Global Trade Issues Reverberate Through the U.S. Economy

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Ted Koenig President & CEO of Monroe Capital LLC provides a private credit asset management perspective on current global trade issues impacting the U.S. economy and how these issues will affect restructuring insolvency in the future. He discusses the need for investors and restructuring professionals to understand global trade concerns and how they impact dependencies regarding geopolitical risks and the overall global markets.

Pressing global issues currently affecting U.S. businesses will likely affect the restructuring insolvency community in the coming year. Oil disputes in the Middle East; uncertainty around Brexit in the U.K.; distress in the European banking system; trade stalemates between the U.S. and China, India, Japan, and Europe; and the ongoing crisis at the Mexican border represent many of the larger threats to domestic U.S. businesses. While U.S. stocks continued to hit record highs into July, how these global difficulties ultimately play out could materially impact U.S.-based companies.

These concerns speak to why it is important for all investors and restructuring professionals to understand geopolitical risks and global markets, how they're interconnected, and where these dependencies are beginning to fray.

Middle East

As of July, oil prices had dropped 20% since April due to uncertainty over the tariff standoff between the U.S. and China. Market watchers took note of a slowdown in the Chinese economy in July that further impacted the demand of oil. While these developments affect the energy sector most acutely, a number of other industries feel the pinch when oil prices decrease, namely manufacturers and industrial companies that serve the energy industry. At the same time, businesses with less exposure to the energy industry may benefit from lower input costs.

Other developments in the Middle East can also be felt across other sectors. President Trump imposed sanctions against Iran in response to that country's breach of the 2015 nuclear deal, from which the U.S. withdrew last year. In addition to the executive order imposing economic sanctions, the U.S. sent 1,000 troops to the region for precautionary purposes. These growing tensions will likely translate into an increase

in certain U.S. defense contracts spanning weapons, food, shelter materials, and much more. Beyond oil sanctions, the White House included additional measures intended to squeeze Iran's steel, aluminum, copper, and iron industries, production in the latter of which Iran has increased by nearly 7%, year over year.

While all of this will have broader implications across the economy, energy, in particular, has become extremely volatile, and it is difficult to predict what the future holds.

Europe

Uncertainty, however, is not confined within emerging markets. In June 2016, a majority of British voters (51.6%) opted to exit the European Union. Theresa May, who succeeded David Cameron as prime minister after that vote, subsequently composed several proposals aimed at producing agreement with the EU on terms for Britain's smooth departure from the union. However, May was unable to garner enough support in Parliament for any of her proposals, the Brexit move date was delayed to October 31, and May resigned as prime minister.

Boris Johnson, who had emerged as the most vocal proponent ahead of the Brexit referendum and replaced May as prime minister in July, declared that he would complete Britain's withdrawal from the EU even if the parties failed to reach agreement on terms before the October 31 deadline, resulting in a so-called "no deal" or hard Brexit.

Amid the uncertainty surrounding Brexit over the past three years, the British economy has suffered. Many large U.S. banks, including JP Morgan, Bank of America, and Goldman Sachs, have used the U.K. as a "home away from home," but many global financial institutions have already moved their employees from the U.K. to Dublin, Paris, Frankfort, and Barcelona. All of those cities have seen sharp increases in the number of financial professionals moving in, prompting spikes in demand for office space, housing, food, and related commerce.

U.S. financial institutions would certainly be exposed under a hard Brexit scenario, which could affect as many as 2 million American jobs. In terms of global commerce, the U.S. engages in $1.3 trillion in total trade with the EU annually, $263.2 billion of which stems from the U.K. In having to rewrite trade agreements as Britain strikes out on its own, tariff uncertainty will also grow, further impacting stock prices. Lastly, the British pound is set to lose significant value, especially under a no deal Brexit, which would make the U.S. dollar stronger, potentially slowing global export sales by U.S. companies.

The automotive sector, for instance, accounts for 13% of British exports today. Auto sales will likely be affected by tariffs, while supply chain delays could further disrupt the industry. The CEO of Jaguar Land Rover recently expressed concern over a hard Brexit, contending that Jaguar could face GBP 1.2 billion ($969 million) of increased tariffs, which could force the company to move out of the U.K. For American auto companies with plants in the U.K., new trade agreements will likely hurt their ability to sell cars around the world. Moreover, raw materials could become more expensive, which would be felt by consumers, as American auto companies have engine facilities or similar manufacturing operations in the EU.

