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INVESTMENT INSTITUTE

Global Perspectives

WEEKLY GUIDANCE ON ECONOMIC AND GEOPOLITICAL EVENTS

April 3, 2018

Rising Tariffs—Trade War or Negotiation Technique?

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Key takeaways

» *Despite the headlines related to potential trade wars, we believe that the U.S. is simply using tariffs to establish a stronger negotiation position as it attempts to rebalance the global trading system.*

» *While a global trade war is a possibility, we do not view it as the most likely outcome. No country wins in an escalating trade war, and we expect negotiations to eventually adjust imbalances in import tariffs and accessibility for U.S. goods entering foreign markets.*

What it may mean for investors

» *Markets likely will continue to experience increased volatility as trade negotiations play out. It is difficult to position portfolios for spontaneous or fluid geopolitical events, yet proper diversification may minimize adverse effects when they occur.*

Amid the headlines related to potential trade wars, we believe that the U.S. is seeking to change the existing framework of global trade by seeking "fair and reciprocal" trade to reduce outstanding trade deficits and barriers to market access. At this point, the proposed U.S. trade actions seem to be negotiation tactics, rather than punitive action. As a result, we view the probability of a full-blown trade war as low. There are no winners in such wars. Global capital markets likely will continue to experience increased volatility until trade deals are renegotiated.

Long-standing trade issues the U.S. seeks to resolve

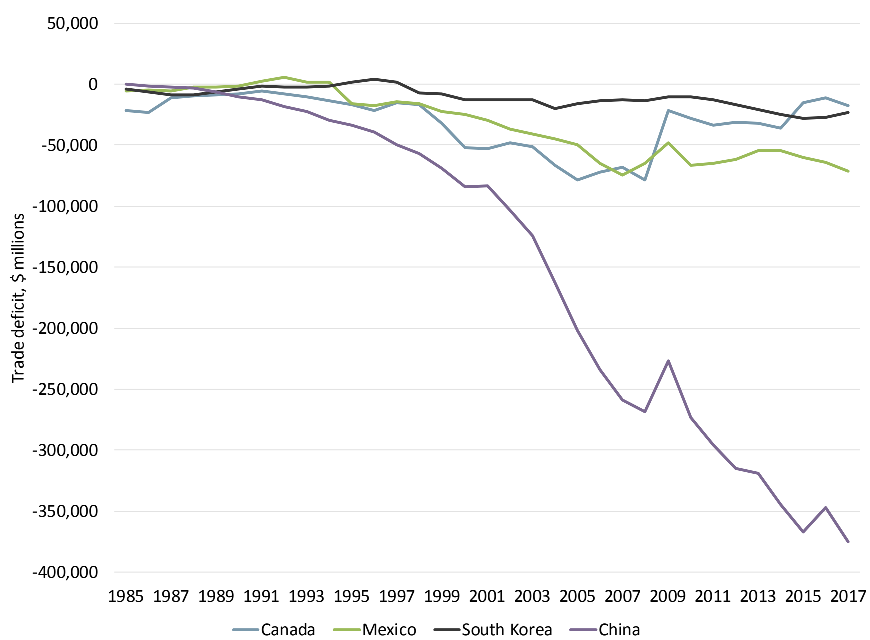
The global economy has experienced tremendous growth—supported by expansion in trade. This system has evolved over decades, leading to either bilateral or multi-nation trade agreements. These may be free trade agreements, in which goods and services are exchanged mostly without tariffs—or negotiated trade agreements in which tariffs are set for individual goods. While the original goal of these trade agreements was an improvement in trade for all parties, these gains have proved to be asymmetric over time. Some countries have developed into trade surplus nations (the country exports more than it imports), while others have sustained persistent trade deficits. The U.S. falls into the trade deficit category. While the U.S. runs trade surpluses with certain countries, its overall annual trade deficit has widened during this economic expansion and stood at $568.4 billion in 2017.

Trade deficits may exist for a variety of reasons. Some countries have an advantage in certain products or industries and are able to produce items more cheaply. This includes low-cost consumer goods in countries with cheap labor or a commodity advantage, such as oil from the Middle East. Other countries may not use many of the exports that the U.S. offers. Emerging-market economies may not have a large demand for the advanced goods and services produced by the U.S. Size also may be a factor. Smaller countries simply are unable to import the volume demanded to match the imports of the largest consumer base in the world.

The desire for inexpensive goods and access to foreign markets has contributed to the U.S. entering into trade deals that may not have been in its long-term interests. Chart 1 reflects the changing trade deficits of the U.S. with a sample of significant trading partners. Deficits with Canada and Mexico increased significantly following the implementation of NAFTA (the North American Free Trade Agreement) in 1994. While the U.S. trade deficit with Mexico continues to increase, the Canadian deficit has decreased as shale oil production in the U.S has risen. The South Korean trade deficit increased following the signing of the United States – Korea Free Trade Agreement (KORUS) in 2007. Since 2015, this has begun to reverse as tariffs have been reduced on U.S. products imported into the Republic of Korea. This agreement is currently being renegotiated to further equalize access and tariffs for U.S. firms.

