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Disruption Decoded

Global Economics and Strategy: Protectionism Risks: What's Next?

Trade frictions are likely to persist, but the strong starting point of global demand, particularly capex, would be an offset. Global growth should remain strong unless we move into a protectionist push scenario with the US imposing broad-based tariffs and trade partners responding commensurately.

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Executive summary

Risks of trade frictions broadening out and persisting remain high: The timing (measures taken in January and March), intensity (toughest option chosen in the case of steel and aluminum tariffs) and nature (invoking Section 232 for the first time since 1982) of recent trade measures have come as somewhat of a surprise. In this context, while the initial response from trade partners has been measured and has helped to prevent an exacerbation of trade frictions, the risk of trade frictions broadening out remains high.

How will recent protectionist measures impact the global economy? As things stand, the direct impact on global trade and economic growth from the recent two rounds of trade measures (on solar panels, washing machines, steel and aluminum) will be limited, in our view, as it will only affect an estimated 1.7% of US goods imports, taking into account exemptions for Mexico, Canada and Australia.

Strong starting point of underlying global demand to offset rising US trade policy uncertainty: To be sure, there is still considerable uncertainty over the outlook for trade policy, which could weigh on business confidence. However, we believe that underlying demand conditions are still well supported and will matter more for the trajectory of overall trade growth. With global growth likely to reach close to 4%Y in 2018 and the global capex cycle recovering (which tends to have a stronger influence on global trade), this should keep global trade growth supported. Moreover, the rise in the US non-oil trade deficit to its highest level since the mid-2000s is a sign of already strong end demand, with fiscal reform providing further support.

What would lead us to the 'protectionist push' scenario? Our US public policy analyst Michael Zezas had previously laid out a framework to assess the potential scenarios that could arise (for more details, see his report). With the announcement of tariffs on steel and aluminum by the US, we have already entered into a scenario of 'temporary trade dispute' (a scenario in which the US sets temporary, de-escalating tariffs and trading partners respond in equal-or-lesser measure via WTO adjudication, targeted product actions, etc.). If the US were to take up further measures such as using Section 301 to investigate the intellectual property rights practices of trade partners (which ultimately leads to the imposition of tariffs on selected import products from China or in a broad-based fashion), introducing a reciprocal tax, heightening its response to trade partners and if NAFTA trade negotiations break down, it would move us closer towards a 'protectionist push' scenario (in which the US institutes broad tariffs and trading partners respond in kind and/or the US follows up with further meaningful action).

Possible policy actions and implications under the 'protectionist push' scenario: In particular, the key risk event that is in immediate focus is if the US uses Section 301 under the Trade Act of 1974 to investigate China's intellectual property policy. If used aggressively, this could have the largest impact on the US and China as well as the global economy.

In this context, we see three possible outcomes:

1) Bilateral agreement to cut the US-China trade deficit by US$100 billion (4% of China's exports and 4% of US total imports) over a reasonable time frame, resulting in a de-escalation of the situation.

2) Targeted use of Section 301, levying a 20% tariff on US$60 billion of Chinese high-tech products (semis, telecom, computer and medical equipment, etc.), and a measured response from China (with measures broadly compatible with WTO rules). Chinese policymakers may step up efforts to reduce imports from the US. This could include cutting imports of US agricultural products and transportation equipment, restricting domestic sales of some US products and raising tariffs in selected sectors. This would have a moderate impact on growth in both the US and China.

3) Aggressive use of Section 301, resulting in a broad-based 20% tariff hike across Chinese manufactured goods, and a commensurate response from China. This would have the strongest impact, with our US chief economist Ellen Zentner estimating that GDP could be lowered by 1pp relative to our baseline after four quarters, while in China, this could result in a 1pp drag on real GDP growth. Moreover, the impact would extend and be amplified by global value chains (accounting for two-thirds of global trade) and tighter financial conditions and only be partially offset by easier policies, resulting in a material drag on global growth.

From a markets' perspective, trade tensions don't dominate our forecasts, but they make both sides of the 'tricky handoff' worse: We think that markets will face increasingly strong headwinds from May as G3 core inflation starts rising and PMIs begin moderating (the opposite of last year's pattern). Increased tariffs push up costs and push down growth, making both headwinds (modestly) worse.

We think that increased trade risk should weaken USD (stronger EUR, JPY) in the medium term, the opposite of what was seen in the 1980s. We think that the best hedges against a rise in trade frictions lie in strategies that we think work under current conditions, but have additional optionality to rising trade tensions, and highlight CAD, AUD and MXN as the key currencies which would be relatively impacted.

For US equities, these developments are consistent with our strategists' thesis of increased volatility and lower potential returns this year: In a late-cycle environment where we expect markets to begin contemplating a peak rate of change on earnings growth and economic surprises before year-end, a material rise in protectionism would involve additional risks, increase volatility further and likely dampen broader risk appetite.

For European equities, the negative headlines on trade are used as one explanation for Europe's recent underperformance: The sectors that have the largest exposure to exports and a stronger currency include chemicals, industrials and autos, and are also some of the most expensive (relative to history) and the most overbought (on one-year momentum). We would avoid these, while liking the European market overall.

For Asia/EM equities, we feel that uncertainty on the issue of trade protectionism can drive valuation adjustment to the downside: Within the space, North Asia and Mexico are most exposed to the US in terms of listed equities' revenue sensitivity while ASEAN, Turkey, Russia, South Africa and Brazil are potentially less impacted. However, in the case of Mexico, our LatAm strategists have recently upgraded their stance, arguing that a lot of potential risks are now in the price. From a sector perspective, our revenue sensitivity suggests that the IT sector is most exposed to the US, followed by energy and consumer discretionary.

For US rates, in a 20% tariff scenario we expect the market to consider the short-term inflationary impact, while discounting any long-term effect on inflation. However, a tightening in financial conditions after the imposition of tariffs could limit the widening in breakevens and the overall increase in government bond yields. Overall, if 20% tariffs are enacted, we would expect to see the 5s30s breakeven curve invert meaningfully as breakevens widen, led by the front end. Such an inflation breakeven curve flattening would put further flattening pressure on the nominal yield curve – moving it closer to our forecast for a completely flat term structure this year. In addition, if the Fed were to respond to near-term inflation by raising rates more than it would have otherwise, the yield curve would flatten even more than we are expecting.

For Asia rates/FX, we think that all but an aggressive use of Section 301 could see AXJ currencies supported. If policy-makers in current account surplus environments were to respond to further trade barriers by reducing FX purchases, this could even provide additional upward pressure for Asian FX. Should a more aggressive application of Section 301 crystallise, we would turn more cautious on Asian currencies – except JPY. Buying CNHJPY downside looks attractive to us in such a scenario, while we would also turn more bullish on front-end China rates.

Economics: Protectionism risks: What's next?

Global economics team

The imposition of tariffs by the US since the start of the year has raised concerns about the impact that these measures would have on global growth. There are also concerns that trade frictions could broaden out and persist, particularly if more measures were to be taken up. In this report, we discuss the potential future trade policy actions, possible outcomes and their implications for the global economy and various asset classes.

US protectionist measures on the rise

US announcement of fresh protectionist measures raises concerns: The US announcement of import tariffs of 25% on steel and 10% on aluminum at the start of the month raised some concern. First, the initial announcement came faster and was more broad-based than expected. Second, the basis for this action was security concerns, under Section 232 of the Trade Expansion Act of 1962, rather than anti-dumping or countervailing duties which fall under regular procedures under WTO rules. This made it more difficult for trading partners to respond in a similar fashion. Third, the impact on trading partners is larger (at 1.2% of US imports) than that of tariffs on washing machines and solar panels (0.6% of US imports) announced in January. Note that this is taking into account exemptions for Mexico, Canada and Australia.

Direct impact of recent measures manageable, but risks of further rise in trade frictions remain in place: The announced tariffs brought us into the 'temporary trade dispute' scenario which our US public policy strategist Michael Zezas has laid out previously (Exhibit 2). We think that the impact of recent targeted measures will be manageable and not derail our constructive global macro outlook. Indeed, US imports of the four targeted products (excluding imports from countries being exempted from the tariff) account for just 0.2% of global exports in 2016. However, risks of a further rise in trade frictions remain in place.

Exhibit 1:

US protectionist measures implemented so far – timeline

Recent Trade Actions by US	Date	Base for Action
Safeguard tariff on solar cells and modules imports up to 30%	Jan-18	Section 201 safeguard investigation based on Trade Act of 1974 (global safeguard investigations, import relief for domestic industries) under USITC
Safeguard tariff on washing machine imports up to 20%	Jan-18	Section 201 safeguard investigation based on Trade Act of 1974 (global safeguard investigations, import relief for domestic industries) under USITC
25% tariff on steel imports	Mar-18	Section 232 investigation based on Trade Expansion Act of 1962 (to determine effect of imports on national security)
10% tariff on aluminum imports	Mar-18	Section 232 investigation based on Trade Expansion Act of 1962 (to determine effect of imports on national security)
Requested dispute settlement consultations with India at WTO to challenge India's export subsidy programs	Mar-18	WTO exemptions for developing countries concerning the provision of export subsidies; India surpassed the defined economic benchmark for developing countries in 2015

Source: US Department of Commerce, Morgan Stanley Research

Exhibit 2:

Three US trade policy scenarios

Scenario	Outcome
De Facto Status Quo	The administration chooses not to act on tariff recommendations from the Commerce Department, perhaps preferring to keep them as part of ongoing negotiations. Negotiations could ultimately succeed, perhaps in part due to partners' addressing the administration's focus on trade deficit concerns. Market concerns are allayed, with investors interpreting the behavior as a high degree of reluctance on the part of the US to break from free trade norms.
Temporary Trade Dispute	Similar to the Bush steel tariffs in 2002 and Obama tire tariffs in 2009, this administration undertakes product-specific actions on these upcoming triggers without signaling a broader protectionist push, potentially as a negotiating tactic. While a WTO challenge would be expected, the administration could signal its ambivalence about complying with the results of their review. A temporary 'tit for tat' could also ensue, as it did with China's auto tariffs in response to the Obama tire actions. That tension could certainly abate over time through a combination of face-saving solutions, cosmetic changes, and WTO adjudications (as was the case with both Bush and Obama administration's actions), effectively returning us to the status quo. Nevertheless, the process could justifiably spark market concern about a rising probability of a 'tit for tat' trade conflict with key partners and/or a hard exit from NAFTA.
Protectionist Push	The administration acts on a tariff opportunity, and follows this with demonstrative signals of a broader protectionist push. This could be in the form of subsequent tariff actions and/or more definitive statements or actions on NAFTA negotiations (such as the activation of article 2205). While this approach would not definitively mean the US is taking a more long-term protectionist approach, markets could reflect a meaningfully higher probability of this approach and all its economic implications.

Source: These scenarios are replicated from US Public Policy: Trade Policy: Beyond the Hypothetical, January 22, 2018.

'Temporary trade dispute' scenario unfolding

The recent developments affirm our base case that trade tensions would settle into a 'temporary trade dispute' scenario. Under this scenario, tariffs are enacted, similar to those undertaken in the Bush and Obama administrations, but with exceptions for key treaty partners and other appropriate carve-outs. The response from trading partners would be in equal-or-lesser measure and, over time (perhaps a couple years), both sides de-escalate (see US Public Policy Brief: Trade Policy: How Tense Can it Get? March 5, 2018).

Why are we not in the 'protectionist push' scenario yet?

- Canada and Mexico were exempted from this round of tariffs. If they had not been, NAFTA talks could have been made more difficult and prone to failure.
- The EU's announced measures were product-specific as opposed to broad and escalatory.
- The tariffs will reportedly make available waivers for trading partners through an application process, keeping open the possibility of an even more muted international response in the near term.
- The president appears to have set terms for trade deficit reduction with China that could signal a longer negotiating time frame to delay or blunt Section 301 actions.

Risks skewed towards a move into the 'protectionist push' scenario: Risks remain that we could be moving into the 'protectionist push' scenario – a scenario which would entail the US imposing broad-based tariffs and trade partners responding more meaningfully, thereby leading to a broader and more persistent rise in trade frictions.

What are we watching that could escalate the situation?

- **Aggressive use of Section 301:** While the administration has not been specific with the remedies it is considering pursuing regarding intellectual property, some media reports suggest that it could include as many as 100 products and a restriction on US investment by Chinese nationals. Furthermore, the investigation is aimed at one partner – China. Separating China out from the crowd that is affected by current trade efforts could be taken as an escalation.
- **Reciprocal tax:** While the administration has not yet fully detailed what such a tax would look like, based on public comments we take it to be an effort to 'level the playing field' by taxing imports near or equal to the difference between the exporting country's VAT and US state and local sales taxes or the difference in import tariffs for major product categories. However, it's not clear to us that the president has the authority to enact something this broad within the existing set of laws. Note that this may be perceived as more aggressive than select anti-dumping measures or countervailing duties due to its broad-based nature in terms of products and countries affected.
- **An escalatory US response:** For example, the president has publicly discussed the idea of putting a tariff on European auto imports if the EU imposes a tariff on US exports.
- **NAFTA negotiations breaking down:** NAFTA negotiations are also ongoing and a more benign outcome is likely. However, there remains a risk of the US withdrawing from negotiations, especially if they drag on for longer and beyond looming political events (i.e., Mexican presidential elections and state elections in the US ahead of November mid-term elections). In such case WTO rules would likely prevail.

Exhibit 3:

Upcoming potential US trade policy decisions

Opportunities for Trade Conflict	Approx. Date	Next Action
Section 301 Investigation: Chinese Intellectual Property Practices	Summer 2018	USTR findings and remedy recommendations by summer 2018, possibly earlier.
Reciprocal Tax	Unknown but risks rising	While no clear details have been revealed by the administration, the President has recently reiterated support for such action, suggesting that the US is moving materially closer to enacting a "reciprocal tax."
NAFTA Negotiations	No set date for next round	While six out of 30 topics have been agreed, on most contentious issues there have been no major signs of breakthrough. Negotiations may be interupted by Mexican presidential election in July.

Source: New York Times, Washington Post, Wall Street Journal, Politico, USITC, Commerce Department, Inside US Trade, Morgan Stanley Research

What's next? Possible actions and implications for growth

In this section we describe three possible protectionist actions by the US along the lines presented in the previous section, i.e., A) Use of Section 301, B) A reciprocal tax and C) Withdrawal from NAFTA. We then assess **the impact on growth, taking into consideration possible responses from major trading partners.**

We find that a case where the **US aggressively uses Section 301 to act on intellectual property and China responds strongly would have the largest negative repercussions** on the US and China and thus also global trade and GDP growth. An alternative version of the Section 301 use, a reciprocal tax on select countries/sectors or the breakdown of NAFTA negotiations would likely have a more manageable impact.

While not interrupting existing trade directly in a manner similar to the actions above, we think that there could be **further restriction of US inward and outward investment related to technology and infrastructure** on the basis of national security concerns. This would affect cross-border investment in and from the US, China and other nations (a bill that would give the Committee on Foreign Investment in the United States (CFIUS) a larger mandate to do that is currently being reviewed in Congress).

