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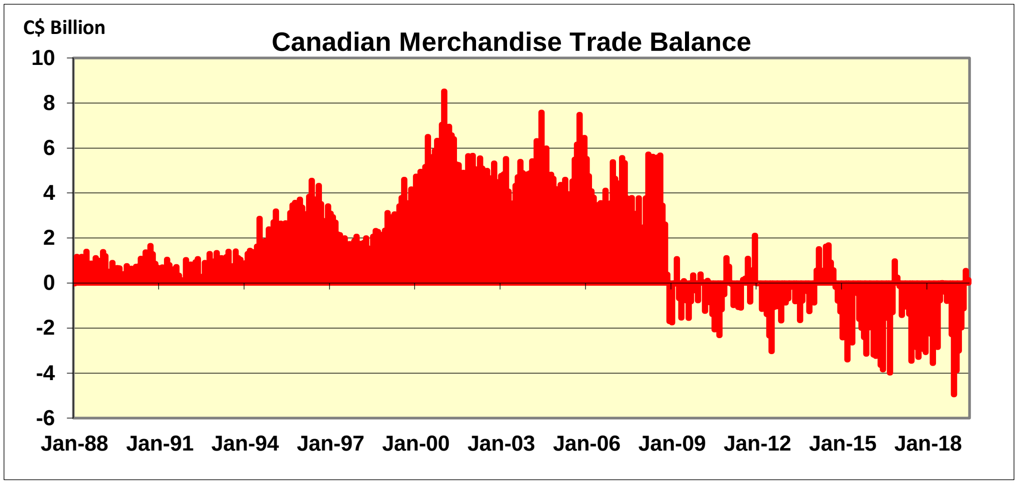
Trade Worries the Markets

By Richard J. Wylie, CFA

Trade disputes are not a new phenomenon. However, the recent increase in tensions, primarily among the U.S. and its principal trading partners, has fostered a number of material uncertainties. Data suggest that recent tariffs, and threats of new ones, have altered business behaviour and economic activity. As a nation that is reliant on international trade, Canada is particularly susceptible to these winds of change. With the business cycle and the current bull market showing their age, investors are understandably concerned with the escalating rhetoric and the ever-increasing risks of protectionism. Having a professional advisor and a sound financial plan can help ease investor concerns when negative headlines dominate the media.

Figure 1



Source: Statistics Canada

Impact of the financial crisis

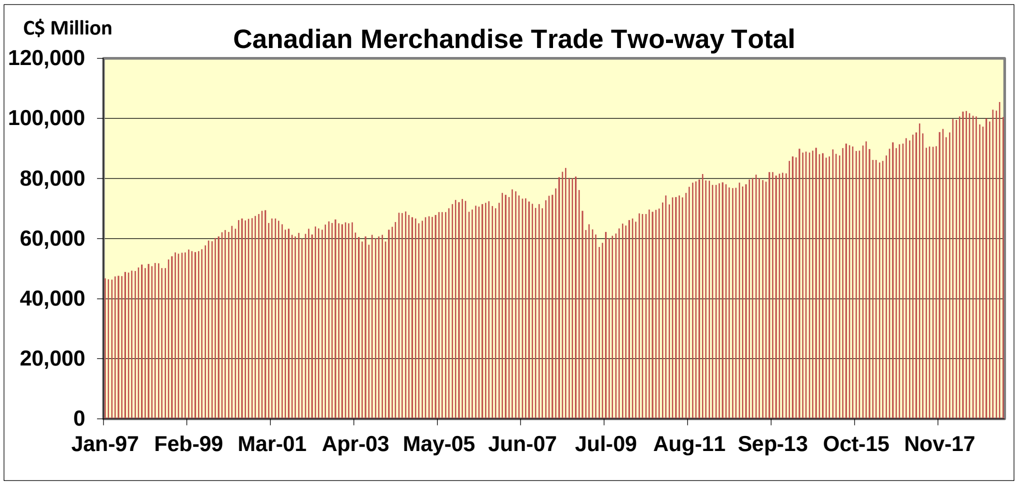
As Figure 1 shows, Canada's trade position was consistent during the three decades that preceded the financial crisis in 2008-09. Merchandise trade produced surpluses on a regular basis and deficits, when they did appear, were separated by extremely long gaps. In fact, a $30 million trade deficit was recorded in January 1980. The next deficit ($1.7 billion) emerged only at the dawn of the financial crisis in December 2008, almost 29 years later. One of the primary effects of the financial crisis was a tightening of credit, which exporting firms rely upon to finance trade. In addition, many countries imposed a number of reactionary trade barriers to protect their domestic economies, providing a secondary hit to international trade. This ensured that not only did liquidity and falling markets become the world's problem, so did trade. Even though some of the direct trade barriers were eliminated relatively quickly, trade disputes continue among many of the world's nations – including those that say that they espouse free trade.

More recently, Statistics Canada showed that Canada's merchandise trade balance shifted to a small surplus ($556 million) in May 2019 and remained in surplus ($136 million) in June. These are now the first back-to-back surpluses since November 2016 ($1.0 billion) and December 2016 ($259 million). Despite considerable uncertainty and continued political wrangling, the surplus with the U.S. stood at $5.7 billion in June and $5.9 billion May. The May figure was largest surplus with the U.S. since October 2008 ($6.2 billion) but remains well below the record of $11.6 billion set in October 2005 (current measures only go back to 1997).

