Macroeconomic Update: List 4 Tariffs

Important disclosures can be found in Appendix

August 2, 2019

Analysis of Forthcoming 10% Tariff on $300B of Chinese Goods

Following failed trade talks earlier this week, President Trump announced yesterday that a 10% tariff rate will be going into effect on an additional $300 billion worth of Chinese goods beginning September 1st.

These tariffs had been threatened on several occasions over the past year, most recently in the lead up to the June G20 meeting in Japan. However, until yesterday's announcement, it was unclear whether these tariffs were ever likely to become more than a threat given that:

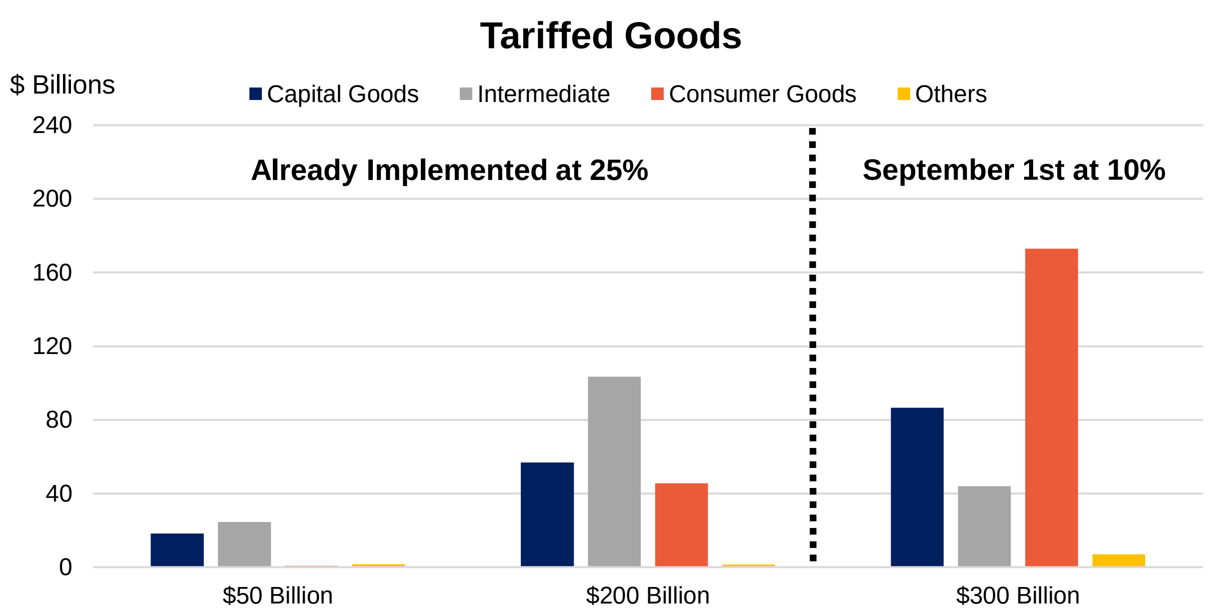
1. Trade tensions have already contributed to slowing economic activity in the U.S. and also globally
2. Any further tariffs on Chinese goods will likely substantially impact U.S. consumers, much more so than tariffs already implemented over the past 18 months
3. Generally, it's thought to be politically favorable for incumbent politicians to stimulate growth coming into reelection years rather than risk instability, which can be damaging economically and oftentimes politically

Due to the above reasons not to push forward with further tariffs, yesterday's announcement came as a surprise to most. U.S. financial markets closed on Thursday at down roughly 1%, WTI oil prices fell almost 8% (the worst day in over 4 years), while Asian markets traded down roughly 2% overnight and the Chinese Yuan notably weakened against the dollar.

Revisiting some of the finer details and implications of these tariffs, there are a number of key points to consider

List 4 Tariffs to Have a Much Higher Impact on the Consumer

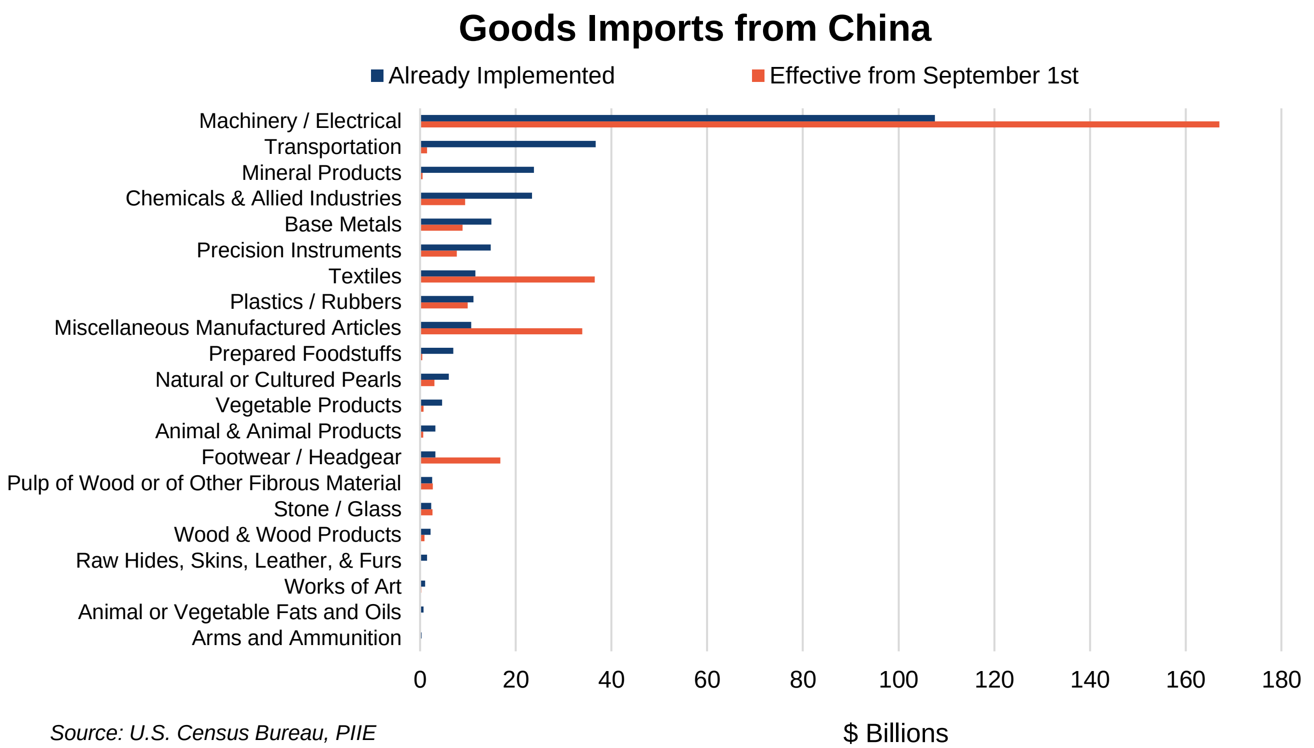
Perhaps of greatest significance, the tariffs coming into effect from September will have substantially more impact on consumer products imported from China, whereas previously implemented tariffs on Chinese goods had mainly focused on more industrial-related capital and intermediate goods.



