What US Auto Tariffs Would Mean For Europe

Cedric Gemehl
cgemehl@gavekal.com

Nick Andrews
nandrews@gavekal.com

Last week's public hearings in Washington heard a chorus of industry opposition to the US administration's proposed import tariffs on cars and car parts. But in Europe at least, markets appear to be coming around to the view that the tariffs will go ahead regardless. After Friday's fall, the auto and auto parts sub-index of the Stoxx 600 has slumped -15% since late May when the US Commerce Department announced its Section 232 investigation, compared with a -3% decline for the broader index (see the chart on p3).

Europe's policymakers have few responses to softening growth

While the prospect of tariffs is troubling enough for auto sector investors, there is also the possibility of wider economic effects. The imposition of 20% tariffs on Europe's US$60bn annual automotive exports to the US threatens to inflict an additional blow on an already shaky economy. After eurozone growth accelerated to 2.7% in 2017, most indicators have turned south in 2018. As a result, the International Monetary Fund this month cut its forecast for eurozone growth this year from 2.4% to 2.2%. Constrained by fiscal rules, and with little dry powder in the central bank's armory, policymakers have few options in response to softening growth. In consequence there are concerns that auto tariffs could trigger a more severe slowdown, or even a recession.

In theory, tariffs on US auto imports could hit Europe through three main channels:

1) Tariffs could hit the profits of European carmakers, either though cost or through price effects. On one hand, carmakers could attempt to protect their US market share by spreading the cost of US tariffs across their global businesses, reducing their profit margins. On the other, they could pass the tariffs on to US consumers in full, which would erode the US sales of European cars as consumers shifted to cheaper domestic alternatives.

US tariffs on auto and parts imports could hit European carmakers' profits and investment plans

2) Tariffs could create an incentive to move production closer to the US consumer, which would inflict an opportunity cost on Europe in the shape of lost investment and job creation at home.

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
Eurozone current account surplus fell to €22.4bn SA in May, from €29.6bn in Apr	N/a; 12m cumulative current account surplus at 3.6% of GDP vs 3.2% a year ago	Fall in primary income led to reduced surplus; trade wars will add to pressure
Canada CPI rose 2.5% YoY in Jun, up rom 2.2% in May	Above expected 2.3%; inflation at six-year high	Broadbased nature of inflation uptick means BoC likely to continue with rate hikes
Thailand trade surplus rose to US$1.6bn in Jun, vs US$1.2bn in May	Above expected US$1.3bn; exports rose 8.2% YoY in Jun vs 11.6% in May	Amid trade wars, Thailand's export dependence makes THB vulnerable to the downside
Taiwan export orders fell -0.1% YoY in Jun, vs 11.7% in May	Below expected 7.4%; unexpected fall could partly be due to base effect	Rising threat of trade wars will likely weigh on Taiwan's exports and growth ahead

3) The imposition of auto tariffs could damage broader business confidence as it would undermine confidence in the global trading system. This could lead companies in other sectors to scale back or freeze investment and hiring in Europe.

The first and second channels are unlikely to precipitate a severe slowdown. Sure, they would have a negative effect, but the impact is likely to be mitigated by a number of factors.

The direct impact of auto tariffs would fall most heavily on Europe's strongest economies

