GLOBAL MACRO, ECONOMICS & RATES STRATEGY RESEARCH

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Weekly Dashboard

On trade war: our view on the economic and equity impact

In today's *Dashboard* we want to again run through our view on the potential impact of a trade war with China. First we'll run through some of what we have already published on related to the mechanics of the trade impact on US growth (the impact is modest) and then we want to draw out an important point on the equity market.

Not too long ago we published a piece that highlighted what a full-on trade war between the US and China was worth from a growth perspective to the Unites States. There seems to be a question about how one defines a trade war. In our analysis, we tried to take out such ambiguity. Here is how we run through the GDP effect of a broader trade with China. We go about this by trying to draw out a static scenario where behavioral shifts are negative for the United States (so as to take the more painful assumptions). Essentially, we assume a scenario where 1) an across-the-board tariff of 25% on all Chinese goods does not alter consumer behavior in the United States (i.e., the cost is merely absorbed with no change to volumes); and 2) a commensurate 25% tariff on US imports to China alters consumer behavior there to the full extent of the tariff (thus no change in nominal $ exports to China but a decline in volumes).

Under this still unlikely scenario, the impact to GDP from the import side would be through the price channel. China represents 20% of our total imports of goods and thus a 25% across-the-board price increase (again, the consumer absorbs the cost of the tariff, which becomes effectively a domestic tax) would increase import prices by 5%. Based on a simple regression, a 5% increase in import prices adds about 60 basis points to the year/year rate of headline PCE prices. This then reduces real GDP by about 40 basis points (all else equal).

On the export side, a 25% retaliatory tariff on US goods that was subsequently offset by a decline in demand for US exports in China (again the more painful assumption) would reduce real GDP by about 15 basis points. We export about $130b in goods annually to China and thus in order to maintain a nominal total $130b post tariff (extreme price sensitivity), goods volumes would need to be reduced by about 20%. China accounts for about 8% of our exports, thus the ~15bps negative impact on real GDP.

So all in, we estimate a deterioration in the trade relationship that leads to across-the-board 25% tariffs on all goods between the US and China would reduce US real GDP by about 55 basis points. Again, with the assumption that US consumers would be willing to absorb the full brunt of the tariff (tax) and that Chinese consumers would fully shun it.

The point is that while a reduction of -0.5% on US GDP is not insignificant, it must be remembered that this is drawn from very unfavorable assumptions. What it would also do is completely neutralize all of the good of the tax cuts (which we estimate is worth roughly +0.5ppts).

Now let's consider the impact from this trade policy on the equity market. Over recent years a basket of the S&P 500 companies most exposed to China (as a % of revenues) has vastly outperformed the broad index but more recently trade concerns have created significant volatility in this space.

This group is quite tech-heavy and that sector has carried the broad index for some time now. But intensifying trade tensions don't mean that broad equities are all of a sudden poised for negative returns. This is because domestic-sensitive sectors have potential to pick up the baton in terms of leadership. Indeed, with tax policy that is geared towards domestic outperformance (due to the more pronounced decline in effective tax rates in particular), increased global tensions mean that domestic-sensitive equities (and more specifically, small caps) are likely to be a pretty attractive place to hide for those that want equity exposure.

So, much like the economic effect, where a broad-based trade war with China basically unwinds all of the upside potential from tax cut legislation, the impact on markets is also likely to be more of a dampener of positive returns (which are also juiced by tax cuts), but not necessarily enough to undo a still-broadly constructive outlook.

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This report is priced at 2:00 PM ET on June 21, 2018.

For Required Conflicts Disclosures, please see page 7.