Source: U.S. Census Bureau, P.I.I.E.
Note: Moved goods falling under HTS: 85171200 - 'Telephones for cellular networks or for other wireless networks' into Consumer Goods classification despite technically being a Capital Good

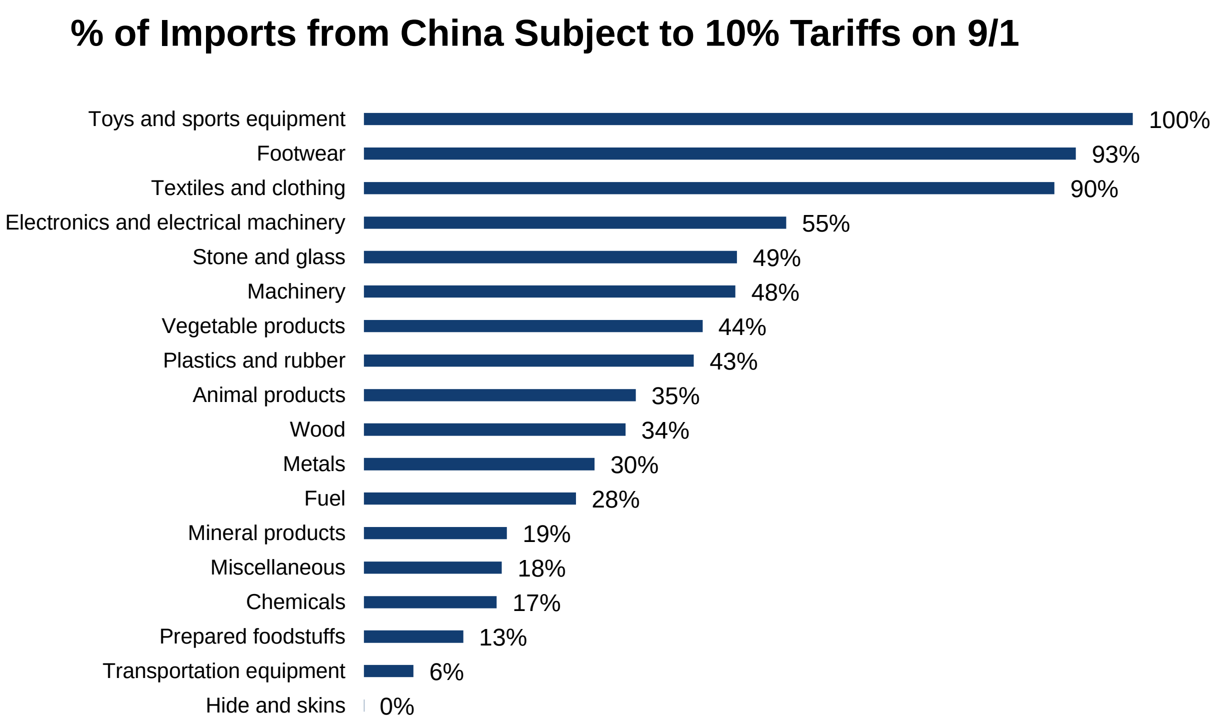
Of those consumer goods, consumer electronics, toys, clothing, textiles, footwear etc. will be most impacted by these tariffs.

Goods classified in the Machinery / Electrical category would remain the most impacted class, but whereas previous tariff lists mainly included a wide array of industrial related goods in this category, in the threatened $300 billion it would be mostly consumer electronics like smartphones, computers & equipment, video games etc.



