

# ECOWEEK

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## US: The import tariff boomerang

- Import tariffs have a negative impact on the targeted country. Retaliation will in turn have negative consequences for the country which started the tariff hikes
- Even in the absence of retaliation, there will be negative consequences
- Household spending will suffer from a loss of spending power due to an increase in inflation following higher import prices and/or a switch to domestically produced goods
- For the same reason, aggregate corporate profits may suffer. Companies may also cut back their investment because of increased uncertainty
- Empirical research confirms these outcomes

The “little squabble”<sup>1</sup> between the US and China on trade has moved back to the front page. It has been there before, causing havoc in markets, before becoming less of an issue, following the truce between Trump and Xi Jinping on the occasion of the G20 in Buenos Aires in December last year. Understandably, investors are eagerly hoping, with increasing impatience, for a new meeting, with a similar outcome, at the G20 on 28-29 June in Osaka. The softness of data this week in China and the US (in both cases, retail sales and industrial production were disappointingly weak) show that the negotiating parties are not exactly in a strong cyclical position. As a reminder, US Q1 growth was strong but of poor quality<sup>2</sup> whereas China only managed to surprise positively in the same quarter because it had taken enough measures to stop the growth slowdown.

Import tariffs, by construction, have a negative impact on the country which is targeted: export volumes and/or profit margins suffer<sup>3</sup>. Retaliation measures will in return hit the country which started the tariff hikes and third countries may also be hurt due to trade diversion. However, even in the absence of retaliation, the country which started will face negative consequences.

Consider US households: unless the price elasticity of their demand would be huge, they will lose spending power because of more expensive imports from China.

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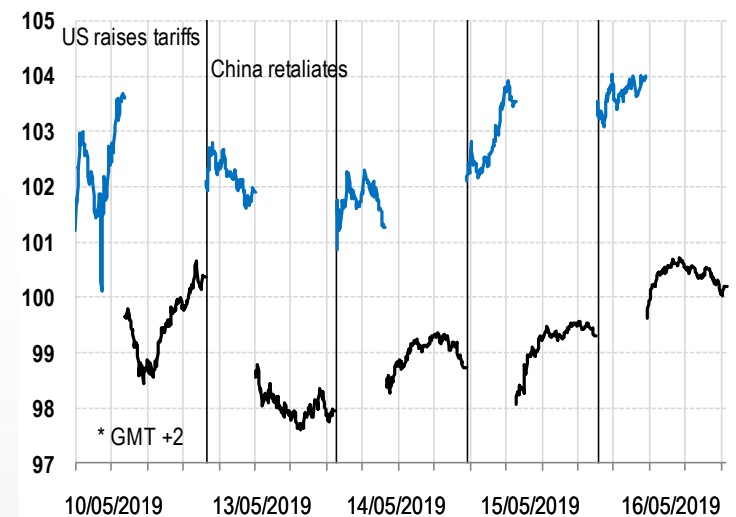
<sup>1</sup> “Trump calls trade war with China ‘little squabble’”, Reuters, 14 May 2019

<sup>2</sup> United States: Strong growth but questions about quality, BNP Paribas, EcoWeek n° 19-18, 3 May 2019

<sup>3</sup> Profit margins suffer when exporting companies hit by tariffs decide to lower their prices. A weakening of their currency would cushion the impact, but imported inputs would become more expensive and weigh on profit margins.

### STOCK MARKET SESSIONS

- Shanghai index, 09/05/2019 09:00:00 \*= 100
- S&P500, 09/05/2019 22:00:00\* = 100



Source: Bloomberg, BNP Paribas

p. 3

Markets Overview

p. 4

Pulse & Calendar

p. 6

Economic scenario

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Switching to consumer goods produced in the US will have a similar impact: they were more expensive than imports from China to start with and increased domestic demand may entice US producers to raise their prices. As a consequence, households may even be forced to switch to other, cheaper brands, in order to avoid having to pay more, something which would lower their consumer satisfaction.

