AQUILA FLASH

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Trump's war on enforced knowledge transfer. Hold off on boosting equity exposure for now.

Unfortunately, a "mini trade war" is the price the rest of the world must pay as Republicans campaign to hang on to the votes of globalization's losers in the upcoming mid-term elections. But US protectionist pressures go beyond mere populist rhetoric. The US wants to inhibit China's attempts to grab US intellectual property, especially when it comes to the defense industries.

A mini trade war is upon us

Republicans and the Trump Administration will do almost anything to keep their control of Congress in this year's mid-term elections. Polls suggest they have a difficult task ahead.

In launching his "war against unfair competition", President Trump is angling for support from the supposed losers in globalization (i.e. white middle-income workers in traditional industries). This war does not have to be particularly aggressive. It might work even if the tactics remain essentially verbal and focused on symbolic industries. In fact, President Trump is sticking to his promises; so one should take him seriously when it comes to US trade policy. Initial steps are a 25% tariff on steel imports and a 10% tariff on aluminum imports. But these are only the current headlines. The real objectives are elsewhere.

A war against the forced transfer of intellectual property

The Trump Administration's main targets are the non-tariff trade barriers being put up by China, her treatment of patents, intellectual property and her tendency, when it comes to enforced joint ventures, to suck their intellectual property dry and not to invest in them. Once these joint ventures have been effectively crippled, a newly-formed, 100% Chinese-owned company, armed with stolen technology, is well placed to clean up. The US is no longer prepared to put up with such behavior, especially when it comes to technology transfer in the defense industry. China clearly has superpower ambitions, and not unnaturally, the US (as the world's No 1 superpower) wants to delay China's advance as long as possible.

It is the enormous technological superiority of the US which keeps the People's Liberation Army in check. Absent that technological advantage, the law of large numbers would become decisive as might the lower "pain threshold" of democracies when it comes to military action.

Trump's secondary objective: Cutting America's enormous bilateral trade deficits

The Administration is focused on the very large surpluses that China, Japan and Germany have with the US, and indeed on all industries where the US has a substantial trade deficit.

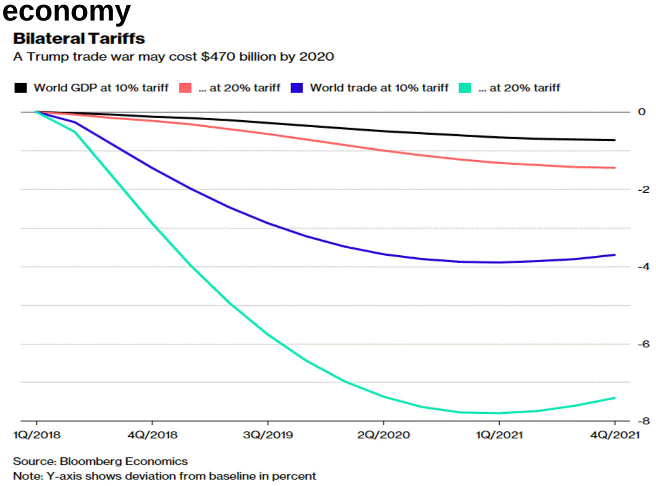
Well defined US objectives should prevent an all-out trade war

Given the well-defined US objectives – preventing weapon and information technology transfer and a reduction in very large bilateral trade balances – it should be possible to avoid an all-out trade war, something which is anyway not in the interests of the Trump Administration. Its populist wooing of globalization's losers should not be taken too literally.

We note that, China's response thus far has been remarkably moderate.
But what would be the consequences of a global trade war should, against expectation, one develop?

Serious trade conflict would have devastating consequences
The effects on world growth, corporate earnings and global stock markets could be devastating.
The graph below shows the potential negative impact of tariffs on growth as modelled by Bloomberg Economics. Should all countries immediately introduce a 20% general import tariff, global GDP (world trade) is calculated to be 1.8% (8%) lower than otherwise by 2021.

The impact of protective tariffs on the world economy



Upcoming US elections dictate the policy stance of the Trump Administration
As already outlined, we think the risk of an all-out trade war is low.
President Trump is however prepared for meaningful declines in US corporate earnings and a pullback in the stock market. He would view these as the unavoidable consequences of his campaign against knowledge transfer and of his populist measures aimed at the losers from globalization. Such collateral damage is viewed by the Administration as a price worth paying for the votes of those dependent on declining industries in America's rust-belt.

Are we close to the end of the stock market's correction?
Equities face some powerful headwinds.

1. The current economic cycle is now past its peak. In coming weeks, data, especially the sentiment indicators for EU economies, will probably show a slight tendency towards weakness.
2. As expectations are already high, a certain degree of disappointment may already be baked into the upcoming earnings season, even if reported growth trends are positive.
3. Uncertainty about the future trade policies of the Trump Administration increases the risk premium, and undermines the business incentive to invest. Moreover, the continuous turnover of White House staff makes it difficult to anticipate Administration policy.
4. Central banks are moving away from accommodation on a worldwide basis. The Fed has made clear that it thinks US stocks and US property are expensive. A 10% correction in the stock market will not deter the Fed from pursuing its goal of normalizing US monetary policy.
5. Valuations, especially for US stocks, are on an historical comparison, very high. This is particularly true of technology stocks, especially the so-called FANGs – Facebook, Amazon, Netflix and Google. Recently these four have come under pressure. Thus exactly those stocks which had hitherto shown the strongest positive momentum are now undergoing a correction.

We are staying underweight in equities and our higher than normal cash position should give us the opportunity to build up our equity weighting at more attractive price levels. There are no indications, that the market correction is about to end soon.
However, we also caution against a substantial underweighting of equities. In our view, such a position would imply an impending recession, something we do not yet see on the horizon.

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