May 6, 2019

INTERNATIONAL ECONOMIC REPORT

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PRESIDENT TRUMP THREATENS MORE TARIFFS ON CHINA; UNCERTAINTY A DISINCENTIVE FOR INVESTMENT AND A DOWNSIDE RISK TO GROWTH

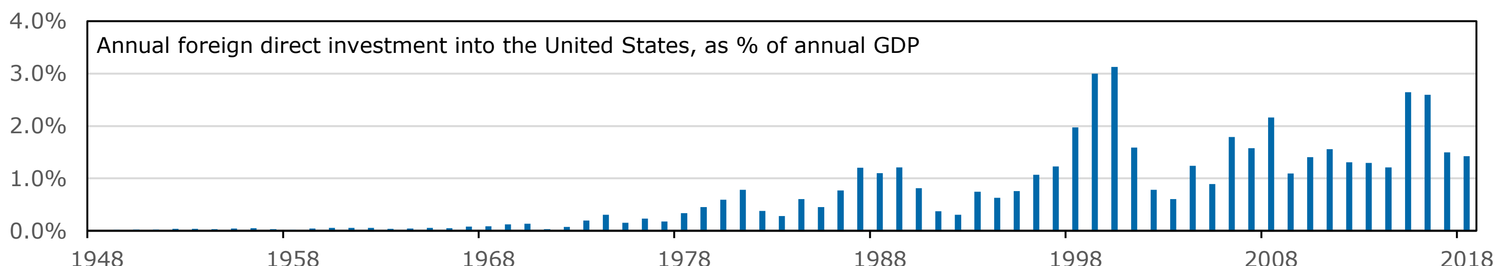
SUMMARY

- President Trump tweeted a threat to broaden the 25 percent tariff currently applied to $50 billion of goods imported from China to all goods imports from China; stocks fell globally on the news.
- If tariffs are indeed broadened, their predictable effects on the US economy would include modestly higher inflation, slower real income growth, and slower real GDP growth.
- Even if tariff policy ultimately is unchanged, additional uncertainty will restrain business capex growth.
- In light of the tight US labor market, additional disincentives for investment make it more likely that a bottleneck to growth forms and hastens the end of the current economic expansion.
- Trade policy uncertainty is a downside risk to PNC's forecast for continued US growth in 2019 and 2020.

Stocks in the US, China, and other major world markets fell May 6 after President Trump tweeted a threat to broaden the 25 percent tariffs on imports from China to apply to $250 billion in goods beginning May 10, then eventually to all $540 billion in goods imports from China, up from $50 billion previously, unless a new US-China trade deal is completed by then. Tariff escalation looks more likely near term in light of the new threat, but is by no means assured. Before this ultimatum, President Trump had set a January 1 deadline to conclude the negotiation, then pushed it back to March 1, then beyond; the dates seem arbitrary. He has threatened to raise tariffs far more times than his administration actually has: NAFTA withdrawal, EU car imports, and Japanese goods imports all spring to mind.

If tariffs on Chinese imports do increase, their predictable effects will include modestly higher US inflation, lowering real US disposable income and consumption; profit margin pressures on US importers and businesses that use imports as inputs for production; increased Chinese retaliation against US exports; and a smaller but more concentrated increase in production and profits for US-based companies protected by tariffs. If tariffs do increase, these effects will be a modest headwind to US growth in the rest of 2019 and in 2020.

CHART 1: FOREIGN DIRECT INVESTMENT PLUNGES 40 PERCENT IN 2017 AND 2018 FROM 2015-2016 LEVEL; DECLINES OF THIS MAGNITUDE ARE RARE OUTSIDE OF RECESSIONS



Source: Board of Governors of the Federal Reserve System, Bureau of Economic Analysis, St. Louis Fed FRED database

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But even if tariff policy is ultimately unchanged, this latest threat will have a tangible, albeit unpredictable, effect on business investment in the US and globally. Tariff advocates have argued that they will make businesses divert investment into the United States to maintain tariff-free access to US consumers, adding to US growth. But, as the statistics on the economy's performance in the two and a half years since this policy began make clear, that diversion of investment is not happening. In fact, foreign direct investment into the United States fell by 40 percent in 2017 and 2018 from the 2015 and 2016 level; historical declines of this magnitude are rare outside of recessions (See chart 1). Falling foreign direct investment into the United States is especially noteworthy given that overall investment accelerated in 2017 and 2018 as US growth rose above trend and the tax cut sweetened incentives for business capex.