Turning to US companies, higher import prices of finished products may weigh on sales volume whereas increased prices of intermediate inputs would reduce profit margins. This may force companies to change their global value chains –e.g. moving from China to e.g. Vietnam or Mexico- but this entails an opportunity cost: the money could have been spent on productivity enhancing investments. Supply bottlenecks due to a demand shift to domestically produced goods can cause wage and price increases. When profits are under pressure this may change the risk profile of companies and end up increasing their financing cost. Finally, a high level of tariff uncertainty on a protracted basis will end up weighing on growth.

Empirical research confirms these theoretical relationships. According to Amiti et al.<sup>4</sup> the import tariff measures taken last year “were costing U.S. consumers and the firms that import foreign goods an additional \$3 billion per month in added tax costs and another 1.4 billion dollars per month in deadweight welfare (efficiency) losses.”<sup>5</sup> ECB research shows that non-financial companies of the Dow Jones Euro Stoxx 300 index which are negatively affected by tariffs have cut back their investment: the investment to net asset ratio declined, whereas it increased for those benefitting from tariffs<sup>6</sup>. Research by Kyle Handley and Nuno Limão shows that China’s accession to the WTO in 2001 led to a reduction in US trade policy uncertainty which stimulated Chinese companies to invest in technology upgrading and export entry into the US<sup>7</sup>. It seems safe to assume that US companies would not act differently than their European or Chinese peers when faced with tariff policy uncertainty on a sustained basis.

William De Vijlder

<sup>4</sup> Mary Amiti, Stephen J. Redding and David Weinstein, *The impact of the 2018 trade war on US prices and welfare*, National Bureau of Economic Research, working paper 25672, March 2019

<sup>5</sup> The deadweight welfare loss refers to the tariff-induced distortion of consumers choices between domestically produced versus imported products.

<sup>6</sup> ECB, *The economic implications of rising protectionism: a euro area and global perspective*, Vanessa Gunnella and Lucia Quaglietti, ECB Bulletin 3/2019

<sup>7</sup> Kyle Handley and Nuno Limão, *Policy Uncertainty, Trade, and Welfare: Theory and Evidence for China and the United States*, American Economic Review 2017, 107(9).



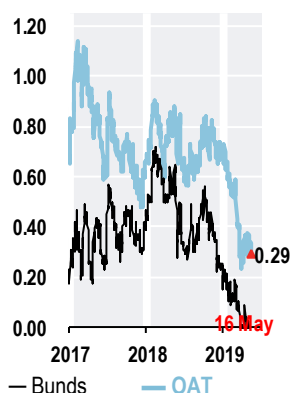
## Markets overview

### The essentials

Week 10-5 19 > 16-5-19

↗ CAC 40	5 327	▶ 5 448	+2.3 %
↘ S&P 500	2 881	▶ 2 876	-0.2 %
↘ Volatility (VIX)	16.0	▶ 15.3	-0.8 pb
↘ Euribor 3M (%)	-0.31	▶ -0.31	-0.3 bp
↘ Libor \$ 3M (%)	2.53	▶ 2.53	-0.3 bp
↘ OAT 10y (%)	0.35	▶ 0.29	-5.3 bp
↘ Bund 10y (%)	-0.05	▶ -0.09	-4.4 bp
↘ US Tr. 10y (%)	2.46	▶ 2.41	-4.7 bp
↘ Euro vs dollar	1.12	▶ 1.12	-0.6 %
↘ Gold (ounce, \$)	1 287	▶ 1 287	-0.0 %
↗ Oil (Brent, \$)	70.9	▶ 73.3	+3.5 %

