Tallying up trade tensions’ toll

As US-China trade tensions continue to escalate, we remain on watch for signs that tariffs and uncertainty are weighing on the US economy. Thus far, the impact has generally been confined to the industrial sector, which has borne the brunt of tariff-related cost increases. Manufacturing activity fell for a second consecutive quarter in Q2 with most subsectors seeing declines, on net, over the first half of the year. Factory output increased in the last two months, but further softening in the ISM manufacturing index in July (including a nearly three-year low in the production index) suggests limited momentum. Manufacturing has also been a laggard in terms of hiring. Job growth in the sector has averaged 8,000 per month in 2019, down from last year’s 22,000 pace—that’s the most significant slowing in any industry this year. Transportation and warehousing has also seen a moderation in hiring as tariffs crimp overall trade flows. Those employment trends can’t be solely attributed to trade policy, though. Job openings in manufacturing are back at cycle highs, suggesting tight labour markets are also a factor in slower hiring.

Uncertainty about trade policy is clearly weighing on business sentiment, and that appears to be influencing capex decisions. US business investment declined in Q2 for the first time since 2016. Investment in structures fell across a number of industries, while equipment investment was close to flat over the first half of 2019. On the trade side, exports have slowed over the last year while imports continued to increase. Tariffs have done little to reduce the US trade deficit with China and the country’s overall deficit continues to widen, particularly with Mexico, the EU, and some of China’s neighbours. As a result, net exports have subtracted more than 1/2 percentage point, on average, from US GDP growth over the last year.

Consumers continue to power the US economy, for now

While we can point to a number of impacts from rising trade tensions, context is important. Even with slower business investment, industrial production and exports, US GDP growth remained above trend in Q2. A more-than-4% jump in consumer spending, making up for softer gains in the prior two quarters, was the driving force. Households continue to be supported by decent employment and wage growth, healthy savings and lower borrowing costs. July’s confidence data showed consumers are feeling better than they have all year. The worry, though, is that a fresh round of tariffs will start to weigh on sentiment. Earlier tariff hikes generally spared consumer goods, but the proposed 10% levy on all remaining Chinese imports (about $265 billion) would change that, potentially raising prices for smartphones and other consumer electronics. At this stage, the impact on the $14.5 trillion US consumer sector should be manageable. But the fact that Trump is no longer trying to spare consumers in his trade fight means households could be exposed to further escalation in trade tensions.

Markets pricing in deeper cuts from the Fed

The Fed cut rates as expected in July with a 25 basis point reduction disappointing a few observers hoping for 50 bps of easing. The central bank also opted to end its balance sheet reduction two months earlier than scheduled (rather than easing with one lever and tightening, however modestly, with another). While acknowledging strong labour markets and moderate economic growth, the Committee thought uncertainty over trade policy and slowing global growth warranted slightly more accommodative monetary policy. In his press conference, Chair Powell characterized the move as mid-cycle easing rather than the start of a longer, more traditional rate-cutting cycle. Past mid-cycle cuts in 1995 and 1998 each saw the Fed lower rates by 75 basis points, so it’s reasonable to expect another cut or two this time around (our forecast is for one more move in September). But Powell doesn’t seem to have convinced markets of that—following Trump’s latest trade threats, investors are betting on nearly 100 basis points of additional easing by the middle of next year. There is clearly a risk that the Fed cuts rates slightly further than our forecast assumes, but we still don’t think the current outlook warrants more than the mid-cycle adjustment that Powell is trying to guide markets toward.