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Eco Bullet Points

No major updates this week

Overview: The current economic expansion has been characterized by healing household balance sheets (de-levering) and spending growth driven by aggregate wage growth. Given the lack of imbalances in household credit and no apparent stress in the labor market, we find it very difficult to call for a consumer-led economic slowdown—let alone an outright recession—occurring over the next couple of years (our forecast horizon). But while the fundamental underpinning of the expansion remains firmly in place, calls for an economic slowdown have grown louder as the Fed continues to remove emergency levels of accommodation (often confused with policy tightening). Since economic recessions have typically followed Fed tightening cycles, for some market participants, the current removal of accommodation is seen as the beginning of the end in terms of not only the economic expansion, but the now 9-year long bull market in equities. The significant difference this time around is that the economic expansion has not been characterized by an expansion in household credit nor an overextended corporate borrowing environment. We find it hard to believe that the removal of something that has not managed to accelerate the cycle beyond its organic potential will bring about its demise. Thus we believe the thesis that the Fed's gradual removal of accommodation will lead to a sharp economic slowdown is flawed. For more on this please see our US Economic Focus. With tax cuts adding to an already constructive economic backdrop, topline GDP growth should come in around 3% for the next two years. Please see our 2018 year ahead for more.

Consumer: Stronger spending in April (0.4% after adjusting for inflation) came at the expense of savings, with the rate slipping to 2.8% from 3.0% prior. Note that the step-up in the savings rate earlier this year was a technical phenomenon (the BEA assumed tax cuts at the beginning of the year and not post late Feb when tax tables were actually altered) and thus the unwind is not shocking. Still, the decline over the last few quarters is feeding the sensationalist narrative machine of the bears once again. So a dose of reality is in order. The truth is a simple savings rate model based on household net worth and the level of rates predicted much lower savings rates this cycle—and a rate below 1% more recently. That actual savings was well north of this fundamental model suggests a couple of things: 1) the echo of the credit boom/bust via massive household balance sheet repair (where liabilities/assets are still declining even at present) and 2) the likely demographic-induced savings catch-up for retirees that was necessary on the back of much lower expected fixed income returns (secular stagnation theory leading to lower for longer rates narratives). That the savings rate has corrected lower in recent quarters is not surprising. With households now looking at a relatively healthy financial position (strong balance sheets with no obvious tether to asset bubbles, accelerating wage growth, ultra-low unemployment) and with lower taxes in-tow, don't expect the savings rate to turn higher near-term. As we have highlighted since tax reform became a potential reality: the multiplier effects from mature economic expansion tax cuts is likely to be much more pronounced than typical post-recession implementation. Thus, multipliers gauged from the empirical data are useless in this case. We think the first inkling of robust economic momentum will come in 2Q, where we are tracking around 4% real GDP.

Employment: The continued cyclical recovery in labor participation remains critically important in terms of the near-term sustainable pace of payroll growth. We've highlighted the thesis that given a significant "re-entrance" back into the labor force from the cyclical cohort (25-54 year olds), trend payroll growth can remain in the neighborhood of 175-200k for some time still. What really matters in terms of the longevity of the current expansion is the fact that this cyclical recovery of the prime working age cohort only began in early 2016. This is a very positive trend that should continue to pay dividends via much firmer than "potential" job growth (i.e. what is dictated by population growth alone) and much more persistent downward pressure on the u-rate. That said, this trend should also help temper wage growth somewhat in the near-term. So while wages should continue to firm, they would likely run at a much faster clip if not for this labor force dynamic.

Inflation: The run-up in inflation to the Fed target (headline PCE inflation was 2.0% for the second straight month in April) is not merely an energy story. We track pricing trends for the volatile and non-volatile components of PCE inflation and find that the low-vol basket accelerated to a 1.8% y/y pace in April from 1.7% prior and as low as 1.3% back in October. Note the current run-rate also compares to a 1.8% pace in April of last year (so it's not easy comps driving the advance in this case). The volatile series is certainly doing its part, running up to 2.9% after being in near deflation territory this time last year. But the fact that even non-volatile, trendy inflation components are rising to the Fed target suggests this is not merely a transitory phenomenon defined by firming gasoline prices and softer year-ago comparables.

