



**NATIONAL  
BANK**

**FINANCIAL MARKETS**

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# STRATEGY UPDATE

Economics and Strategy

June 18, 2018

## Trade war = slower earnings growth

**China announced last Saturday that it would retaliate tit-for-tat (same amounts and same dates) if the U.S. follows through on its decision to impose tariffs on \$50 billion worth of Chinese imports.** Beijing said that a 25% levy on \$34 billion of U.S. agricultural products and autos would be applied on July 6 with another \$16 billion of U.S. goods (including coal and oil) set to be hit by tariffs at a later date.

**President Trump threatened last week to impose tariffs on an additional \$100 billion of Chinese imports if Beijing retaliated.** In addition to tariffs, Washington is also set to release a June 30 proposal to limit Chinese investment in the United States unless Beijing agrees to ease investment restrictions for American investment in China.

At this juncture, it is important to keep in mind that tariffs imposed by the U.S. and China cover about 12% of two-way trade between the two countries (U.S. imports about \$500 billion and exports about \$130 billion to the middle kingdom). **The trade spat would be quite manageable for the global economy were it not for Mr. Trump's threat to target another \$100 billion of Chinese products if Beijing does indeed levy tariffs on U.S. products on July 6.**

**So it's getting a lot more complicated on the geopolitical front at a time where the Federal Reserve is still inclined to hike a few more times in 2018 despite a stronger USD.** This is a combination that could pose a challenge to earnings growth and equity markets given that PE expansion is very hard to come by at this point in the economic cycle. As the chart below shows, the bottom-up consensus of equity analysts sees earnings rising a robust 14.6% over the coming year.

## S&P 500 composite index: EPS Performance

	2017	2018	2019	2020	12 months forward
S&P 500	11.8	22.1	9.8	10.3	14.6
ENERGY	342.5	94.0	15.3	10.9	42.0
MATERIALS	15.4	25.9	8.3	12.7	16.0
INDUSTRIALS	4.7	19.2	12.8	11.0	15.6
CONS. DISC.	6.6	19.1	12.1	13.7	15.2
CONS. STAP.	6.2	11.8	7.5	8.1	9.1
HEALTH CARE	8.0	12.9	8.7	9.1	10.7
FINANCIALS	8.5	30.5	9.9	10.3	18.8
IT	18.5	22.9	9.6	11.2	12.7
TELECOM	-0.2	14.0	1.8	0.8	7.5
UTILITIES	2.8	5.9	5.3	4.8	5.6
REAL ESTATE	-12.9	-12.7	4.5	8.8	-4.7

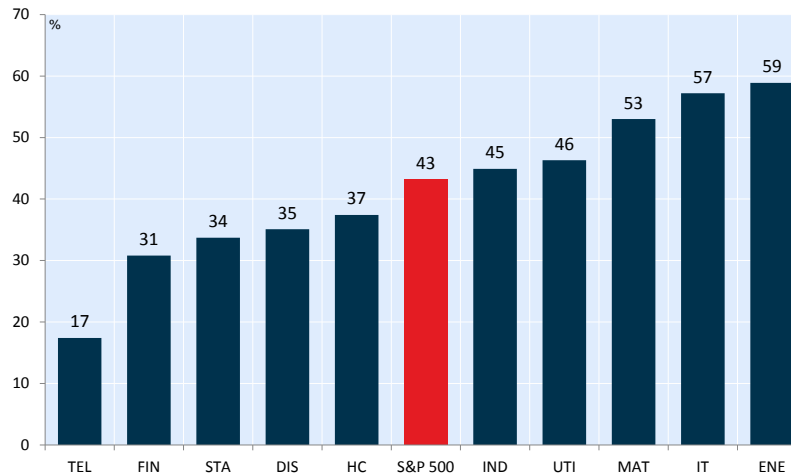
6/15/2018

NBF Economics and Strategy (data via Datastream)

Until last week, we had assumed that Mr. Trump would avoid a trade war with China in the run up to the U.S. midterm election because of the risks posed to U.S. earnings: foreign sales account for 43% of all sales for S&P 500 constituents - chart. Alas, that doesn't seem to be the case. There is of course still time between now and July 6 to avoid a tariff war, but the window is getting pretty small.

