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# Trading blows

Trade conflicts are likely to prove a defining feature of the next Trump presidency

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## In a nutshell

- President-elect Trump is likely to focus on cutting deals directly with one or at most two trading partners at a time, seeing these as business transactions.
- It is going to be a far cry from the days when the U.S. used to push for multilateral free trade, but need not prove too damaging in the short term.
- In terms of relations with China, we believe that trade may end up embedded into some sort of "grand bargain," involving geopolitics as much as economics.

Roughly half-way through Donald Trump's first presidency, we ran a series of pieces defending the ideas behind free trade, but also explaining that the topic was unlikely to go away. The political turmoil in British and U.S. policymaking after the electoral events of 2016 reflected not just the moods of the moment or the idiosyncratic personalities involved, we argued. Instead, they hinted at deeper, structural factors, playing out in local labor markets, particularly in areas that voted for Trump and the United Kingdom in favor of leaving the European Union.

All these are topics we will no doubt have plenty of occasion to return to over the next four years. For investors, however, the more immediate issue is how to prepare for the year ahead. In our most recent 12-month outlook, we have downgraded growth expectations for China, reflecting the very real prospect of more trade conflicts with the new U.S. administration. Many emerging markets risk being squeezed in the middle. For Europe and in particular the already vulnerable sentiment in Germany, we expect a further hit from uncertainty. Investors and companies alike will rapidly need to adjust to a new administration where another punitive sector tariff may suddenly be announced by tweet at any moment. This was illustrated most recently by the kerfuffle over imposing punitive tariffs on all imports from Mexico and Canada due to their migration and drugs policies. As for the U.S. itself, a lot will depend on how tariffs and trade conflicts measure up against other negative (think of restrictions on migration) and more positive aspects of looming Trump policies, from a potential easing of corporate tax burdens and deregulation to efforts on boosting the efficiency of the federal government. The rest of this note summarizes our current thinking on these issues.

### Does Trump have a mandate?

For policy dynamics, perhaps the most important aspect of Trump's election to a second, nonconsecutive term, is that his share of the popular vote is up sharply from dismal showings in both 2016 and 2020, though not quite as much as it seemed on election day. At the time of writing, it is at 49.86% and with most of the votes still to be counted in California, it will probably slide further in coming weeks.[1] That is relatively weak by historical standards, and one of the reasons – apart from ticket splitting and under voting, with many Trump voters not casting their votes for down-ballot candidates – why Republican performance in Congressional races has been lackluster. Republicans appear on track for one of the smallest House majorities in recent U.S. history. For any investor taking this as a sign of trade moderation ahead, however, we would caution that hawkishness on trade in general and trade with China in particular has become a rare area of bipartisan agreement over the past 8 years.

### Deals replace classical economic theory

President-elect Trump is likely to focus on cutting deals directly with one or at most two trading partners at a time, seeing these as business transactions. There is a good, principled case against this approach. Free trade allows countries to specialize in providing goods and services they are best at. Removing tariffs and other restrictions, even unilaterally, generally tends to leave all countries involved better off, both when they start trading and as they continue to get better in producing goods and services they are already quite good at. But whatever the niceties of both classical and modern economic theorizing on international trade, that fight is politically lost, at least for now.

Instead, there is likely to be a focus on quick wins, including once again renegotiating free trade between the U.S., Mexico, and Canada. With China, trade may end up embedded into some sort of "grand bargain," involving geopolitics as much as economics. Under Trump, any understanding between Washington and Beijing on even something as technical as standards for electric vehicles or quotas for soybeans would, almost certainly, also need to reflect both sides' concerns on seemingly unrelated issues, from North Korea and Ukraine to Iran and U.S. hydrocarbon exports to China. For China, the biggest ask is likely to involve direct export restrictions on key technology exports by the U.S. and its allies, which have stepped up substantially under Joe Biden.