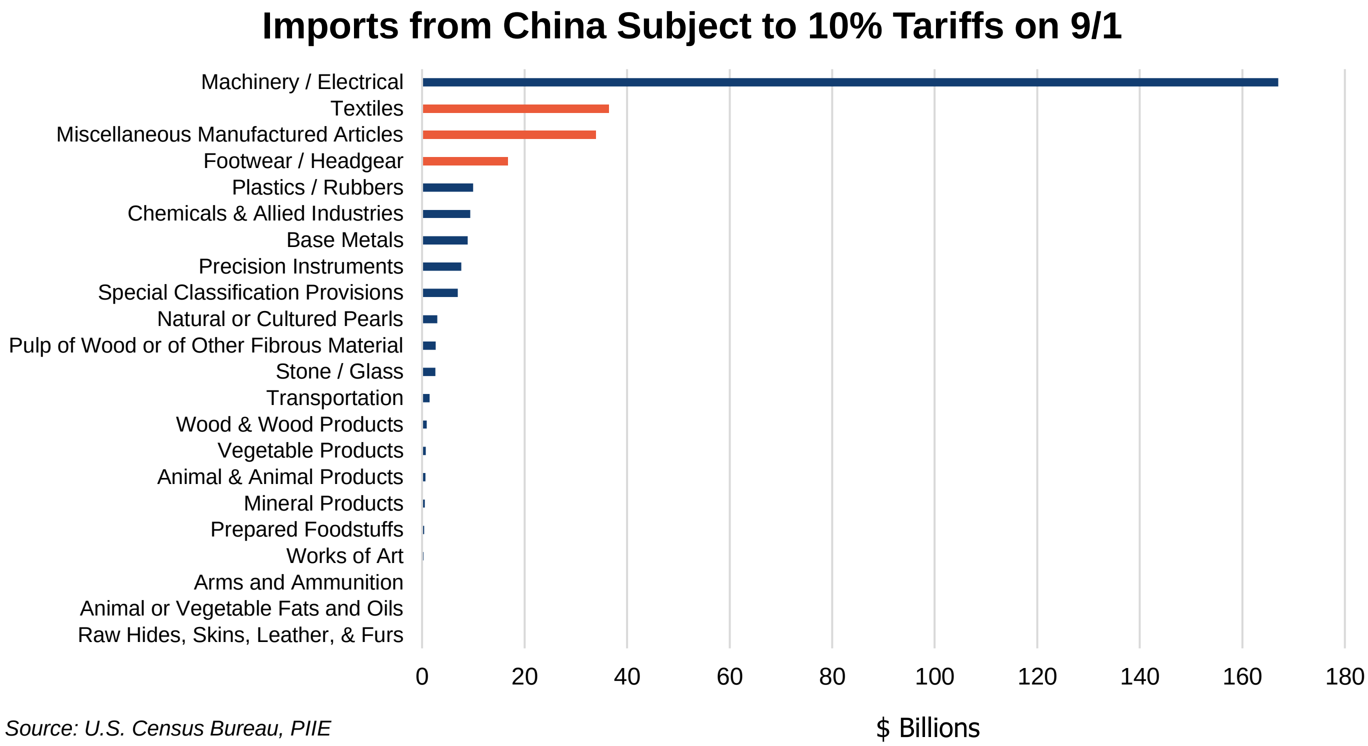
Source: U.S. Census Bureau, PIIE

This point is clearer in the chart below which shows the percentage, by category, of imports from China which will be become tariffed on September 1st. For example, the below chart shows that 100% of goods classed as toys & sports equipment have avoided tariffs up to this point, but without exception are about to be tariffed at a 10% rate.



Source: PIIE

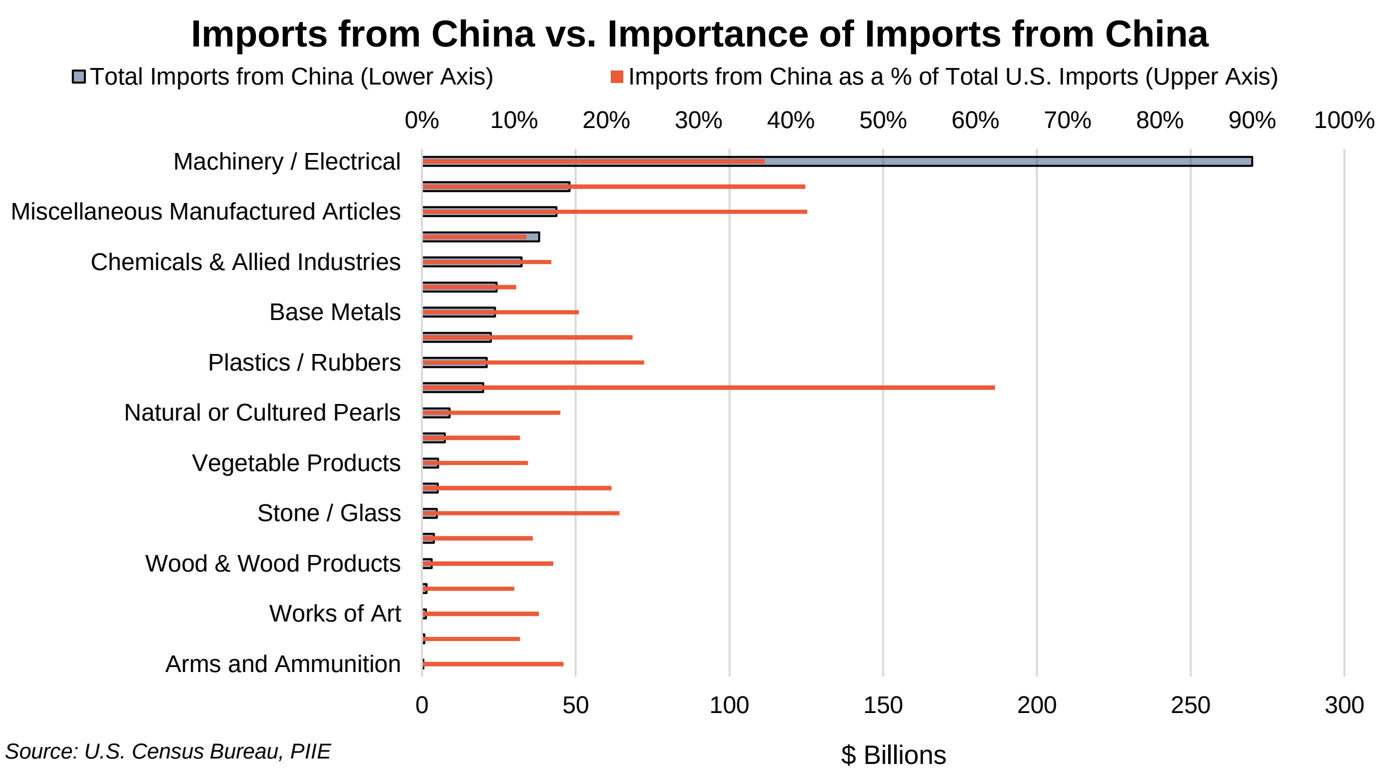
The other 3 most impacted goods classes will also be mostly consumer goods.



