

OCM Asset Management

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Briefing note: 10th April 2019

Fresh trade concerns add to market risks: The EU's 'trade twitch' with the US

Just as US- China trade tensions are beginning to show signs of cooling, a fresh clash in international trade emerged yesterday, after the US threatened to levy tariffs on around \$11bn of European goods. The move comes in retaliation to European subsidies for aircraft manufacturer Airbus following a lack of progress in trade talks which have been ongoing since July.

Tensions escalated over the week just as the US appears close to resolving its year-long spat with China. With markets having already priced in a trade resolution with China, a fresh set of tensions could further disrupt global growth, particularly given signs of weakness in the US and EU economy.

What products are the tariffs going to be levied on?

The US is weighing tariffs on \$11bn of EU products, including civilian aircraft and agricultural goods ranging from cheese to oil. The levies would come on top of American tariffs already imposed on European steel and aluminium imports. The US has also threatened to add tariffs on EU automotive products for 'national security reasons' which would be extremely damaging to the EU economy.

The US has said that two categories were being considered for the most recent bout of tariff hikes:

1. New helicopters, aircraft and aircraft parts coming from France, Spain, Germany and the UK (aimed predominantly at Airbus as this is where the company has manufacturing facilities)
2. A broad range of products from all EU member states, weighted towards food imports such as cheese, jams, fresh fruits, seafood and wines. Other goods including motorbikes, kitchenware, essential oils and handbags were also on the proposed list.

What is the reason behind the escalation of tensions?

The Trump Administration is proposing the levies in response to EU subsidies to support Airbus which were judged by the World Trade Organisation (WTO) to be illegal and considered by the US to be adversely impacting US-based aircraft manufacturer Boeing. The move represents a significant escalation in tensions between Washington and Brussels, and also comes at a sensitive time for the EU as it grapples with uncertainty over Brexit and European Parliament elections.

Back in June last year, as a response to a WTO ruling that the EU subsidies to Airbus were illegal, the US imposed tariffs of 25% on steel imports and 10% on aluminium imports from the EU in a move aimed to help the US industry, however this simply raised costs for many businesses that import these products. The EU responded with tariffs on \$3.4bn of US steel, agricultural and other products.

The two countries have been in talks to scale back the tariffs since July, however negotiations have not formally begun and preliminary negotiations have not yielded much progress, with the US stating that the EU is unwilling to include agriculture in the talks. With a lack of progress and increasing frustration on both sides, the new tariff proposal represents an acceleration of transatlantic tensions which poses a significant risk to global growth.

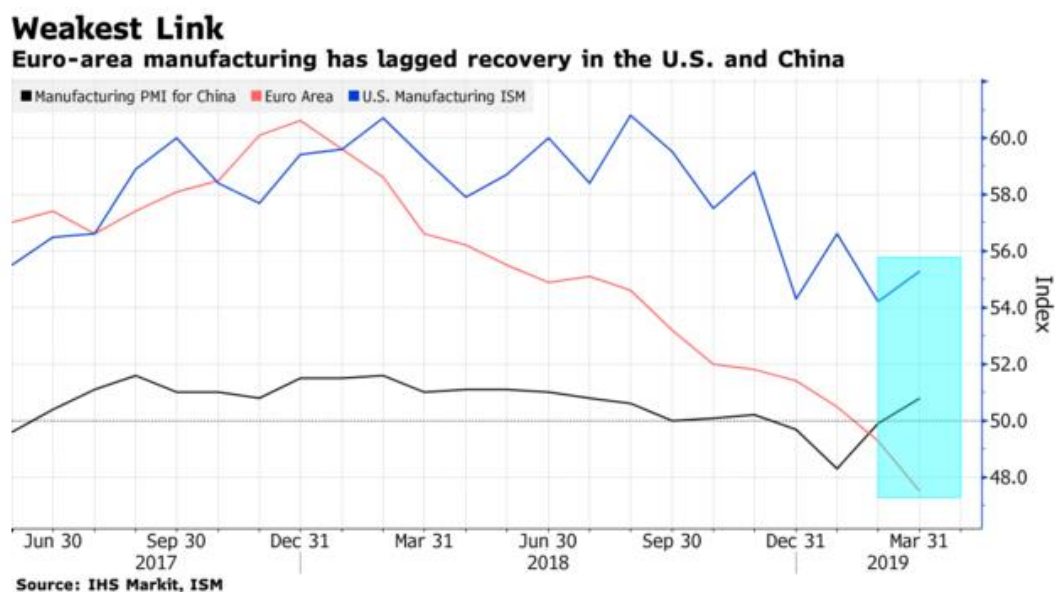
Airbus has said it sees no legal basis for the US proposal, given that the company had taken necessary measures to comply with the elements that remained following the WTO report regarding Airbus subsidies back in May 2018, however the US argues that the tariffs would be justified because of the EU's failure to comply with WTO rulings. The US argues that Airbus benefitted from illegal aid to the detriment of Boeing over many years.

A WTO-appointed arbitrator will determine the EU's retaliation rights, as the US move comes after a WTO ruling that the US had itself illegally subsidised the production of Boeing aircraft, with the EU expected to respond. Additionally, attempts to tax Airbus aircrafts come just as Boeing is facing challenges over its 737 Max airliners amid concerns that technical problems were to blame for two crashes in recent months. The tariffs would help Boeing during a challenging period at the expense of Airbus. The EU has said it is open to talks with the US to resolve the issues, however there is clearly a large amount of tension and frustration on both sides. The US is waiting for WTO clearance to implement the duties.

The ECB's list of concerns

Renewed tensions with the US come at a time when the ECB has every reason to remain cautious about the Eurozone economy. Now the central bank has to contend with a fresh tariff threat from the US, a stagnant Italian economy, continuing Brexit uncertainty and further cuts this week by the IMF to global growth expectations (down from 3.5% to 3.3%). It is clear that the export-driven economy will struggle over 2019, with significant downside risks ahead for European markets. No policy shift is expected today from the central bank, however warnings about risks to growth and inflation could become louder as the year goes on.

The US tariff proposal could dampen confidence, dimming prospects for a rebound later this year. The Eurozone is already exposing itself as a weak link in the global economy, with Italy in recession and an industrial slump in Germany, combined with the impact of negative interest rates on bank profitability. Further weakness via a trade war with the US would likely be extremely damaging to the EU economy.



What would the impact of the tariffs be?

While the size of the tariffs is relatively small compared with the hundreds of billions involved in the US and China trade conflict, the announcement suggests a breakdown in talks at a time when global economic growth is declining. The two countries have been negotiating since July last year about how to avoid further US tariff hikes as President Trump seeks to reduce the trade deficit with key European countries such as Germany, however talks have since broken down, posing a threat to overall economic growth. The announcement of new tariffs comes as US negotiators appear increasingly frustrated at the lack of progress being made in talks with the EU.

Given the evident weaknesses in the Eurozone economy, the introduction of new tariffs and a potential further escalation of tensions could have the power to send Europe into recession. At the same time, the US also risks damaging its own economy which is already showing signs of weakness.

Our positioning

Just as it seemed that international trade tensions were abating, renewed tensions between the EU and US pose a real risk to global growth, increasing the downside risks in the global economy over 2019. Given current risks and excessive weakness in the area, our portfolios have low European exposure, with the main source of exposure coming from a long/short strategy which seeks to benefit from a drop back in markets.

It is our view that the risks in European markets are already excessive given uncertainties and weak economic data, however a potential escalation of trade tensions could further exacerbate existing trade woes in the Eurozone. For this reason, we will not be increasing exposure to this area until the economic data and trade outlook improves.

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