Housing: We would argue that a rising rate environment is not necessarily a reason to throw in the towel on housing. If the increase in rates is happening for the "right" reasons, i.e., rising growth prospects, then the generally better backdrop would significantly offset any increase in mortgage costs. Note that the cost of ownership still remains exceptionally low by historical standards. The mortgage payment/income ratio is sitting at just 15% and it has largely moved sideways in the post-recession era. Critically, the rates back-up needed to make an impact is sizeable. Given current home prices and the level of median family income, the average mortgage rate would have to rise all the way back to 6.25% in order for this mortgage payment/income ratio to hit the pre-bubble "norm" of 20%. From a valuation standpoint, despite the significant recapture of lost home equity, current real estate assets relative to their replacement cost remain well off the peak in each of the last three prior economic expansions.

Fed: Our base case for 2018 has long been that the Fed will hike at least 4 times and thus the added momentum to both economic growth and inflation merely cements this long-held view. Beyond that, we see no reason why the Fed would all of a sudden pause hard in 2019—especially when we consider the step up in tax savings to households that could accelerate consumer spending further. Thus we see a clear path for the Fed to maintain a hike at every other meeting in place through the end of 2019, with the top of the target range at 3.5% by then. With the neutral rate also likely to rise as potential GDP accelerates, terminal FF should eventually be in the neighborhood of 4%. This would leave cyclical short rates at about 100bps above neutral, which in the past has been the minimum level of terminal tightening.

Eco Indicators and Fedspeak

The personal income and spending report is the highlight (Fri).

Mon	25-Jun	Indicator	Period	RBC	Consensus	Prior
	10:00	New Home Sales	May	650k	670k	662k
Bottom Line:	New home sales should decelerate slightly as mortgage purchase apps slipped a bit through the month of May.					

Tue	26-Jun	Indicator	Period	RBC	Consensus	Prior
	10:00	Conf. Board Consumer Confidence	Jun	128.0	127.2	128
	13:00	*Fed's Bostic Speaks in Birmingham, Alabama*				
	13:45	*Fed's Kaplan Speaks in Houston*				
Bottom Line:	Look for consumer confidence to remain at a high level as evidenced by the rebound in ultra-high-frequency consumer sentiment indices.					

Wed	27-Jun	Indicator	Period	RBC	Consensus	Prior
	8:30	Durable Goods Orders, Ex Transportation, Capex	May	-2.2% , 0.5% , 0.5%	-0.7% , 0.5% , 0.6%	-1.6% , 0.9% , 1.0%
	12:15	*Fed's Rosengren Speaks on Ethics and Economics*				
Bottom Line:	Aircraft and autos orders should hold topline durable orders down on the month. That said, look for the underlying components to look decent.					

Thur	28-Jun	Indicator	Period	RBC	Consensus	Prior
	8:30	GDP Annualized QoQ	1Q T	2.2%	2.2%	2.2%
	8:30	Initial Jobless Claims	43274	215k		218k
	10:45	*Fed's Bullard Speaks on U.S. Economy and Monetary Policy*				
	12:00	*Fed's Bostic to Meet With Fed Up Coalition in Atlanta*				
Bottom Line:	The third cut of 1Q GDP is extremely rearview mirror and should come and go with little fanfare. Meanwhile, jobless claims look poised to print near the cycle lows once again.					