Source: U.S. Census Bureau, PIIE

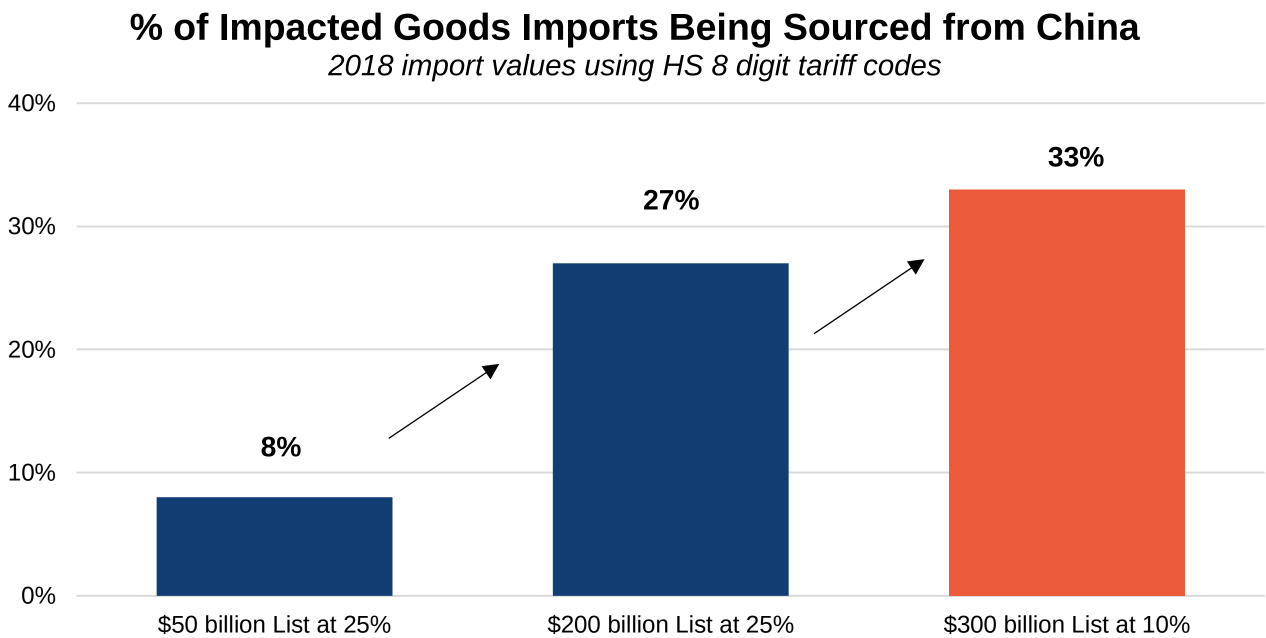
U.S. is More Reliant on China to Supply Products About to Be Tariffed

This is concerning as those 3 goods categories are also the relatively most dependent on imports from China, which means that these tariffs will be more difficult to quickly offset by shifting share of production and thus have a larger impact.



Source: U.S. Census Bureau, PIIE

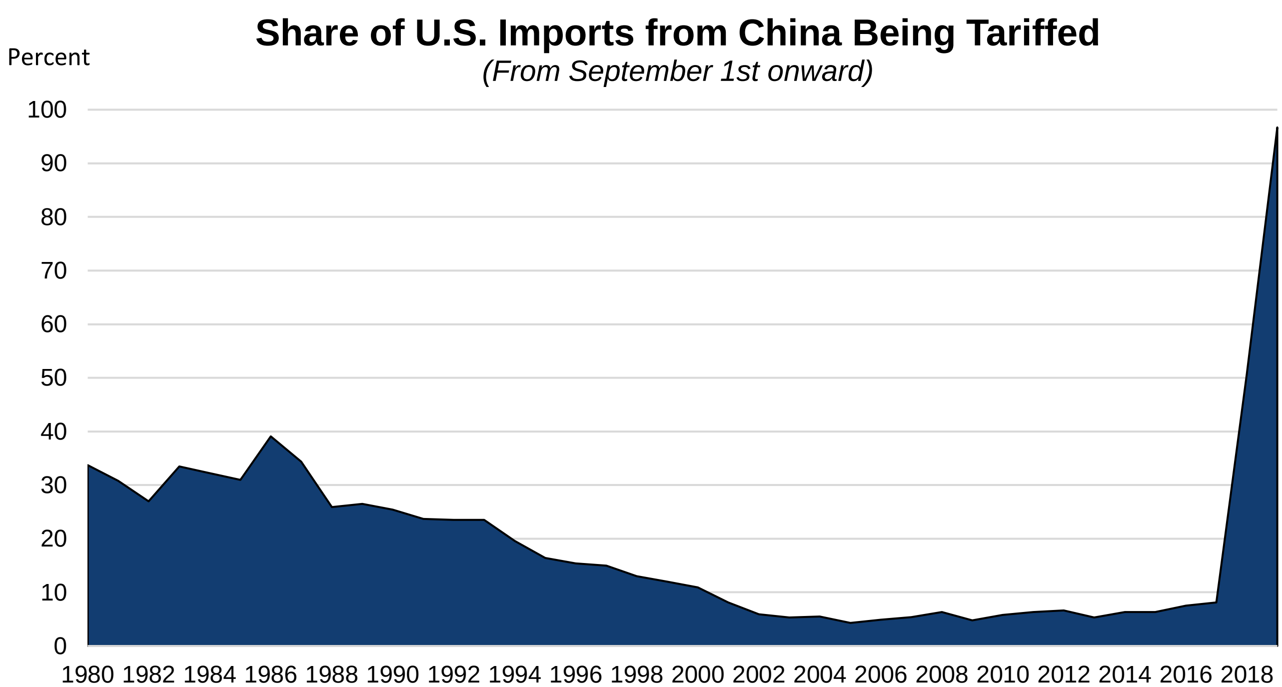
In total, the goods included on each tariff list have been progressively more reliant on China producing them. Among the list of goods about to tariffed, we import 1/3 of our overall total imports of these goods from China, meaning it will be incrementally more difficult to shift that demand elsewhere in the near-term.