### The "China shock"

However, the new administration will need to proceed with care. While it is too early to say how exactly trade policies feed in Donald Trump's electoral appeal in 2024, there is a now massive body of empirical work underlying the outsized role they have played in a whole series of electoral events throughout the Western world, related to what has come to be called the "China shock." To put it briefly: since the early 1990s China's entry into the global trading system, after more than 70 years of relative isolation and growing Chinese import competition played a decisive role in reshaping local labor markets in the U.S. and elsewhere. This appears

[1] See Cook Political Report, 2024 National Popular Vote Tracker

to have contributed to big divergences in regional economic performance within developed countries, with equally outsized, locally concentrated electoral consequences. Indeed, one way to think about rising trade tensions is as a revolt of the losers from globalization against the winners, a belated sign of political processes finally working – if not quite in the ways you might have wished or expected.

With the benefit of a couple of years of hindsight, such a backlash should not be all that surprising. In general, one of the key reasons tariffs and other protectionist measures have a long history of being politically appealing despite usually being economically costly, especially in the longer term, is that the winners (such as one or a couple of large U.S. domestic producers of a given good or service) are usually concentrated and well organized. By contrast, the losers, such as consumers, who will typically end up paying via somewhat higher prices are dispersed, not organized and often not even aware which relative price changes might be related to tariffs and other trade measure.

The traditional, rules-based, multi-lateral framework under the umbrella of what became the World Trade Organization (WTO) was geared towards channeling and harvesting these dynamics. Until the "China shock" came along, most international trade took place in broadly similar goods, and between countries of broadly similar levels of economic developments. Since the 1970s, trends such as the fall in manufacturing employment, growth in services and a growing wage premium of better educated workers were making themselves felt in many industrialized countries, more or less simultaneously. Policymakers in different trading partners were more or less dealing with similar challenges, not least in terms of compensating losers within each country.

## Trump's playbook versus traditional, multi-lateral trade negotiations

Under these circumstances, traditional, rules-based, multi-lateral trade negotiations have a pretty marvelous quality. When discussing trade with their counterparts from around the world, it makes policymakers behave as if they had bought into the classical economic case for free trade, whatever their personal views on the matter. If a key industry enlists your help in opening up foreign markets and you mistakenly happen to think of trade as a zero-sum game, you are likely to demand "concessions" in return. Your foreign negotiating partners will take the same approach. And, after a lot of haggling, your deal will reflect a give-and-take that moves all parties closer to free trade. Each tariff or quota you "concede" might well make economic sense to give up on unilaterally but would be politically impossible without some "concessions" you win in return.

Regrettably, it is unlikely we will see similar dynamics between the U.S. and China any time soon, though prospects may be a little better for trade deals between the new administration and geopolitical allies. For evidence, look no further than at the "historical trade deal" Trump signed with China in January 2020, just before the Covid 19 pandemic. The deal committed China to purchase $200 billion of additional U.S. exports before December 31, 2021, on terms that both sides appear to have known to be unrealistic – even in the absence of a pandemic and a recession. As it turned out, additional exports China bought amounted to approximately zero.[2] Politically, it nevertheless turned out to be quite successful.

Using a similar playbook, we would expect the new administration to use various types of "emergency" measures as quasi negotiating tactics. The hope would be to secure crowd-pleasing "concessions" for the benefit of politically well-connected industries. On top of that, we expect some tariffs (for example ones benefiting well organized manufacturing interests) to be based on statutory measures, in part because as part of budget reconciliation bills, this would make it easier to pay for extending tax policies from the first Trump presidency beyond December 2025, a key priority for the first 100 days. Packaging the two together has another advantage. More favorable tax arrangements, for example for manufacturing firms relying on imported intermediate goods, could help compensate for new tariffs. This would likely take the form of a deduction on pretax profits for domestic manufacturing-derived profits. If well calibrated, trade measures as part of broader tax and industrial policies could boost U.S. industrial capacity without much damaging competition in U.S. markets for goods and services. For other countries, however, it also means that there will be plenty of uncertainty on the timing of various measures, on whether any general tariff on all importer nations will be imposed, how far tariffs on Chinese goods might fall short of the 60% or so Trump mentioned during the campaign and how much inventory build up takes off ahead of measures. On all these, as well as the impact on trade flows by diverting production outside of China, investors are likely to see plenty of guesstimates floating around. We would caution that different assumptions are likely to be used for different purposes. It is not necessarily useful, for example, to make exactly the same assumptions on trade diversion whether one is trying to assess U.S. inflation dynamics, Mexican gross domestic product (GDP) or Chinese manufacturing profitability.

