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Economics Group

Special Commentary

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Trade Outlook: In Low Visibility, Trust Your Gauges

"*Economists put decimal points in their forecast to show they have a sense of humor*"

-William Gilmore Simms, 19th Century American Novelist

Economics is seldom an exact science. Forecasting trade dynamics amid the uncertainty introduced by tariffs is already like flying through fog. When visibility is low, pilots have to trust their gauges. But as the government shutdown drags on, a number of economic indicators which rely on government funding are not being published, so we are without all our usual instruments. In this report, we attempt to estimate how the U.S. economy is faring in terms of international trade by checking the available, and sometimes alternative, measures.

In short, we find that robust consumer spending toward the end of 2018 is likely to result in a year-end surge in retail sales. This solid domestic demand will likely lift imports faster than exports, which remain beset by retaliatory tariffs and slower global growth.

Trade's Role in the Economy: From a Help to a Hindrance

Although the implementation of tariffs actually began with the softwood lumber tariffs in late 2017, they did not really get underway in earnest until the rollout of the steel and aluminum tariffs in June 2018 and the broader $200 billion tariffs directed against China last September.

One effect of these tariffs was an initial surge in goods leaving the country as U.S. exporters rushed to get their goods to foreign markets before expected retaliatory tariffs began to bite. That proved to be only a temporary boost, however, as exports fell in four of the past five months for which we have data, even as imports increased every month throughout this period (Figure 1). In terms of GDP impact, the result of this was a 1.2 percentage point boost to growth in the second quarter, followed by a 2.0 percentage point drag in the third quarter (Figure 2).

Exports fell in four of the past five months for which we have data.

Figure 1

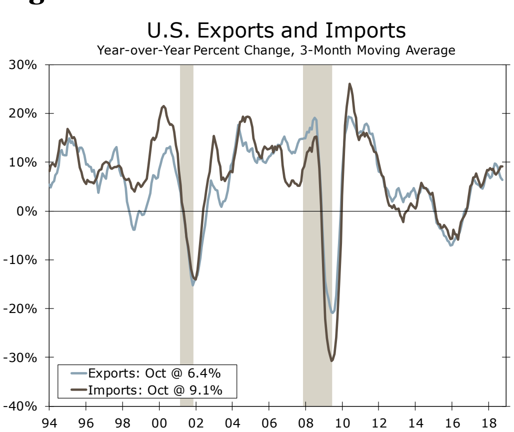
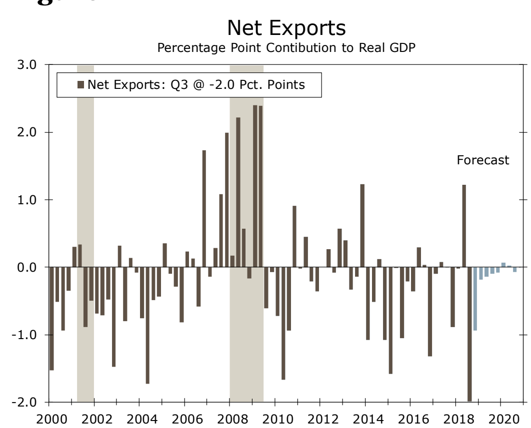


Figure 2



Source: U.S. Department of Commerce and Wells Fargo Securities

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Trade will remain a headwind to economic growth in the fourth quarter.

Our expectation (also shown in Figure 2) is that trade will remain a headwind to economic growth in the fourth quarter and will weigh on growth throughout the forecast period, though admittedly to a somewhat lesser extent as time goes on.

There are two primary factors underpinning our expectation of a trade drag in the fourth quarter: solid U.S. consumer spending likely increased imports, and trade tensions continued to weigh on exports, particularly to China.

Solid Consumer Spending Likely Lifted Q4 Imports

Upbeat consumer confidence and a tight labor market likely translated into a solid gain for 2018 holiday sales. The temporary closure of the U.S. Department of Commerce means that we are still awaiting December retail sales figures, but the weekly Redbook index for same-store sales was up more than 6% for every week in December. To put an exclamation point on that, the 9.3% year-over-year increase in same-store sales in the final week of 2018 was the biggest on records that date back to the mid-1990s.