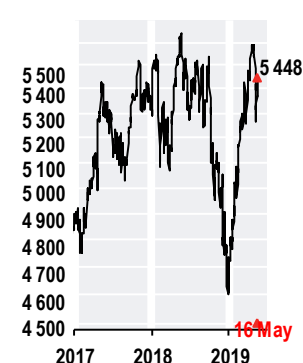
10 y bond yield, OAT vs Bund



Euro-dollar



CAC 40



### Money & Bond Markets

Interest Rates	highest' 19	lowest' 19
€ ECB	0.00 at 01/01	0.00 at 01/01
Eonia	-0.37 at 01/01	-0.37 at 26/02
Euribor 3M	-0.31 at 24/01	-0.31 at 24/04
Euribor 12M	-0.13 at 06/02	-0.13 at 16/05
\$ FED	2.50 at 01/01	2.50 at 01/01
Libor 3M	2.53 at 01/01	2.52 at 13/05
Libor 12M	2.63 at 21/01	2.63 at 15/05
£ BoE	0.75 at 01/01	0.75 at 01/01
Libor 3M	0.81 at 29/01	0.80 at 13/05
Libor 12M	1.04 at 11/01	1.04 at 15/05

At 16-5-19

Yield (%)	highest' 19	lowest' 19
€ AVG 5-7y	0.34 at 09/01	0.34 at 16/05
Bund 2y	-0.65 at 05/03	-0.65 at 15/05
Bund 10y	-0.09 at 01/01	-0.10 at 15/05
OAT 10y	0.29 at 08/01	0.24 at 27/03
Corp. BBB	1.34 at 08/01	1.26 at 07/05
\$ Treas. 2y	2.24 at 18/01	2.20 at 15/05
Treas. 10y	2.41 at 18/01	2.37 at 27/03
Corp. BBB	3.94 at 01/01	3.93 at 15/05
£ Treas. 2y	0.71 at 27/02	0.63 at 02/04
Treas. 10y	1.07 at 18/01	0.99 at 25/03

At 16-5-19

10y bond yield & spreads

3.96%	Greece	405 pb
2.55%	Italy	263 pb
1.08%	Portugal	117 pb
0.91%	Spain	99 pb
0.39%	Belgium	48 pb
0.29%	France	38 pb
0.22%	Austria	31 pb
0.14%	Finland	23 pb
0.10%	Netherland	19 pb
0.10%	Ireland	19 pb
-0.09%	Germany	

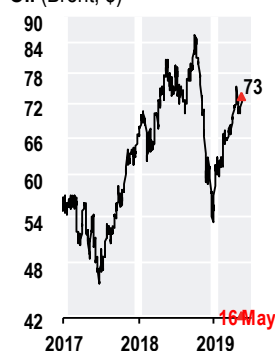
### Commodities

Spot price in dollars	lowest' 19	2019(€)
Oil, Brent	73.3 at 01/01	+41.2%
Gold (ounce)	1 287 at 02/05	+2.7%
Metals, LME	2 872 at 03/01	+4.8%
Copper (ton)	6 071 at 03/01	+4.4%
CRB Foods	346 at 07/03	+9.0%
w heat (ton)	183 at 10/05	-5.2%
Corn (ton)	140 at 24/04	+4.9%

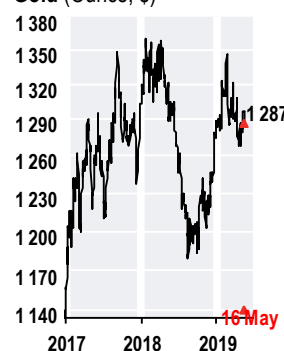
At 16-5-19

Variations

Oil (Brent, \$)



Gold (Ounce, \$)



CRB Foods



### Exchange Rates

€ =	highest' 19	lowest' 19	2019
USD	1.15 at 10/01	1.11 at 25/04	-2.2%
GBP	0.90 at 03/01	0.85 at 14/03	-2.6%
CHF	1.14 at 23/04	1.12 at 02/04	+0.2%
JPY	122.90 at 01/03	122.54 at 03/01	-2.0%
AUD	1.63 at 03/01	1.57 at 18/04	-0.3%
CNY	7.87 at 09/01	7.51 at 25/04	-2.0%
BRL	4.49 at 16/05	4.18 at 31/01	+1.4%
RUB	79.30 at 01/01	71.51 at 23/04	-9.1%
INR	82.00 at 04/02	76.84 at 03/04	-1.9%