The trade deficit with China is an altogether different story. While the trade deficit had been increasing, it accelerated significantly following China's 2001 entry into the World Trade Organization (WTO). Outside of the rising trade deficit, a further point of contention is the forced transfer of proprietary technology by U.S. firms seeking to do business in China. The removal of this provision is a key point in the announcement of $50-60 billion in U.S. tariffs on Chinese goods and limitations placed on Chinese investment in the United States. This issue has been raised before. Although the Chinese have stated a willingness to take action, nothing has been done on their part.

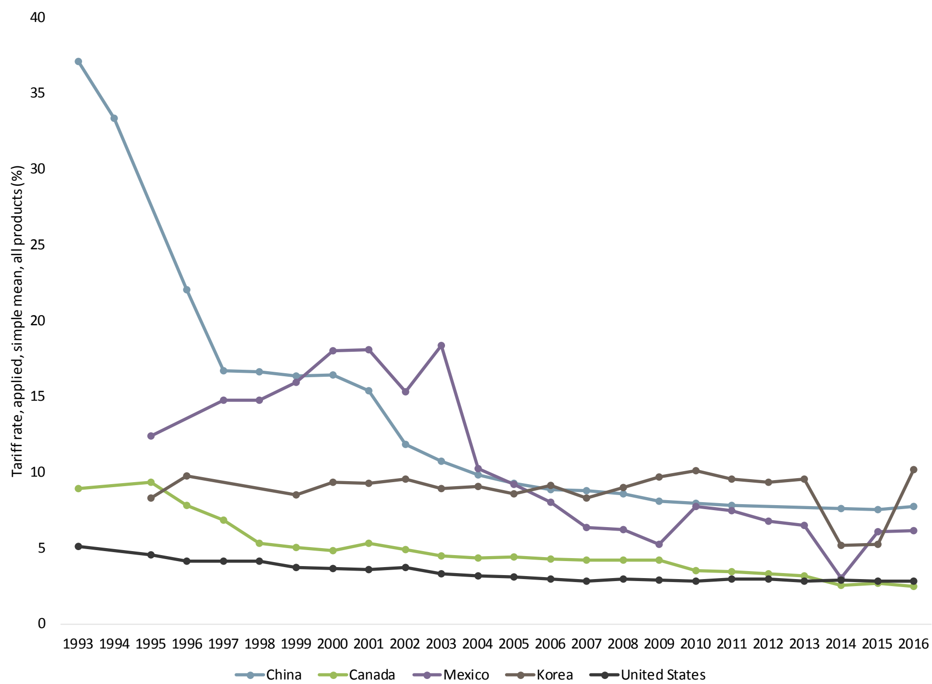
Chart 1. Trade deficits for the U.S. may be unsustainable



Sources: U.S. Census Bureau, Wells Fargo Investment Institute. Data shows annualized trade levels from 1985 through 2017.

Trade agreements are very complicated—detailing different tariffs (for different products)—which may decrease over time. For example, the U.S. tracks tariffs on almost 13,000 imported goods. Tariff levels may be driven by many different factors, from the importance of a good to the local economy to extensive industry lobbying. The WTO classifies countries as developed and developing. Developing countries are allowed more trade protections through the ability to charge higher tariffs and restrict access to foreign goods. Interestingly, WTO members themselves decide whether their country is a developed or developing country. Under this system, China, Korea and Mexico are offered the same support as the world's least developed countries. Chart 2 reflects the average tariff rates for the same list of trading partners and shows how they have changed over time. China's tariffs have declined significantly in recent decades. Yet, the U.S. clearly has had a consistently lower tariff rate than its trading partners. Auto imports are a good example. A U.S. auto imported into China and the European Union includes a 25% and 10% tariff, respectively. However, the U.S. only charges a 2.5% tariff on imported automobiles.[1] The higher average foreign tariffs make U.S. goods more expensive for the local population, contributing to reduced exports and larger trade deficits for the U.S.

Chart 2. The U.S. has some of the lowest tariffs among its trading partners



Sources: World Bank, Wells Fargo Investment Institute. Notes: Data includes 1988 through 2016.

[1] Shepardson, David, "U.S. to push for 'reciprocal tax' on trade partners: Trump", Reuters, February 12, 2018.

Attempting to resolve trade imbalances does not necessarily lead to a trade war

Although it is a possibility, we do not believe that U.S. efforts to resolve trade imbalances and gain greater access to markets will necessarily lead to a full-blown trade war. Statements have been made by Chinese officials that China is interested in negotiations and that it seeks to avoid a trade war. As the country with the highest level of household spending in the world[2], the U.S. does have leverage to use in these trade negotiations. The recent tariff announcements on steel and aluminum, along with those on products from China, seek to change trading partners' behavior—but not to limit overall trade.

