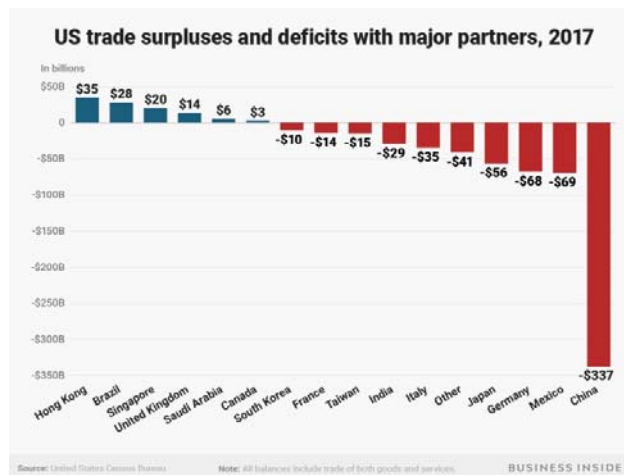




How Tariffs Can Impact the US and the Global Capital Markets

President Trump recently fired the first shot against the rest of the world by imposing tariffs on imports to the tune of \$34 billion. The tariffs cover various goods from China, as well as \$3 billion on aluminum and steel imports from Europe. As has been widely publicized, the affected countries retaliated with equal measure. We believe the trade war is likely to escalate before these countries are able to negotiate an agreement that suits all interested parties.

Before we get into the core of the paper, we'd like to state that it would have been prudent to establish a bi-lateral trade agreement with U.S. allies before engaging in a trade war with our largest offender, which is indisputably the country of China (see the table below). As we know, China is a country historically known to manipulate its currency and infringe on copyrights, while its practice of subsidizing its companies continues to this day. With that said, the objective of this paper is to explain how the imposition of tariffs and associated policies may affect capital markets over the medium and the long-run.





Impact on Commodities:

Historically, commodities have been the first to feel the impact of any trade disagreement. The US exports over \$130 billion in agricultural products annually, with over \$20 billion going to China alone. Soybeans, cotton, corn, wheat, dairy, meat, and grains constitute the bulk of these exports. In the short-run, making changes to the supply chain isn't possible and since most of these exports are perishable, a major price decline will likely ensue. However, in the medium and long-run prices tend to find a new and typically higher equilibrium. As for energy and oil, we believe these commodities should hold up well in the short-term but if the trade war is prolonged, it is possible that this scenario could provoke an economic slowdown which would most likely impact demand and lower prices. Other commodities, such as gold, timber, and forest products should do well regardless as these can be stored, or in the case of timber, left to grow.

Impact on Domestic Equities:

As we know, not all equities are the same and companies with low foreign exposure tend to generate relatively better returns in such times. Generally, these are smaller-cap companies with little exposure to factors beyond their own shores. From a sector perspective, equities in the materials sector tend to perform best. For example, domestic steel companies are the biggest and direct beneficiaries of the steel tariffs levied on the Chinese firms. On the other hand, the consumer discretionary sector tends to struggle as raw material costs increase, this is especially true if the firm has limited capacity to raise prices without impacting demand. In general, the technology, communication and health-care sectors hold up better in such an environment.



Impact on International Equities:

Developed international equities generally have a similar reaction to tariffs as domestic equities because tariffs are levied by both sides using retaliatory tactics. The reaction of emerging economies, conversely, varies both by geography and sector. China, and the US are both big trading partners of various emerging countries; many goods and raw materials from emerging countries are used in Chinese and US finished products before making their way to the outside world. The charts below are a depiction of what countries are vulnerable in the case of a prolonged trade war between China and the US. The top chart indicates those countries that trade with China for products that may come under the US tariffs, while the bottom chart represents countries that trade with the United States for products that may come under the Chinese tariffs. Clearly, Mexico, S. Korea, and Czech Republic are the most vulnerable countries.

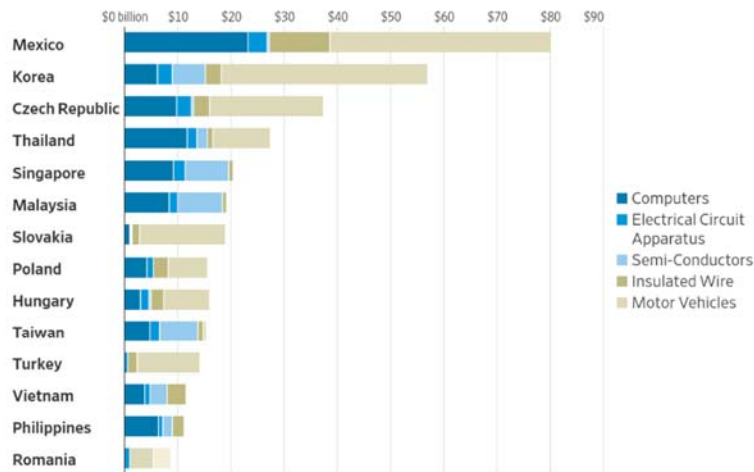
Impact on Fixed Income:

The United States is in a unique position due to its control of the world's reserve and trading currency, the US Dollar (USD). United States treasury bonds and bills provide a haven for investors during times of turmoil, which leads to USD appreciation and lower US interest rates. Global bonds, especially those denominated in local currency, tend to under-perform. Emerging market bonds tend to do the worst as there is a flight of capital to safer countries.

While the above-mentioned impacts have tended to come to fruition in past tariff battles, Lynx does not advise investors to make trade or portfolio decisions based on these points. Please talk to your consultant about the implications of a trade war escalation and how it may impact your portfolio. Our bottom line is that all this talk of trade wars and tariff implementation has and will continue to create market noise and additional volatility, but over the long-term, portfolios

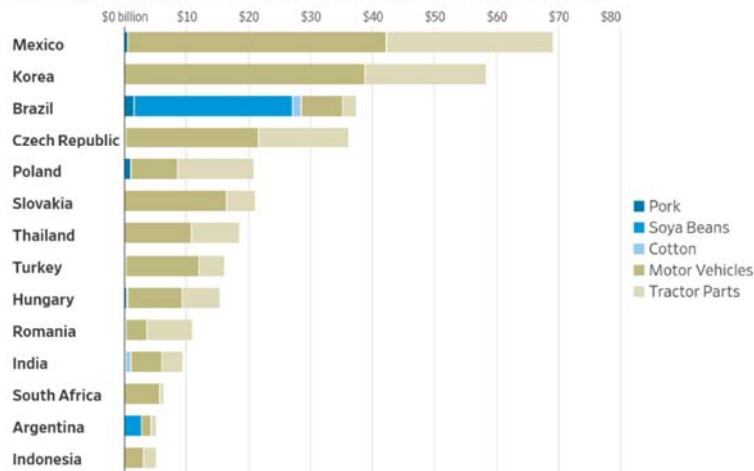
should remain relatively unaffected. This is, of course, if the weight of additional tariffs begins to impact prospects for global economic growth and creates consequential demand destruction.

Exports by emerging markets of the goods subject to U.S. tariffs on imports from China.



Sources: UN Comtrade; USTR; Chinese Commerce Ministry; CE via Capital Economics

Exports by emerging markets of the goods subject to China tariffs on imports from U.S.



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June 2018