

Managing Mixed Messages

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And so it begins. Donald Trump will only be inaugurated as US president in late January, but his social media announcements are already moving markets. Last week he threatened that 25% tariffs would be imposed on Mexico and Canada on his first day in office, with an additional 10% tax on imports from China on top of any other future tariffs.

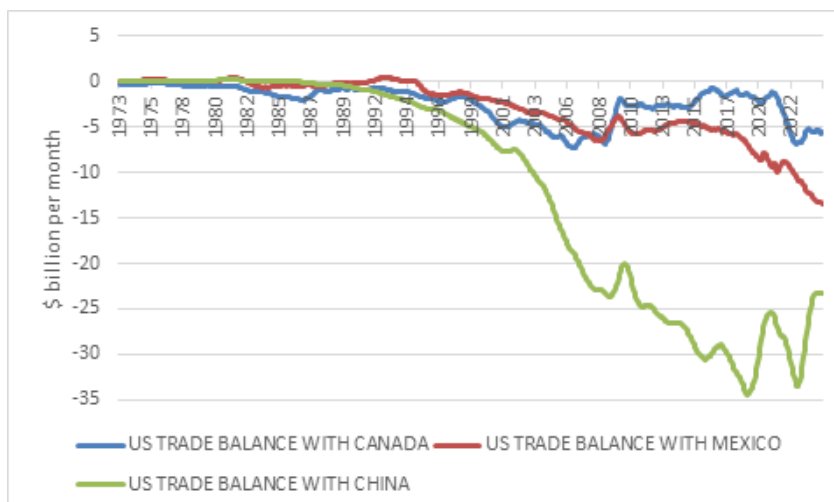
The reason given was that America's neighbours are allowing drugs and illegal migrants to enter the US, while China is blamed for not stopping the export of chemicals used to make a particularly lethal drug, fentanyl. By invoking national security grounds, the president can impose tariffs without going through Congress.

All three countries run trade surpluses with the US, and in fact, the three combined account for half the total US trade deficit. It is notable, as chart 1 shows, that the US trade deficit with China is smaller, though it remains the largest bilateral deficit with any country. Part of the reason why may be that trade from China is rerouted through other countries, including Mexico. This is clearly something Trump will want to address. He has long argued that a trade deficit is tantamount to the US "losing" while other countries are "stealing jobs." What is not said, is that these large deficits are also the result of voracious consumer appetites. Closing them would require less consumption and higher savings rates.

Make Manufacturing Great Again

The US, Canada and Mexico have had a free trade agreement since 1994. It was initially known as NAFTA, until Trump, who called it the "worst trade deal ever made" renegotiated it during his first term. Tariffs on Canada and Mexico could fatally undermine this arrangement, especially if they retaliate. Canada and Mexico are obviously much more reliant on their shared giant neighbour than it is on them, although many US businesses have come to depend on Canadian and Mexican workers and customers.