Source: PIIE, USITC, Cleveland Research estimates

Practically All $540B of Imports from China will be Tariffed in Some Form

From September onwards almost 100% of imports from our largest trading partner will be subject to some form of tariff. Only goods with exceptions will not be subject to tariffs come September.

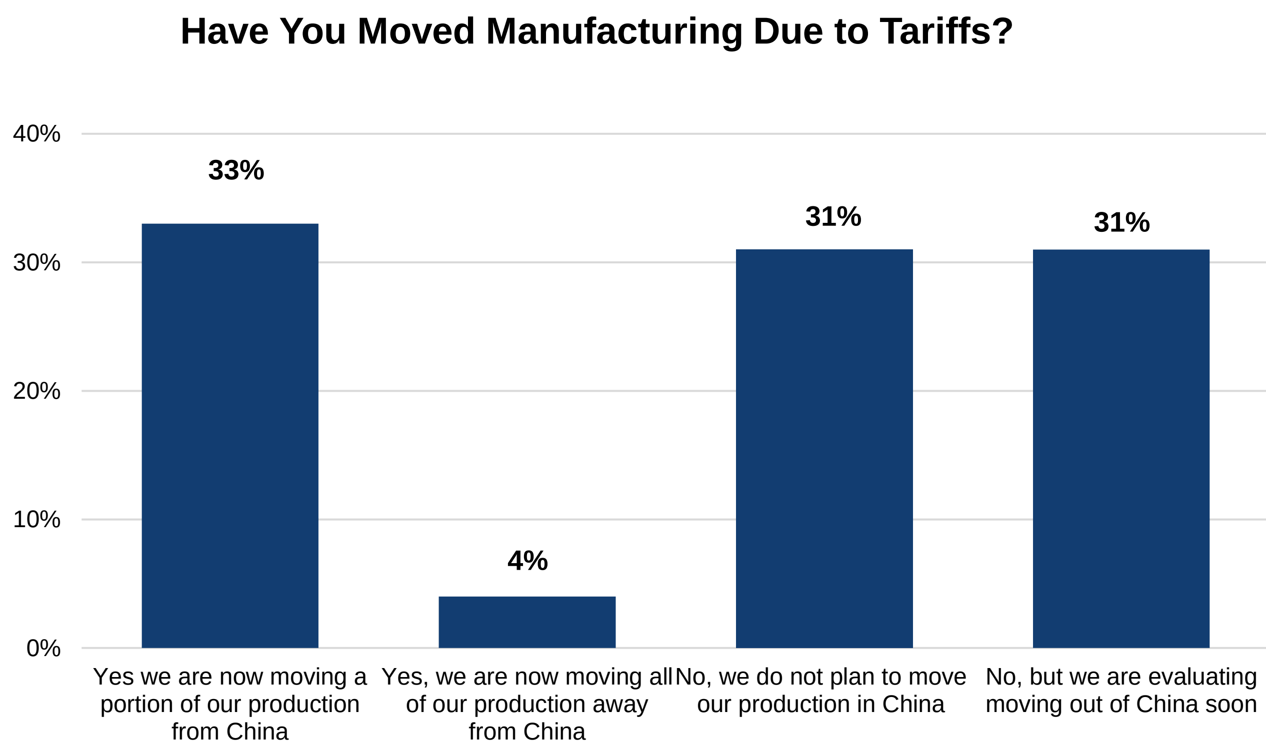


Source: PIIE

Tariffs Will Create Greater Need / Incentive to Shift Production Outside of China

U.S. companies impacted by these tariffs have already begun to shift supply chain logistics outside of China. We've heard numerous instances of this happening across our work after previously implemented tariffs. Alternative countries in Southeast Asia, such as Vietnam, Thailand, and Malaysia, being some of the major beneficiaries.

Specific to the home improvement industry, we were already seeing many instances of this happening and it's likely that these further tariffs will lead to a more accelerated approach to moving production outside of China.