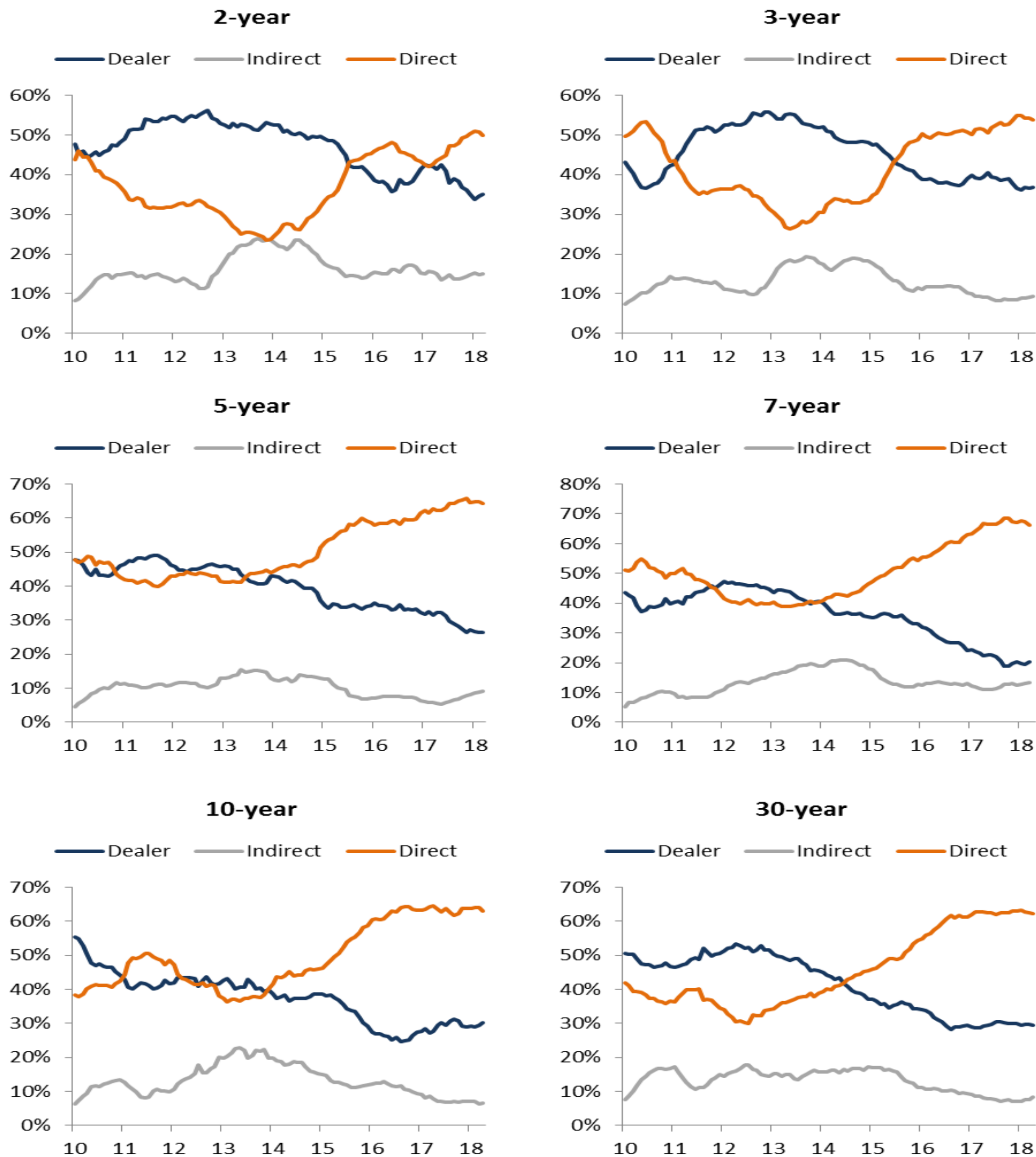
Fri	29-Jun	Indicator	Period	RBC	Consensus	Prior
	8:30	Personal Income and Spending	May	0.4% , 0.5%	0.4% , 0.4%	0.3% , 0.6%
	9:45	Chicago Purchasing Manager	Jun	62.0	60.8	62.7
	10:00	U. of Mich. Sentiment	Jun F	99.0		99.3
Bottom Line:	In a week with limited top-tier data, this report should garner the most attention as it will help fine-tune 2Q GDP estimates. With the employment and retail sales reports already in-hand for May, we do not expect any significant surprises. Income should rise about 0.4% as evidenced by the increase in aggregate wages. Meanwhile, strong retail sales point to an even firmer spending number of around 0.5%. This means the savings rate is poised to tick lower. Recall that given fundamentals (like the low level of interest rates and record net worth) savings should theoretically already be much lower. All in this report should help solidify tracking for 2Q GDP growth of above 4%.					