Exhibit 4:

Possible actions and outcomes

Possible Action	Description	Impact	Degree of Impact
Use of Section 301			
(i) Bilateral Agreement	Cut US-China trade deficit by US$100bn over a reasonable time frame	Potential downward pressure on employment in China depending on pace of implementation	Low
(ii) Targeted Use	20% tariff on $60bn of Chinese high-tech exports; measured response from China	**China:** Notable drag on exports but impact on growth manageable **US:** Negative impact on exports and growth, higher inflation	Moderate
(iii) Aggressive Use	Broad-based 20% tariff on Chinese manufactured goods; commensurate response from China	**China:** Significant drag on exports and growth **US:** Sizable impact on exports and tighter financial conditions leading to drag on growth and higher inflation	High
Enacting a "Reciprocal Tax"	Additional import tariffs on specific countries/goods where US import tariffs are lower in comparison	Manageable impact overall, but EMs likely more affected	Moderate
NAFTA Negotiations Breakdown	US withdrawal from NAFTA, WTO rules prevail	Mexico likely most affected - modest impact in the short term but lower investments will likely weigh on potential growth	Moderate

Source: Morgan Stanley Research

A) The US acts under Section 301 on intellectual property

The key risk event we are watching is the US Section 301 investigation under the Trade Act of 1974 of China's intellectual property policy, with the decision likely coming earlier than we had previously expected (probably a matter of weeks rather than months) and potentially affecting a broad set of Chinese products. Under this law, the US can impose tariffs and quotas as a reaction to unjustifiable, unreasonable or discriminatory practices (see Box A). An initial US trade representative conducts the investigation (currently under way), and the US president takes the final decision.

Possible actions

In this context we are looking at a subset of three possible outcomes **depending on the strength of the US action and China's response.**

a. **A bilateral agreement** to cut the US-China trade deficit by US$100 billion (4% of China's total exports and 4% of US imports) over a reasonable time frame, resulting in a de-escalation of the situation.
b. **Targeted use of Section 301, levying a 20% tariff on US$60 billion of Chinese high-tech exports, and a measured response from China:** This includes semiconductors, telecommunication products, computer equipment, medical equipment, pharmaceuticals and aerospace, with US$60 billion of exports in these sectors, equivalent to around one-eighth of China's total exports to the US (around 40% of China's overall exports are high-tech exports). The response from China will likely be measured (and WTO-compatible), and it may step up efforts to reduce imports from the US. This could include cutting imports of US agricultural products and transportation equipment, restricting domestic sales of some US products and raising tariffs in selected sectors.
c. **Aggressive use of Section 301, resulting in a broad-based 20% tariff hike** across Chinese manufactured goods, **and a commensurate response from China**: We believe that China could impose a similar tariff on all goods imports from the US under this scenario.

Impact on the US and China

In terms of the impact of those different actions on the US and China, we think that **the scenarios of a bilateral agreement and targeted use of Section 301 will have a more moderate impact,** while the aggressive use of Section 301 would be the most detrimental, **with significant negative repercussions for growth in both countries. Specifically concerning the least benign scenario,** we expect the following:

With regards to the US, our US chief economist Ellen Zentner estimates that a 20% import tariff and a similar response from China would lower GDP by 1pp relative to our baseline after four quarters, pencilling in a hit on exports and negative financial market response (~100bp tightening in financial conditions). At the same time, inflation would be affected with a lag of three quarters, ending 0.2pp higher relative to our baseline forecasts after four quarters and 0.4pp higher after six quarters. The Fed should in theory look through this transitory increase in inflation and take into consideration the downward effect on potential growth. However, little to no slack in the labour market, rising wages and core inflation would complicate the situation in the near term.

With regards to China, our China economist Robin Xing estimates that a broad-based 20% tariff on exports to the US would result in a 5.6pp drag on export growth and 1pp on real GDP growth after considering the spillover impact on investment, employment and household consumption. Meanwhile, in order to avoid a major growth correction, policy-makers could halt the domestic deleveraging process, and adopt expansionary fiscal policy.

With regards to the global impact, we think that any growth change affecting the US and China would be amplified by global value chains (accounting for two-thirds of global trade) and tighter financial conditions and only be partially offset by easier policy. This is particularly so due to the size and integration of China into the global supply chain. 43% of China's overall exports are exports by multi-national companies.

Box A: US Section 301 investigations – an historical perspective

Section 301 of the Trade Act of 1974 is the principal statutory authority under which the US may impose trade sanctions on foreign countries that either violate trade agreements or engage in other unfair trade practices.

Section 301 investigations have not usually led to escalating trade tensions in the past: According to a recent AEI study, among the 86 cases of Section 301 investigations between 1975 and 1993, only 15 resulted in sanctions. Among the remaining cases, 40 ended with the targeted countries making significant concessions, while 31 were resolved with the US backing down from the investigations amid moderate concessions from targeted countries.

At the sectoral level, Section 301 investigations had a modest short-term impact on trade flows: There are two historical instances in which the Section 301 investigations targeted multiple countries and where granular data on the products involved are available (so that the impact can be more accurately assessed). In the first case, the US steel industry filed a petition in late 1981 against unfair subsidies from multiple European countries. The US trade representative initiated an investigation in February 1982, which led to a combination of tariffs and quotas imposed by the US president in July 1983. As a result, US steel imports rebounded strongly in 1984 after a period of subdued growth in 1982-83. In the second case, US soybean producers protested against export and production subsidies and quantitative restrictions in multiple countries that had weighed on US imports. The US trade representative initiated an investigation in May 1983 and pursued dispute settlement procedures in February 1984. Consequently, US soybean exports rebounded in 1985, following a rare three-year decline during 1982-84.

But the impact on bilateral trade flows at an aggregate level appears to be limited: One of the reasons is that the impacted sectors usually account for a small portion of a country's total exports. That said, Section 301 investigations can imply rising trade frictions and could therefore lead to substitution effects (i.e., shifting trade to other countries). In the case of China, there had been no clear evidence of obvious impacts from these investigations. Despite the four Section 301 investigations on China in 1991, 1994, 1996 and 2010, China's export flows did not deviate from trend in these years; there was also no evidence of export growth decline in the following years.

The historical experience with Section 301-related investigations has been that the outcomes have been somewhat limited in the past. As discussed earlier in the report, the key factor which will determine the final impact is the strength of the initial actions and response by trade partners.

B) The US enacts a 'reciprocal tax'

Possible action

In this case, the US would impose reciprocal import tariffs on select trading partners and sectors where US import tariffs are lower than those of its trading partners. In this case, measures would likely target those economies and sectors where the US is running the largest trade deficits and the tariff gap is relatively large. Such a strategy would be more complicated to implement than a general tariff as it would require a detailed assessment of subsectors across major trading partners. At this point, it is not clear that the US president has the authority to enact something this broad within the existing set of laws. Note that such a move would likely imply that tariffs are lifted above the US' binding maximum tariffs agreed on under WTO rules and thus, if done unilaterally (without negotiating with major trading partners concerned), may result in the US having to compensate for the trading partners' loss in trade (WTO).

Impact on countries and sectors

Compared with a more broad-based 20% tariff on Chinese export products, the impact of a reciprocal tax would likely be more manageable as it would affect a narrower set of products and imply a more measured adjustment of tariffs. In addition, such action would likely not be met with aggressive responses from trading partners. Based on our analysis of trading partners that account for the largest part of the trade deficit, we find that it is particularly emerging markets, notably China, Mexico, Korea and India, where the gap between import tariffs is somewhat higher. For China, the aggregate gap between weighted average import tariffs on manufactured goods relative to the US is only 2.6pp. Among developed markets the gap is significantly smaller. See a full list of top export products (those accounting for a large part of the surplus with the US) below.

Exhibit 5:

Import tariffs in major US trading partners

US trade deficit by country, top 5 sectors						Total US Trade Balance, US$bn	Weighted Average Import Tariff % on Manufactured Goods (US at 1.7%)
Country	1	2	3	4	5		
China	Electric machinery	Nuclear reactors, boilers, machinery	Furniture and bedding	Toys. Games and sporting equipment	Apparel articles and accessories	-375	4.3%
China import tariff %	8.7	8.0	7.0	10.9	16.2		
US import tariff %	1.5	1.2	1.6	2.0	12.8		
Mexico	Vehicles	Electric machinery	Nuclear reactors, boilers, machinery	Furniture and bedding	Optic, photo, medic or surgical instruments	-71	3.8%
Mexico import tariff %	10.5	3.5	2.7	10.6	2.4		
US import tariff %	3.1	1.5	1.2	1.6	1.1		
Japan	Vehicles	Nuclear reactors, boilers, machinery	Electric machinery	Rubber and articles	Iron and steel articles	-69	1.1%
Japan import tariff %	0.1	0.0	0.1	0.2	0.5		
US import tariff %	3.1	1.2	1.5	1.6	1.2		
Germany	Vehicles	Nuclear reactors, boilers, machinery	Pharmaceutical products	Optic, photo, medic or surgical instruments	Electric machinery	-64	2.0%
Germany import tariff %	6.2	1.8	0.0	1.6	2.5		
US import tariff %	3.1	1.2	0.2	1.1	1.5		
Italy	Nuclear reactors, boilers, machinery	Vehicles	Beverage and spirits	Pharmaceutical products	Footwear	-32	2.0%
Italy import tariff %	1.8	6.2	4.3	0.0	11.1		
US import tariff %	1.2	3.1	1.8	0.2	10.5		
India	Glass and glassware	Organic chemicals	Ores, slags and ash	Misc articles of base metal	Apparel articles and accessories, knit	-23	5.7%
India import tariff %	9.9	7.1	3.4	10.0	10.0		
US import tariff %	5.1	2.8	0.1	2.4	10.1		
Korea	Vehicles	Electric machinery	Nuclear reactors, boilers, machinery	Articles of iron and steel	Rubber and articles	-23	2.4%
Korea import tariff %	7.6	5.8	5.9	4.6	7.0		
US import tariff %	3.1	1.5	1.2	1.2	1.6		
Canada	Mineral fuel, oil	Wood and articles of wood	Aluminium and articles	Vehicles	Natural pearls, precious metals and stones	-18	1.0%
Canada import tariff %	0.7	1.1	1.2	3.6	1.4		
US import tariff %	0.5	1.1	3.5	3.1	2.1		

Source: UN Comtrade, WITs, WTO, Morgan Stanley Research; Note: We focus on the G-20 economies in this exercise. *For more details on which sub-sectors are contained in the different product categories see here. Sectors with a high bilateral tariff difference are shaded in blue.

C) NAFTA negotiations breakdown

Possible action

The latest news indicates that the US administration is showing flexibility towards Mexico and Canada. This is in line with our call for continued NAFTA negotiations rather than a breakdown as the most likely outcome for now. That said, there is a risk of the US withdrawing from NAFTA if no deal is reached over a prolonged period of time. **In the case of withdrawal, WTO rules would likely prevail.** We explore the possible impact on Mexico as it would be most affected by such action. Mexican policy-makers may consider some response such as targeted tariffs on agricultural products from politically important Midwestern states.

Note that the US president can attempt to unilaterally withdraw from NAFTA, giving six months' notice under Article 2205 of the agreement, although there is still a great deal of constitutional uncertainty regarding the ultimate ability of the US administration to leave the treaty without congressional approval, given that there are no precedents.

Impact on Mexico

In this case we would see GDP growth in Mexico falling some 0.8pp below trend from a combination of modest tariffs under WTO rules, reduced investment protection (currently provided under NAFTA) and greater institutional uncertainty, in addition to the extra edge provided to US factories from lower taxes that would partly erode Mexico's attractiveness as a manufacturing hub. However, it is worth highlighting that the adjustment would be gradual, the main reason being that it will not be a quick task to ramp up US factories and supply chains, add new capacity and attract workers back to manufacturing (see **Protectionism and the global economy in perspective**). Lower investment levels over time – with its adverse consequences for Mexico's already sluggish productivity growth – would lead to a rethink of the country's potential growth.

Further restriction of foreign direct investment inflows and outflows: The US could also further restrict foreign direct investment of foreign companies, particularly Chinese companies, in the US and vice versa on the basis of security concerns. Recent examples of action in this direction were the US president's blocking of the acquisition of Lattice Semiconductor in September 2017 by China Venture Capital Fund Corporation Limited and the acquisition of Qualcomm by Singaporean chipmaker Broadcom this month as suggested by the CFIUS. A bill currently under review in Congress would enlarge the CFIUS mandate to restrict investments, particularly in the area of technology and infrastructure.

Beware of the indirect impact of protectionist actions: While we assess the direct impact from the majority of the aforementioned actions to be more moderate with the exception of a more aggressive use of Section 301, we see downside risks from the indirect impact, which is more difficult to measure. First, the dominance of global value chains (about two-thirds of global trade according to the WTO) means that the impact of protectionist measures could be larger than our estimates suggest. This is particularly the case for highly integrated regional production networks in Asia and the euro area. Second, the increasing threat of protectionism raises uncertainty which, if it persists, would negatively affect business investment in the US and its major trading partners.

Protectionism and the global economy in perspective

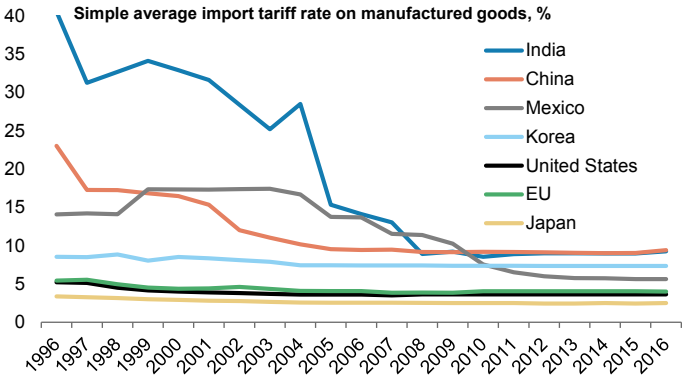
Protectionism usually rises during phases of economic weakness

From a longer-term perspective, trade has been progressively liberalised since the 1990s: The collapse of the Soviet Union, creation of the WTO, opening for trade of China as well as decline in transport and communication costs were all supportive of further trade liberalisation. Since then, import tariffs have been declining across major regions, including the US and its major trading partners. **Short-term dynamics in protectionism have typically been linked to economic cycles,** i.e., tariffs and non-tariff measures would tend to increase temporarily during economic downturns and decline during times of economic recovery. Examples are the US import tariffs imposed during the 2000s and 1980s (see Box B). Both the US and several other major countries have also increased protectionist measures in the aftermath of the global financial crisis, although mostly in the form of non-tariff measures.

