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Global Trade At A Crossroads: If U.S. Tariffs Trigger A Trade War With China, Corporate Credit Will Suffer

March 23, 2018

(***Editor's Note:*** *Details of the Trump Administration's March 22 announcement of tariffs on $50 billion-$60 billion of Chinese imports have yet to be finalized. In the interim, our analysts have provided their preliminary views on the possible effects of the U.S. tariffs--and retaliation by China--on various sectors globally.)*

U.S. President Donald Trump's long-threatened package of trade sanctions on China have landed, but a trade war isn't yet inevitable. S&P Global Ratings believes China's response will be the key determinant. The threatened tariffs and investment restrictions on China won't likely cause deep pain to the Chinese economy, nor, in our view, would they materially affect corporate borrowers in either country. A greater risk is that the situation escalates from here.

So far China's response has been relatively measured, indicating potential tariffs on about $3 billion of U.S. imports. The question now is whether China will take additional retaliatory action, including broader tariff and non-tariff restrictions on U.S. business or investment in China. Such moves could escalate into a full-blown trade war between the world's two largest economies--with spillover effects on global business confidence, investment, and growth.

Key Takeaways

- The Trump administration intends to impose tariffs on $50 billion-$60 billion of Chinese imports, lodge a WTO dispute against China's technology licensing, and restrict Chinese investment in strategic industries and technologies.
- Even assuming a high 25% tariff rate on the likely targeted imports, our calculations show the overall impact on Chinese corporates and banks will be contained.
- The impact is limited because the U.S. represents only about 15% of China's goods exports, and China's domestic activity now drives its economic growth rather than exports as in earlier decades.
- China's response so far has been measured, flagging potential tariffs on about $3 billion of U.S. imports. However, the situation remains dynamic, with the risk of further tariffs and restrictions on investments and market access.
- A trade war between the world's two largest economies would hurt global confidence, economic growth, and credit.

PRIMARY CREDIT ANALYSTS

David C Tesher
New York
(1) 212-438-2618
david.tesher@spglobal.com

Terry E Chan, CFA
Melbourne
(61) 3-9631-2174
terry.chan@spglobal.com

Paul R Draffin
Melbourne
(61) 3-9631-2122
paul.draffin@spglobal.com

Christopher Lee
Hong Kong
(852) 2533-3562
christopher.k.lee@spglobal.com

SECONDARY CONTACTS

Jose M Perez-Gorozpe
Mexico City
(52) 55-5081-4442
jose.perez-gorozpe@spglobal.com

Paul Watters, CFA
London
(44) 20-7176-3542
paul.watters@spglobal.com

See complete contact list at end of article.

The U.S. president announced on March 22 three separate actions the administration will take in response to what the U.S. believes are China's unfair trade practices. These practices are described in the U.S. Trade Representative's Section 301 (Trade Act of 1974) investigative report on China's acts, policies, and practices related to technology transfer, intellectual property, and innovation. The three actions are:

- Tariffs. The Trade Representative will publish a proposed list of products and any tariff increases within 15 days of yesterday's announcement. After a period of notice and comment, the Trade Representative will publish a final list of products and tariff increases.
- WTO dispute. The Trade Representative will pursue dispute settlement in the World Trade Organization (WTO) to address China's discriminatory technology licensing practices.
- Investment restrictions. The Secretary of the Treasury will address concerns about investment in the U.S. directed or facilitated by China in industries or technologies deemed important to the U.S.

Still, at the same press conference, President Trump also said he is open to negotiations with China. Indeed, the administration demonstrated its willingness to negotiate on trade with its retreat on the recently announced steel and aluminum tariffs. Earlier on March 22, the U.S. trade representative said the European Union, along with Argentina, Australia, Brazil, and South Korea, will be initially be exempted from the 25% steel and 10% aluminum tariffs scheduled to come into effect today (March 23). (Canada and Mexico had earlier been exempted.)

As of now, our base case for limited ratings impact doesn't factor in a Sino-U.S. trade war. China has so far flagged that it may impose tariffs on 128 U.S. products, including pork, recyclable aluminum, fruit/nuts, wine, and steel pipes. However, these products represent a relatively modest percentage of trade from the U.S. If China's response is more retaliatory, we would re-analyze the impact on industry sectors in both countries.

China-U.S. Exports And Imports

The $50 billion-$60 billion targeted by potential tariffs could affect up to 10%-12% of Chinese imports to the U.S. This is based on the major product categories for U.S. goods imported from China last year, which totaled $506 billion (see chart 1). As the trade dispute appears to be about technology and intellectual property, it stands to reason that the products subject to tariffs could well be drawn from the computers and semiconductors, cell phones, and industrial machinery categories. However, it is unclear whether the tariffs will focus on just one or two product categories or be more widespread; in the former, the impact could be more material for players in those sectors.