* This calendar shows only the economic indicators that RBC forecasts. For a comprehensive list of indicators, please see the rolling calendar at the back of this document.
Source: RBC Capital Markets US Economics, Bloomberg

Treasury Auction Calendar

Date	Issue	Amount ($bn)	Bid/Cover	Tail	12-auction averages Indirect %	Direct %	Dealers %
26-Jun	2Y Notes Auction	34.0	2.85	0.04	47.1%	15.5%	37.4%
27-Jun	5Y Notes Auction	36.0	2.48	0.16	63.5%	10.1%	26.4%
28-Jun	7Y Notes Auction	30.0	2.52	0.20	65.2%	13.4%	21.4%
27-Jun	2Y FRN Reopening	16.0					
25-Jun	3M Bills	48.0	3.00		36.2%	7.3%	56.5%
25-Jun	6M Bills	42.0	3.15		49.4%	4.6%	46.0%

Exhibits: Percent of competitive bids accepted (12-month average)



Source: US Treasury, Bloomberg, Haver

Economic and Rates Forecasts

No major changes this week.

Real Economic Activity													
% q/q saar, unless indicated	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	2017	2018	2019
Real GDP	3.2	2.9	2.2	4.1	2.9	2.8	2.4	3.4	3.4	3.4	2.3	3.0	3.0
Consumer Expenditures	2.2	4.0	1.0	4.1	2.8	2.8	1.7	3.2	3.2	3.2	2.8	2.8	2.7
Residential investment	-4.7	12.8	-2.0	5.0	8.0	5.0	5.0	5.0	5.0	5.0	1.8	2.9	5.4
Non-Res Investment	4.7	6.8	9.2	5.2	5.2	5.2	8.0	8.0	8.0	8.0	4.7	6.5	6.9
Capex	10.1	7.9	7.5	8.0	8.0	8.0	10.0	10.0	10.0	10.0	4.9	8.1	9.3
Exports	2.1	7.0	4.2	4.0	4.0	4.0	4.0	4.0	4.0	4.0	3.4	4.3	4.0
Imports	-0.7	14.1	2.8	5.0	5.0	5.0	5.0	5.0	5.0	5.0	4.0	5.1	5.0
Net Exports ($b)	-598	-654	-651	-664	-678	-692	-706	-720	-735	-750	-622	-671	-728
Inventory change ($b)	39	16	20	40	45	50	55	60	65	70	15	39	63
Government	0.7	3.0	1.1	1.0	1.0	1.0	1.0	1.0	1.0	1.0	0.1	1.3	1.0
Final Sales	2.4	3.4	2.0	3.6	2.8	2.7	2.3	3.3	3.3	3.3	2.4	2.8	2.9
Private Domestic Final Sales	2.2	4.8	2.1	4.3	3.4	3.2	2.8	4.0	4.0	4.0	3.0	3.3	3.5
Nominal GDP	5.3	5.3	4.2	6.2	5.0	4.9	4.3	5.6	5.5	5.5	4.1	5.1	5.1
Contribution to GDP													
percentage points	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	2017	2018	2019
Consumer Expenditures	1.5	2.8	0.7	2.8	1.9	1.9	1.1	2.2	2.2	2.2	1.9	1.9	1.9
Residential investment	-0.2	0.5	-0.1	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.2
Non-Res Investment	0.6	0.8	1.1	0.7	0.7	0.7	1.0	1.0	1.0	1.0	0.6	0.8	0.9
Capex	0.7	0.6	0.6	0.6	0.6	0.6	0.8	0.8	0.8	0.8	0.4	0.6	0.7
Net Exports	0.4	-1.2	0.1	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.2	-0.3	-0.3
Inventories	0.8	-0.5	0.1	0.5	0.1	0.1	0.1	0.1	0.1	0.1	-0.1	0.1	0.1
Government	0.1	0.5	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.0	0.2	0.2
Other key metrics													
	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	2017	2018	2019
Headline CPI (% yoy)	2.0	2.1	2.2	2.8	3.0	2.6	2.3	2.1	2.0	1.9	2.1	2.6	2.1
Core CPI (% yoy)	1.7	1.8	1.9	2.3	2.6	2.4	2.3	2.2	2.2	2.1	1.8	2.3	2.2
Headline PCE prices (% yoy)	1.5	1.7	1.8	2.3	2.4	2.2	2.1	2.0	1.9	1.9	1.7	2.2	2.0
Core PCE prices (% yoy)	1.4	1.5	1.6	1.9	2.0	2.0	2.1	2.0	2.0	2.0	1.5	1.9	2.0
Unemployment (%)	4.3	4.1	4.1	3.9	3.8	3.7	3.6	3.5	3.4	3.3	4.4	3.9	3.5
Housing starts (thou units)	1172	1259	1320	1320	1325	1330	1300	1325	1350	1350	1208	1324	1331
Interest rates													
% end of period	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	2017	2018	2019
Fed Funds*	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.50	1.50	2.50	3.50
2-year	1.47	1.89	2.27	2.50	2.65	2.80	3.00	3.25	3.40	3.55	1.89	2.80	3.55
5-year	1.92	2.20	2.56	2.80	2.95	3.10	3.25	3.45	3.55	3.65	2.20	3.10	3.65
10-year	2.33	2.40	2.74	3.00	3.15	3.30	3.45	3.60	3.70	3.75	2.40	3.30	3.75
30-year	2.86	2.74	2.97	3.20	3.45	3.60	3.70	3.75	3.80	3.85	2.74	3.60	3.85