Timing and tools of recent US actions are unusual: Using recent history as a guide, **protectionist efforts should revert at the time when the global economy is recovering.** Given that global GDP growth has moved above trend during the past year and US aggregate demand growth continues to strengthen, with the fiscal reform providing additional tailwinds, the timing of the recent increase in US protectionism is somewhat unusual. In addition, the use of outright tariffs rather than non-tariff measures puts a more aggressive spin on the US actions.

Exhibit 6:

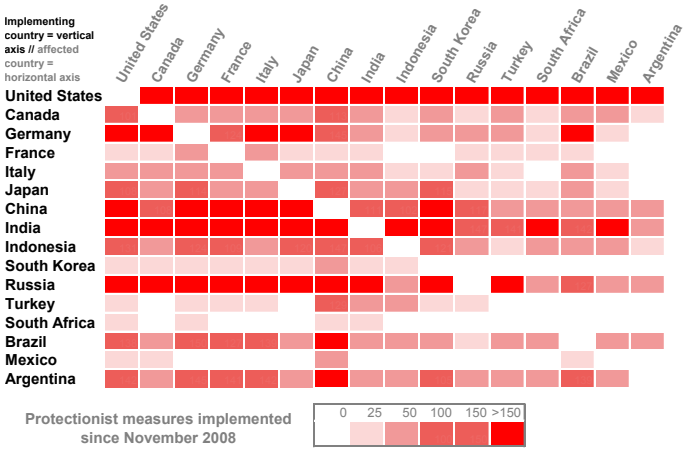
Import tariffs have declined since the creation of the WTO...



Source: WTO, Morgan Stanley Research

Exhibit 7:

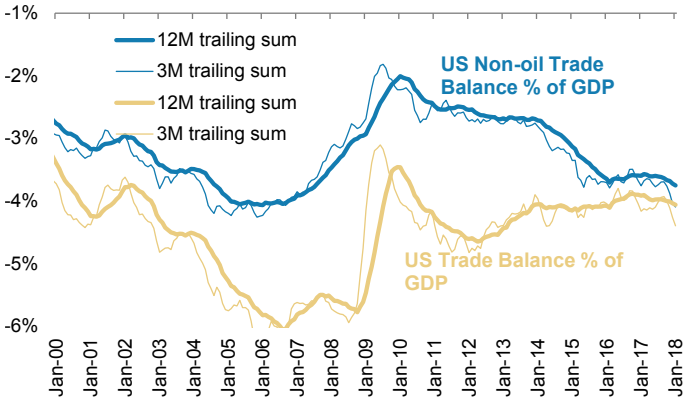
...but protectionist measures have risen post-GFC



Source: Global Trade Alert, Morgan Stanley Research

Exhibit 8:

US non-oil trade balance has widened significantly



Source: Haver Analytics, national sources, Morgan Stanley Research

Exhibit 9:

US male labour force participation rate on a downward trend

Source: Haver Analytics, BLS, Morgan Stanley Research

What has changed compared to previous episodes of US protectionism? President Trump had made trade a **key theme of his campaign during the presidential elections** in November 2016, arguing that he would **want to reduce the US trade deficit and bring jobs back** to the US. A still low participation rate among prime-age men (Exhibit 9) and the continued widening of the trade deficit during recent months have both lent support to his efforts.

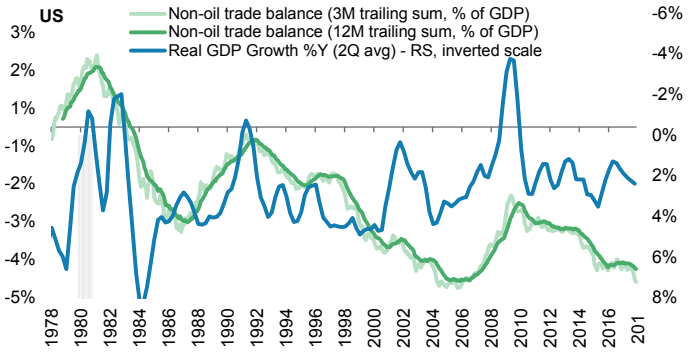
Will protectionist measures narrow the trade deficit/create jobs? In our view, there are **both structural and cyclical forces playing against the administration's efforts to reduce the US trade deficit** via import tariffs. From a cyclical point of view, the US non-oil trade deficit has widened visibly against the backdrop of strengthening aggregate demand, particularly business capex, which is reflected in a widening of the capital goods deficit, and fiscal reform should provide further support (Exhibit 10 and Exhibit 12). From a structural point of view, it will be difficult to quickly ramp up existing factories, build new ones and attract workers to those industries where the US has been running large deficits for years. Note that employment in the manufacturing sector has been on a downward trend for decades (Exhibit 11) and the US lacks production capacity relative to major trading partners such as China. In the case of aluminum, for example, the US has a total capacity of 1.8mnt, running at a 55% operating rate, while it imported 7mnt in 2017. In addition, it will be difficult for the US to displace major manufacturing powerhouses such as China, given that the latter has several competitive advantages such as economies of scale due to its large labour force and abundant resources, supportive government policies, adequate infrastructure and an efficient production and supply network in the region.

Broad-based increase in import tariffs likely to affect competitiveness, raise inflation

Given the lack of domestic capacity, the increase in import tariffs on intermediate goods or raw materials **would come at the expense of an increase in input prices for US companies,** which would negatively affect their competitiveness and/or profits (depending on whether they pass price increases on to consumers or take a hit on their margins). In the case of NAFTA, for example, 60% of US imports are used in the production of 'Made-in-America' final goods and services. Similarly, foreign enterprises have accounted for 43% of Chinese exports in 2017. The dominance of global value chains in global trade (about two-thirds of the total) implies that there will be negative repercussions for US multinationals. From an economic point of view, tariffs on finished consumer products (~40% of total US imports) would be more effective in achieving a reduction in the trade deficit as they are not used in domestic production processes. However, the implementation would be politically more difficult, given the direct impact on consumer prices.

Exhibit 10:

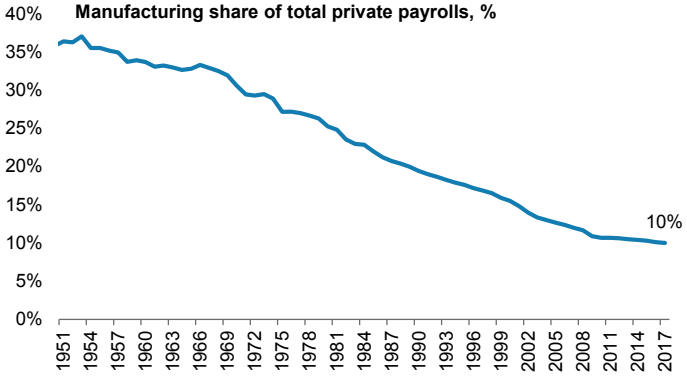
Stronger aggregate demand leading to wider US non-oil trade balance



Source: Haver Analytics, Morgan Stanley Research.

Exhibit 11:

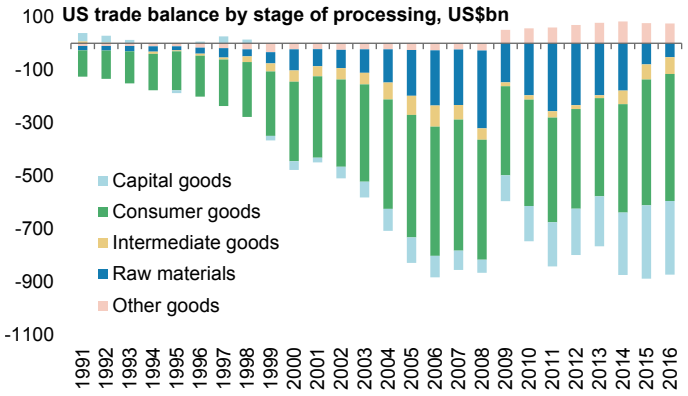
Manufacturing sector employs just 10% of private payrolls



Source: Haver Analytics, Morgan Stanley Research

Exhibit 12:

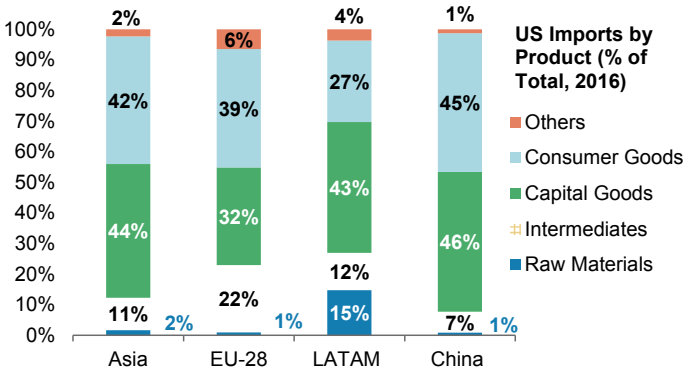
Breakdown of US trade balance



Source: World Bank (WITS), Morgan Stanley Research; Note: Trade balance of 'other goods' is the residual balance after the four main stages of processing categories have been accounted for. Data include import charges and may differ from customs value data from Census Bureau used in other charts.

Exhibit 13:

US imports by region and type of goods



Source: World Bank (WITS), Morgan Stanley Research

Conclusion

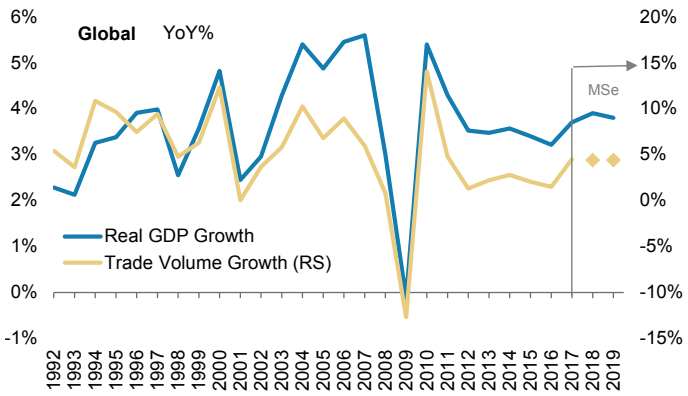
Our base case of stronger for longer growth remains intact, unless we move into an aggressive protectionist push scenario: Our base case view is still that the global growth backdrop remains favourable, and hence underlying demand for EM exports should stay supported. Notably, global growth has accelerated during the past quarters, driven by the acceleration in global capex. The pick-up in investment has supported a recovery in global trade and created positive spillover effects. This has underpinned our positive view that the global economy will be stronger for longer, with EMXC becoming a key driver over our forecast horizon. Moreover, the rise in the US non-oil trade deficit to its highest level since the mid-2000s is a sign of already strong end demand, with fiscal reform providing further support.

However, an increase in trade frictions would pose downside risks to growth, particularly if we see the introduction of a broad-based import tariff by the US and more aggressive responses from major trading partners, particularly China: This would be primarily the case if the US uses Section 301 aggressively. Other more measured actions explored in this note would likely be less detrimental to growth.

To gauge the risks to that view, we would keep a close eye on the policy actions from the US and its trade partners, business sentiment and Asian export growth (in particular Korea's exports growth as it is the first real-time trade indicator and is released on the first day of each month).

Exhibit 14:

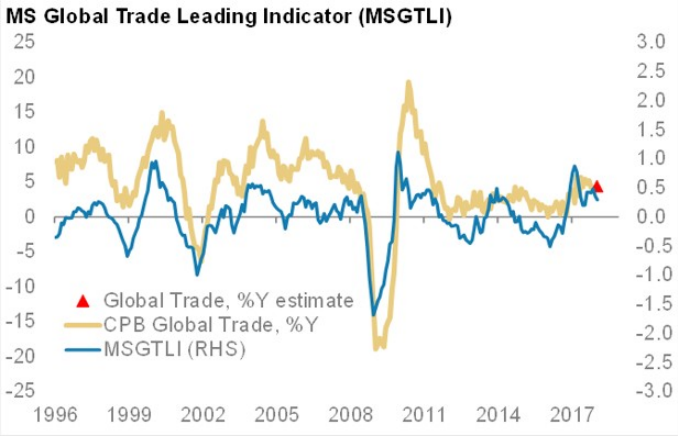
Global trade to remain supported as global growth is expected to hold up



Source: IMF, CPB, Morgan Stanley Research forecasts; Global growth from 2017 onward includes countries under Morgan Stanley coverage only. Note: Historical global trade refers to only goods, while Morgan Stanley forecasts include both goods and services.

Exhibit 15:

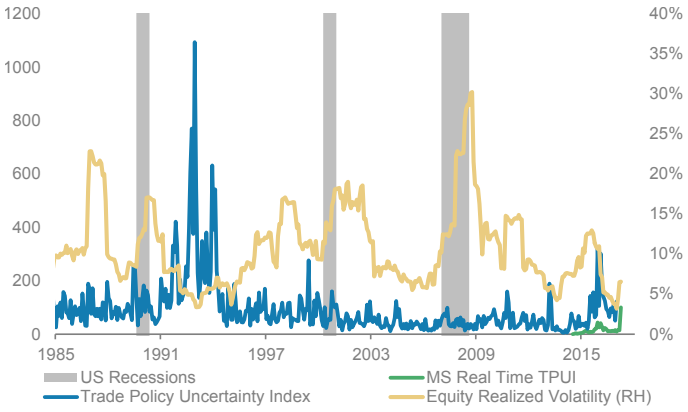
Global trade growth cruising at a solid pace



Source: CPB, Haver Analytics, Morgan Stanley Research

Exhibit 16:

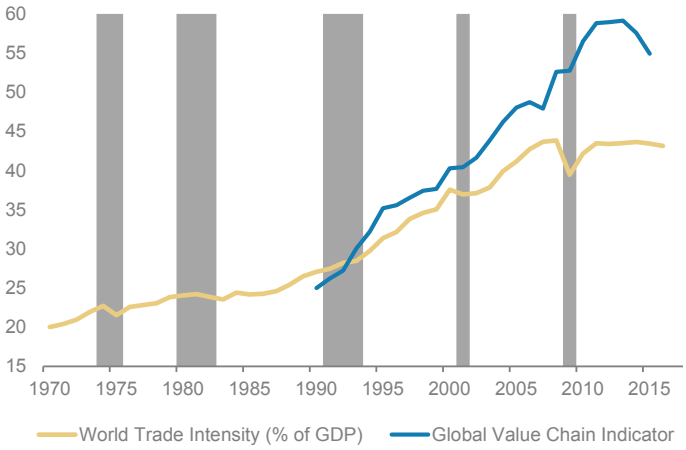
Realised volatility for US equities versus trade policy uncertainty



Source: Bloomberg, Google Trends, Baker, Bloom at www.PolicyUncertainty.com, Morgan Stanley Research; Note: MS Real Time Trade Policy Uncertainty Indicator (TPUI) based on the popularity of specific trade-related web searches.

Exhibit 17:

Trade intensity more than doubled since the mid-1970s, global value chains did the same since 1990



Source: OECD, Morgan Stanley Research; Note: Trade intensity is the sum of exports and imports in GDP (also known as the degree of openness). GVC indicator is the ratio of intermediate goods imports to final domestic demand.