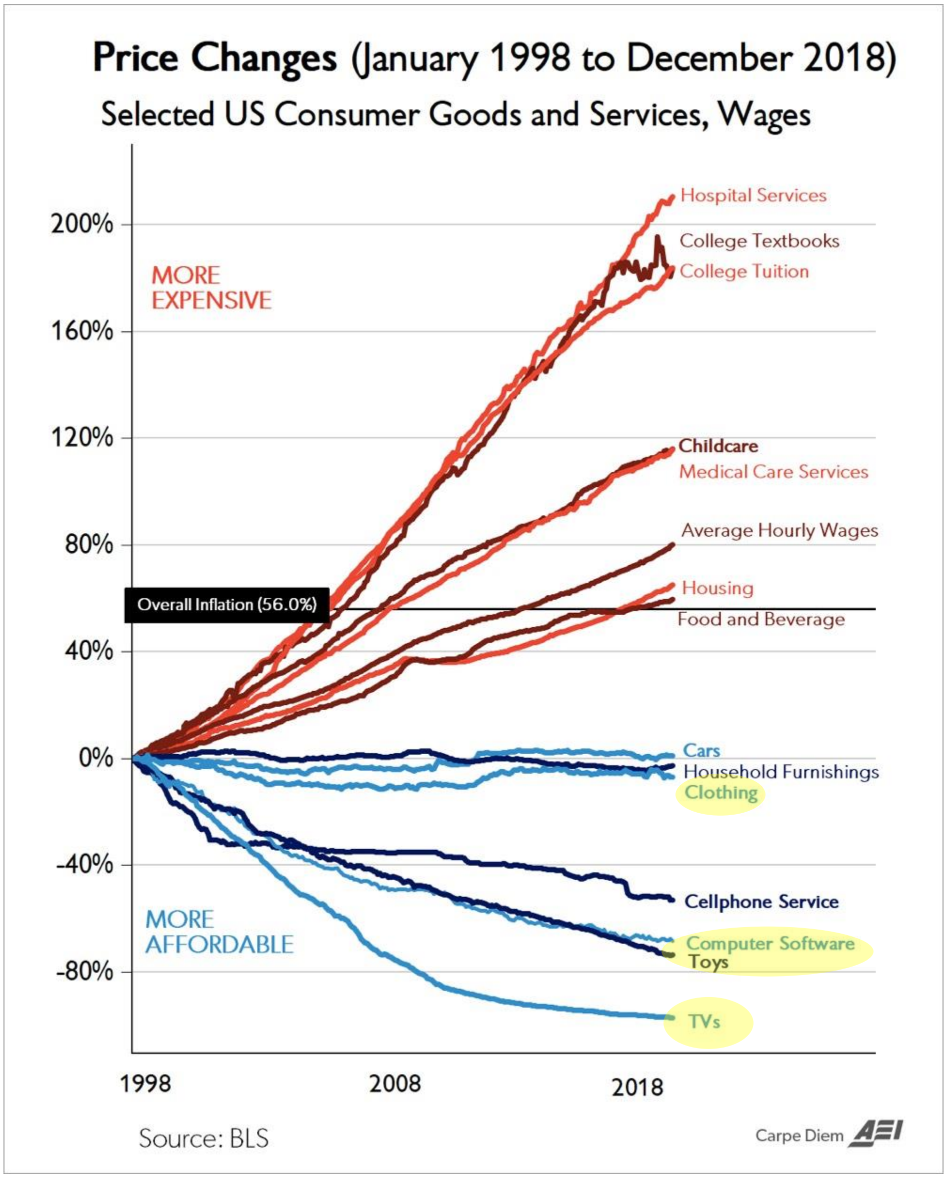


Source: CRC, 7/18 | 2019 Home Imporvement Summer Update Webinar Polling Results, 40+ responses

Tariffs on Chinese Consumer Goods Will Likely Lead to Higher Consumer Inflation

Beyond just home improvement-related companies, it will probably be more apparent that these tariffs will likely lead to much more aggressive efforts from U.S. companies to source consumer electronics and clothing/apparel from outside of China in order to avoid the full cost impact from these tariffs.

This would be a major change as Chinese manufacturing has played a huge part in these goods typically becoming cheaper over time, contributing to keeping overall U.S. inflation low.



It is difficult to foresee the actual net inflation impact considering that there are other mitigating factors. For example, many of the factories now subject to List 4 may have some room to lower prices and help absorb the 10% as they have benefitted from currency FX over the last 6 months (much of the first 10% of List 3 was also absorbed by China) and also oil prices have been falling dramatically on concerns that global oil demand will start declining in unison with global economic growth.

If manufacturing can't be cost-effectively shifted elsewhere, or if tariffs don't become fully offset by Chinese currency weakening or Chinese government subsidies, then forthcoming tariffs would potentially be enough to register an upward movement in nominal consumer inflation to somewhere around +20 – 30bps based off tariff impacted categories' relative weightings and assuming 1) majority of these goods are imported to the U.S. and 2) U.S. will continue to import these goods to a similar degree from China.