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Figure 3

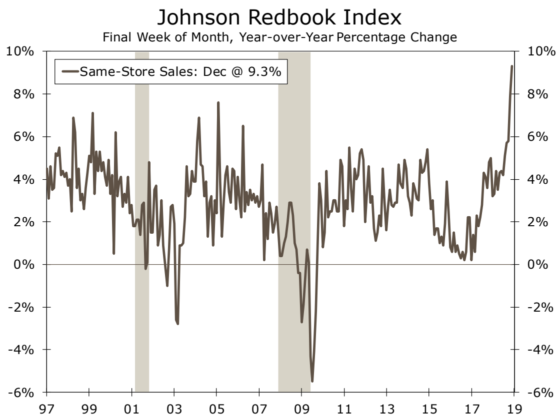
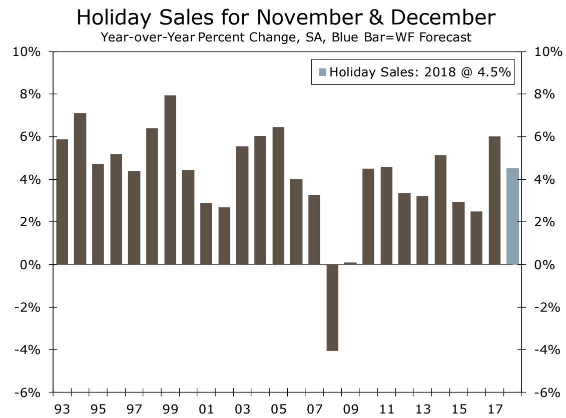


Figure 4



Source: Bloomberg LP, Redbook Research Inc., U.S. Department of Commerce and Wells Fargo Securities

We may be flying blind since we are still missing trade data for the final two months of 2018 and are without retail sales data for December. But, based on still-high levels of consumer confidence, the solid jobs report in December and the record print for Redbook same-store sales, we feel justified both in our above-consensus call back in October for holiday sales to rise 4.5% (Figure 4), and also with our expectation that imports surged in the fourth quarter.

The Great Wall or China?

The only Oval Office address of the current administration was fixated on a border wall with Mexico. Whether or not to fund that wall remains the sticking point between the two parties and that is what is holding up the reopening of the government. But in terms of our outlook for trade, the foreign economy that matters much more is China.

China can weigh on exports in different ways. It can do so directly, through retaliatory tariffs. It can also weigh on exports indirectly either through the disruption of supply chains or as slower Chinese growth weighs on demand both from China and other countries that depend on China to sustain growth. A trade fight that hurts China might be seen as something that would boost net exports, but anyone rooting for China's demise does so at the peril of the U.S. manufacturing sector. This is because a number of U.S. factories source material from China, and increasingly U.S. exports rely on emerging markets. In 2017, the U.S. sent more than $700 billion of exports to developing economies, an amount that accounted for 47.5% of all exports that year. China is not only the world's largest emerging market, it is also a sizeable influencer of economic growth in those developing parts of the world on which we depend for trade.

The Chinese economy downshifted about a decade ago from the double-digit percentage GDP growth seen in the years preceding the global recession of 2009 to just high single-digit percentage growth more recently. Throughout the course of 2018, however, the world's second-largest economy has found an even lower gear. We expect full-year GDP growth in China likely slowed to just 6.6% in 2018, which, if realized, would mark the slowest full-year economic growth in China in the modern era. Our forecast also anticipates the slowing trend in real GDP growth in China will continue in 2019 and 2020 (Figure 5).

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A number of factors explain the slowing growth outlook for China, including a highly-geared corporate sector and an aging population, but the incipient trade fight with the United States is certainly a significant headwind. China sends a little less than 20% of its exports to the United States, or at least it did before the trade war began.

As the trade tariffs pile up, the imbalance in the bilateral trade relationship is weighing on the Chinese economy as is evident in a number of higher frequency indicators. The manufacturing PMI fell into contraction territory in December (Figure 6), a development that dealt another blow to Chinese stock prices which had already been under pressure.

Figure 5

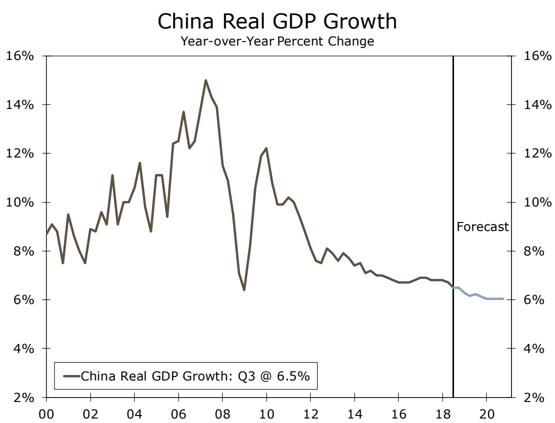
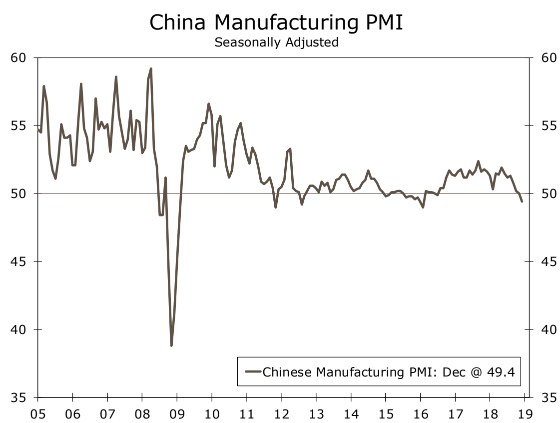


Figure 6



Source: Bloomberg LP and Wells Fargo Securities

Perhaps even more relevant to our discussion about prospects for trade, there is evidence that slower growth in China may have slaked China's once unquenchable thirst for imported goods, at least for a moment. Real imports in China fell in two out of three months in the third quarter and were down in the first two months of the fourth.