Box B: Lessons from earlier episodes of US protectionism

Past episodes of major US protectionist measures could be instructive in assessing the related growth impact and how the course of events may unfold. Here **we focus on two episodes, given the similar nature and intensity** of the policy actions compared to the currently announced measures:

1. **Protectionist measures against Japan in the 1980s:** The Reagan administration began to implement a series of protectionist policies against Japan starting from 1981, primarily targeting its auto exports and later semiconductors. These include voluntary export restraints and tariffs.
2. **Steel tariffs by the Bush administration in 2002:** Initiated as a safeguard measure in March 2002, President Bush raised steel tariffs from 0-1% to 8-30%. The tariffs were intended to last three years to allow consolidation in domestic operations and reduce layoffs.

We draw two important lessons from these episodes:

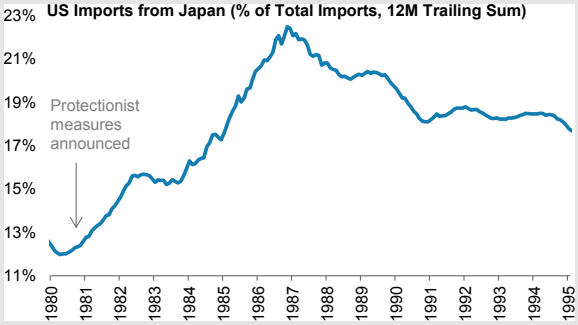
1) Underlying demand conditions are more critical in determining the outlook for trade: Despite the slew of protectionist measures against Japan in the 1980s, the country continued to maintain its market share in the US throughout much of the decade until 1987. This suggests that other factors were more important in determining Japanese imports. Indeed, US end-demand was strong, with the economy recovering faster than the rest of the world after the 1980-83 global recession. Trade growth in Japan did decelerate during the early 1980s, but this occurred even before protectionist measures were introduced and was driven by the global recession at that time. In this context, with global growth expected to reach close to 4%Y in 2018, global trade is likely to stay supported, especially with recovering global capex (which exerts a stronger influence on trade growth).

2) Policy dynamics are relevant: In the 2002 episode, the steel tariff turned out to be short-lived as trading partners responded proactively. For instance, the EU prepared to impose tariffs on politically salient US imports and filed a complaint under the WTO framework, which it won. The US eventually lifted the tariffs in 2003, after the WTO ruling but before any EU levy. In the current context, various trading partners have already stepped up to voice their concerns, with the EU discussing targeted tariffs on US imports in response. In addition, protectionist measures are facing headwinds domestically. For example, US steel-consuming companies which are facing higher input costs from the introduction of import tariffs could challenge the tariffs on steel in court.

Congress may also counter the president's recent measures by amending or repealing current trade laws, including legislation that grants the executive branch the power to raise tariffs. However, this would probably require a majority vote count to prevent the president's veto, which appears unlikely at the current juncture.

Exhibit 18:

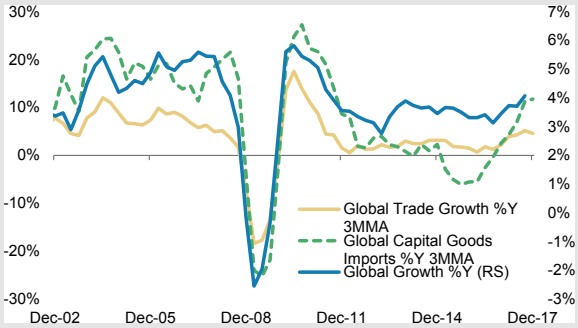
Japan's market share in the US held up in the 1980s



Source: CEIC, Morgan Stanley Research

Exhibit 19:

Global growth and capex recovery should continue to support global trade



Source: CPB, Haver Analytics, Morgan Stanley Research; Note: Aggregate of countries for global growth under Morgan Stanley coverage only.

Box C: The impact of recent measures on the US and major trading partners

The products affected so far (washing machines, solar panels, steel and aluminum) only account for 1.7% of total US imports, taking into account exemptions for Mexico, Canada and Australia, and thus have a small weight in CPI. Moreover, estimates of the US import demand elasticity for these large durables and inputs tend to range from ~0.0 to 1.5. Hence, the impact on growth and inflation should be limited.

Among the G20, Mexico, Canada, Korea, Germany, China and Japan have the highest exposure to exports to the US a percentage of GDP (at >3% of GDP). So far, the announced measures on washing machines, solar panels, steel and aluminum would only affect 0.1% to 1.0% of those countries' total exports and an average 0.1% of their GDP (Exhibit 20). This excludes NAFTA members Mexico and Canada, since these countries are, at least temporarily, exempt from the recently announced measures. Their direct exposure is higher at an average 1.8% of exports and 0.4% of GDP. For Brazil and Russia, which are not among the largest trading partners but large exporters of steel and aluminum to the US, the impact on GDP is also manageable at 0.1%.

Exhibit 20:

Announced tariffs measures thus far have a relatively small direct impact on trade partners

Exports to US as % of Total Exports	China	Japan	Korea	Germany	Canada	Mexico	Brazil	Russia
Steel products	0.04%	0.3%	0.5%	0.1%	1.0%	0.5%	1.0%	0.1%
Aluminum products	0.1%	0.03%	0.03%	0.04%	1.6%	0.1%	0.04%	0.6%
Washing machine	0.03%	0.0%	0.04%	0.0%	0.0%	0.1%	0.0%	0.0%
Solar panel	0.1%	0.1%	0.3%	0.0%	0.0%	0.2%	0.0%	0.0%
Sum	0.2%	0.4%	0.8%	0.1%	2.6%	0.9%	1.0%	0.7%
Exports to US as % of GDP	0.05%	0.05%	0.3%	0.1%	0.6%	0.3%	0.1%	0.1%

Source: Haver Analytics, Morgan Stanley Research

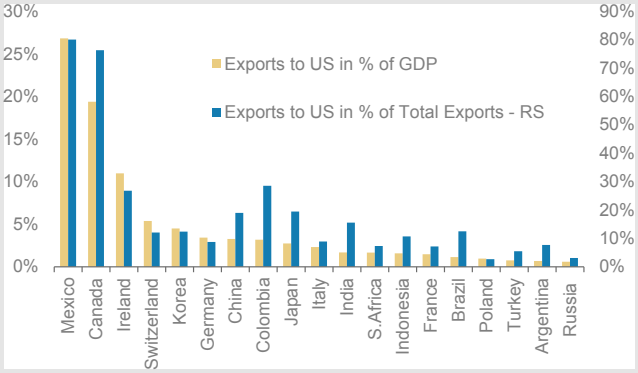
Exhibit 21:

Countries with largest US goods trade deficit

Source: Haver Analytics, Morgan Stanley Research

Exhibit 22:

Asia, Mexico and Canada exports have high exposure to US



Source: UNComtrade, Morgan Stanley Research.

In the following sections, we first provide key investment implications on various asset classes, and then offer detailed analyses on the impact and likely policy responses at the regional/country level.

Strategy: Trades for trade

Cross-asset strategy

Andrew Sheets

Trade tensions don't dominate our forecasts. But they make both sides of the 'tricky handoff' worse: We think that markets will face increasingly strong headwinds from May as G3 core inflation starts rising and PMIs begin moderating (the opposite of last year's pattern). Increased tariffs push up costs and push down growth, making both headwinds (modestly) worse. The implications:

1. Weaker USD in the medium term (stronger EUR, JPY): We think that increased trade risk should weaken USD in all but the most extreme scenario, the opposite of what was seen in the 1980s. Today is different for two reasons:

(a) USD is modestly expensive on historical valuation, which may make other nations more open to (some) currency strength as a means to blunt US criticism.

(b) Unlike the 1980s, demand for capital and dis-saving outside the US is quite high. Demand for capital in Japan, Europe and EM, coupled with already high current account surpluses, supports the flow out of USD.

2. A relative negative for CAD, AUD and MXN: Trade policy is uncertain. We think that the best hedges against an escalation lie in strategies that we think work under current conditions, but also have optionality on trade tensions escalating. CAD has outperformed rising interest rate differentials, and remains exposed to any deterioration of NAFTA negotiations. AUD now offers lower carry than USD, and we think it would be vulnerable to any escalation in US-China trade tension. MXN is inexpensive with high carry, but we see similar positives, with less headline risk, in IDR, RUB and ZAR. In the most extreme scenario, our FX strategists argue that buying CNHJPY downside via options offers value as a hedge.

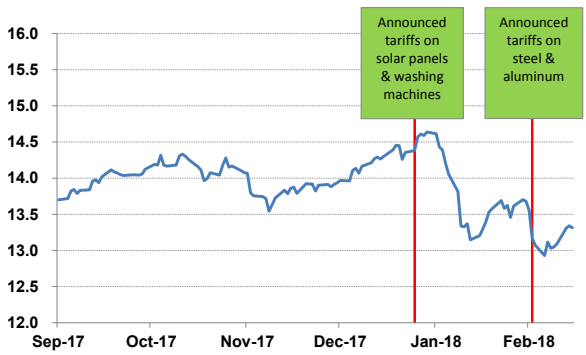
3. Europe equities – worry about expensive exporters, not the whole market: Negative headlines on trade are used as one explanation for Europe's recent underperformance. It's true that European companies have above-average exposure to global revenue. But what's odd is that investors appear to be selling the entire market, rather than the sectors that actually have the largest exposure to exports and a stronger currency. These sectors, including chemicals, industrials and autos, are also some of the most expensive (relative to history) and the most overbought (on one-year momentum). We would avoid these, while liking the European market overall.

4. For US equities, these developments are consistent with our strategists' thesis of increased volatility and lower potential returns this year: In a late-cycle environment where we expect markets to begin contemplating a peak rate of change on earnings growth and economic surprises before year-end, a *material* rise in protectionism would involve additional risks, increase volatility further and likely dampen broader risk appetite. We think that a *material* rise in protectionism would favour defensives (health care, REITs, telco and utilities), particularly those with low foreign revenue exposure, over cyclicals and sectors/companies with high foreign revenue exposure. Sectors with supply chain disruption risk from implementation of increasing US/retaliatory tariffs include apparel, autos, comm. equipment, retailers (broadline, dept. stores and specialty), semis, solar and tech hardware. Additionally, we note prior work showing US-based companies with relatively high revenue exposure to China here.

5. Asia/EM equities: Assessing market exposure (Jonathan Garner): Increasing trade protectionism is in our view one of a number of challenges facing Asia/EM equity markets in 2018 (two others are tightening monetary policy in China and the US and very high valuations at the start of the year). We feel that uncertainty on this topic can drive valuation adjustment to the downside and it is noteworthy that forward P/E for our coverage peaked thus far for the year at the end of January in the same week that the US president signed into law tariffs on solar and washing machines. A second leg down in the multiple took place at the time the steel and aluminum tariffs were announced.

Exhibit 23:

MSCI AC Asia Pacific 12-mth forward P/E – some evidence that US protectionism is impacting the valuation multiple on the Asian equity markets

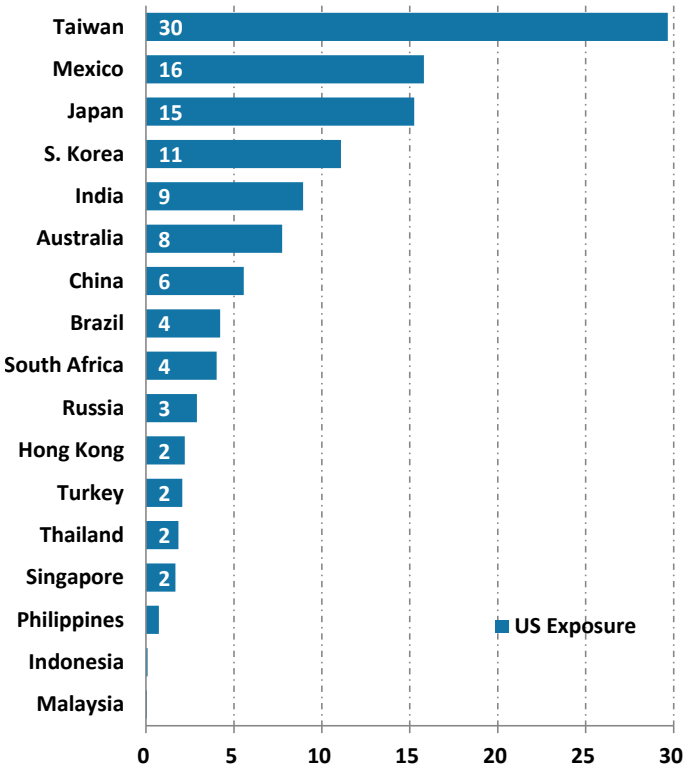


Source: MSCI, IBES, Datastream, Morgan Stanley Research; Data as of March 14, 2018.

We have also been highlighting that there is significant diversity in listed equities' revenue sensitivity to the US, as shown in **Exhibit 24**, with North Asia and Mexico most at risk and ASEAN, Turkey, Russia, South Africa and Brazil potentially less impacted. Indeed, Brazil, Russia and Thailand are currently the best-performing markets in EM year to date while Korea is one of the worst, although protectionism risk is only one of a number of factors (including sector skew) driving this. That said, in some cases valuations and currencies have already adjusted significantly to price in an adverse scenario, and our LatAm equity strategy team recently upgraded its stance on Mexico, arguing that a lot of potential risks are now in the price (see Latin America Model Portfolio - Mexico and Peru upgraded; Chile downgraded, March 7, 2018).

Exhibit 24:

EM countries' listed equities' revenue exposure (%) to the US, 2017E – a story of divergence

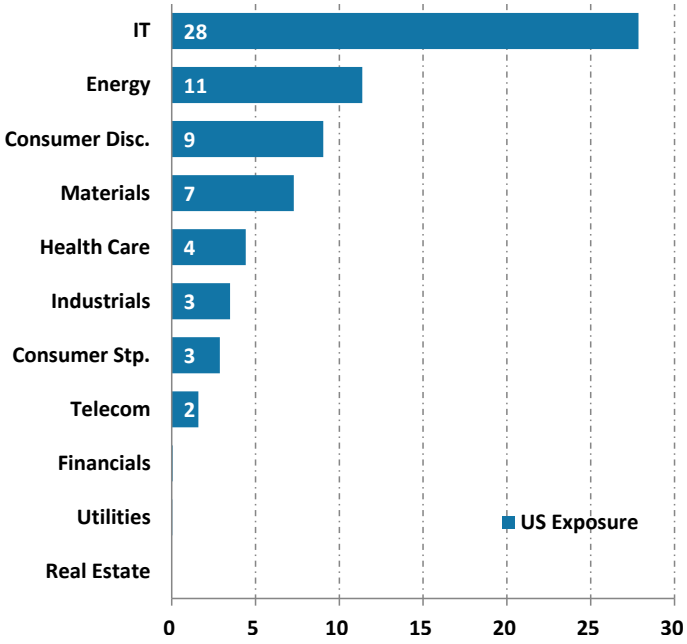


Source: Morgan Stanley Research estimates

From a sector perspective, our revenue sensitivity suggests that the IT sector is most exposed to the US, followed by energy and consumer discretionary. IT and consumer discretionary also have long and complex supply chains with many intermediate goods needed to produce the final product, and there is significant potential for interruption to these in an adverse scenario. Meanwhile, real estate, utilities and financials lack direct revenue exposure to the US.