Trading partners

Given the historic economic relationship and physical proximity of Canada and the U.S., it is not surprising that two-way trade flows between the two countries have been substantial for many years. Even though consistent, individual country data only dates back to 1997, Figure 2 does reveal some interesting details of the recent evolution of Canada's merchandise trade. During 1997, combined merchandise imports and exports totalled $580 billion, or an average of $48.3 billion per month. The monthly figure hit a peak of $83.5 billion in July 2008. The financial crisis pared this back to $57.2 billion in May 2009.

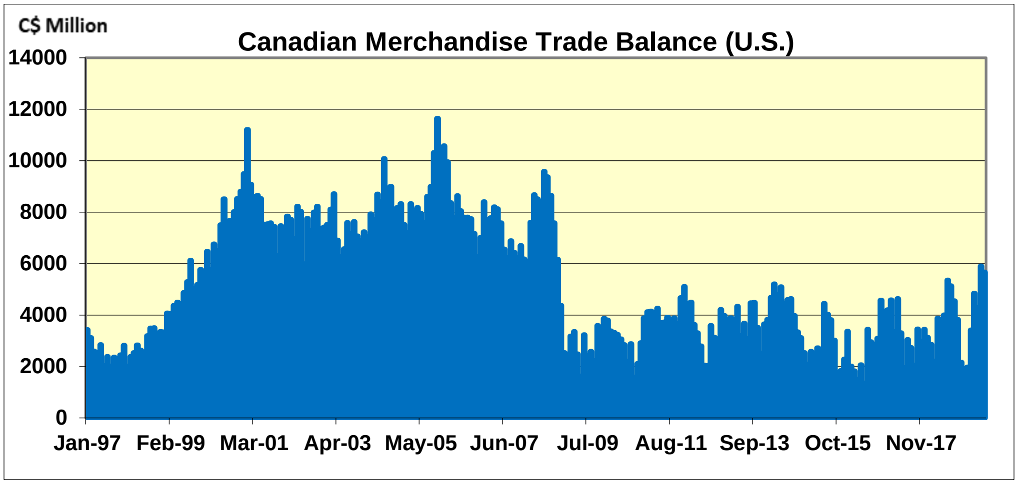
Figure 2



Source: Statistics Canada

Along the same timeline, combined merchandise imports and exports with the U.S. amounted to $453 billion, or 78.1% of the total. From 1997-1999, two-way merchandise trade with the U.S. averaged 79.4% of Canada's total. During the most recent complete three-year period (2016-2018), this figure had fallen to 69.7%. Still, despite the shifting patterns in the underlying trade relationship, Canada has consistently run merchandise trade surpluses with the U.S. As can be seen in Figure 3, the trade surplus has varied over the last 22 years but it has never been in a deficit position.

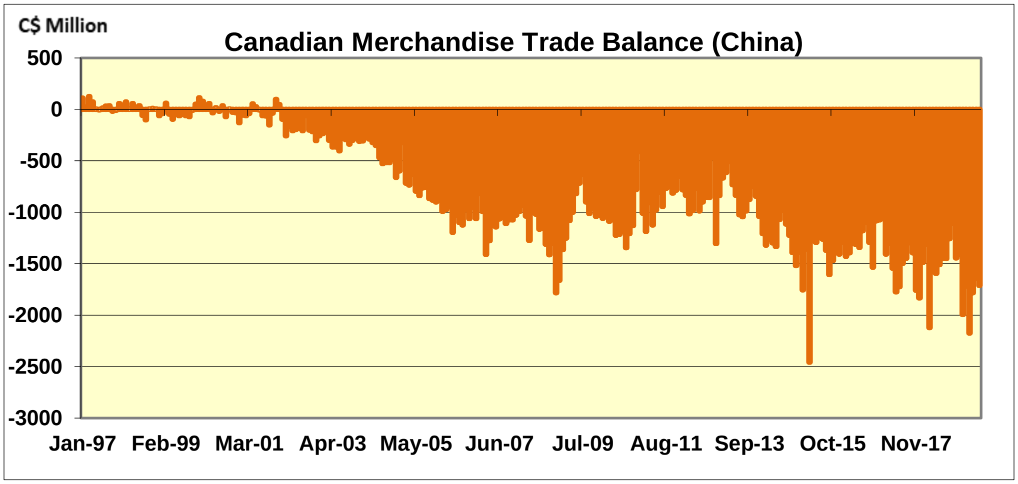
Figure 3



Source: Statistics Canada

Another dramatic change over past two decades has been the emerging economic prominence of China. Not surprisingly, Canada's merchandise trade with China has also evolved significantly over the same period. Minor surpluses were observed in the final years of the 1990s with a $5.7 million average monthly trade surplus between January 1997 and December 1999. In 1997, two-way trade amounted to just $4.8 billion or $401 million per month, representing just 0.8% of Canada's total. Between 1997 and 1999, two-way merchandise trade with China averaged 0.9% of the total. During the most recent complete three-year period (2016-2018), this figure had climbed to 6.0%. Additionally, Canada has consistently run merchandise trade deficits with China. As can be seen in Figure 4, the last trade surplus ($46.7 million) occurred in December 2001. The deficit has varied over the last 18 years, posting a record high ($2.5 billion) in March 2015.