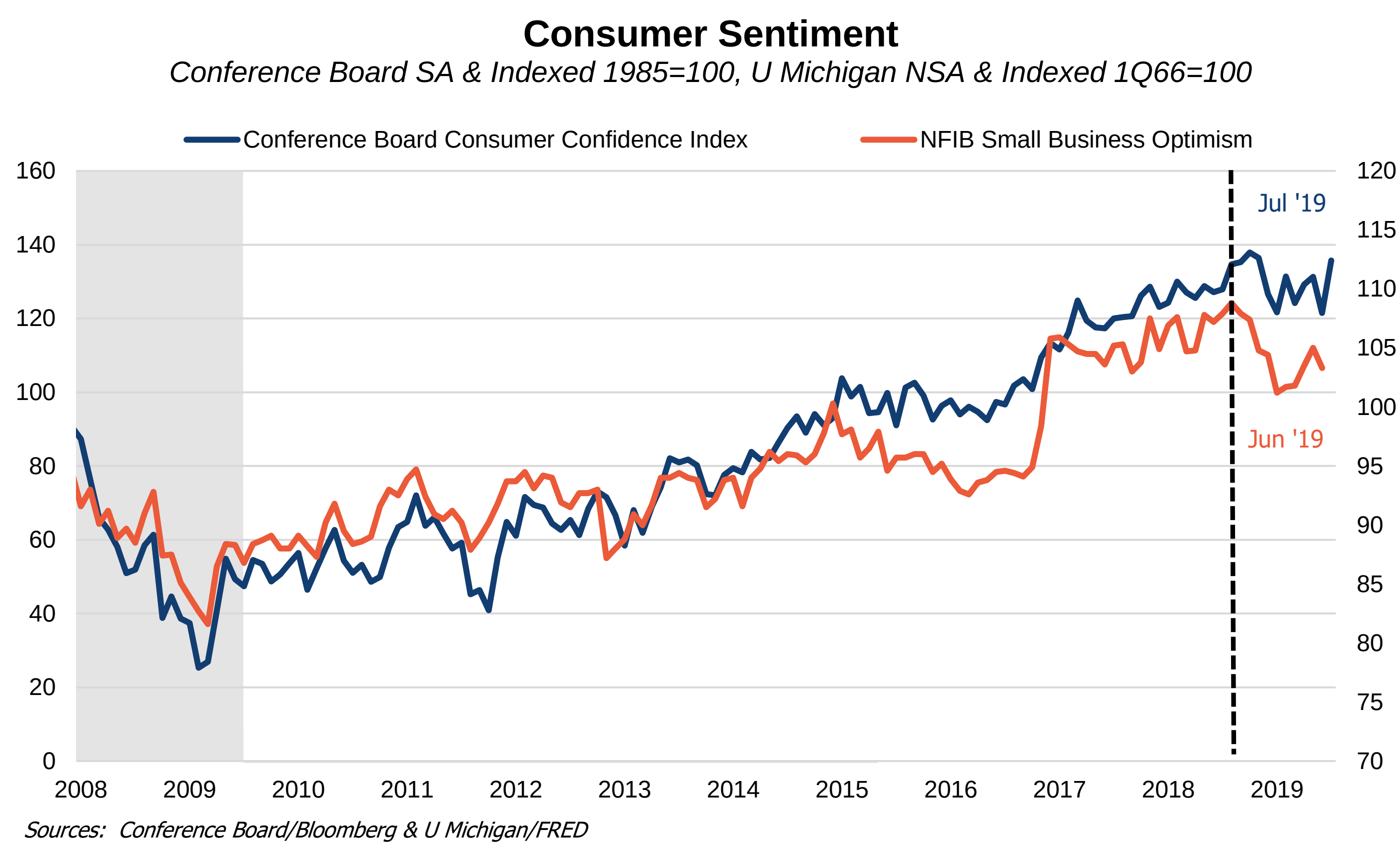
List 4 Tariffs Present a Major Concern from a Macro Perspective

From a consumer perspective –

Greater consumer inflation erodes purchasing power and destroys confidence, important drivers of spending

The Federal Reserve Bank of New York estimated that following tariffs being increased from 10 to 25% on $200 billion worth of Chinese goods in May, it would increase costs for the average U.S. family by $831 per year. Presumably the 10% tariffs beginning in September will lead to a loss of a similar size given that these tariffs impact a greater volume of consumer facing goods (albeit at a lesser rate).

On a related note, consumer & business confidence falls as both become relatively worse off.