Chart 1: US bilateral trade balance

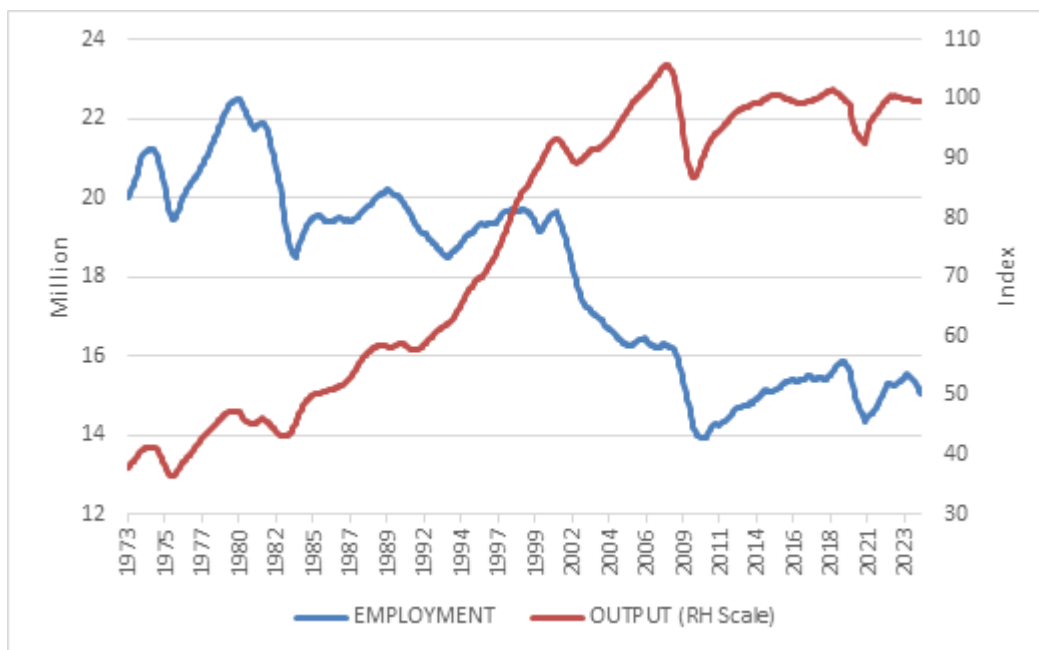


Source: LSEG Datastream

Offshoring production to Mexico, and particularly China, cost millions of US manufacturing jobs. Blaming those countries is not the whole story, since it was American CEO's who made the decision in the interest of higher profits. Manufacturing wages are still around three times higher in the US than in China, and about six times higher than in Mexico. This remains a major obstacle to reshoring, specifically labour-intensive production. Automation, however, is a trend that is likely to continue. As chart 2 shows, US manufacturing employment has declined sharply, especially since 2000, while output increased.

The chart also shows that neither Trump's earlier interventions, nor the Biden administration's industrial policy push, has raised factory employment on a sustained basis. While Biden has overseen a surge in factory construction, they are mainly high-tech facilities that employ relatively few people. Nonetheless, Trump seems determined to make US manufacturing great again.

Chart 2: US manufacturing sector



Source: LSEG Datastream

This leaves investors trying to manage mixed messages. On the one hand, there is the bluster and bombast, the threats of an all-out trade war. On the other hand, unlike some of his other nominations, the economic team Trump has lined up is seen as pragmatists. In particular, Howard Lutnick and Scott Bessent, the nominated Commerce and Treasury Secretaries respectively, are both Wall Street titans who know business and finance and understand how reckless policies could backfire.

For instance, much of the trade between US, Mexico and Canada does not consist of finished goods, but rather happens in complex supply chains, particularly in the auto sector. Engine components might be manufactured in Canada, assembled in Mexico, and then added to the vehicle in a US facility. Imposing tariffs in such a situation simply adds to cost, it will not necessarily result in more production in the US, not in the short term at least. Adding capacity to US factories could take years, and companies might not want to make that investment if there is a possibility that Trump's successor could change policies again.

Moreover, even though the US is the world's number one oil exporter, it imports a lot of oil from Canada, mostly via pipelines. Canadian oil is sour (it has a higher sulphur content) and heavier (denser) than American oil, and is an important feedstock for US refineries, particularly those close to the border. Canada also imports US oil. For both countries, domestic oil is not a pure substitute, at least not until refineries are retooled and pipelines rerouted at great expense. Again, the likely outcome is a combination of higher prices for consumers and lower margins for producers.

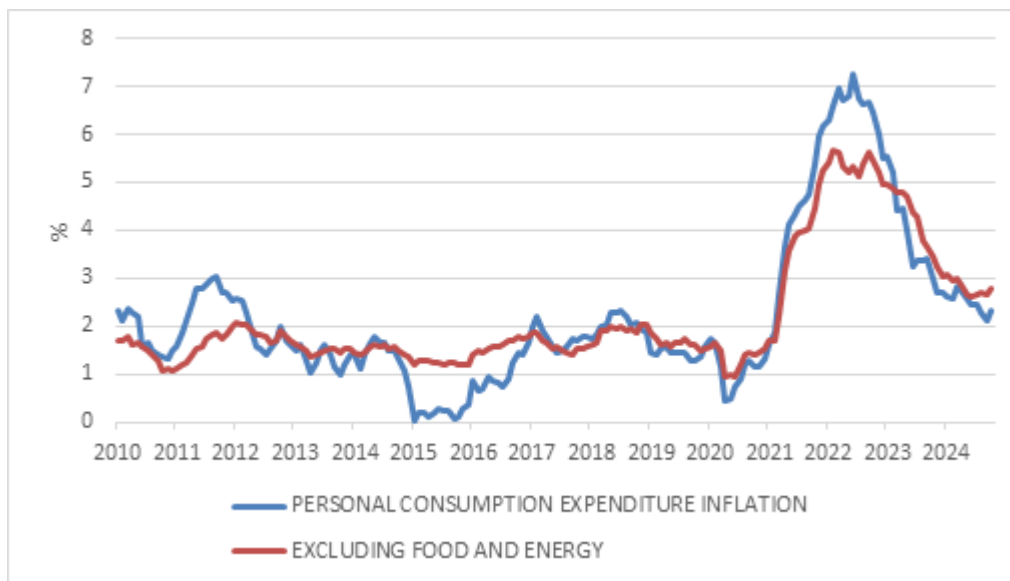
The consensus view among investors seems to be that Trump's advisers will be able to temper some of his extreme demands and limit the fall-out, and that much of it is simply a negotiating tactic. Indeed, a few days after the tariff threat, Trump had a "wonderful" conversation with Claudia Sheinbaum, the new Mexican president, saying that she agreed to his demands.

