Tortoise QuickTake
Credit Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, senior members of Tortoise provide a timely update on trending topics in the market.

Welcome to the weekly Tortoise credit podcast. I'm Greg Haendel, Senior Portfolio Manager at Tortoise. Between the 16th to 18th century mercantilism was the primary economic system of trade in Europe and other parts of the globe. The theory behind mercantilist trade believed that a nation's strength could be maximized by accumulating as much wealth as possible given global wealth was believed to be static. As such, national strength could be maximized by limiting imports via tariffs while also maximizing exports. Following the 18th century, the theory of comparative advantage began to flourish which in essence led to free trade or nearly free trade whereby each trading partner could maximize economic growth by focusing on producing each countries' comparative advantage and importing that which can be produced more efficiently by others, without trade restrictions. In today's podcast we will briefly discuss the recent regression toward mercantilism (by use of tariffs) between the U.S. and China and what it could mean for various U.S. corporate industries.

As most listeners or readers are already well aware, The United States is currently embroiled in the initial stages of a trade war with China. Most market pundits believe that the escalation of the trade war (which is using tariffs as the primary weapon) is intended strictly as a negotiating tactic by the United States and is aimed toward forcing China to stop their intellectual property theft, improve unfair trade practices and open up the Chinese market to more U.S. goods and services. Despite some initial threats, the U.S. has already imposed tariffs on $34 billion of Chinese exports of machinery, components and electronics with additional tariffs on $216 billion of Chinese exports already announced and scheduled but yet to be imposed. China has retaliated by imposing its own tariffs on $34 billion of U.S. exports to China on items such as farm goods, aerospace products and other items and has vowed to match the next round of U.S. tariffs imposed on a dollar for dollar basis.

Thus far the escalating trade war has had minimal effect on the U.S. financial markets although internationally China's currency has depreciated over 8% versus the dollar between April 11th and July 23rd, 2018 largely as a result of the trade war. Within U.S. financial markets, and fixed income in particular, there has been minimal effect upon corporate bond spreads in general with no industry specific credit spread differentiation reflecting potential winners and losers from the trade war. Rather, corporate credit spreads continue to be driven by supply/demand technicals and reflect the view that trade-related disruption will be less than the headlines suggest while many of the headlines are strictly posturing and negotiating tactics. The risk to this general market view is a further escalation of the trade war beyond words and posturing resulting in disruptions to companies, industries and the market in general.

Should the trade war escalate and substantial tariffs get imposed by both the U.S. and China, there will be industry winners and losers. The implications of a trade war are far reaching and probably the most severe for the technology industry. The Chinese manufacturing market is one of the largest in the world for chip and device manufacturing with several large U.S. tech companies sourcing half of their products and components from China. Fortunately Chinese officials have largely only focused on qualitative retaliation within the tech industry thus far. The implications for the auto sector are centered primarily on the auto parts sub-sector. U.S. vehicle exports to China are a modest portion of overall U.S. vehicle exports and represent a minimal percentage of new vehicle sales in China. Further, while China remains a critical market for GM and Ford, the vast majority of their sales to the region are generated by vehicles produced locally in China in 50/50 joint ventures with Chinese partners. In addition, finished vehicle imports from China to the U.S. are de minimis. However, higher tariffs on imported auto parts could reduce volumes, raise costs for manufacturers in the U.S. and potentially raise costs to U.S. consumers.

On the consumer front, U.S. retailers could be hurt if U.S. tariffs are enacted on Chinese imports of consumer goods such as apparel given that many retailers source products from China. Over time, companies could have some ability to transfer their sourcing to other countries but that doesn't come without costs.

In the farming sector, the 25% tariff already levied on agricultural and soybeans products exported from the U.S. to China is negative for farmers (especially soybean farming), grain processors and agricultural equipment companies. Within capital goods, the latest round of U.S. tariffs included some Chinese aerospace products, which is a slight negative for Boeing. However, if China imposes retaliatory tariffs on aircrafts from the U.S., this could have a material effect on Boeing given China is a substantial customer. Further within capital goods, tariffs on steel imports are driving input costs higher for a range of capital goods manufacturers with most of these companies planning to pass higher steel prices through to consumers.

Last but not least, while the Chinese have yet to impose any tariffs on U.S. oil or LNG imports, should they go that route with an escalation of the trade war, we believe there would be little effect on U.S. oil and gas as there would essentially just be a substitution effect globally regarding who buys U.S. oil and gas given it's a fungible asset. The larger issue in oil and gas is the previously imposed tariffs on steel which results in a modest increase in pipeline construction costs.

The current trade war between the U.S. and China may very well turn out to be a high stakes negotiation and posturing that never result in tariffs on a substantial amount of trade between the U.S. and China. One or both countries will have to make some sort of concession in the coming months, otherwise, we will experience material disruptions to various companies, industries and the market and economy in general during the 3rd or 4th quarter of 2018 and beyond.

At Tortoise we believe active fixed income management, strong fundamental analysis and sound industry and issuer selection can help avoid many of the pitfalls associated with a further escalation of the trade war with China.

Thank you for listening, we'll talk to you again next week.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.

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