Exhibit 25:

Asia ex Japan/EM listed equities' sector revenue exposure (%) to the US, 2017E – IT, energy and consumer discretionary most exposed



Source: Morgan Stanley Research estimates

6. US rates (Matthew Hornbach): In the case of a 20% tariff scenario, we expect the market to consider the short-term inflationary impact of such tariffs, while discounting any long-term effect on inflation. However, a tightening in financial conditions after the imposition of tariffs could limit the widening in breakevens and the overall increase in government bond yields. Overall, if 20% tariffs are enacted, we would expect to see the 5s30s breakeven curve invert meaningfully as breakevens widen, led by the front end. Such an inflation breakeven curve flattening would put further flattening pressure on the nominal yield curve – moving it closer to our forecast for a completely flat term structure this year. In addition, if the Fed were to respond to near-term inflation by raising rates more than it would have otherwise, the yield curve would flatten even more than we are expecting.

Assessing stock-level revenue exposure to the US

Jonathan Garner

Stock-level impact: Our revenue exposure guide provides further stock-level information on exposure to different end markets while our two prior reports on this topic (US / China protectionism – potential market and stock-level impact, January 19, 2017, and Re-emergence of protectionism risks – assessing the impact, January 23, 2018) also contain a number of tables highlighting firms most at risk both in Asia/EM and broader markets.

Exhibit 26:

EM/Asia (including Japan) listed companies with at least 25% revenue exposure to US, sorted by % of revenues from the US

Ticker	Company	Country	GICS Industry Group	Mkt Cap US$Mn	US Revenue Exposure (%)	Domestic Exposure (%)	Foreign Exposure (%)
MBFL.NS	MphasiS Limited	India	Software & Services	2,424	78.0	7.0	93.0
WFD.AX	Westfield Corporation	Australia	Real Estate	15,193	74.0	0.0	100.0
PENOLES.MX	Industrias Penoles S.A.B. de C.V.	Mexico	Materials	9,208	70.0	17.0	83.0
MFRISCOA1.MX	Minera Frisco, S.A.B. de C.V.	Mexico	Materials	1,664	70.0	30.0	70.0
2330.TW	TSMC	Taiwan	Semiconductors & Semiconductor Equipment	236,385	68.0	12.0	88.0
2474.TW	Catcher Technology	Taiwan	Technology Hardware & Equipment	8,779	65.0	4.0	96.0
600486.SS	Jiangsu Yangnong Chemical	China	Materials	2,607	63.0	37.0	63.0
ERJ.N	Embraer	Brazil	Capital Goods	13,793	62.9	10.8	89.2
2018.HK	AAC Technologies Holdings	China	Technology Hardware & Equipment	21,523	62.4	30.8	69.2
2311.TW	Advanced Semi Engineering	Taiwan	Semiconductors & Semiconductor Equipment	12,543	62.0	17.0	83.0
INFY.NS	Infosys Limited	India	Software & Services	41,149	61.9	3.2	96.8
HCLT.NS	HCL Technologies	India	Software & Services	21,107	61.6	4.5	95.5
4958.TW	Zhen Ding	Taiwan	Technology Hardware & Equipment	1,848	61.0	10.1	89.9
7270.T	SUBARU Corp	Japan	Automobiles & Components	26,695	61.0	15.0	85.0
1476.TW	Eclat Textile	Taiwan	Consumer Durables & Apparel	2,867	60.0	5.0	95.0
300433.SZ	Lens Technology	China	Technology Hardware & Equipment	10,707	60.0	17.0	83.0
002241.SZ	GoerTek Inc	China	Technology Hardware & Equipment	7,564	60.0	23.4	76.7
0288.HK	WH Group	China	Food Beverage & Tobacco	17,657	57.0	36.0	64.0
2317.TW	Hon Hai Precision	Taiwan	Technology Hardware & Equipment	57,541	55.0	1.0	99.0
WIPR.NS	Wipro Ltd.	India	Software & Services	24,783	54.7	4.6	95.4
CCB.CN	Cementos Argos S.A.	Colombia	Materials	5,576	54.2	29.1	70.9
TCS.NS	Tata Consultancy Services	India	Software & Services	93,398	54.0	6.3	93.7
NWSA.O	News Corporation	Australia	Media	10,016	54.0	28.0	72.0
RMD.N	Resmed Inc.	Australia	Health Care Equipment & Services	12,589	53.0	5.0	95.0
9910.TW	Feng Tay	Taiwan	Consumer Durables & Apparel	2,987	52.0	0.0	100.0
002475.SZ	Luxshare Precision Industry Co., Lt	China	Capital Goods	11,248	50.0	15.8	84.2
4506.T	Sumitomo Dainippon Pharma	Japan	Pharmaceuticals, Biotechnology & Life Sciences	5,814	50.0	30.0	70.0
REDY.NS	Dr. Reddy's Lab	India	Pharmaceuticals, Biotechnology & Life Sciences	6,652	48.7	13.9	86.1
GGBR4.SA	Gerdau S.A.	Brazil	Materials	7,159	48.0	32.0	68.0
CPU.AX	Computershare Limited	Australia	Software & Services	7,340	48.0	15.0	85.0
TEML.NS	Tech Mahindra Limited	India	Software & Services	7,936	47.8	4.5	95.5
2382.TW	Quanta Computer Inc.	Taiwan	Technology Hardware & Equipment	8,497	47.0	8.0	92.0
2325.TW	Siliconware Precision Industries Co	Taiwan	Semiconductors & Semiconductor Equipment	NA	45.0	30.0	70.0
2303.TW	UMC	Taiwan	Semiconductors & Semiconductor Equipment	6,317	45.0	30.0	70.0
ORA.AX	Orora Limited	Australia	Materials	3,114	45.0	51.0	49.0
LUPN.NS	Lupin Ltd.	India	Pharmaceuticals, Biotechnology & Life Sciences	6,575	44.3	33.3	66.7
CADI.NS	Cadila Healthcare Ltd.	India	Pharmaceuticals, Biotechnology & Life Sciences	7,031	44.0	42.5	57.5
7267.T	Honda Motor	Japan	Automobiles & Components	65,845	44.0	17.0	83.0
2801.T	Kikkoman	Japan	Food Beverage & Tobacco	8,141	44.0	43.0	57.0
SUN.NS	Sun Pharmaceutical Industries	India	Pharmaceuticals, Biotechnology & Life Sciences	21,676	43.0	23.0	77.0
COH.AX	Cochlear	Australia	Health Care Equipment & Services	7,576	43.0	5.0	95.0
ALPEKA.MX	Alpek SAB de CV	Mexico	Materials	2,960	43.0	37.0	63.0
7974.T	Nintendo	Japan	Software & Services	53,711	43.0	25.0	75.0
CSL.AX	CSL Ltd	Australia	Pharmaceuticals, Biotechnology & Life Sciences	53,420	42.0	9.0	91.0
000660.KS	SK Hynix	S. Korea	Semiconductors & Semiconductor Equipment	48,583	41.0	3.0	97.0
600391.SS	Chengfa Tech	China	Capital Goods	NA	41.0	33.0	67.0
BVN.N	Compania de Minas Buenaventura	Peru	Materials	3,863	40.0	40.0	60.0
1316.HK	Nexteer Automotive Group	Hong Kong	Automobiles & Components	5,548	40.0	40.0	60.0
TWE.AX	Treasury Wine Estates	Australia	Food Beverage & Tobacco	9,875	40.0	23.0	77.0
300136.SZ	Shenzhen Sunway Communication	China	Technology Hardware & Equipment	5,974	40.0	44.3	55.7
8750.T	Dai-ichi Life Holdings	Japan	Insurance	26,070	40.0	56.0	44.0
5108.T	Bridgestone	Japan	Automobiles & Components	38,898	40.0	20.0	80.0
600500.SS	Sinochem International Corp	China	Capital Goods	NA	39.2	51.0	49.0
000270.KS	Kia Motors	S. Korea	Automobiles & Components	12,684	38.2	38.3	61.7
ANN.AX	Ansell	Australia	Health Care Equipment & Services	2,832	38.0	3.0	97.0
2324.TW	Compal Electronics	Taiwan	Technology Hardware & Equipment	3,194	37.0	7.0	93.0
6326.T	Kubota	Japan	Capital Goods	26,288	37.0	35.0	65.0
ICHB.MX	Industrias CH, S.A.B, de C.V.	Mexico	Materials	2,012	36.0	64.0	36.0
7201.T	Nissan Motor	Japan	Automobiles & Components	41,476	36.0	13.0	87.0
0981.HK	SMIC	China	Semiconductors & Semiconductor Equipment	7,124	35.0	48.0	52.0
3231.TW	Wistron Corporation	Taiwan	Technology Hardware & Equipment	2,251	35.0	25.0	75.0
4503.T	Astellas Pharma	Japan	Pharmaceuticals, Biotechnology & Life Sciences	26,351	35.0	33.0	67.0
GLEN.NS	Glenmark Pharmaceuticals	India	Pharmaceuticals, Biotechnology & Life Sciences	2,627	33.7	25.1	74.9
0658.HK	China High Speed Transmission	China	Capital Goods	2,720	33.0	67.0	33.0
4502.T	Takeda Pharmaceutical	Japan	Pharmaceuticals, Biotechnology & Life Sciences	47,245	33.0	35.0	65.0
2395.TW	Advantech	Taiwan	Technology Hardware & Equipment	5,648	32.0	8.0	92.0
7733.T	Olympus	Japan	Health Care Equipment & Services	13,377	31.5	21.0	79.0
0857.HK	PetroChina	China	Energy	242,159	31.5	68.5	31.5
ALFAA.MX	Alfa SAB de CV	Mexico	Capital Goods	6,465	31.0	35.7	64.3
0992.HK	Lenovo	China	Technology Hardware & Equipment	6,481	31.0	27.0	73.0
5803.T	Fujikura	Japan	Capital Goods	3,027	31.0	38.0	62.0
1910.HK	Samsonite International	Hong Kong	Consumer Durables & Apparel	6,312	30.6	3.1	96.9
600584.SS	Jiangsu Changjiang Electronics Tecl	China	Semiconductors & Semiconductor Equipment	4,110	30.0	40.0	60.0
IVL.BK	Indorama Ventures PCL	Thailand	Materials	8,694	30.0	5.0	95.0
7951.T	Yamaha	Japan	Consumer Durables & Apparel	8,155	30.0	34.0	66.0
7752.T	Ricoh	Japan	Technology Hardware & Equipment	7,131	30.0	38.0	62.0
005380.KS	Hyundai Motor	S. Korea	Automobiles & Components	31,203	29.7	40.7	59.3
2768.T	Sojitz	Japan	Capital Goods	4,094	29.0	61.0	39.0
CPA.N	Copa Holdings	Panama	Transportation	5,828	28.8	11.0	89.0
QBE.AX	QBE Insurance Group	Australia	Insurance	11,502	28.0	30.0	70.0
COP.SN	Empresas Copec S.A.	Chile	Energy	22,009	28.0	8.0	92.0
7203.T	Toyota Motor	Japan	Automobiles & Components	207,595	28.0	23.0	77.0
6724.T	Seiko Epson	Japan	Technology Hardware & Equipment	8,771	28.0	24.0	76.0
6098.T	Recruit Holdings	Japan	Commercial & Professional Services	42,600	28.0	49.0	51.0
CX.N	Cemex	Mexico	Materials	11,985	27.5	17.5	82.5
AMC.AX	Amcor	Australia	Materials	14,049	27.0	4.0	96.0
6971.T	Kyocera	Japan	Technology Hardware & Equipment	25,323	27.0	20.0	80.0
EC.N	Ecopetrol SA	Colombia	Energy	37,457	26.0	39.0	61.0
4578.T	Otsuka Holdings	Japan	Pharmaceuticals, Biotechnology & Life Sciences	24,937	26.0	51.0	49.0
4902.T	Konica Minolta	Japan	Technology Hardware & Equipment	4,961	26.0	20.0	80.0
4543.T	Terumo	Japan	Health Care Equipment & Services	19,157	25.2	36.0	64.0
601231.SS	Universal Scientific Ind. (Shanghai)	China	Technology Hardware & Equipment	4,767	25.0	40.0	60.0
9914.TW	Merida Industry	Taiwan	Consumer Durables & Apparel	1,394	25.0	3.0	97.0
1919.HK	China COSCO	China	Transportation	9,604	25.0	18.0	82.0
AWC.AX	Alumina Limited	Australia	Materials	NA	25.0	20.0	80.0
3396.HK	Legend Holdings	China	Technology Hardware & Equipment	NA	25.0	35.0	65.0
066570.KS	LG Electronics	S. Korea	Consumer Durables & Apparel	16,772	25.0	25.0	75.0
CMCM.N	Cheetah Mobile Inc.	China	Software & Services	NA	25.0	45.0	55.0
6954.T	Fanuc	Japan	Capital Goods	55,757	25.0	22.0	78.0
6201.T	Toyota Industries	Japan	Automobiles & Components	21,052	25.0	40.0	60.0
7751.T	Canon	Japan	Technology Hardware & Equipment	43,019	25.0	23.0	77.0

Source: Morgan Stanley Research; Note: For important disclosures regarding companies that are the subject of this screen, please see the Morgan Stanley Research Disclosure Website at www.morganstanley.com/researchdisclosures. We have also published a global exposure guide in June 2017, see Global Strategy: Global Exposure Guide 2017 (15 Jun 2017).

Asia ex-Japan FX and rates

Jesper Rooth

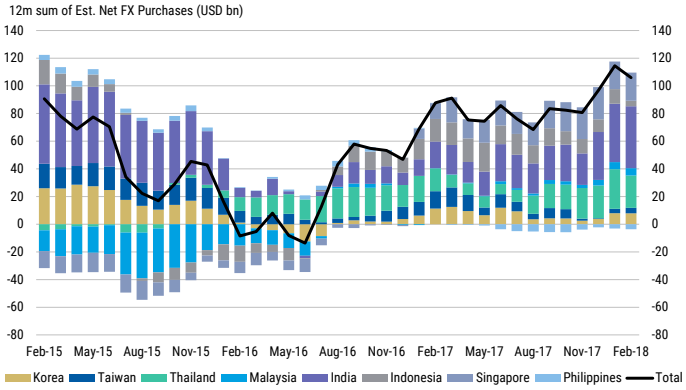
Among the scenarios laid out in **Exhibit 4**, we think that all but an aggressive use of Section 301, which we discuss below, could see AXJ currencies supported in the medium term. If policy-makers in current account surplus environments were to respond to further trade barriers by reducing FX purchases, this could even provide additional upward pressure for Asian FX. Recent comments from central banks in Malaysia and Taiwan point in this direction and are important in the context of recent US trade announcements and the upcoming April Treasury Report, in our view.

