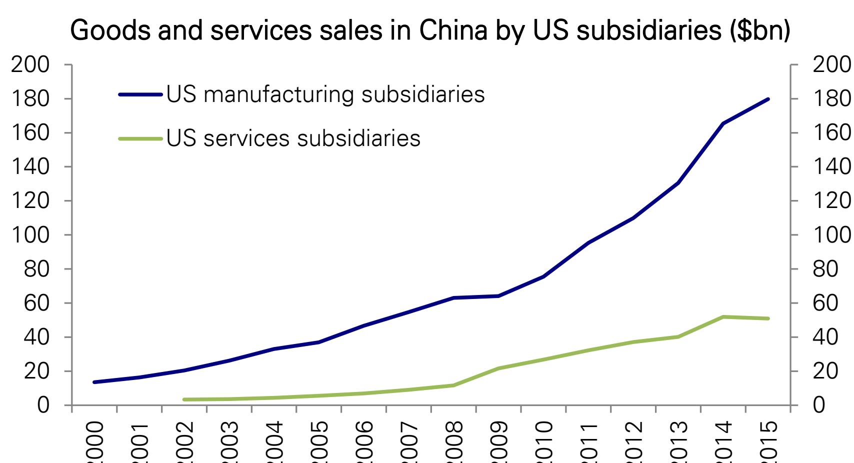
Figure 5: Bilateral trade flows are small compared to the size of the US and Chinese economies



*GDP at nominal prices converted to USD at market exchange rates

Source : BEA, IMF, Haver, DB US Equity Strategy

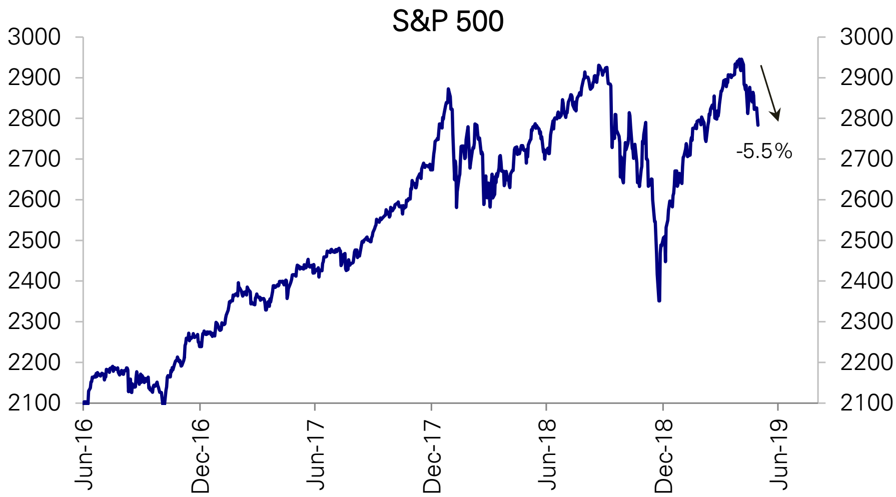
Figure 6: US companies' subsidiaries in China had sales of $220bn which are not counted in trade numbers



"US subsidiaries" refer to majority-owned foreign affiliates of US multinational enterprises

