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Weekly Note: Can "Trade Wars" derail the risk rally?

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Despite better than expected earnings, with 80% of the S&P 500 beating estimates, some markets are losing momentum. Importantly, global equities have undergone almost zero-change due to declines in both Europe and Japan which have off-set gains in the US; credit spreads stopped tightening in the US high-grade, the Euro high yield, and the EM sovereigns plus corporates. Meanwhile, volatility rose to three-month highs both in currencies and US rates.

Volatility's rise is a reminder that risk-adjusted returns in 2018 should decline from 2017's highs as last year's shock-free environment gives way to inflation and policy surprises.

TABLE 1 THIS WEEK IN MARKETS

Name	YTD %	MTD %	WTD %
DOW JONES	6.09%	6.09%	-0.11%
S&P 500	5.81%	5.81%	-0.34%
RUSSELL 2000	2.89%	2.89%	-1.23%
NASDAQ COMPOSITE	7.57%	7.57%	0.15%
Euro Stoxx 50	3.01%	3.01%	-0.93%
FTSE 100	-2.01%	-2.01%	-1.44%
DAX 30	2.10%	2.10%	-1.68%
NIKKEI 225	1.46%	1.46%	-3.52%
HANG SENG	9.92%	9.92%	-0.22%
S&P/ASX 200	-0.45%	-0.45%	0.01%
EUR-USD X-RATE	3.42%	3.42%	0.06%
EUR-GBP X-RATE	1.46%	1.46%	-0.48%
Gold Spot $/Oz	2.90%	2.90%	-1.31%
Crude Oil	6.59%	6.59%	-1.84%

So, who is to blame for these wobbles? Quite simply put; Washington.

In particular, there have been three major developments, headline-wise, that need our attention: Firstly, the US imposed protective tariffs on two items on Monday (solar panels and washing machines); secondly, Commerce Secretary Ross made remarks at Davos in which he stated that more enforcement actions are likely; and finally, Treasury Secretary Mnuchin also made comments on the same snowy slopes with regards to a weak dollar being good for US trade.

The question is; how damaging are these comments and tariffs? Will they really be a shock to the financial markets?

For perspective, the US has been engaged in a trade conflict with other countries every year for at least a half century; that is if we define conflict as US Department of Commerce investigations into unfair foreign trade practices that often result in the unilateral imposition of protective tariffs.

The number of petitions that US corporates have filed annually has averaged at about 50 but has ranged from 6 to 180. This ebb and flow, however, generally mirrors the US business cycle (more claims in recessions than expansions) rather than Washington's orientation (Democrat or Republican). According to a US government study, the US International Trade Commission (ITC) ruled in favour of US claimants (triggering sanctions) on about 40% of cases and with foreign defendants about 40% of the time; the remainder of cases were either terminated or suspended. Not a bad outcome for a procedure some might consider inherently biased and inconsistent with WTO principles.

These background conflicts almost never merit any investor's attention – except those investing in single-name stocks of companies involved in the claim – because the value of US imports subject to tariffs has been trivial. On average, only about 0.4% of US imports are investigated annually across all cases, with an even lower share eventually subject to protective tariffs due to an affirmative judgement by the ITC.

As such, it seems that in the majority of cases, changes in foreign trade policy with respect to tariffs don't have a huge impact on the financial market.

However, once a decade, a trade conflict is labelled a trade war because it involves a high-profile sector, a major trading partner, retaliatory actions, and an appeal to the WTO over a couple of years. The US-Japanese auto dispute from January 1993 to June 1995 is the most famous, with the US-EU steel dispute from June 2001 to December 2003 being the second.

During the auto dispute, US equities delivered below-average returns (including -1.5% returns in 1994), and also declined during the steel dispute (including -23% in 2002); that being said, trade was the sideshow. The greater challenge for equities in 1994 was the Fed's record-fast hiking cycle (+300bp in a year). Indeed, from mid-2001 to 2002 it was the 2001 recession plus the 2002 corporate accounting scandal that compelled more than 100 companies to restate earnings.

Controlling for context, it's not obvious that stocks paid much attention to the two greatest trade conflicts of the past three decades, which incidentally still only involved a token share of US imports (0.2% for steel, 1% for luxury cars).

We will have to see if the recent pressure on risk assets persists and if Trump, having put so much weight on equity markets' performances, backs away from some of his more aggressive trade rhetoric.

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