But much ultimately depends on Trump, his moods and his biases. His first term saw churn and infighting among his top staff. It is already clear that some in his inner circle are hardliners, while others are more pragmatic.

In fact, Trump still seems somewhat like a Rorschach test, with investors seeing in him what they want to see. Based on the market response, equity investors believe that Trump will be good for profits and good for share prices. In his first term, Trump viewed the S&P 500 as his real-time approval rating, and he was sensitive to not doing anything to upset the apple cart too much. This time round, there are three important differences. Trump will not be standing for re-election and might not care about the market's approval. Secondly, the S&P 500 is 30% more expensive today than at the time of his 2016 election, with the forward price: earnings ratio rising from 17 to 22.5. It is expensive relative to other markets and its own history. And while one can easily make the argument that the US should trade at a premium, the extent of the premium suggests a lot of good news is already priced in. There is probably more room for disappointment than for positive surprise.

Thirdly, the US economy is in a different space. In 2016, it was going through a soft patch. On the eve of the election, real GDP growth was around 1.5%, below what would be considered full capacity. Inflation was also low, another sign of economic slack or idle resources. Today, real growth is running close to 3%, above estimates of the long-term trend. While enough voters were unhappy with the state of the economy to defect from the Democratic Party, the fact remains that unemployment is near a record low. Plans to deport illegal migrants or just stem the flow of incomers could result in worker shortages. Today inflation is not as high as it was two years ago but remains above the Federal Reserve's 2% target and the decline stalled out in recent months.

Chart 3: US inflation



Source: LSEG Datastream

Therefore, it seems likely that the Federal Reserve will not cut rates as much as was expected a few months ago. This is where the rubber hits the road for South Africa, although we will have to wait and see whether South African exports to the US will also face increased tariffs. As the US interest rate outlook shifted, it has put upward pressure on the dollar and downward pressure on the rand. This ultimately also shifts the outlook for domestic interest rates.

Chart 4: Trade-weighted US dollar index



Source: LSEG Datastream

There have also been mixed messages with the dollar. Trump has noted his desire for a weaker dollar in the past, since a strong dollar makes imports cheaper while making American goods more expensive in global markets. However, many of his new advisers – and indeed predecessors – maintain the line that a strong dollar is in America's interest. Trump further muddied the waters over the weekend by threatening 100% tariffs should the BRICS countries create their own shared currency or back another currency to replace the dollar. He is largely attacking a straw man here, since the idea of a BRICS currency remains a fantasy.

Back in the real world, Bessent knows the complexities of global foreign exchange markets very well. He was part of the George Soros firm that famously "broke the Bank of England" in 1992, by forcing a devaluation of the pound against the Deutschmark. He later pulled off another multi-billion-dollar trade betting against the Japanese yen. Already some are saying he is the right person to coordinate another Plaza Accord, referring to the 1985 agreement among major economies to engineer a weaker dollar.

The rest of the world would also welcome a softer dollar, provided it is a disorderly depreciation. What no-one wants is a situation where investors are dumping the dollar because they are concerned for America's long-term financial, economic and political health. US federal debt was \$19 trillion when Trump started his first term. Today it is \$35 trillion and is set to rise rapidly.

Still, other major currencies are beset with weaknesses. Japan is still on a rate hiking path, but the increments are small and the starting point very low. China's economy requires large-scale stimulus, and interest rates there have further to fall. Europe remains beset with political infighting. The French government seems on the verge of collapse as parties square off over passing a debt-reducing budget. This follows barely a week after Germany's ruling coalition fell apart, leading to fresh elections early next year. The dollar still looks like the "cleanest dirty shirt".

In summary, investors will have to get used to mixed messages. The good news is that the experience of the past few years holds important lessons. We saw that businesses are resilient through all sorts of crises, and these crises have forced corporate leaders to identify weak links in their supply chains and potential fixes. If a trade war is coming, it will be disruptive, but not necessarily destructive. It will also create opportunities along with the risks. Appropriate diversification and patience will help investors navigate an uncertain environment.