U.K. farmers will also be required to operate outside of the EU's Common Agricultural Policy (CAP), forcing a new policy to be implemented. CAP provided GBP 4 billion ($3.2 billion) of support to farmers annually, and the U.K. government might not support farmers during an economic downturn. This would hurt trade for many American food companies, especially those that concentrate on wheat, dairy, and meat.

American pharmaceutical companies could face stricter laws and increased costs to sell drugs in the EU from the U.K. Many U.S. pharmaceutical companies based their EU operations in the U.K. because the

European Medicines Evaluation Agency (EMEA), which is the EU equivalent to the U.S. Food and Drug Administration, was located in London. However, the EMEA relocated to Amsterdam in March in response to Brexit. U.S. companies now must either relocate their testing facilities to an EU country or face new obstacles and costs to reach EU customers from England. Pfizer alone expects to absorb approximately $100 million in Brexit-related costs.

Meanwhile, beyond all of the questions regarding Brexit facing investors, Europe's banking sector has yet to fully recover from the global financial crisis. Germany's Deutsche Bank is set to dramatically scale back its investment bank, cutting 18,000 jobs as its retreat from Wall Street continues. This will affect thousands of jobs in the U.S. and demonstrates the sluggish nature of the economic landscape in Europe.

This is also a major signal for the lending world. A weak banking sector across Europe could have severe consequences. Deutsche Bank is Germany's largest lender and has posted negative earnings for three of the last four years. It is now embarking on a complete overhaul of the company, which some observers believe may not be enough.

In addition, many European lenders have struggled amid decelerating growth trends in both Germany and Italy. About 70% of financing in Europe is bank lending, whereas in the U.S., banks can raise money through issuing stocks and bonds, allowing them to earn fees when lending conditions are poor. Most French, British, and Swiss banks have initiated some degree of cost-cutting and are directing much of their focus away from investing activities toward wealth management operations.

Asia

While the Middle East and Europe face considerable challenges, U.S. investors are largely focused on developments in Asia. China and the U.S. are the two largest economies in the world, collectively controlling approximately 40% of the global economy. While trade tensions have created cracks in the relationship, the U.S. remains China's largest trading partner.

Recently, the Trump administration hiked tariffs to 25% from 10% on $200 billion in Chinese goods. China responded in kind, imposing new tariffs and raising existing tariffs on U.S. goods. Despite on again/off again signs of progress in negotiations, the two countries remain at a stalemate. Companies in the U.S. that generate a significant portion of their revenue from China are likely to be negatively affected by lower domestic demand in China. Manufacturers in the U.S. will also feel the pinch where input costs grow in their supply chains as a result of increased tariffs. Gross margins for these companies could be under attack. Should the trade dispute escalate, it could also have a spiral effect for both shareholders and employees of the companies affected.

From a macroeconomic perspective, countries facing new or higher tariffs will experience declines in real exports and GDP. The U.S. will be directly affected by all of this if capital spending and fixed investment become restrained due to the trade war. This, in turn, will result in financial stress, declining equity prices, and reduced foreign investment in emerging markets targeted by U.S. import tariffs.

The stock market has proven resilient, as U.S. stocks set record highs in July. However, according to Bloomberg Economics' model, within two years, output in China and the U.S. will fall by 0.5% and 0.2%, respectively, relative to a scenario in which there was no trade war. From an investment outlook, the dispute has led to uncertainty along with money being pulled out of the market. In the first half of 2018, Chinese foreign direct investment into the U.S. was down 90% from the comparable period in 2017.

Several industries will be affected to varying degrees. While the U.S. is premising its trade stance on protecting U.S. intellectual property, the tech sector would be vulnerable if the trade war extends indefinitely. Anecdotally, prices of cell phones, laptops, and tablets imported from China could increase by around 20%. Since China accounts for 90% of total laptop and tablet imported to the U.S., American consumers would certainly be affected, but the pain would also extend to chip makers and electronics manufacturers, such as Intel Corp. and Micron Technology.