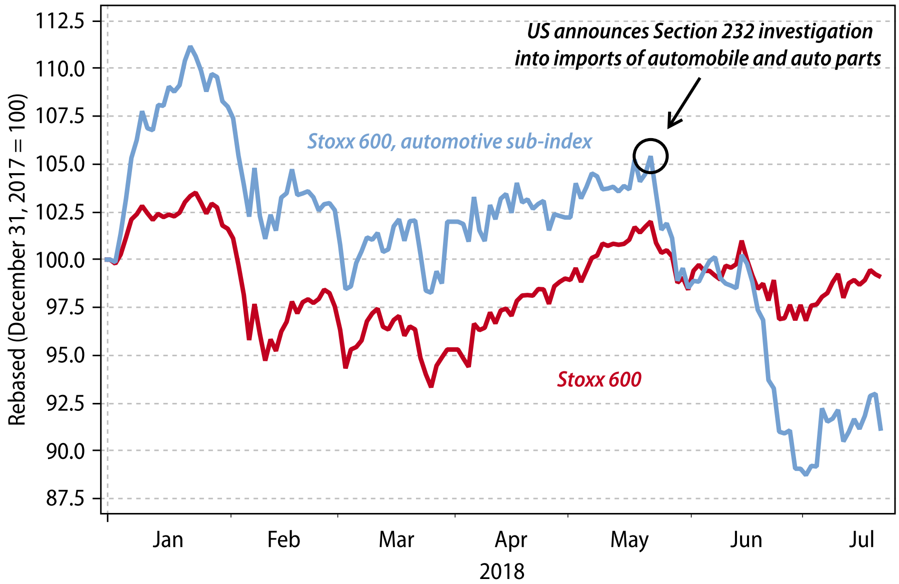
- The impact on profits, jobs and investment would fall most heavily on Europe's strongest economies. Germany alone accounts for 60% of Europe's US$60bn annual exports of cars and car parts to the US. But while these exports are undeniably chunky, their importance should not be exaggerated; they are just 2% of total exports in an economy that has increasingly been driven by domestic consumption (see **Spending Again In Germany**). Of course, the effects would also ripple along Germany's automotive supply chain. But the countries most integrated into that chain—Poland, Hungary and the Czech Republic—all grew at between 4.2-5.2% year-on-year in the first quarter. As a result, the blow would fall on those countries most able to absorb it.
- With capacity utilization tight at the global level, and demand still solid (although not as strong as in 2017), producers are likely to be able to pass on a relatively high proportion of tariff costs to consumers, while maintaining healthy sales in non-US markets. These sales will be supported by non-US trade agreements such as the EU-Japan deal which was closed last week.
- In theory, all else being equal, in a world of flexible exchange rates the imposition of tariffs is likely to see the euro depreciate against the US dollar, offsetting their impact.

The indirect impact of US tariffs on European business confidence could prove more severe

This leaves the third channel, which is potentially the most serious: the effect on confidence. Although nerves have hit the equity markets, it is not clear that fears of a trade war are yet having a big impact on business sentiment. True, business surveys softened in the first half of the year. But this mainly reflected a normalization from historically high levels at the end of last year, with survey readings stabilizing in recent months at levels consistent with solid growth. Business investment continues to rise, supported by restored corporate profitability, attractive financing conditions and broad-based demand.

However, while US tariffs on imports of autos from Europe are not in themselves a severe threat to this picture, a great deal depends on how the trade conflict develops from here. The danger is that tit-for-tat retaliation will impose additional costs on European consumers, as well as trigger the imposition of US tariffs on a much broader range of goods from Europe. In that case, the negative impact of an escalating trade war on European business sentiment would indeed have the potential to trigger a severe slowdown in the European economy.

The stocks of Europe's carmakers have been an early casualty



Gavekal Data/Macrobond

A full-blown trade war is not yet in the price; stay underweight eurozone equities

What does all this mean for eurozone equity markets? So far, stock prices are only discounting auto tariffs, not a broader trade conflict. This is bad enough news. Although automobiles and components make up a relatively modest 6% of the Euro Stoxx index by capitalization, they account for 13% of aggregate profits. With the sector's forward P/E ratio down to 6.8, its lowest since 2012, the broader market's forward P/E has also adjusted lower to 13.5.

The possibility of a deeper collapse in confidence in the global trading system resulting from a further escalation of the trade war is not yet in the price. As a result, eurozone equity markets are likely to face formidable headwinds going forward. With our favored momentum indicators having reversed, with the trend since December pointing lower, we advise an underweight position in European equities in the absence of any resolution to the evolving trade conflict.