Market Reaction to Tariffs Misses Larger Opportunity in Asia

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The latest tariffs in the U.S.-China trade dispute may be giving investors a second bite of the cherry!

The U.S. government hiked the tariff on US$200 billion of Chinese exports to 25% from 10%. In response, China raised tariffs on nearly US$60 billion of U.S. goods to as high as 25% from around 10%. The expansion of tariffs is of small consequence to GDP, either in the U.S. or in China.

The issue here is twofold: first, the impact on sentiment, mostly corporate investment, is far greater in both the U.S. and China than in reality. That means that actual effects are borne by the economy and reflected in the market to a much greater extent than are warranted, giving rise to opportunity. Second, the fear that the tariffs may signal something more than the current dispute—a full blown trade war that could rip apart supply chains and undermine the global economy. This is far more serious, but yet not enough to derail domestic economies. It could lead to a dismantling of the U.S.'s international influence and signal the rise of China and a different kind of world order. But this is something that I suspect neither the U.S. nor China is ready for and they are unlikely to accept.

So the likelihood remains that a trade deal is done, albeit one that doesn't clear up the fundamental tension between the two powers and doesn't remove the incentives for China to continue to expand its economic sphere of influence and expansion of manufacturing supply chains into Southeast Asia and even further afield.

Indiscriminate Reaction

After weak performance in 2018, Asia got off to a roaring start in the first quarter and that rally continued, backed by looser monetary policy in China and a “pause” in rate increases by the U.S. Federal Reserve. Much of that performance seems to be unwinding under increased tariffs on Chinese goods. The market reaction has been indiscriminate—penalizing exporters and domestic demand-driven businesses alike. It is as if investors are saying that tariffs are enough to plunge us into a deep global recession. It is not irrational to be concerned about an expansion that has been going on for a decade but tariffs are simply not powerful enough to create a significant downturn.

Furthermore, there seem to be few significant imbalances in the U.S. financial system. Yes, one can point to auto loans and some loose lending in other areas, but it is nothing like on the scale of the 2000s. In Asia, policy has been, if anything, too tight for the past five years or more. Any shock to the system, and certainly one that is as moderate in its impact on GDP as a tariff increase, should be easily offset by monetary or fiscal policy. It may even prod Asian governments into implementing the stimulus that they should have been doing for the past three years.

In addition, the average opinion in the market seems to be focused on the short run. And is also taking it for granted that U.S. policy alone drives Asia's economies. That is surely short-sighted! Not only do Asia's governments have the room to manoeuver in terms of macroeconomic policy, but Asia's businesses also have the ability to sidestep a lot of these trade issues by changing their supply chains. None of this is without cost; nor can it be implemented immediately. Markets seem determined, however, to view a standoff between the U.S. and China as a short term, zero-sum game. In so doing, they are agreeing with the rhetoric of the U.S. administration.

Asia Embraces Trade and Cooperation

In the background, Asia continues to deliver faster economic growth than the U.S. Growth has been shared more evenly across its citizens than in the U.S. Asia is embracing trade and international cooperation through the One Belt One Road project. Reformist governments are holding onto power in elections in the region. The medium-term prospects for earnings growth in the region seem to be much better than for the developed world. Asia has the opportunity for balanced growth—the West is embroiled in a struggle between labor and corporate profits. Asia has savings and infrastructure projects to spend those savings on. Projects that promise to bring hundreds of millions of people into the global economy. Asia's companies are increasingly dominant in their own consumer markets as well as making cross-border intraregional investments that will enhance their competitive position in what remains the world's fastest-growing region.

But, no, say the markets—all this can be brought down by an incremental 15% of tariffs on exports to the U.S. consumer. So markets may be giving investors a second bite of the cherry—ignoring the opportunities that tariffs create for Southeast Asian investment and growth; indiscriminately selling down domestic-demand champions along with weak exporters, and giving short shrift to the structural advantages that point to continued fast long-term growth in Asia.

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