At 16-5-19

Variations

### Equity indices

Index	highest' 19	lowest' 19	2019	2019(€)
CAC 40	5 592 at 23/04	4 611 at 03/01	+15.2%	+15.2%
S&P500	2 946 at 30/04	2 448 at 03/01	+14.7%	+17.3%
DAX	12 413 at 03/05	10 417 at 03/01	+16.6%	+16.6%
Nikkei	22 308 at 25/04	19 562 at 04/01	+5.2%	+7.4%
China*	86 at 09/04	68 at 03/01	+12.8%	+15.1%
India*	606 at 02/04	530 at 19/02	+1.5%	+3.5%
Brazil*	1 888 at 04/02	1 888 at 16/05	+0.7%	-0.7%
Russia*	682 at 23/04	572 at 01/01	+9.0%	+18.8%

At 16-5-19

Variations

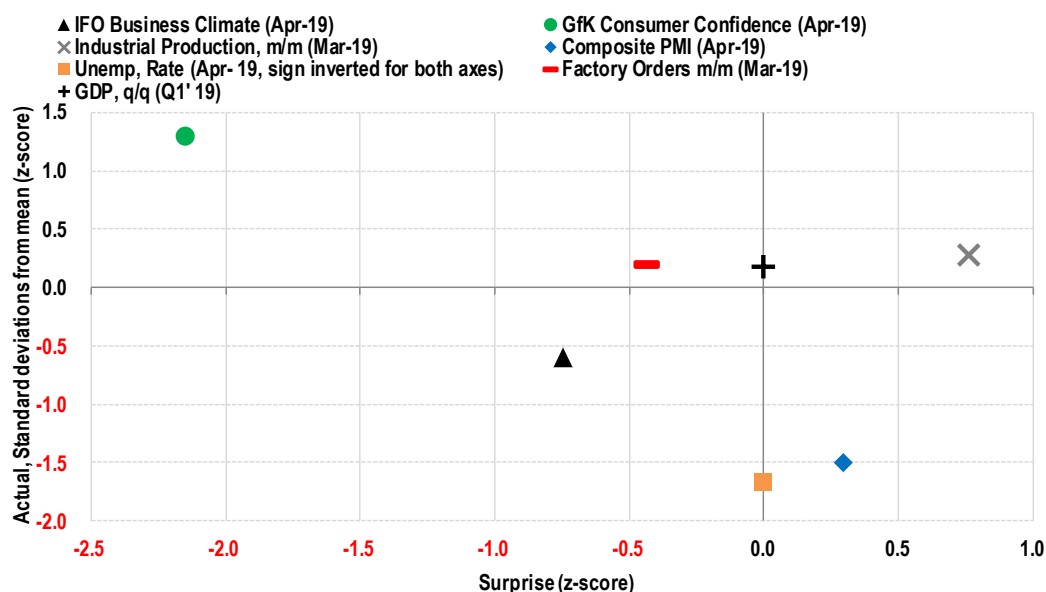
\* MSCI index



## Pulse

## Germany: improving economic news flow

Over the past few months, the news flow for the German economy has definitely improved. Manufacturing output strengthened for the second consecutive month, although remaining well below last year's level. Also industrial orders rose slightly, although falling short of market expectations. Even though consumer confidence slightly weakened April, it remained at a very high level. Thanks to the resilience of consumer demand and construction activity, GDP increased by 0.4% in Q1. This was better than expected only a couple of weeks before. However, the decline in the ZEW economic sentiment indicator for May, published last Tuesday, points at sluggish growth in the coming months, as the US-China trade dispute and Brexit continue to weigh on industrial activity.