## Market implications

At least in the short term, we would see such measures as broadly neutral for U.S. risk assets, including equities and corporate bonds, with potential additional boosts in sentiment as uncertainty recedes. Overall, we expect many of Trump's tax and spending promises made on the campaign trail will probably need to be scaled back to reflect the political, fiscal and economic realities.[3] Voters – fearful of inflation – and bond markets should act as a check on some of the new administration's ambitions, leading to only modest upticks in inflation and U.S. economic growth. Meanwhile, we would expect geopolitics and particularly the need for allies in conflicts with China to threaten rather than actually implement tariffs on allies of the scale Trump has been musing about on the campaign trail.

## Conclusion

So, nothing to worry about, all that much, when it comes to trade? Not quite, at least if we consider the longer-term costs both for the U.S. and the world economy. Plenty of risks loom along the way towards compromises. For example, U.S., Chinese and perhaps European brinkmanship could result in things getting out of hand, at least for a while, not least in areas such as carbon border taxes where existing European policy priorities clash with the new administration's goals.

More fundamentally, there are good reasons why protectionism, industrial policies and big government in general eventually went out of favor in much of the Western world. Historically, governments and state bureaucracies have not been very good at picking winners. At a very basic level, the case for unilateral trade liberalization is the same case you can make for free markets and against state planning in general. After all, there is always an alternative to free markets and free trade. It's called government intervention, subject to all the hazards conservatives used to fret about before 2016. Already, there is pretty compelling evidence from the initial trade war that companies making campaign contributions to Republican candidates disproportionately benefited from tariff exemptions, securing valuable competitive advantages on a case- by-case basis over competing rivals within the same sectors.[4]

Needless to say, this is not how enforcing laws and due process are supposed to work, either under U.S. domestic law or under international trade law. Respect for the rule of law and private-property rights, even those of unsavory foreigners, let alone their U.S. trading partners, have long been an important factor underpinning U.S. soft power world-wide. They are also underappreciated reasons why U.S. companies have been so attractive, for so long, to foreign investors. Another, however, is the capacity of liberal democracies, free markets and countries governed by the rule of law for self-renewal. With the previous policy consensus on trade shattered, U.S. policymakers (on both sides) have been trying to come up with effective policy responses to what voters have been demanding. For now, we are cautiously optimistic they can do so without doing too much lasting damage.

[2] Bown, C. (2022) "China bought none of the extra $200 billion of US exports in Trump's trade deal", Peterson Institute for International Economics
[3] Chart of the week- Debt or Alive? (dws.com)/DWS as of 11/15/2024
[4] Fotak, V., Lee, H., Megginson, W. and Salas, J. (2024) The Political Economy of Tariff Exemption Grants, in: Journal of Financial and Quanti-tative Analysis

# Glossary

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

The European Union (EU) is a political and economic union of 27 member states located primarily in Europe.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The United States House of Representatives is a legislative chamber consisting of 435 Representatives, as well as non-voting delegates from Washington, D.C. and U.S. territories. Representatives are elected for two-year terms and each state's representation is based on population as measured in the previous Census.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The Republican Party (Republicans), also referred to as Grand Old Party (GOP), is one of the two major political parties in the United States. It is generally to the right of its main rival, the Democratic Party.

The United States Congress is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

The World Trade Organization (WTO) is an international organization based in Switzerland, which regulates commerce between nations through mutually agreed rules.

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