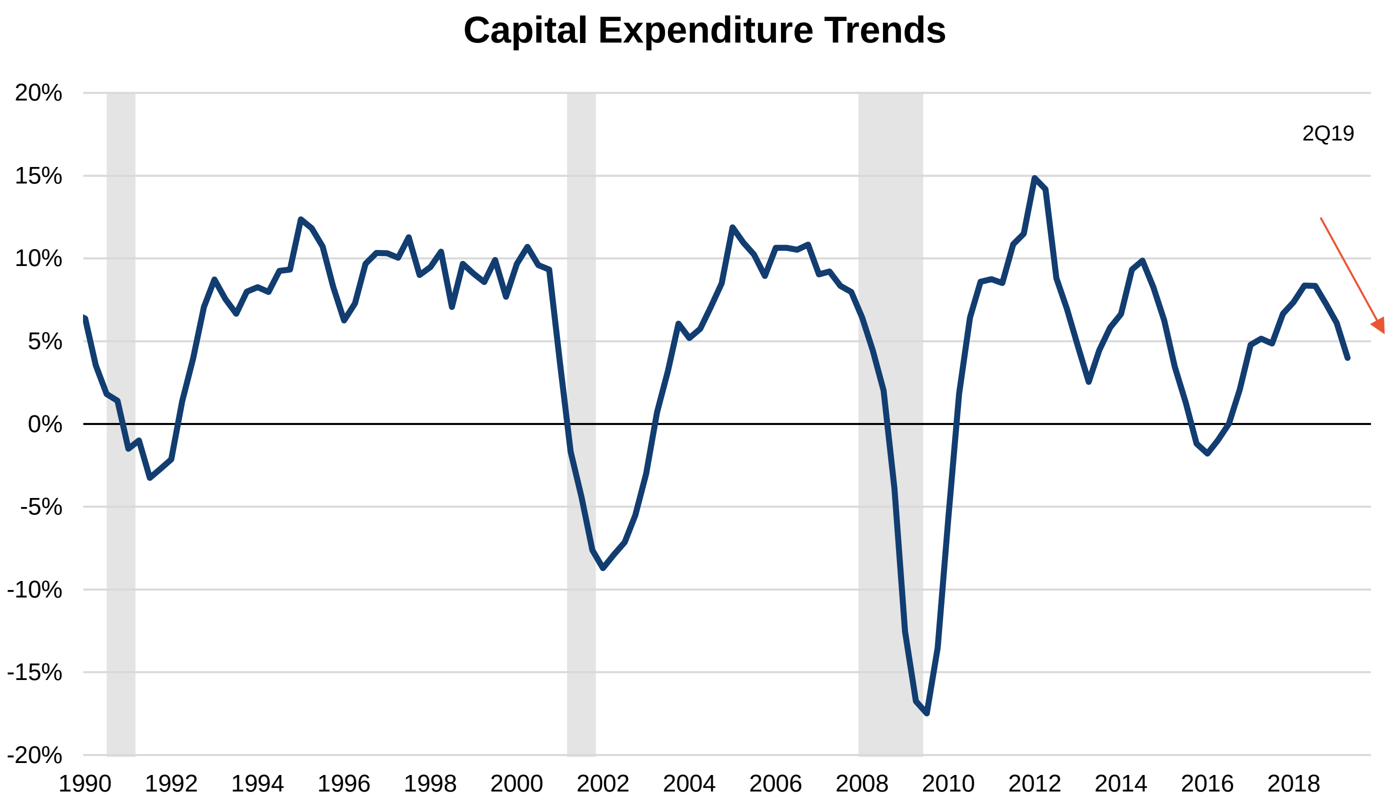


*Black line denotes introduction of 10% tariffs on $200 billion worth of Chinese goods in September 2018.
*Consumer confidence rebounded substantially in July but the recent tariff announcement will likely lead to reduced confidence in the months ahead.

From a business perspective –

Demand slows, profit margins become squeezed and the investment environment becomes more cautious

- Consumers with weaker purchasing power and greater concerns over economic growth generally stop spending as much leading to slowing or falling demand
- Unless tariffs can be fully offset or passed through, they can cause profit margins to become tighter
- Rapidly changing trade policy and uncertainty as to whether tariffs will remain in place or be added to months from now is contributing to a much more cautious investment environment.



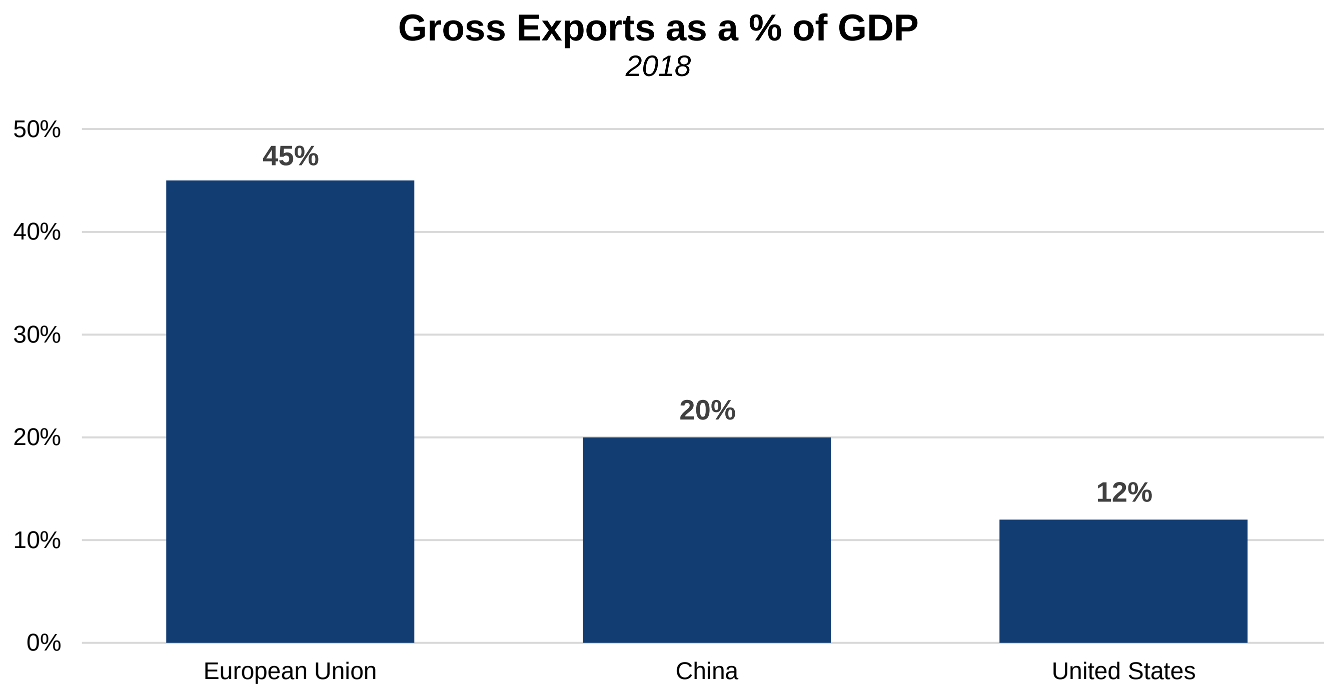
Source: FRED, BLS & BEA

Combined, the tariff impact on both businesses and consumers leads to slower economic growth and it's most likely that yesterday's tariff announcement will add to further and accelerating economic slowing. For that reason, should these tariffs come into effect from September it adds substantial credibility to the possibility of a recession on the horizon.

From a global economic perspective -

Demand / trade volumes are slowing outside of countries benefitting from supply chains logistics being relocated outside of China

Combined the U.S. & China account for roughly 40% of GDP. Given both countries are slowing as a result of tariffs and an ongoing trade war, it is contributing to overall global activity slowing. For example, although the EU isn't being directly impacted by tariffs, the fact that both the United States and China are both slowing, and Europe is relatively most reliant on trade, it's leading to significant slowing here as well.



Source: World Bank, Eurostat, FRED, Factset

Global demand falling is compounding on weaker U.S. and Chinese activity and it's one more reason for further tariffs adding to a greater recession risk.

For some of the reasons outlined above, we think there's a substantial chance of weaker economic data over the next couple of months unless forthcoming tariffs are called off or withdrawn…although we'll have to wait and see how U.S. businesses and consumers actually react to this tariff increase before drawing any conclusions in terms of the likelihood of a recession in the near-term.

Theoretically, the fact that tariffs beginning in September impact a greater volume of goods and importantly a substantial volume of consumer goods for the first time, it leads us to believe that these tariffs will cause an even greater amount of economic slowing than those that have been already implemented.

APPENDIX

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