Sources : Markit, Bloomberg, calculs BNP Paribas

## Indicators preview

Next week will see the publication of important data covering the month of May: Markit PMI in several countries, eurozone consumer confidence, business confidence in France, IFO business climate in Germany. In addition we will have, in the US, existing and new home sales as well as durable goods orders and, in the UK, inflation and retail sales. Japan will publish first quarter GDP. Finally, the publication of the FOMC minutes will benefit from the usual attention.

Date	Country/Region	Event	Period	Survey	Prior
05/20/2019	Japan	GDP Annualized SA QoQ	1Q	-0.2%	1.9%
05/21/2019	Eurozone	Consumer Confidence	May	--	-7.9
05/21/2019	United States	Existing Home Sales MoM	April	2.5%	-4.9%
05/22/2019	Japan	Core Machine Orders MoM	March	--	1.8%
05/22/2019	United Kingdom	CPI MoM	April	--	0.2%
05/22/2019	United States	MBA Mortgage Applications	May 17	--	-0.6%
05/22/2019	United States	FOMC Meeting Minutes	May 1	--	--
05/23/2019	Japan	Nikkei Japan PMI Mfg	May	--	50.2
05/23/2019	France	Business Confidence	May	--	105
05/23/2019	France	Markit France Composite PMI	May	--	50.1
05/23/2019	Eurozone	Markit Eurozone Composite PMI	May	--	51.5
05/23/2019	Germany	IFO Business Climate	May	--	99.2
05/23/2019	United States	Markit US Composite PMI	May	--	53.0
05/23/2019	United States	New Home Sales	April	670000	692000
05/24/2019	United Kingdom	Retail Sales Ex Auto Fuel MoM	April	--	1.2%
05/24/2019	United States	Cap Goods Orders Nondef Ex Air	April	--	1.4%

Source: Bloomberg, BNP Paribas



## Economic scenario

### UNITED STATES

- Growth is expected to slow to 2.3% this year. Trade war uncertainty acts as a drag, the housing market is softening, corporate investment should slow, as well as exports in reaction to the past strengthening of the dollar against a broad range of currencies.
- Core inflation remains well under control and has eased a bit.
- Following the dovish message from the January FOMC meeting, markets are pricing in a policy easing in the course of 2020.

### CHINA

- Economic growth continues to slow, with an export outlook severely darkened by US tariff hikes.
- The central bank is easing liquidity and credit conditions, though the reduction in financial-instability risks via regulatory tightening should remain a priority. Fiscal policy has also turned expansionary through increased infrastructure spending and a rising number of household/corporate tax cuts.
- In the short term, private domestic demand should be affected by the knock-on effect of weakening exports and the continued moderation in the property market. Fiscal measures should support consumer spending.

### EUROZONE

- The slowdown is becoming increasingly evident, especially in the German economy, which has suffered from one-off factors but also from a slowdown of exports to China. Capacity constraints also play a role. Business climate in the manufacturing sector continues to decline. Italy has now entered a technical recession with quarterly growth negative in the third and fourth quarter of 2018.
- Inflation is now expected to decrease following the past drop in the oil price, while core CPI is hardly moving. The activity slowdown also implies that the pick-up in core inflation should be slower than expected until recently. We do not expect the ECB to move rates this year (see below).

### FRANCE

- Growth is slowing although the economy should show some resilience. Households' consumption should get a boost from the tax cuts and the jobs recovery but inflation reduces purchasing power gains. Business investment dynamics remain favourable. The global backdrop is less supportive. A slight rise in core inflation is appearing but remains to be confirmed.

### INTEREST RATES AND FX RATES

- In the US, the Fed has announced to be patient before deciding on any change in its policy. We expect key rates to stay on hold. We have changed the forecast for 10 year treasury yields and now expect a yield of 2.80% by mid-year and 2.70% at the end of the year.
- As the ECB confirmed that key rates won't change this year, the forecast for 10 year Bund yields and now expect a yield of 0.30% by mid-year and 0.40% at the end of the year.
- No change expected in Japan.
- The prospect of a narrowing bond yield differential between the US and the eurozone should cause a strengthening of the euro, all the more so considering it is still below its long-term fair value (around 1.34).