## U.S.: Foreign sales are an important component of earnings

Foreign sales as a percentage of total sector sales in S&P 500 (2016)



NBF Economics and Strategy (data via <https://us.spindices.com/documents/research/research-sp-500-2016-global-sales.pdf>)

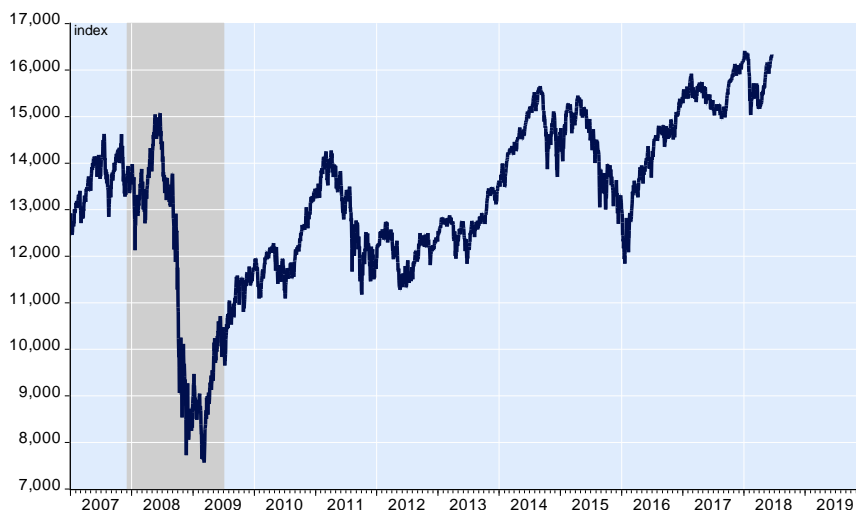
**Under these circumstances, we are changing our asset mix recommendation. We are reducing our equity exposure by three percentage points in favour of cash.** The S&P/TSX has done well in recent months and is closing in on our yearend target of 16,700. Though a weaker CAD will help support earnings, there is a limit to what currency alone can achieve if the U.S. trade policy turns more aggressive on Canadian products (two-way trade between Canada and the U.S. is a whopping \$USD 630 billion, i.e., bigger than U.S.-China trade flows).

NBF Asset Allocation			
	Benchmark (%)	NBF Recommendation (%)	Change (pp)
<b>Equities</b>			
Canadian Equities	20	20	-4
U.S. Equities	20	20	+3
Foreign Equities (EAFE)	5	8	
Emerging markets	5	3	-2
<b>Fixed Income</b>	45	39	
<b>Cash</b>	5	10	+3
<b>Total</b>	100	100	

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## Canada: How much more upside...

S&P/TSX



NBF Economics and Strategy (data via Datastream)

The auto sector is a case in point. **Mr. Trump issued a stark warning against auto imports from Canada (possibility of a 25% tariff).** In a special report published earlier this year, we highlighted that this sector is the most exposed to U.S. protectionism (1.3% of all jobs) with Ontario being the most vulnerable province (2.6% of all jobs and 3.1% of GDP).<sup>1</sup>

<sup>1</sup> See our special report “Reality check: Canadian exposure to U.S. protectionism” (March 28, 2018).