We think the above dynamic could be most pronounced where security relations with the US are closer, e.g., Taiwan and Korea. While net FX purchases for Korea and Taiwan have been moderating over the past few years (**Exhibit 28**), policy-makers have expressed discontent with local currency outperformance versus regional peers in the recent past (see here). With trade tensions continuing to increase, such concerns may be viewed as less important going forward. That would be USDAXJ-bearish. However, in light of our more cautious view on the broader EM asset class, we stick with relative value recommendations of being long SGD, IDR and MYR versus IDR and PHP (see FX Pulse: Preparing for a Corrective USD Rebound, March 15, 2018).

For AXJ rates markets, we do not think that the more benign scenarios described in **Exhibit 4** (i.e., all but more aggressive use of Section 301) would be enough to warrant a change of strategy. If local currencies are allowed to appreciate to a greater degree, this would represent a tightening of financial conditions, which net-net should reduce the pressure to hike domestic interest rates. Any negative impact on growth, which has largely been exports-led, would point in the same direction. On the other hand, if rising inflationary pressure stemming from increased trade barriers translates to a faster pace of Fed rate hikes, this would put pressure on (north) Asian central banks to tighten policy rates from a macro-stability standpoint. At this juncture, we think that the impact from these opposing factors is likely to be moderate on AXJ rates. We continue to suggest receiving SGD 2y vs. USD 2y, receiving KRW 1y vs. USD 2y, and paying HKD 5y outright.

Exhibit 27:

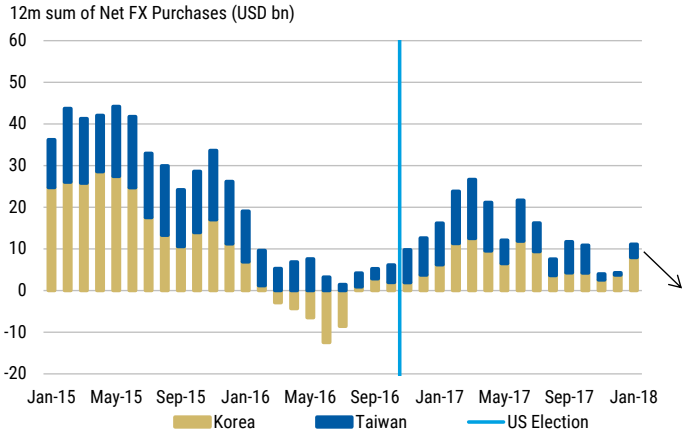
AxJ ex. China: Estimated net FX purchases



Source: Bloomberg, Morgan Stanley Research; Note: FX reserve valuation effects estimated by assuming that the breakdown of respective FX reserves is in line with COFER data averages and 1-5y government bond indices.

Exhibit 28:

Korea and Taiwan: Estimated net FX purchases



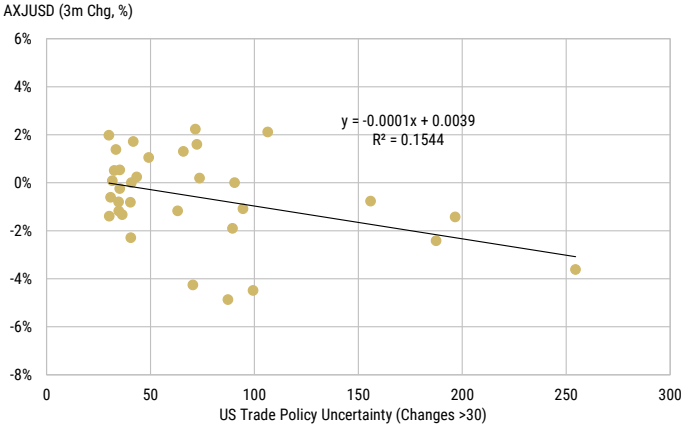
Source: Bloomberg, Morgan Stanley Research; Note: FX reserve valuation effects estimated by assuming that the breakdown of respective FX reserves is in line with COFER data averages and 1-5y government bond indices.

Should a more aggressive application of Section 301 crystallise, we would turn more cautious on Asian currencies – except JPY – in general. More specifically, if aggressive measures lead to a broader setback in risk sentiment, we think that USDAXJ would underperform. Indeed, USDAXJ has historically tended to rally when measures of US trade policy uncertainty have moved sharply higher (**Exhibit 29**). We have previously argued that long JPY versus AXJ crosses such as KRW would do well if trade tensions were to escalate. We think this holds true still, but focus on CNHJPY as opposed to KRW, given the relative underperformance of KRW since January. CNHJPY implied vol also trades considerably cheaper (3m around ~8%) compared to JPYKRW (3m around ~10%). Buying CNHJPY downside benefits from the historical positive correlation between USDCNH and USDJPY (**Exhibit 30**), which tends to turn negative in times of risk-aversion.

For rates, an aggressive application of Section 301 would on the margin turn us more bullish on AXJ, and particularly so for China NDIRS. **As described by our China economist Robin Xing**, such a development would likely be met by a dialling back of the deleveraging campaign, as well as easing of fiscal and monetary policy. As such, we would turn more bullish on rates in general, and China front-end rates in particular, should this scenario materialise.

Exhibit 29:

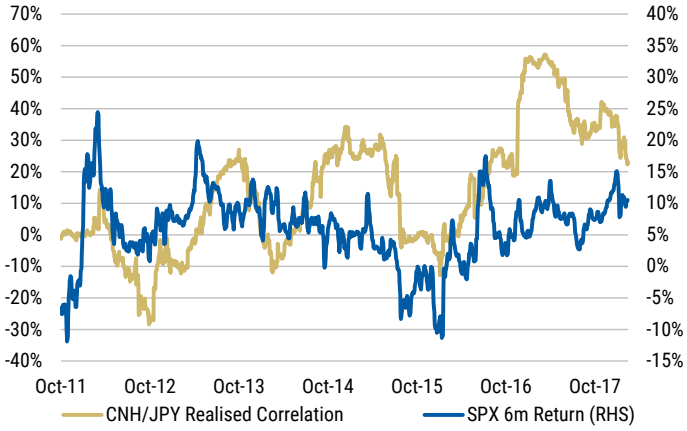
USDAXJ response to moves higher in US trade policy uncertainty



Source: Bloomberg, Morgan Stanley Research

Exhibit 30:

USDCNH and USDJPY correlations tends to go negative in times of risk-off



Source: Bloomberg, Morgan Stanley Research

Exhibit 31:

Live rates trades

Trade	Entry Date	Level	Rationale	Risks
Receive SGD 2y vs USD 2y	2/26/2018	73bps	Historically we have observed that SGD-USD rates differentials tend to widen when the Fed increases; we see this dynamic reoccurring with this round of Fed hikes.	Risks to the trade include a deterioration in local data, a weakening of the global trade cycle as well as a dovish surprise by the MAS.
Pay HKD 5y	2/26/2018	2.32	Planned increased issuance for 2018 IPOs in the HK equity market, expected Hang Seng Index underperformance relative to global peers and chance of increased EFP issuance to drain liquidity should all place upward pressure on HIBOR and increase HKD swap rates.	Continued economic optimism towards China leading to a stronger Hang Seng Index and greater HKMA tolerance for approaching the upper band of its convertibility undertaking.
Receive KRW 1yr vs 2y USD	1/29/2018	46.3bps	We see the scope for further rate hikes to be priced in versus the current trajectory as limited. Policy-makers' increasing unease with KRW strength could further complicate hiking rates, in our view. Despite the continued re-pricing higher of front-end rates in the US, short-dated KTBs remain attractive on an asset swap into other currencies due to the wide KRW cross-currency basis.	The risks to the trade include a substantial move higher in USDKRW, a new, hawkish BoK governor, as well as a further acceleration in Korean growth/inflation.

Source: Morgan Stanley Research

Protectionist measures, impact and responses – regional/country perspectives

US: Assessing the impact of a 20% import tariff hike

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In Rising Risk of Protectionism: Measuring the Impact, January 5, 2017, we outlined the economic impact of hypothetical, one-way tariff scenarios on the US economy. In an economy running a sizeable trade deficit, tariffs tend to create near-term upside to GDP from first-order implications as imports fall and the trade balance narrows. However, when excluding effects on net trade, **it is clear that private final domestic demand is damaged. Moreover, there tends to be a long-term, permanent loss of output.**

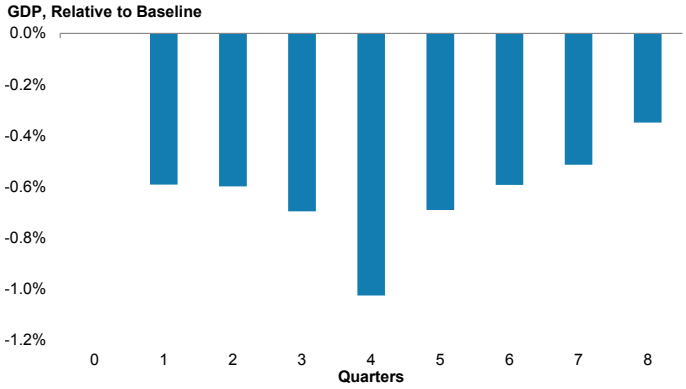
The scenario we describe includes no assumption of retaliation, which is unrealistic. When modeling import tariffs with a hit to exports from retaliation, and a general 100bp tightening in financial conditions to capture the financial market response, the hit to GDP peaks four quarters out, and is a sizeable 1pp (**Exhibit 32**).

Tariffs also tend to increase domestic inflation. In the 'no retaliation' 20% tariff scenario, over the course of a year, our model simulations suggest a net CPI impact of +10bp. This effect builds slowly over time, peaking at +50bp two years out as sticky consumer prices adjust inertially to higher input costs on the back of the tariffs. Over the longer run, paired with net negative growth impacts and lower productivity, **tariffs also lead to a more persistent wedge in prices relative to the baseline,** with CPI running about 10bp higher (**Exhibit 33**).

Even in a scenario that assumes import tariffs with a hit to exports from retaliation, and a general 100bp tightening in financial conditions, the drag on CPI peaks at +40bp nearly two years out (**Exhibit 34**).

Exhibit 32:

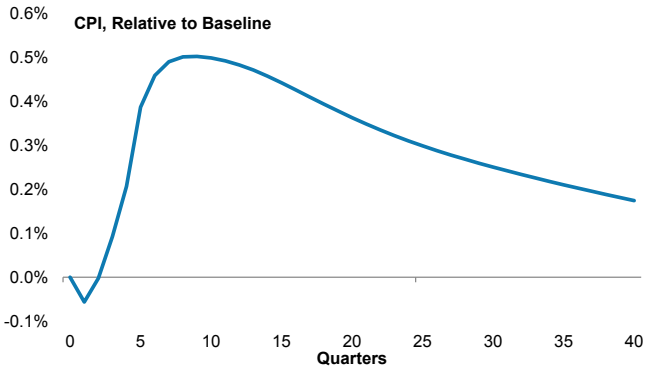
GDP scenario of 20% tariff with retaliation and financial market response



Source: Morgan Stanley Research estimates

Exhibit 33:

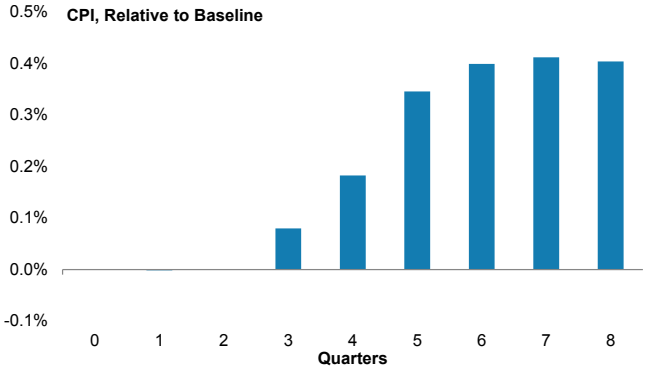
CPI relative to baseline in 20% tariff scenario



Source: Morgan Stanley Research estimates

Exhibit 34:

CPI relative to baseline in 20% tariff scenario with retaliation and financial market response



Source: Morgan Stanley Research estimates

In theory, monetary policy-makers should look through this as a transitory, one-off level shift higher in prices and resist the urge to react. In reality, however, given the tightness in the US economy at this late stage of the business cycle with a positive output gap, little to no slack in the labour market, rising wages and core inflation, all against the backdrop of easy financial conditions, the FOMC may find it difficult to fight the urge to at first lean against the added near-term inflationary pressures, despite the downward effect on the longer-run growth potential. Of course, starting points matter. If price (P) is above goal (P*), the price-level target tells you that you must offset the tariff impact later with tighter policy at some point, which might not be desirable. Of course, the US is in the opposite situation now (P<P*).

Trade tariffs may also at the margin escalate the conversation on the FOMC around price-level targeting versus inflation targeting. In the most recent Monetary Policy Report, a special section was devoted to the examination of monetary policy rules. The price-level rule suggests that the cumulative shortfall in inflation with respect to the 2% goal may be as large as 4%. Under a price level-targeting framework, monetary policy decisions should be tied to past inflation shortfalls. In other words, the FOMC should have greater tolerance for above-target inflation, and should let it persist for some time in order to make up for past shortfalls. In two recent FEDS working papers, Nalewaik (2015, 2016) introduced an analytical framework for assessing how far the FOMC should go in its tolerance for above-target inflation. The findings suggest that **the FOMC can afford to be more patient and tolerant with regard to upward pressure on prices from tariffs.**[1] [2]

On the other hand, in an inflation-targeting framework one should let inflation bygones be inflation bygones, so to speak, and the FOMC should only focus on returning inflation to the 2% goal, tolerating only short-term fluctuations around that goal. Should this view prevail, the FOMC will find it hard not to raise rates more quickly if core inflation meets and surpasses the 2% goal on the near-term horizon.

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1. Nalewaik, Jeremy J. (2015). "Regime-Switching Models for Estimating Inflation Uncertainty," Finance and Economics Discussion Series 2015-093. Washington: Board of Governors of the Federal Reserve System. http://dx.doi.org/10.17016/FEDS.2015.093. Page 10 offers a relatively "safe" range for total PCE price inflation (0.4 to 3.3 percent). If inflation stays in that range, it is unlikely that it will revert to what the author calls the very bad "high variance, high-persistence" state. Think the 1970s.

2. Nalewaik, Jeremy (2016). "Non-Linear Phillips Curves with Inflation Regime-Switching," Finance and Economics Discussion Series 2016-078. Washington: Board of Governors of the Federal Reserve System, http://dx.doi.org/10.17016/FEDS.2016.078. This paper gives similar ranges for core PCE price inflation rather than total, conditional on slack. It also estimates specifications where if U is too far below the "natural rate" for too long, inflation reverts to that 1970s behavior.

