TRADE WARS AND COMPANY SURVIVAL

THE ISSUES THAT WILL DETERMINE COMPANIES' SURVIVAL OF SUPERPOWER TRADE WARS

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In January Trump slapped tariffs of up to 30% on imports. In March 2018 he added tariffs of 25% and 10% on imported steel and aluminium respectively. China and the EU retaliated with actual or threatened tariffs on hundreds of imported US products, but Trump hit back with a threat of further taxes.

Companies and investors caught in the cross-fire between tit-for-tat trade wars are concerned because:

- The US and China appear to be taking a hard-line approach to recent trade hostilities and the EU and Canada are pushing back, so escalation is possible, and the economic consequences worse.

- The warring parties (EU, US, and China especially) are dominant economic powerhouses and their actions affect global and domestic GDPs, as well as the fortunes of millions of companies and people around the world.

- History tells us that trade wars have few, if any, winners.

Gavyn Davies suggests a global trade war could knock 1-3% off GDP over a few years. The FT reported that whereas capital expenditure (capex) by some US companies had risen, a Credit Suisse survey suggested many businesses remained more hesitant about investing. Some have opted to hold onto their mountains of cash because of the uncertain outlook caused by trade war and geo-political tensions.

Capex

With reduced capex comes reduced employment and reduced productivity gains. Inefficiency eats into profit margins and competitiveness, lowering company values and economic growth, which leads to less capex, and so the vicious downward spiral continues.

Some companies might manage the situation by shifting production overseas, but in the process losing exported jobs. Relocation would also consume investment and time to raise production and adjust to the new dynamic, and in the meantime, the profit margin would diminish.

Uncertainty

A great drag on companies' profits and a disruptive influence on supply chains, is the uncertainty that trade wars create. When will they end? Will they escalate? Which sectors will be affected and to what extent?

Chinese parts, for example, relied upon by US manufacturers, could become unavailable, or they might not. Just a month later, the US is backpedalling on its April 2018 ban on selling US company parts to Chinese company ZTE, a reversal that will cause turmoil among exporters and importers that must now reverse their plans to circumvent the ban.

Governments might retaliate to their counterparts in other ways. In 2016, China shut down Korean companies operating in China in retaliation to South Korea's actions. Hyundai and Lotte (both Korean) were denied car parts from local suppliers and 100 Lotte shops were closed. Countries have been known to expropriate foreign companies' assets.

In the aftermath of the 2007 global financial crisis, investors stood on the sidelines for years with their pockets full of cash until asset prices and markets stabilised from the shock. The same hesitation could occur during trade wars and other geopolitical crises.

Higher funding costs

We have already seen some shareholders switching out of volatile equity investments into safer havens such as government bonds. That is likely to raise yields for borrowers, especially for high-yield borrowers, increasing interest payments and lowering corporate profits.

Currency risk

Investors' flight to safety could significantly impact exchange rates as they dump risky currencies (such as those of some emerging market countries) and buy safer ones (such as USD), causing currency losses for companies that have not hedged their currency risks. Conversely, companies with a depreciating currency could benefit – for example, from the increase in value of overseas earnings that are reported in the depreciating currency. Those gains could be offset more or less, by higher import costs.

The IMF reckons that (without trade retaliation) the USD could appreciate by 5%. Appreciation of the USD could accelerate, causing further rises in costs of USD-denominated commodities, such as oil.