Figure 4



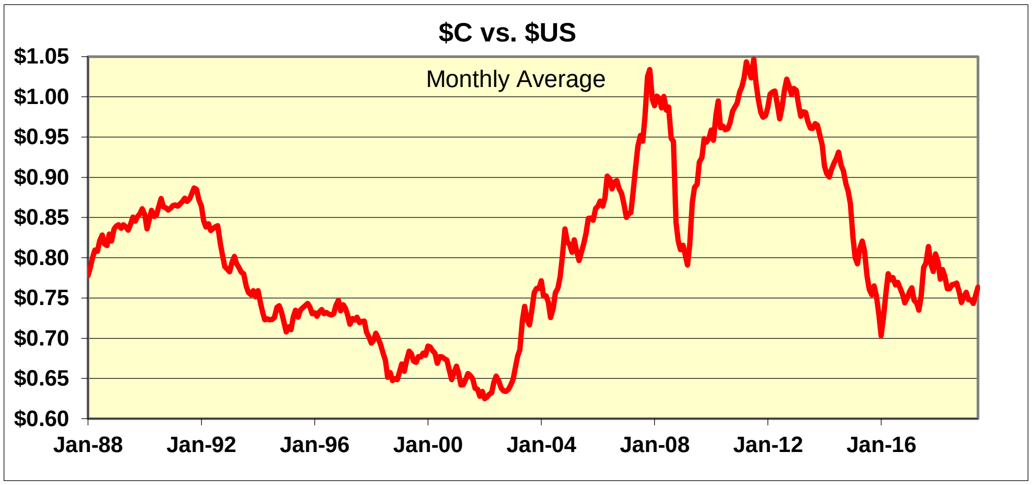
Source: Statistics Canada

Currency

Historically, as with any other trading nation that allows its currency to float freely in the market, the Canadian dollar has acted as an economic "shock absorber." Generally, when an economic shock occurs, the value of that country's currency declines. A weaker Canadian dollar makes our exports more competitive, allowing foreign buyers to acquire them for less. This in turn allows Canada's export sectors to strengthen. At the same time, foreign imports coming into Canada become more expensive and local consumers tend to select domestically produced substitutes, where available.

As can be seen in Figure 5, the Canadian dollar was relatively strong in the aftermath of the global financial crisis. At the peak of the crisis, many investors sought out the perceived safety of the U.S. dollar and in March 2008, the Canadian dollar traded at an average value of US$0.79. However, it then moved above par with its U.S. counterpart and remained there for most of 2011. Since then, the relative strength of the two economies and weakness in commodity demand caused the Canadian dollar to weaken. However, the "shock absorber" influence of the weaker currency has been more muted of late. Despite the fact that the Canadian dollar has now been consistently below the US$0.80 level since 2015, merchandise trade has been in a significant deficit position for most of that time.

Figure 5



Source: Bank of Canada

More recent trade issues

On April 3, 2018, the U.S. released its $50 billion list of Chinese products under consideration for 25% tariffs. China has remained firmly in its sights since then, but most of the other U.S. trading partners have also felt the heat. In April, President Donald Trump raised the rhetoric with this statement: "(The trade) war was lost many years ago by the foolish or incompetent people who represented the United States. Now we have a trade deficit of $500 billion a year, with intellectual property theft of another $300 billion."

Closer to home, the North American Free Trade Agreement was replaced by the Canada-United States-Mexico Agreement in November 2018. In December 2018, Meng Wanzhou, Chief Financial Officer of technology company Huawei, was arrested in Vancouver on an extradition request from the United States. Subsequently, China has barred shipments of Canadian canola, meat products, peas and soybeans. The growing global economic prominence of China in the past three decades has raised its importance as a trading partner with Canada. Canadian companies are now more susceptible to these barriers than ever before. These forces have hurt Canadian businesses, economic growth and the currency. Some estimates suggest that the global cost of an escalation in these ongoing trade spats could reach US$800 billion[1]. Like any other disruptive influence, professional advice and a well-constructed financial plan can help alleviate investor stress during challenging times.

Conclusions

- Although international trade disputes are as old as international trade, the recent escalation of the scale and scope of these disputes has prompted changes in economic behavior. At the same time, Canada’s free-floating currency has not provided the same degree of “shock absorption” that it has in the past.
- Canada’s primary trade partner continues to be the United States. Nevertheless, the increasing importance of China on the world economic stage has raised its importance as a destination for Canada’s exports and a source of our imports.
- The effect of the current and threatened disruptions on the financial markets is apparent. Having a professional advisor and a sound financial plan can help investors deal with the uncertainties of this investing environment.

[1] Bloomberg. “All-Out Trade War Could Cost the Global Economy $800 Billion,” June 5, 2019.