China: Mapping China's policy response to a rise in trade frictions

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While our base case assumes a measured response from China as it deals with rising trade tensions, recent developments suggest broadening and more persistent protectionism risks. In this context, **we look into the potential impact of US trade policy on China under four scenarios, and explore China's possible reaction function.** We believe that China's response could remain pragmatic if the impact on growth is manageable, while it may impose tariffs/reduce imports from the US and adjust domestic policy should the risk of a growth correction heighten. Although a bilateral agreement to reduce the US-China trade deficit could result in a de-escalation of the situation, it should be conducted over a reasonable time frame to avoid adverse short-term impacts (**Exhibit 35**).

Exhibit 35:

Exploring China's possible reaction function

	US' Possible Trade Policy	Impact on China	China's Response
Scenario 1: Tariff hike on selected high-tech items from US Section 301 investigation result	A 20% tariff on US$60bn of China's high-tech products (around 1/8 of China's goods exports to the US)	-Export Growth:-0.7ppt -Real GDP Growth:-0.1ppt	- To turn to WTO processes and launch counter investigations in select sectors. - To cut imports/reduce domestic sales on some US goods, and raise tariffs in selected sectors should trade friction broaden.
Scenario 2: 'Reciprocal tax' on selected products	Additional import tariff on China's key sectors that have the largest trade surplus with the US, to make its tariff rates equal to that of China.	-Export Growth:-1.4ppt -Real GDP Growth:-0.2ppt	- To craft a coordinated response with other countries
Scenario 3: Broad-based tariff hike from US Section 301 investigation result	A 20% tariff on all US goods imports from China	-Export Growth:-5.6ppt -Real GDP Growth:-1.0ppt	- A commensurate response to impose similar tariff on all goods imports from the US
Scenario 4: Grand Bargain to Reduce US-China Trade Deficit	A plan with China to reduce US-China trade deficit by US$100bn over a reasonable time frame	-Potential downward pressures on job market, depending on the pace of implementation	- Capacity relocation from China to the US - To increase China's imports from the US in sectors such as agriculture, transportation equipment, and petroleum products

Source: Haver Analytics, CEIC, Morgan Stanley Research

(1) Tariff on selected high-tech items from Section 301 investigation result

The US Section 301 investigation is the key risk we are watching, as the decision likely comes earlier than we had previously expected (probably a matter of weeks rather than months) and potentially affecting a broad set of Chinese products. According to Bloomberg (March 7), the US government is contemplating tariff hikes on over 100 imported goods from China, as part of the Section 301 investigation into China's intellectual property practices. Reuters reported that the amount of Chinese goods subject to US tariff hike could be US$60 billion. Other possible measures include investment restrictions (New York Times, March 15). We think this could include restricting US firms' investment in China via joint venture and technology transfers.

Growth impact: We believe that China's high-tech industries could be most exposed to potential penalties. This includes semiconductors, telecommunication products, computer equipment, medical equipment, pharmaceuticals and aerospace. Were the US to impose a 20% tariff on US$60 billion Chinese goods in these sectors (around one-eighth of China's exports to the US), China's total export growth could come down by 0.7pp, translating into a drag of 0.1pp on GDP growth after considering the spillover impact on investment, employment and household consumption.

How could China respond? Considering the relatively manageable impact on China's growth, China will likely maintain a measured response. China's near-term response could be to turn to WTO processes and launch counter investigations in select sectors (for instance, China launched an anti-dumping probe into US sorghum imports in early February). That said, should the scope of tariff hikes be broader than expected and lead to a higher risk of a growth correction for China, we believe that policy-makers may step up efforts to reduce imports from the US. This could include cutting imports of US agricultural products and transportation equipment, restricting domestic sales of some US products and raising tariffs in selected sectors.

(2) Reciprocal tariff

Growth impact: Under this scenario, we assume that the US could impose additional import tariffs on China's five sectors that have the largest trade surplus with the US – electric machinery, nuclear machinery, furniture, toys & sports equipment and apparel articles & accessories – to make its tariff rates equal to that of China in these sectors. This could translate into a drag of 1.4pp on China's exports and 0.2pp on China's real GDP growth.

How could China respond? As the growth impact likely remains modest, we believe that China will adopt a pragmatic approach. Given that China is not the only country to be affected by the US' reciprocal tariff hikes, its policy-makers may prefer to craft a coordinated response with other countries.

(3) Broad-based tariff from Section 301 investigation result

Growth impact: This is the most severe scenario from the Section 301 investigation result, where the US could impose a broad-based 20% tariff hike across all goods imports from China. This could weigh down China's export growth by 5.6pp and translate into a drag of 1.0pp on China's real GDP growth after considering the spillover impact on investment, employment and household consumption. In this scenario, the major growth correction would complicate policy-makers' plan in China to double 2010 real GDP by 2020 (which requires 6.3% CAGR during 2018-20).

How could China respond? We believe that China could use an equivalent approach and impose similar tariffs on all goods imports from the US under this scenario. Indeed, during the NPC press conference last Thursday, the Chinese government said that "China will certainly make an appropriate and necessary response" in the case of increased trade tension. Meanwhile, in order to avoid a major growth correction, policy-makers could halt the domestic deleveraging process, and adopt expansionary fiscal policy.

(4) Bilateral agreement to cut US-China trade deficit by US$100 billion over a reasonable time frame

In this scenario, China will negotiate with the US and form a plan to reduce the US-China goods trade deficit (which currently stands at US$375 billion) by US$100 billion over the medium term, and drop the case of massive US tariff hikes. The trade deficit could be narrowed gradually via capacity relocation from China to the US, and a rise in China's goods imports from the US.

- **Reducing US imports from China via capacity relocation:** Similar to Japan's experience in the 1980s, China could relocate some of its domestic capacity to the US for sectors that are higher value-added and likely more attractive to the US for domestic production. We identified 11 higher value-added sectors in **Exhibit 36**, which together account for US$244 billion worth of China's exports to the US in 2017. If China were to relocate 20% of the capacity in these sectors, it would be equivalent to a reduction of US$49 billion in the US-China trade deficit.
- **Increasing Chinese imports from the US:** In **Exhibit 37**, we identify key US export sectors that take up over 5% of total US exports while the share to China in the sectors is less than 15% (given that China takes up 15% of global GDP in 2017). Assuming that the shares of China in these sectors were to increase to 15%, it could mean a ~US$46 billion reduction in the US-China trade deficit. Meanwhile, the US could export more energy products (crude oil/natural gas) to China with continued shale gas/oil revolution and increased policy support. According to the EIA, US crude oil production is expected to rise by 21%, and natural gas production by 13%, in 2019 (versus 2017). Assuming that China's share in US oil and gas exports were to rise from 16% in 2017 to 20-25% by 2019, this could lead to another ~US$3-6 billion reduction in the US-China trade deficit.

That said, any trade deficit reduction is likely to be conducted at a gradual pace: First, the capacity relocation process will likely take time, as China has been closely integrated in the Asia production chain, rendering a fast relocation costly. And given that foreign enterprises have accounted for 43% of China's exports in 2017, the relocation cannot be driven by Chinese enterprises alone. Meanwhile, rapid capacity relocation may not leave sufficient time for the service sector to absorb job losses in the manufacturing sector, putting downward pressure on domestic consumption. In addition, should China increase imports from the US in the short term, it might need to cut imports from other economies, disrupting the global trade dynamic. Therefore, to reduce the short-term disruptions, we believe that China's trade surplus with the US should be reduced at a manageable pace over the longer term, which requires persistent bilateral cooperation.

Exhibit 36:

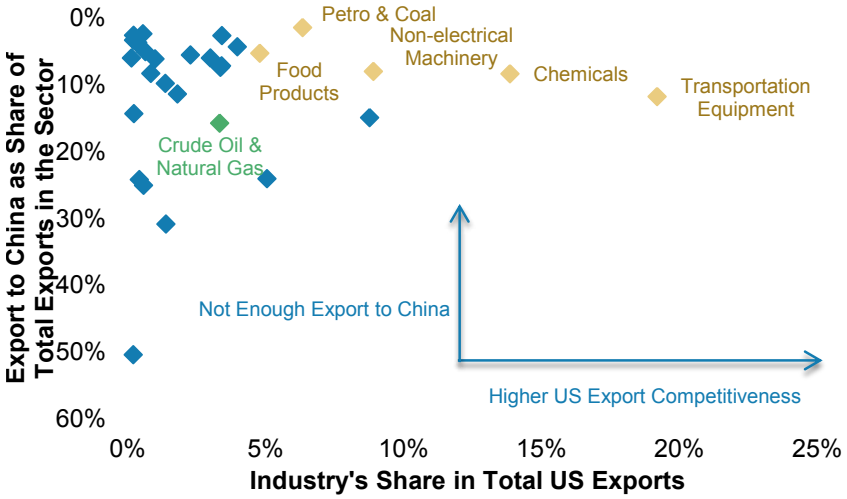
Sectors that may engage in capacity relocation

Top China Exporting Sectors to the US	Total Export in the Sector (US$ bn)	% of China's Total Export	Potential Relocation Amount (US$ bn, Assume 20% Relocation)
Communications Equipment	78	15%	15.6
Computer Equipment	59	12%	11.7
Semiconductors	23	5%	4.6
Household Appliances	14	3%	2.9
Motor Vehicle Parts	14	3%	2.7
Audio & Video Equipment	13	3%	2.6
Electrical Equipment	12	2%	2.4
Other General Machinery	11	2%	2.2
Precision Instruments	7	1%	1.5
Electrical Equipment	7	1%	1.3
Industrial Machinery	6	1%	1.3
Total	**244bn**	**48%**	**49bn**

Source: Haver Analytics, Morgan Stanley Research

Exhibit 37:

Where can China increase imports from the US?



Source: Haver Analytics, Morgan Stanley Research

Asia: Most exposed to a rise in trade frictions

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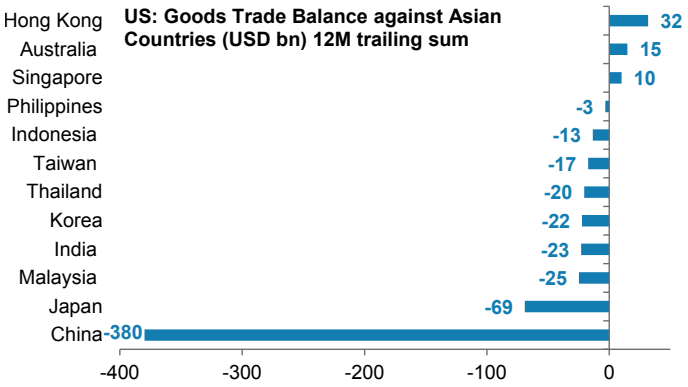
Asia is most exposed to a rise in US protectionism: Asia is the most exposed region to a rise in US protectionism due to its share in the US trade deficit and highly integrated regional production network. The US currently runs a trade deficit against nine of the 12 Asian countries under our coverage, with the exception of Australia, Hong Kong and Singapore. Collectively, major Asian countries accounted for 71% of the US goods trade deficit in 2017.

A rise in trade frictions would likely have a much broader impact on growth in the region than just the direct impact on exports growth, considering the highly integrated production network and the high dependence on trade and manufacturing for growth. The interconnectedness of trade in Asia (intraregional exports account for half of total intermediate exports) suggests that any trade barriers against one country in the network would generate an amplified impact across the region. As a case in point, while the US is a heavy importer of final goods from China in the region (China accounts for 60% of US capital goods and consumer imports from Asia), China also imports almost half of its intermediates from the neighbouring Asian countries.

Some economies will be relatively more affected by protectionist measures than others depending on the size of the US trade deficit with them and the share of intraregional exports in intermediates (an indirect measure of an economy's participation in the regional supply chain). In this regard, China, Japan and Korea would probably face more headwinds in this environment; China and Japan were the first and third top contributors to the US' goods trade deficit in 2017 (Korea was also among the top ten), while the three economies are important players in the regional production network.

Exhibit 38:

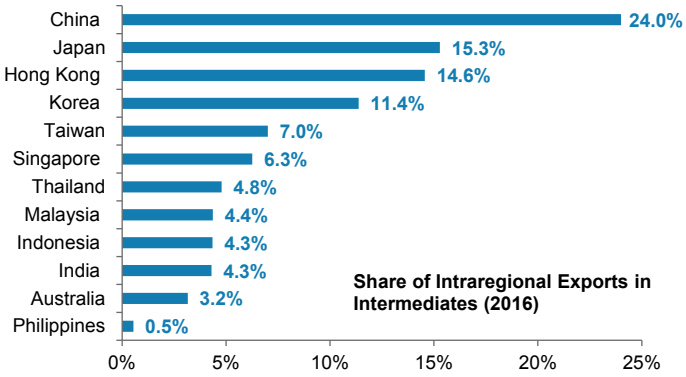
US runs a goods trade deficit against most Asian countries



Source: US Census Bureau, Morgan Stanley Research. Data as of Jan-18.

Exhibit 39:

China, Japan and Korea account for more than half of intraregional exports in intermediates



Source: UN WITS database, Morgan Stanley Research.

Direct impact of recent measures should be relatively muted: The items on which tariffs have been implemented thus far (solar panels, washing machines, steel and aluminum) account for only about 4.1-5.5% of the total exports and 0.8-1.9% of GDP of key impacted economies like China, Japan and Korea. More importantly, their exports of these products to the US are even smaller, accounting for just 0.2-0.8% of their total exports and 0.05-0.3% of GDP. Specifically in the case of China, the combined likely direct impact on China's export growth of recent US tariff hikes on steel, aluminum, solar panels and washing machines is estimated at -0.1pp. These metrics suggest that, as things stand, the direct impact of these measures should be relatively muted.

Indirect impact of broadening and persistent trade frictions could be larger: However, considering the intensity and timing of the trade measures, the risks of trade frictions broadening and persisting could have a more material impact on the region's export and overall growth outlook. In this context, we are tracking two key drivers – underlying demand and whether there will be a further broadening of trade frictions.

With global growth likely to reach close to 4%Y in 2018 and with the global capex cycle recovering (which tends to exert a stronger influence on global trade), export growth in Asia should remain supported. Hence, we expect that protectionist measures on select sectors should have a manageable impact on Asia's overall trade growth and its trend in market share of global exports.

However, should trade frictions broaden and persist for longer, the region would be one of the most affected via the potential disruption to global supply chains, in our view. The impact could also linger over the longer term as companies might re-evaluate their decisions on where to locate their production facilities. As a result, the response of trade partners and whether a significant rise in trade tensions can be avoided will be key to watch.

What will be the policy response? We think that the policy imperative within the region is to avoid exacerbating trade frictions, as the announced measures, by themselves, are not likely to have a significant impact on overall trade growth, and we thus continue to believe that the response from Asia to recent actions will be relatively measured.