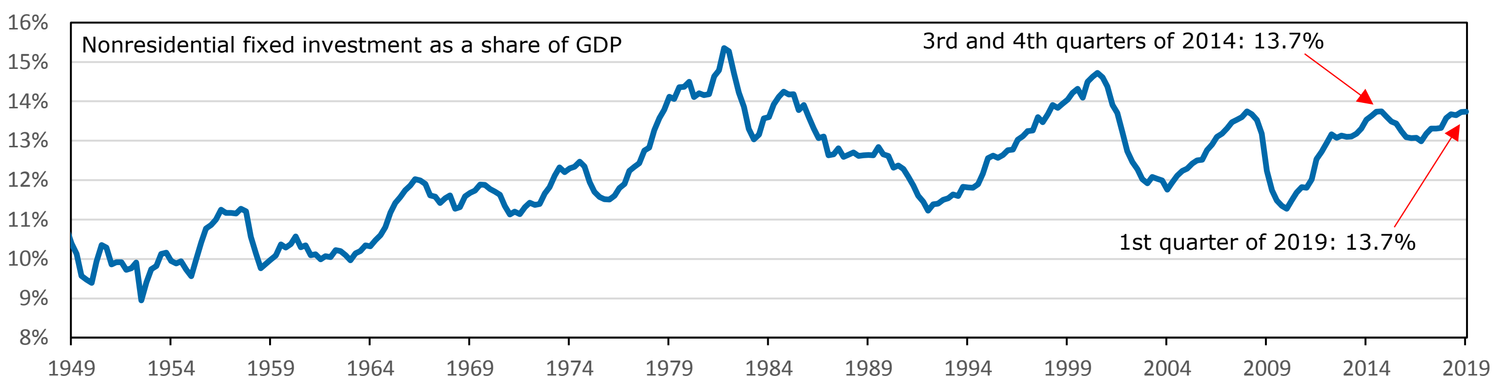
Plunging FDI is a canary in the coalmine, pointing to the limitations of the tariff strategy. Since businesses recognize that tariff rates could revert to lower historical levels during the life of capital equipment purchased today, making investments to capitalize on tariff protection less profitable, policy uncertainty is an incentive to delay investment until the trade policy outlook is clearer. And while tariffs can be seen as an incentive to invest in the US instead of China, they can also be seen as an incentive to divert investment to third-party countries that are exempted from both US tariffs and Chinese retaliation—like Mexico, Vietnam, or Canada.

Disincentives for investment, in turn, increase the risk of bottlenecks forming in the US economy that could hasten the end of the current expansion. The US unemployment rate is at a 49-year low, job openings have exceeded active jobseekers for 13 months, and many business surveys report difficulty finding qualified workers. Ordinarily, a tight job market should encourage businesses to invest in capital equipment to make their existing workforces more productive. But business investment as a share of US GDP is unchanged from 2014, and below its peak in both the 1980s and 1990s (See chart 2). Forward-looking surveys, like the ISM manufacturing and non-manufacturing purchasing managers indices, suggest investment growth will cool in the second half of 2019. The latest bout of tariff uncertainty has more important implications for the longevity of the US economic expansion, which in June will become the longest on record, than for its immediate effect on prices of imported goods.

The US economy is in good shape in 2019, with the job market exceptionally strong and real GDP in the first quarter growing an above trend 3.2 percent, according to the first estimate from the Bureau of Economic Analysis. PNC forecasts that real GDP growth will moderate in the rest of 2019, and average 2.3 percent for the full year, then slow to 2.0 percent in 2020 as a scarcity of workers limits economic growth, interest rates provide less boost to growth, and fiscal policy moves from a positive for growth to neutral.

However, the possibility of an all-out trade war with China is a key downside risk to this outlook. Other downside risks include a hard Brexit between Great Britain and the European Union, or a big drop in stock prices that spooks investors and businesses. Even so, one important downside risk the economy faced at the turn of 2019 has faded: The Federal Open Market Committee indicated in March that it does not expect to raise its key policy rate this year, reducing concerns that monetary policy could start to weigh on growth at a time when the economy is slowing.

CHART 2: CAPEX BUMP MIA—EVEN AFTER AN UPTICK IN 2017 AND 2018, THE SHARE OF GDP ACCOUNTED FOR BY BUSINESS INVESTMENT IS UNCHANGED FROM 2014



Source: Bureau of Economic Analysis, St. Louis Fed FRED database

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