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FIRST ANALYSIS—NEWS OR EVENTS THAT MAY AFFECT YOUR INVESTMENTS

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U.S.-China Tariffs—The Risks are Rising

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Key takeaways

» *Risk assets pared recent gains following the U.S. Trade Representative's (USTR) announced list of tariffs on an additional $200 billion worth of Chinese imports. This latest announcement has increased our likelihood of potential for escalation.*

» *While the risks have increased, we do not believe that we are in the midst of a trade war yet.*

What it may mean for investors

» *We recommend that investors continue to position themselves with the expectations of continued positive developments in the economic and corporate earnings environment, but expect trade related concerns to dominate headlines.*

Global equity markets moved lower Wednesday (July 11, 2018) following uncertainties related to the latest announcement from the USTR outlining $200 billion of Chinese goods likely to be subject to 10% tariffs in the latest turn in the ongoing U.S.-China trade spat. Despite heightened media attention surrounding the USTR's announcement, we still expect cooler heads to prevail in the ongoing trade dialogue. That said, we believe that the risks related to rapid escalation towards a full blown trade war have increased somewhat relative to our published view on July 5.[1]

Table 1. How could this situation play out?

Scenario	Probability as of 7/5/18	Probability as of 7/11/18	Economic & Market Implications
Quick Resolution	10%	10%	Most Favorable Outcome
Rapid Escalation to Cutting Off Trade	10%	20%	Most Unfavorable Outcome
Prolonged Negotiation with Eventual Solution	80%	70%	Still Favorable Outcome

Source: Wells Fargo Investment Institute, July 11, 2018.

[1] See our July 5, 2018 *International Strategy* report, "U.S.-China Tariffs—What's Next?" for more details on our expected scenarios.

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In general, we expect a scenario of prolonged negotiations (our base case scenario) to prevail with periods of heightened optimism (quick resolution) and excessive pessimism (rapid escalation) to play out over time as outlined in our prior report.

Does the USTR's announcement mean that we're in a trade war now?

No. Negotiations in May failed to achieve President Trump's goals regarding intellectual property and trade deficit concerns, and in June he telegraphed that he would raise the stakes. A U.S. attempt to restart negotiations on June 15 did not produce new negotiations—thus the follow-through on the U.S. threat to increase pressure with new tariffs on China.

By contrast, the most serious economic consequences from trade disputes occur when countries place tariffs across all goods with the goal of cutting off trade. Such prohibitively high rates might need to be 50% or higher. We believe that scenario would look more like a trade war. The current circumstance is not so severe, and its incremental and measured character is still consistent with pressure to negotiate. The issues in question have been discussed for decades in multilateral forums but in vain. A negotiated solution on such difficult questions likely requires additional pressure. The worst scenario does not yet appear to us to be either imminent or inevitable.

We would become concerned if 1) the two countries move closer to prohibitive tariff rates on all goods or 2) the two countries cut off foreign investment or devalue their currencies sharply. As this week's announcement moves to broaden the set of goods included in tariffs, we modestly raise the probability of a trade war (see Table 1), the most unfavorable outcome. In our July 5 report, we discuss the potential economic outcomes under the three scenarios.

What should investors do now? Should they just sit tight and simply wait it out?

Often during a highly visible negotiation, all that we can do is simply wait to see how things play out and take action if/when the facts change. We expect cooler heads to prevail, but anticipate both positive and negative surprises as Beijing and Washington look to save face while at the same time achieving their trade related agendas.

For now, the U.S. and Chinese economies continue to post solid growth, and the pace of global trade is still strong. We recommend that investors continue to position themselves with the expectation of continued positive developments in the economic and corporate earnings environment, but expect trade related concerns to dominate headlines and drive higher levels of market uncertainty. We recommend that investors use periods of uncertainty to rebalance their portfolios; we see opportunity in U.S. stocks, particularly in cyclical sectors, and high quality corporate bonds.

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