Possible outcomes from these U.S. actions include:

1. **Retaliation that does not lead to a full trade war:** In this case, trading partners likely would respond with their own tariffs but not with an extreme escalation. Tensions may remain high until these trade issues are resolved.

2. **At least some compromise on outstanding U.S. concerns:** Negotiations would seek to resolve underlying issues that the U.S. believes prevent fair and reciprocal trade. Considering the potential loss of sales to the U.S. market, other countries may be very reluctant to match the U.S. in imposing new tariffs.

3. **A full-blown trade war:** While we do not believe this to be the most likely outcome, this risk does exist. Back-and-forth escalation of tariffs and quotas would reduce global growth and negatively affect all involved. The last time the U.S. joined a trade war was in 1930—imposing average tariffs of between 50% and 60% across a wide variety of goods. The U.S. is a long way from this outcome, and we believe that breakthroughs in negotiation are far more likely.

Investment implications

The U.S. seems determined to address rising trade deficits through fair and reciprocal trade, using tariffs to influence change in trading partners' behavior and making American products more readily available and competitive in markets abroad. The Trump administration maintains that increased financial-market volatility in the short term is acceptable for the longer-term goal of making trade more beneficial for U.S. exports.

While we do not believe that a trade war is the likely outcome, there likely will be near-term market volatility as trade policies are modified. Threats of tariffs have not been the norm for negotiating trade in recent decades, and a new negotiating strategy likely will take time and involve risks. Although we see it as unlikely, the clearest risk is that negotiations fail and that countries impose tariffs in escalating rounds, until trade and global economic growth contract. We could become more concerned about this potential outcome if we were to see rounds of tariffs on the categories that are the largest in U.S. trade, including manufactured goods (especially electronics, autos and parts) and petroleum.

[2] Euromonitor International, "Top 10 Countries by Consumer Expenditure", October 20, 2017

As we have written in the past, it is difficult to position portfolios to address individual geopolitical events.[3] If countries choose to continuously retaliate against each other, it would be negative for all economies involved. Investors may seek to help protect their portfolios with broad diversification across asset classes, geographies, market capitalizations, and sectors. This would help to minimize concentrations that may be negatively affected should trade disruptions spread. However, one area that may benefit (on a relative basis) if trade retaliation escalates is U.S. small-cap equities. With most of their revenues generated domestically, small-cap companies may benefit (relative to larger, multinational firms) if trade is disrupted. Until trade negotiations are finalized, U.S. equity and bond prices, as well as the U.S. dollar, may be prone to uncertainty-driven pullbacks. Yet, we still believe that domestic equity prices and bond yields will finish the year higher.

[3] "Q&A: Investment Implications of North Korea Missile Test", August 29, 2017.

Economic Calendar

Date	Report	Estimate	Previous
04/03/2018	Wards Domestic Vehicle Sales	13.10m	12.94m
04/03/2018	Wards Total Vehicle Sales	16.90m	16.96m
4/4/2018	MBA Mortgage Applications	--	4.80%
4/4/2018	ADP Employment Change	205k	235k
4/4/2018	Markit US Services PMI	54.2	54.1
4/4/2018	Markit US Composite PMI	--	54.3
4/4/2018	ISM Non-Manf. Composite	59	59.5
4/4/2018	Factory Orders	1.70%	-1.40%
4/4/2018	Factory Orders Ex Trans	--	0.40%
4/4/2018	Durable Goods Orders	--	3.10%
4/4/2018	Durables Ex Transportation	--	1.20%
4/4/2018	Cap Goods Orders Nondef Ex Air	--	1.80%
4/4/2018	Cap Goods Ship Nondef Ex Air	--	1.40%
4/5/2018	Challenger Job Cuts YoY	--	-4.30%
4/5/2018	Initial Jobless Claims	--	215k
4/5/2018	Continuing Claims	--	1871k
4/5/2018	Trade Balance	-$56.3b	-$56.6b
4/5/2018	Bloomberg Consumer Comfort	--	56.8
4/6/2018	Change in Nonfarm Payrolls	187k	313k
4/6/2018	Two-Month Payroll Net Revision	--	--
4/6/2018	Change in Private Payrolls	190k	287k
4/6/2018	Change in Manufact. Payrolls	25k	31k
4/6/2018	Unemployment Rate	4.00%	4.10%
4/6/2018	Underemployment Rate	--	8.20%
4/6/2018	Average Hourly Earnings MoM	0.20%	0.10%
4/6/2018	Average Hourly Earnings YoY	2.70%	2.60%
4/6/2018	Average Weekly Hours All Employees	34.5	34.5
4/6/2018	Labor Force Participation Rate	--	63.00%
4/6/2018	Consumer Credit	$15.000b	$13.906b

Source: Bloomberg as of March 29, 2018.

Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates.

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