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To be clear, we do not expect a trade war to push either the United States or China into recession this year, but we do view the hostilities as a net negative for the world's number one and number two economies, respectively.

Change in the Bellwether

For the third time in four months the ISM index, a key bellwether for the U.S. factory sector, lost ground in December and now sits at just 54.1, the softest reading of activity in more than two years. While any print above 50 is consistent with expansion, the softening in the headline figure suggests a moderation in the pace of growth that was presaged by a broad-based decline in regional PMIs in the weeks leading up to the ISM report. New orders fell 11 points to 51.1 and signal factory activity is likely to remain in a soft patch. There was hope for trade. Export orders edged up to 52.8, but excluding the past two months, ISM export orders are growing at the slowest pace since late 2016 when the global trading environment weakened and tariff talk began ramping up (Figure 7).

The deterioration in business activity likely continued into the new year. The government shutdown has prevented the release of factory orders numbers, but the fact that many of the regional Fed surveys are flashing warning signs in January is not particularly encouraging.

The New York Federal Reserve's Empire index slipped to 3.9 in January, the lowest level since May 2017 (Figure 8). There is not a measure for exports in the Empire index, but the orders component also slipped to its lowest since May 2017.

Figure 7

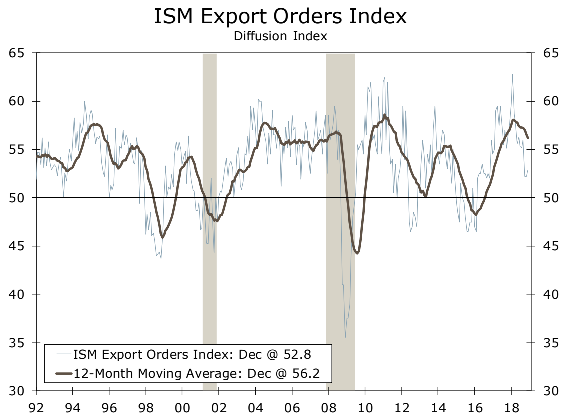
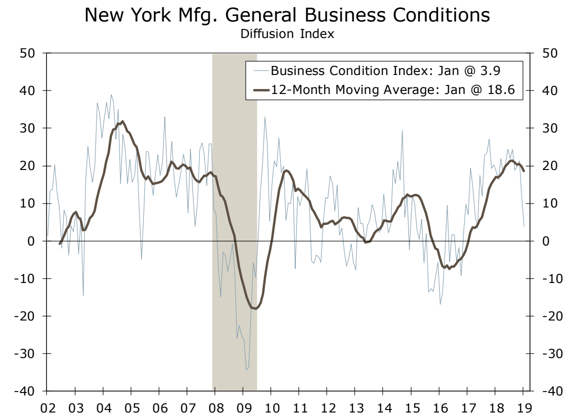


Figure 8



Source: Federal Reserve Bank of New York, Institute for Supply Management and Wells Fargo Securities

A reprieve of sorts came from the Philadelphia Fed's business outlook survey this week when that measure rose to 17.0. Since the start of 2017, this measure has averaged 23.9, so a 17.0 is not great, but it was not as bad as financial markets were bracing for after the ugly Empire print. Similar Fed Surveys from Kansas City, Dallas and Richmond will offer further signals for how business activity fared in January and offer some clues in the absence of hard orders data if the government remains closed.

Conclusion and Highlights to Consider for 2019

While we are admittedly flying blind to some extent due to the lack of available indicator reports, our best read of the instruments at our disposal suggests that trade was likely a drag on GDP growth again in the fourth quarter of 2018. Strong domestic demand particularly in consumer spending likely lifted imports during the period. Exports may grow in the fourth quarter, but with headwinds from retaliatory tariffs and slower growth in China and other foreign markets, we do not anticipate export growth will keep pace with the faster growth on the import side of the ledger.

We expect trade to continue to weigh on growth.

Further out, we expect trade to continue to weigh on growth, but admittedly to a somewhat lesser extent than we thought a few months ago. There are a few reasons for that, but the biggest recent change is the downdraft in oil prices. In 2014-2016, the large decline in oil prices was accompanied by a retrenchment in business fixed investment spending. The most recent oil price declines have been milder and at this point we only anticipate a slowing–rather than an outright decline–in business spending. Even that slowdown, however, portends a softer pace of import growth, which means less of a drag from net exports.

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