If the trade war escalates, China could retaliate with additional tariffs or other strategies designed to harm certain U.S. industries. Tactics could include imposing new taxes and regulations on U.S. companies doing business in China and slowing deal approvals. Recall that China is the largest supplier for Apple phones and other products. Of course, the impact would be felt in other industries, too. Last year, for instance, China increased the tariffs on American-made automobiles entering the country to 40% from 15%. This hurt not only U.S. automakers but also automotive parts companies that supply the OEMs.

Who will ultimately win these trade wars over the long term remains to be seen, but some countries are already benefiting. In March, U.S. companies started shifting production from China, marking a move to Southeast Asian countries, including Indonesia, Malaysia, Cambodia, Thailand, Vietnam, Myanmar, and Laos, and Microsoft and Apple are reportedly looking to move 30% of their production out of China over the next year. Beyond the stable political environments they offer, those Southeast Asian countries feature wages that are roughly half of what manufacturers were paying in China.

However, the need for specialized equipment and highly trained workers creates the potential for supply chain disruptions and other adjustments due to the lack of infrastructure. Currently, nearly all video game consoles imported to the U.S. are made in China, so while wage cuts may offer some relief, a potentially significant supply chain disruption would increase costs under already tight margin conditions.

The trade skirmishes with the U.S. aren't isolated to China. India recently placed retaliatory tariffs ranging from 30% to 70% on approximately 30 U.S. products, including almonds, apples, and certain chemicals, after the Trump administration stripped that country of special trade status that had exempted billions of dollars' worth of its products from American tariffs. India had already been incensed over the U.S.'s refusal to exempt it from tariffs of around 25% placed on steel and aluminum last year. The tariffs on U.S. goods, initiated in June, represent an effort by India to recoup nearly $241 million lost due to the U.S. tariffs.

Market watchers are concerned the trade dispute could affect $44.5 billion worth of U.S. foreign direct investment. The U.S. exported goods worth $33.1 billion to India last year, while importing approximately $54.4 billion, resulting in a U.S. trade deficit of $21.3 billion with the country.

North America

While trade disputes with Asia have received the most recent attention, the U.S. has been similarly aggressive with its closest neighbors, Mexico and Canada. In June, Trump threatened to impose a 5% tariff on all goods imported to the U.S. from Mexico and increase that amount by 5% each month until it hit 25% or he deemed as adequate Mexico's efforts to limit the flow of immigrants to the U.S. Mexico struck a last-minute deal to prevent the tariffs from taking effect.

The threat still looms, however. If tariffs are implemented at some point, the automotive and auto parts industries would be hit hardest, as a large percentage of U.S. vehicles are manufactured in Mexico and shipped across the border for sale. The affordable vehicle category would face the biggest impact, and price

hikes would push many consumers from the new car to the used car market, potentially leading to higher interest rates if demand for used car loans eclipsed the limited supply of money available for such loans.

Motor vehicle parts are also manufactured in Mexico and shipped to the U.S. If the tariffs were to go into effect, those additional costs would likely be passed on to consumers. It could also affect the supply chain, creating shortages that would ultimately slow production of new cars.

Meanwhile, the U.S.-Mexico-Canada Agreement (USMCA) that the Trump administration negotiated to replace NAFTA last October still needs congressional approval, which is far from a sure thing. The main difference between NAFTA and USMCA relates to how "country of origin" is defined in the agreement. There would be an approximately 10% tariff imposed if 75% of a car's components weren't manufactured in one of the three countries. The main benefit would be an expected increase in the automotive workforce.

A less likely alternative would involve the U.S. pursuing a hard exit from NAFTA. This would be devastating for each of the countries in the agreement and could result in tariffs rising by as much as 150% on certain products. The auto, apparel, agriculture, and medical devices industries would feel considerable pressure should tariffs on goods revert to World Trade Organization standards. This scenario could also create shortages in supply chains, leading to higher prices for consumers.

Conclusion

Overall, these global issues are potent and should be taken seriously. All of the regions discussed have various economic and industry implications for U.S. businesses and consumers. Private equity professionals and the restructuring and insolvency industry need to keep a watchful eye on world events now more than ever before, as conditions seem to be changing every day.