Could not car less

Global Daily

RaboResearch
Global Economics & Markets
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Market comments

The European Union has announced punitive tariffs on Chinese EV manufacturers. This is bound to cause a further deterioration in global trade relations. Yet, equity markets did not seem to be all that worried, and instead focused on the improving US inflation data.

Will Europe end up car-less? The tariffs are certainly substantial. Brussels will levy an additional tariff of 17% to 38% on top of the existing 10% import duty. But is that sufficient to prevent the dumping of Chinese cars? Some estimate that duties of 40% to 50% are not even sufficient to disincentivise all Chinese manufacturers. Tellingly, the common stock of Chinese EV manufacturers rallied after the announcement. Contrast the European tariffs to the recent tariff hike in the US. President Biden's raised the import duties on Chinese EV to 100%! And the US doesn't even import that many Chinese-made vehicles.

Or was the EU careless? If the tariffs fail to fully level the playing field for domestic producers, or even advantage them, Europe may just have shot itself in the foot. In that case, the additional import duties do not safeguard the transformation of the European car industry to electric vehicles, and Europe may still be facing a repeat of the collapse of the solar panel industry. Yet, Europe's tariff will certainly anger China, who have already threatened to retaliate.

What's the price to pay? The direct effects of the punitive tariffs on inflation may be limited. It won't make cars any cheaper, but Chinese producers may be forced to take most of the loss. If the tariffs are fully added to the selling price of Chinese EVs, the narrower gap may make these brands much less attractive for European consumers than domestic brands.

Think about it. A car is a multi-year investment. Considering the geopolitical shifts, would you buy a Chinese EV if they are similarly priced as a German brand? Taking into account that the car needs regular servicing and possibly replacement parts, a reliable dealer network is crucial – especially since EVs require a different skillset to maintain than a combustion engine. A skillset that may not be available at every corner garage. Of course, the average consumer may not actively consider all of these things when choosing an EV, but they will probably be sensitive to it implicitly. At equal pricing, established European brands will probably have a leg up.

So arguably Chinese manufacturers will absorb most of the tariff in their margins to maintain their market shares, rather than passing this on to the consumer through higher prices.

Yet, indirectly, the tariff may still add to inflation. China has refrained from an immediate retaliation. Nonetheless, it is clear that Beijing intends to counter Europe's tariffs with anti-trade measures of its own. China has already warned Brussels that its aviation and agriculture sectors could become the targets of retaliatory tariffs. Worse, what if China doesn't strike back through tariffs, but instead decides to impose export bans on key commodities and inputs? That could raise European input costs and prices across sectors. Given Europe's internal divisions when it comes to the automobile industry, China may have an even stronger incentive to retaliate. This could drive a further wedge between EU-countries.

Indeed, concerns about trade wars, combined with the Red Sea crisis and intermittent capacity issues at some ports, are already leading to a new surge in shipping rates.

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All's well that starts well? None of these structural concerns seemed to bother traders yesterday, because the short-term outlook brightened a bit. Somewhat softer US CPI inflation were cause for optimism, and European equities were up 1.2% on the day.

Both headline and core inflation slowed down, in month-on-month as well as year-on-year terms. That's an encouraging sign, indeed. Underlying the core inflation rate, shelter inflation fell from 5.5% to 5.4% y/y and was stable at 0.4% m/m. So there's some progress, albeit slowly. Services less rent of shelter did actually rebound from 4.9% to 5.0% y/y, but slowed down to 0% in month-on-month terms.

This is not yet sufficient for the Fed. Interest rates were left on hold yesterday, as widely expected. But policymakers surprised the market by cutting their median projection to just one rate cut in 2024, whereas they still had pencilled in three cuts at their March meeting. Clearly, the FOMC's confidence about the inflation outlook has been dented, and the encouraging CPI data were not sufficient to reverse this.

That was also evident in Powell's press conference. Powell said he welcomed today's inflation reading and he hoped for more. But hope isn't really a strategy. The Fed Chair added that policymakers need to see more encouraging data to bolster their confidence on inflation. Alternatively, Powell repeated, an unexpectedly weaker labour market could lead the FOMC to cut rates.

The reality is that inflation is very sticky and the FOMC seems to be increasingly aware of this. So, our US strategist believes that a deterioration in the labour market is the more likely route to rate cuts. We do not share the Fed's optimism that they can rebalance labour demand and supply this year without raising unemployment. Therefore, we still expect two cuts this year, in September and December.

Day Ahead

Today has April industrial production figures for the EC, followed by the US PPI figures for May. The annual G7 summit in Italy commences and will continue until Saturday. The summit is anticipated to feature discussions on bolstering support for Ukraine and deliberations on the ramifications of the European elections.

For an overview of our macro-economic and financial markets forecasts please click here.

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