## ..given this?

Canadian job exposure to U.S. protectionist rhetoric

**Table 2 - Employment exposure to industry Canadian exports to U.S.  
(Employment dependent on specific Canadian industry exports to the U.S. as a % of total employment - 2013)**

Exporting industry	CA	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
<b>A - U.S. Protectionist rhetoric</b>											
111 - 112 Crop and Animal Production	0.3%	0.0%	0.6%	0.1%	0.3%	0.1%	0.2%	0.7%	1.0%	0.4%	0.3%
3115 - Dairy Products Manufacturing	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
321 - Wood Product Manufacturing	0.3%	0.0%	0.0%	0.2%	0.9%	0.4%	0.1%	0.2%	0.2%	0.2%	0.9%
326 - Plastics and Rubber Products Man.	0.3%	0.0%	0.0%	0.9%	0.2%	0.4%	0.4%	0.3%	0.0%	0.1%	0.1%
3311 - Iron, Steel mills, Ferro Alloy Man.	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.0%	0.0%	0.0%
3312 - Steel products from purchased steel	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.0%	0.1%	0.0%	0.0%
3313 - Alumina and Aluminum prod. & proc.	0.1%	0.0%	0.0%	0.0%	0.0%	0.4%	0.1%	0.0%	0.0%	0.0%	0.0%
3315 - Foundries	0.0%	0.0%		0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
335 - Electrical equ., appliance and comp. man.	0.1%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.0%	0.0%	0.1%
3352 - Household Appliance Man.	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
3361 - Motor Vehicle Manufacturing →	0.9%	0.2%	0.2%	0.2%	0.3%	0.4%	1.8%	0.4%	0.2%	0.3%	0.3%
3362 - Motor Vehicle body and trailer man.	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.0%	0.0%	0.0%
3363 - Motor vehicle parts manufacturing →	0.4%	0.0%	0.0%	0.0%	0.1%	0.1%	0.8%	0.1%	0.1%	0.1%	0.1%
3364 - Aerospace product and parts man.	0.2%	0.0%	0.6%	0.3%	0.0%	0.5%	0.1%	0.5%	0.0%	0.0%	0.1%
<b>Sub-total</b>	<b>2.8%</b>	<b>0.4%</b>	<b>1.6%</b>	<b>1.9%</b>	<b>1.8%</b>	<b>2.5%</b>	<b>4.1%</b>	<b>2.4%</b>	<b>1.8%</b>	<b>1.2%</b>	<b>1.8%</b>

NBF Economics and Strategy

A negative development in autos could expose the Industrial and Consumer Discretionary sectors of the S&P/TSX, both of which have surged to record highs in recent weeks on CAD weakness (chart). Some profit taking is called for at this time with proceeds to be redistributed in Consumer staples and Telcos. **We stand ready to reassess our position when we get more visibility on the trade front.**

### Canada: Industrials at a record high despite NAFTA

S&P/TSX Industrials vs. S&P 500 Industrials



## Canada: Consumer discretionary at a record high despite NAFTA

S&P/TSX consumer discretionary vs. S&P 500 consumer discretionary



Canada’s Foreign Affairs Minister Chrystia Freeland vowed last week to make a “real push” over the summer to seek a NAFTA agreement. **Because we don’t have a strong conviction that the Minister will be able to deliver on that pledge and because a lot of good news is already priced in Canadian equities, we think that a more defensive stance is justifiable.** In currencies, a less certain outlook on trade wars is forcing us to revise our outlook for CAD. Previously, we had a move towards 1.20 this summer. **Under our revised scenario, USDCAD remains above 1.30 through the end of Q3.**

NBF Currency Outlook*						
	Current 29-Jun-18	2018Q3	2018Q4	2019Q1	2019Q2	2019Q3
USDCAD	1.32	1.33	1.28	1.28	1.27	1.25
US cents per CAD	0.76	0.75	0.78	0.78	0.79	0.80
EURUSD	1.16	1.15	1.19	1.20	1.21	1.23
USDJPY	110	107	109	110	112	113
AUDUSD	0.74	0.73	0.76	0.77	0.78	0.80
GBPUSD	1.32	1.30	1.33	1.33	1.34	1.35
USDCNY	6.44	6.46	6.48	6.50	6.47	6.45
USDMXN	20.69	21.00	20.60	20.40	20.00	19.80

\* forecasts for end of period  
Source: NBF Economics and Strategy

## Economics and Strategy

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