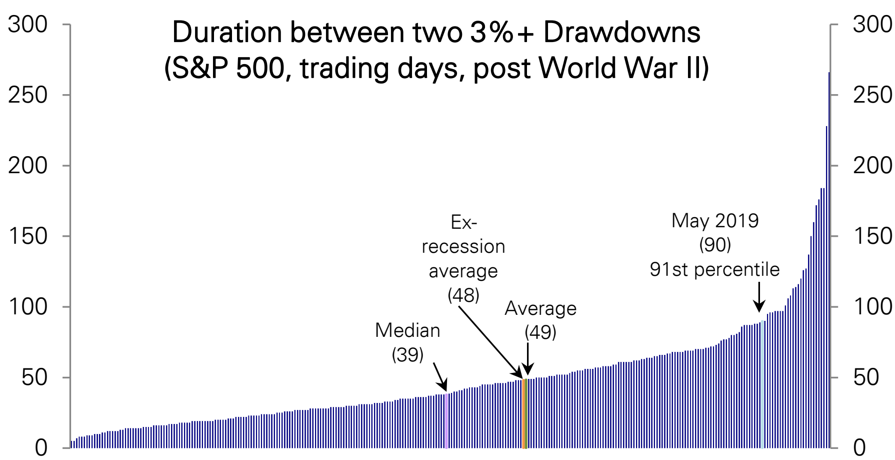
Source : BEA, DB China Economics

Figure 7: The S&P 500 is 5.5% below its recent all-time highs



Source : Haver, DB US Equity Strategy

Figure 8: The S&P 500 typically pulls back 3-5% every 2-3 months



Source : Haver, DB US Equity Strategy

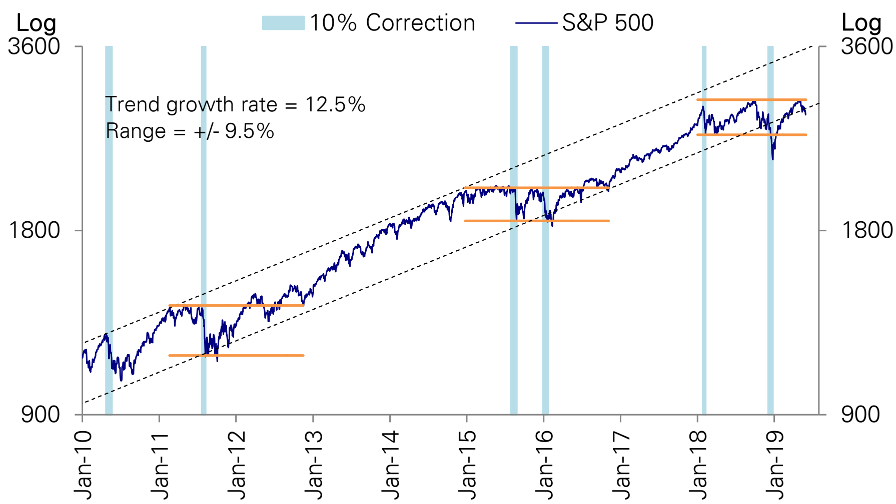
Figure 9: The bulk (75%-85%) of equity returns comes from price appreciation

S&P 500 returns over various phases

Event	Total return	Price return	Dividend yield	Price contribution
Since 1900 ex-recessions	17.0%	13.0%	4.0%	76%
Since Mar 9 2009	17.7%	15.1%	2.6%	85%
Since 2010	13.0%	10.6%	2.4%	82%
Since Trump election	15.3%	12.2%	3.1%	80%

Source : Haver, Bloomberg Finance LP, DB US Equity Strategy

Figure 10: Over the course of this economic recovery cycle, the S&P 500 has appreciated in a clear trend recovery channel which has risen at a 12.5% annual rate. But for the third time in this recovery, equities have gone into a range for an extended period



Source : Haver, DB US Equity Strategy

Figure 11: The duration of the current range bound period is still 5-6 months short of the prior two episodes—the European Financial crisis; and the dollar and oil shocks

S&P 500 in flat phases in this cycle

	Duration (calendar months)	Width of the channel	Avg Mfg PMI	Avg Comp PMI	Avg GDP Growth	Avg UE Rate	Avg EPS Growth (ex tax cut)
Feb 2011 to Nov 2012 (European financial crisis)	21	20.7%	52.8	54.0	2.0%	8.5%	8.6%
Dec 2014 to Nov 2016 (Dollar and oil shock)	22	13.2%	51.2	55.4	2.3%	5.1%	-0.4%
Jan 2018 to date (Trade war)	17	14.1%	57.7	58.3	3.0%	3.9%	11.0%

Source : Haver, DB US Equity Strategy

Appendix 1

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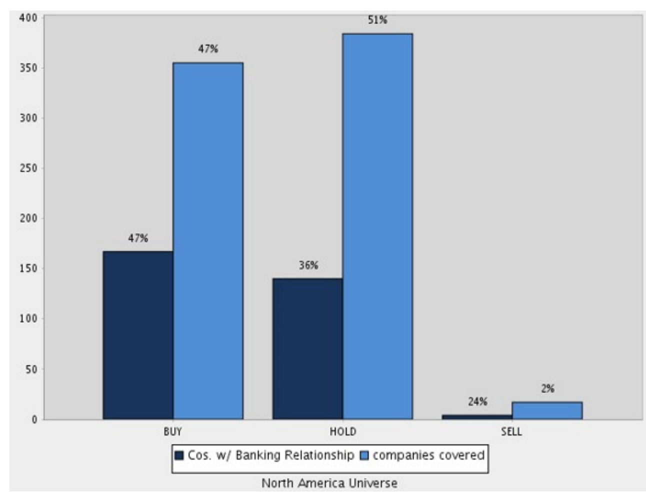

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