%	GDP Growth			Inflation		
	2018	2019 e	2020 e	2018	2019 e	2020 e
<b>Advanced</b>	<b>2.2</b>	<b>1.5</b>	<b>1.3</b>	<b>2.0</b>	<b>1.4</b>	<b>1.6</b>
United-States	2.9	2.3	1.8	2.4	1.7	2.0
Japan	0.8	0.2	0.3	1.0	0.5	0.5
United-Kingdom	1.4	1.1	1.5	2.5	2.0	1.9
<b>Euro Area</b>	<b>1.8</b>	<b>0.9</b>	<b>1.0</b>	<b>1.8</b>	<b>1.2</b>	<b>1.4</b>
Germany	1.4	0.7	0.9	1.9	1.4	1.7
France	1.6	1.2	1.2	2.1	1.2	1.7
Italy	0.8	0.0	0.5	1.3	0.9	1.2
Spain	2.6	2.1	1.7	1.7	1.0	1.4
<b>Emerging</b>	<b>4.5</b>	<b>4.3</b>	<b>4.7</b>	<b>4.8</b>	<b>4.8</b>	<b>4.3</b>
China	6.6	6.2	6.0	2.1	1.6	2.0
India*	7.4	7.6	7.8	3.4	3.3	4.1
Brazil	1.1	2.0	3.0	3.7	3.8	3.6
Russia	2.3	1.5	1.7	2.9	5.1	4.1

Source : BNP Paribas Group Economic Research (e: Estimates & forecasts)

\* Fiscal year from April 1st of year n to March 31st of year n+1

Interest rates, %	End of period	2019				2018	2019e	2020e
		Q1	Q2e	Q3e	Q4e			
<b>US</b>	Fed Funds	2.50	2.50	2.50	2.50	2.50	2.50	2.50
	Libor 3m \$	2.60	2.60	2.60	2.60	2.81	2.60	2.50
	T-Notes 10y	2.42	2.80	2.75	2.70	2.69	2.70	2.50
<b>Ezone</b>	ECB Refi	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	Euribor 3m	-0.31	-0.30	-0.30	-0.30	-0.31	-0.30	-0.30
	Bund 10y	-0.07	0.30	0.30	0.30	0.25	0.30	0.40
	OAT 10y	0.26	0.65	0.65	0.60	0.71	0.60	0.70
<b>UK</b>	Base rate	0.75	1.00	1.00	1.25	0.75	1.25	1.25
	Gilts 10y	1.00	1.85	2.00	2.10	1.27	2.10	2.10
<b>Japan</b>	BoJ Rate	-0.06	-0.10	-0.10	-0.10	-0.07	-0.10	-0.20
	JGB 10y	-0.09	-0.03	-0.05	-0.05	0.00	-0.05	-0.20

Source : BNP Paribas GlobalMarkets (e: Forecasts)

Exchange Rates	End of period	2019				2018	2019e	2020e
		Q1	Q2e	Q3e	Q4e			
<b>USD</b>	EUR / USD	1.12	1.17	1.18	1.20	1.14	1.20	1.25
	USD / JPY	111.0	108.0	105.0	100.0	110.0	100.0	90.0
	GBP / USD	1.30	1.38	1.40	1.45	1.27	1.45	1.51
	USD / CHF	1.00	0.97	0.97	0.97	0.99	0.97	0.93
<b>EUR</b>	EUR / GBP	0.85	0.85	0.84	0.83	0.90	0.83	0.83
	EUR / CHF	1.12	1.14	1.15	1.16	1.13	1.16	1.16
	EUR / JPY	124.0	126.0	124.0	120.0	125.0	120.0	113.0

Source : BNP Paribas GlobalMarkets (e: Forecasts)



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