*top of the target range

Source: RBC Capital Markets US Economics and US Interest Rate Strategy, Haver

Rolling Calendar

MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY
25-Jun	**26-Jun**	**27-Jun**	**28-Jun**	**29-Jun**
10:00 New Home Sales	10:00 Consumer Confidence	07:00 Mortgage Apps 08:30 Advance Trade 08:30 Wholesale Inventories 08:30 Durable Goods 10:00 Pending Home Sales	08:30 Jobless Claims 08:30 GDP (1Q T)	08:30 Personal Income & Spending 09:45 Chicago PMI 10:00 U. of Mich. Sentiment
02-Jul	**03-Jul**	**04-Jul**	**05-Jul**	**06-Jul**
10:00 Construction Spending 10:00 ISM Manufacturing	10:00 Factory Orders 13:00 NYSE Closes Early 14:00 US Bond Market Closes Early Auto Sales (throughout the day)	U.S. INDEPENDENCE DAY US Markets Closed	07:00 Mortgage Apps 08:15 ADP Employment 08:30 Jobless Claims 10:00 ISM Non-Manf 14:00 FOMC Meeting Minutes	08:30 Trade Balance 08:30 **Employment Report**
09-Jul	**10-Jul**	**11-Jul**	**12-Jul**	**13-Jul**
15:00 Consumer Credit	06:00 Small Business Optimism 10:00 JOLTS	07:00 Mortgage Apps 08:30 PPI	08:30 CPI 08:30 Jobless Claims	08:30 Import & Export Prices 10:00 U. of Mich. Sentiment
16-Jul	**17-Jul**	**18-Jul**	**19-Jul**	**20-Jul**
08:30 Retail Sales 08:30 Empire Manufacturing 10:00 Business Inventories	09:15 Industrial Production 10:00 NAHB Housing 16:00 TIC Flows	07:00 Mortgage Apps 08:30 Housing Starts 14:00 Fed Beige Book	08:30 Philly Fed 08:30 Jobless Claims	
23-Jul	**24-Jul**	**25-Jul**	**26-Jul**	**27-Jul**
10:00 Existing Home Sales		07:00 Mortgage Apps 10:00 New Home Sales	08:30 Advance Trade 08:30 Wholesale Inventories 08:30 Durable Goods 08:30 Jobless Claims	08:30 GDP (2Q A) 10:00 U. of Mich. Sentiment
30-Jul	**31-Jul**	**01-Aug**	**02-Aug**	**03-Aug**
10:00 Pending Home Sales	08:30 Personal Income & Spending 08:30 Employment Cost Index 09:45 Chicago PMI 10:00 Consumer Confidence	07:00 Mortgage Apps 08:15 ADP Employment 10:00 Construction Spending 10:00 ISM Manufacturing 14:00 **FOMC Statement** Auto Sales (throughout the day)	08:30 Jobless Claims 10:00 Factory Orders	08:30 **Employment Report** 08:30 Trade Balance 10:00 ISM Non-Manf

Source: RBC Capital Markets US Economics, Bloomberg

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