In the event that trade frictions do rise, the response would probably be in the form of heightened rhetoric, launching of counter investigations of imports from the US, possibly restricting imports of US agricultural products and transportation equipment, and restricting sales of US products.

In China, we believe that policy-makers will try to avoid exacerbating trade frictions, as it will lead to some challenges for domestic deleveraging. Official media reported that Chinese senior officials highlighted cooperation to settle trade disputes, and that the US and China agreed to talk about related issues in Beijing in the near future, in a bid to create conditions for further cooperation. Media also mentioned that Liu He, China's point person for US-China trade talks, asked for an actionable roadmap (wish list) from the White House on his recent US trip. Meanwhile, Premier Li announced that China plans to cut import tariffs on automobiles and some consumer staples goods this year, which is also targeted to reduce trade tensions.

If trade frictions were to rise as we explore **here** , China may consider a more meaningful response. The list of potential actions could include reducing imports of US agricultural products and transportation equipment, restricting sales of some US products and increasing tariffs on US goods.

What are signposts to watch out for? To assess whether trade frictions are escalating and their attendant impact on regional trade, the next key risk event to watch would be the US Section 301 investigation of China's intellectual property practices. Depending on the nature of the penalties, our China economist Robin Xing expects the negative growth impact on China to range from -0.2 to -1.0pp of GDP growth after considering the spillover impact on investment, employment and household consumption (see **China: Mapping China's policy response to a rise in trade frictions** for more details).

Another key risk to watch is the potential US reciprocal tax, with comments and responses from Asian policy-makers an important yardstick to assess whether the current 'temporary trade dispute' scenario could morph into a full-blown trade conflict. As related details have yet to be released by the US administration, Asian policy-makers have so far responded in a measured manner, reaffirming their reservations on any US protectionist measures.

In the meantime, ongoing US trade negotiations with Asian countries against this backdrop remain a significant barometer to assess developments in US-Asia trade relations. In particular, progress in negotiations with Japan and Korea would be key to watch, given that both countries are established US allies while incurring large trade deficits with the US. As such, any actions from the US (on either) that imply a more aggressive approach could flag signs of an escalation in trade tensions. At the moment, Korea is set to hold a third round of negotiations on the US-Korea FTA (KORUS) later this month, while Japan is also engaging in bilateral economic dialogues with the US, with the second round just concluded in October 2017. On a related note, the current NAFTA negotiations could potentially bear an impact on Japan as well, as any increase in the regional/domestic content requirement in car parts could mean more headwinds for Japanese autos manufacturers currently operating in Mexico.

Euro Area and UK: Modest impact, targeted response

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Euro Area

Exposure modest overall: Taking the euro area as a whole, the US is the largest trading partner, accounting for ~13.5% of total euro area exports, followed by the UK and China. To some extent, these numbers are distorted by the netting out of intra-area trade. Taking into account these flows (GDP statistics do include them), then the US becomes more like a medium-sized export destination, e.g., the two largest trading partners of Germany are France and Italy, for France it's Germany and Italy, for Italy the other two, etc.

Sticking to the region as a whole, the euro area has a trade surplus of about €100 billion with the US, close to 1% of GDP. It exports about €280 billion to the US, and imports €180 billion. While not necessarily that large from a macro point of view, the prospect of rising trade tariffs presents risks for European industrials both on input costs and potentially on finished products.

This report looks at the exposure across capital goods, autos and aerospace & defence. For the EU as a whole, the Peterson Institute estimates that the total lost exports of steel and aluminum could amount to about €2.6 billion, or 0.1% of the value of total exports.

Response targeted, similar to the early 2000s: Trade policy is a European Union competence, not euro area. Even though there's no official communication just yet, various media outlets are reporting that the EU may be targeting €2.8 billion of American goods, via a 25% levy on a range of consumer, agricultural and steel products imported from the US. It's not the first time that the EU puts in place these types of policy responses following new US tariffs. It has happened, for example, in the early 2000s:

- In 2002, US tariffs on steel imports rose by 8-30%.
- The EU planned various levies on US goods, totalling US$2.2 billion. It also filed a WTO complaint and won.
- The US tariffs were removed in 2003, after the WTO ruling but before any EU levy.

Watch out for further escalation and a possible indirect impact: Here is how we're thinking about it in broader terms. Steel and aluminium are specific, relatively small sectors compared to the size of total US imports (and relative to the share of EU exports). However, we're mindful that there could be other measures in different sectors and so the impact could be larger. A relatively small reduction in US demand would therefore have contained effects, although we'd be watchful for any indirect effects along the supply chain, and also about any 'trade diversion' effect from the major EMs. To the extent that there are currency implications, this may affect ECB monetary policy. At the margin, it may well make it more cautious.

UK

Direct exposure to tariffs in manufacturing is negligible: The direct impact of the measures announced so far is minimal. UK exports of steel and aluminum to all non-EU countries are less than 0.1% of GDP. Moreover, the UK has the smallest manufacturing sector of any major economy. The UK is exposed if significant frictions arise in the broader US-EU trading relationship, since the US is the UK's largest export market, with the US taking over 18% of all UK exports, or 5% of GDP (£99 billion) in 2016. However, those exports are mainly in services.

External trade policy aligned with the EU: Until the UK nominally leaves the EU in March 2019 – and likely January 2021 if a transition deal is confirmed as we expect – external trade policy, and therefore any response, remains an EU competence.

Anyway, on trade policy, the UK has traditionally been closely aligned with the Commission as a strong supporter of free trade. So far this appears to be continuing, with the prime minister expressing concerns directly to the US president regarding the tariff announcement.

One complication here is Brexit, with the UK looking to sign a subsequent trade deal with the US after it leaves the EU. Although there have been no signs of this so far, it could be argued that this might make the UK government less ready to criticise US actions or to support a retaliation/response.

What to watch out for: Generally, as an open economy (exports plus imports amount to 57% of GDP) and an international financial centre with a small manufacturing sector, the UK is heavily exposed to an increase in trade frictions. With respect to Brexit, protectionist measures and increased trade frictions create challenges for the UK, both in negotiating a new trade deal with the US and for the UK's post-Brexit vision of a more liberal trading regime. These concerns may strengthen the case for a softer, slower Brexit.

LatAm: Regional exposure limited, Mexico in focus

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Overall exposure to US trade policy actions is limited, with the exception of Mexico: Latin America as a region accounted for just 7% of the US merchandise deficit last year; importantly, aggregate figures mask the fact that most major economies in the region actually ran small deficits with the US, with Mexico being the exception. Moreover, the region is relatively less open, with merchandise exports accounting for just 18% of GDP. And commodities account for the bulk of exports from the region – 75% of total exports for LatAm ex-Mexico – which creates more second-round effect risks if generalised trade protectionism were to translate into lower prices for raw materials, rather than a direct impact from the US import tariffs.

Mexico is by far the most exposed country to US protectionism, running a US$71 billion merchandise surplus with the US in 2017. Mexico is also by far the most open economy in the region, with exports representing 35% of GDP, and it is highly leveraged to trade with the US – the destination of just over 75% of all goods exports or the equivalent of 27% of GDP. Moreover, 83% of Mexico's exports are industrial goods, making it more vulnerable to disruptions in the global supply chain, and North America's in particular.

By contrast, South American commodity exporters are much more closed, with Brazil and Argentina exports representing a mere 10% of GDP. The country that is a little more sensitive to the US trade policy actions is Colombia; while it does not have a significant surplus with the US (just US$0.3 billion), 35% of its total exports are shipped there (**Exhibit 40**). Also, Chile's exports of copper to the US are relatively high at US$3.1 billion. But we think that raw materials which do not fit the political narrative of de-industrialisation, outsourcing and job losses are unlikely to be targets should further escalation occur.

Impact of recent tariff hikes is manageable: The region is not a large steel or aluminum exporter to the US, and so we believe that the recent measures will have a limited impact. The most impacted countries in LatAm would be Argentina and Brazil, where steel and aluminum represent 16.5% and 9% of total exports to the US, respectively. Nevertheless, this is minimal in GDP terms, with the total value of these exports amounting to 0.2% of GDP for the region combined. Note also that Mexico has been exempted for now, given ongoing NAFTA negotiations.

Responses likely to remain measured: The response from the region is generally likely to be measured, considering that the US remains among the most important export destinations for most major LatAm economies. More specifically, we see any potential response as limited to targeted tariffs or actions aimed at helping local industry more directly, such as fiscal incentives.

In the case of Mexico, recent history suggests that the response, if any, would be more targeted. Indeed, given that Mexico is a net steel importer, a response mirroring the US tariffs seems unlikely as the probable outcome would be to lift local prices, contributing to erode exporters' competitive edge in key sectors like automobiles and machinery. Moreover, a more forceful response from Mexico would add noise to ongoing NAFTA negotiations, which are the priority of Mexican policy-makers, given the centrality of the trade agreement to its manufacturing sector, which is tightly integrated into the North American supply chain.

Exhibit 40:

Export exposure to US moderate when excluding Mexico

Country	Goods Trade Balance with the US	Exports to US	Goods Trade Balance with US	Commodity Exports
	US$ billion	% of Total	as % of GDP	as % of GDP
Argentina	-5	8%	-1%	8%
Brazil	-8	14%	0%	6%
Chile	-3	15%	-1%	21%
Colombia	0	36%	0%	8%
Mexico	71	77%	6%	6%
Peru	-1	16%	-1%	16%
LATAM	**54**	**45%**	**1%**	**8%**

Source: National sources, Morgan Stanley Research

Canada: NAFTA negotiations in focus

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Canada's exposure significant, but exempted from new tariffs for now: The Canadian economy is heavily exposed to protectionist measures, with nearly 25% of total exports going to the US, which is close to 20% of GDP, given its deep integration with the US economy. Canada is a major steel exporter – Canada's exports of metal and non-metallic mineral products (to all destinations) account for nearly 12% of its total exports, almost on a par with the nearly 19% share taken by energy exports. Primary metals exports to the US make up nearly 5% of its total global merchandise exports, 1.25% of GDP and more than 3% of total Canadian employment. However, Canada has been exempted from recently announced import tariffs on steel and aluminum for now, given ongoing NAFTA negotiations.

Uncertainty with regards to NAFTA negotiations poses headwinds: Uncertainty related to the tariffs and to NAFTA negotiations will continue to pose headwinds to economic activity in Canada. The Bank of Canada's (BoC) January Monetary Policy Report noted uncertainties around trade policies throughout its discussion of the economic outlook and added that "Canada's ability to benefit from an improving global outlook continues to be hindered by uncertainty around the status of trade arrangements" and "[t]he spillover effects of trade policy uncertainty are estimated to be holding back exports by 0.7 per cent by the end of 2019, 0.3 percentage points more than had been anticipated in October".

On the other hand, the exemption of Canada from tariffs on steel and aluminum as an incentive to reach a deal on a new NAFTA underscores the importance of NAFTA negotiations, and may incentivise Canadian negotiators to find common ground on a trade agreement.

CEEMEA: Relatively less exposed compared to other regions

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Exposure and impact of recent measures on the CEEMEA region should be moderate: Trade linkages between **Russia** and US are weak on the whole. The US accounts for only 3% of total Russian exports and 5.5% of total Russian imports (0.7% and 0.8% of GDP, respectively). Hence, trade with US is almost balanced, at -0.1% of GDP. In terms of sectors which may suffer from recent tariff increases, Russia produces 65 million tonnes of steel products per year, and exports 43% of the amount, of which only 3 million tonnes goes to the US (US$1.5 billion or 0.4% of total Russian exports). The proposed tariff on aluminum is smaller (only 10% versus 25% on steel), and here too we see a moderate impact on Russia. Aluminum accounts for another US$1.8 billion of exports, or 0.5% of total exports to the rest of the world.

In **South Africa,** trade relations with the US are governed by the AGOA trade agreement, which for the most part is a free trade agreement that specifically includes certain motor vehicle components and steel products. It is valid until 2025. As at December 2017, South Africa ran a trade surplus with the US equivalent to US$2.7 billion (0.6% of GDP). There are only two relevant arguments from a South African perspective: First, does the US administration have the authority to deviate from an established trade agreement? Legally, yes, via Section 232 of the Trade Expansion Act of 1962. However, this is a significant break with historical precedent where trade agreements have been in effect. Second, do the tariffs apply to raw/unfinished products (e.g., flat rolled steel, raw aluminum), or to the steel and aluminum content of finished imports (e.g., vehicles or parts)? We now know it is the former, and given that South Africa exports very little raw steel and aluminum to the US (vehicles are the primary export), the new arrangement matters very little for South Africa. Local policy-makers are thus unlikely to respond with tariffs.

Turkey's exposure to US imports is small, with only 5% of total exports directed to the US. With regards to the recent measures on steel, the impact seems material for the sector. Steel exports to the US were US$2.2 billion in the last three years on average, representing 6.8% of US steel imports (the sixth-largest). This is 20% of Turkey's total steel exports or 1.3% of its total exports. However, Turkish mills are likely to find alternative destinations for their products (most likely EU markets) if they face infeasible pricing in the US market after the new measures. Ongoing concerns about US tariffs on steel trade have had a limited impact on global steel prices so far, thanks to stronger demand conditions globally. But, in the case of pricing efforts to find alternative markets, we may see a downward correction in profit margins of Turkish steel exporters.

For **CEE,** the impact of the tariffs is negligible, given very low trade in steel and aluminum. More broadly, trade tensions should affect CEE marginally, given that most of the region's trade is with the euro area and the rest of the EU, rather than the US or Asia, which account for less than 3% and 2% of exports, respectively (Poland data). An escalation in trade tensions which would involve the European car industry – something explicitly mentioned by the US administration as a possibility – would of course be far more material for the region. Note that the US accounts for 16% of total EU auto exports, and CEE is deeply plugged into the automotive supply chain which has Germany at its epicentre. Note that auto exports account for as much as 10% of GDP in some countries in CEE, and the impact on the economy goes well beyond just the car sector: indirect effects would include employment and value-added for all the suppliers of these plants, too.

As a result, responses should be measured: We think that responses will be measured. With regards to Russia, the importance of the US as a market for steel exports and for trade overall is low. However, Russia follows the principle of reciprocity in its bilateral international relations, so we think that some response would be likely. It can be asymmetric, similar to the case with financial sanctions, as US trade linkages with Russia are even less important. More importantly, at the moment, the confrontation between the countries takes place at a different level, i.e., financial sanctions and accusations of interfering in elections, and here the response can be much more tangible for Russia's economic outlook. In South Africa, we do not envisage any policy response from the local authorities, as South Africa is, for the most part, a price-taker in global trade. For CEE countries, trade policy is obviously going to be coordinated at the EU level.

What are the signposts to watch out for? From an indirect perspective, we are particularly mindful of any ripple effects this situation may have. The risk we are watching is spillover effects from trade frictions with major countries or regions such as Europe (see possible auto tariffs mentioned above) or China.

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Underweight/Sell	552	18%	87	11%	16%	222	16%
Total	3,149		764			1427	

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