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Chart 1

2017 U.S. Imports From China, US$506 Billion

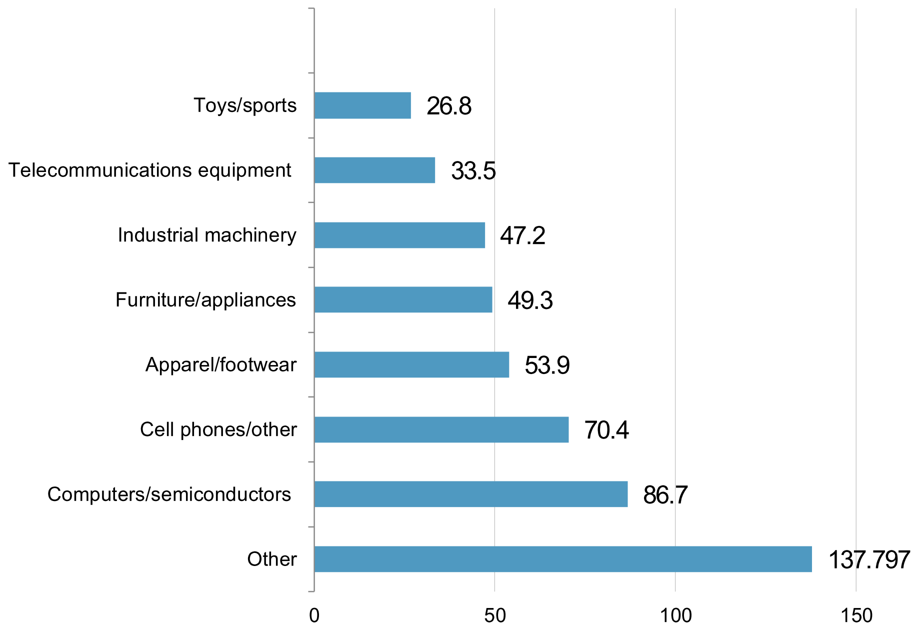
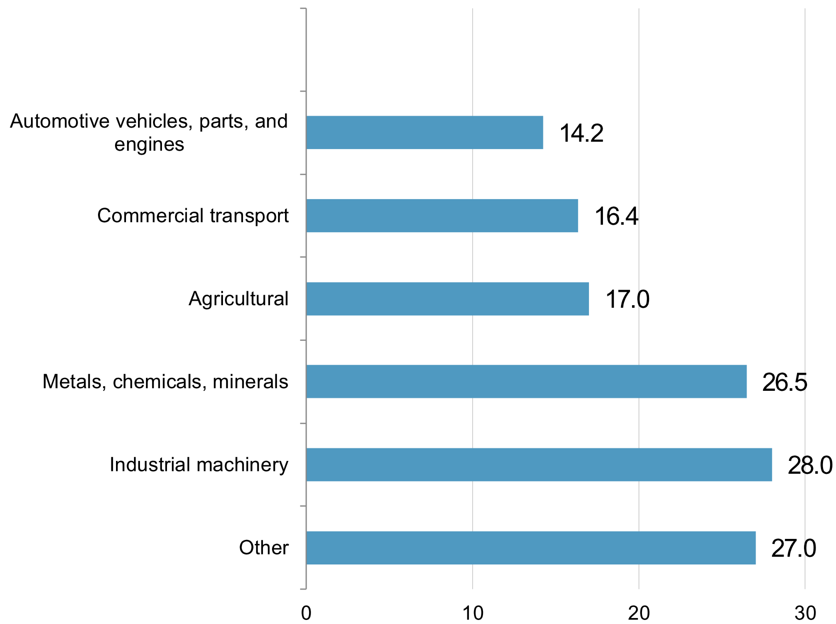


Chart 2

2017 U.S. Exports To China, US$129 billion



Sector Impact

While the near-term effects on corporate credit will likely be muted--barring an immediate escalation of retaliatory measures--there will be some impact for certain sectors. Below we provide our qualitative views on the near-term effects of possible U.S. tariffs under the 25% tariff scenario we asked our analysts to assume, as well as the possibility of investment restrictions and any retaliatory action from China for selected sectors:

Aerospace And Defense: Boeing May Have The Most To Lose

Christopher DeNicolo, Washington DC + 202 383 2398; christopher.denicolo@spglobal.com

Philip Baggaley, New York +1 212 438 7683; philip.baggaley@ spglobal.com

Boeing could lose long-term business to its key competitor, Airbus, if China sought to punish the aircraft maker as a form of retaliation. In 2017, about 23% of Boeing's aircraft deliveries went directly to Chinese airlines or leasing companies; we believe China makes up a similar proportion of Boeing's backlog. It's unlikely that China would cancel any of these existing orders, and it would be difficult for Airbus to materially increase deliveries to China in the short term, due its own large backlog. As aircraft purchase decisions are made by the Chinese government and not individual airlines, the risk is that Airbus would gain a higher proportion of future orders. However, it's unlikely even in the worst case that Airbus would get all future orders from China, as it doesn't have the capacity to deliver the more than 7,200 aircraft that Boeing estimates the country needs over the next 20 years. In terms of the short-term impact of U.S. tariffs, we also believe the impact on Boeing's, or its U.S. suppliers', profitability would not be material, even though some U.S. commercial aerospace suppliers have facilities in or source some parts from China.

Agricultural Products: American Farmers Could Suffer More Than Big Companies

Christopher Johnson, New York, +1 212 438 1433; chris.johnson@spglobal.com

While retaliatory action by China through soybean tariffs would significantly affect the U.S. agricultural sector, it could hurt farmers more than our rated agricultural companies like Archer Daniels Midland Co., Bunge Ltd., and Cargill Inc., which source their grains from farmers for trading and further processing. Lower soybean prices lead to lower sales and profits for farmers and agribusiness companies alike, and Soybean prices have fallen about 7% from the recent Trump tariff talk. But farmers selling crops are competing for sales from agribusinesses sourcing product across the globe and across many commodities. In fact, farmers could be more exposed to price fluctuations because they have built up storage capabilities that they've used to hold onto their crops for longer post-harvest as a way to improve pricing, so their stored supplies could get hit harder when prices unexpectedly decline (what's happening now). Agribusiness companies would not be immune to sudden price changes either, but they tend to hedge and lock in margins once they buy from the farmer. In addition, their businesses are diversified into several other commodities and business functions, lessening the exposure of a targeted retaliatory tariff.

That said, our rated agribusiness companies' earnings have already suffered from a prolonged cyclical downturn, and what was looking like a possible rebound in earnings this year could get derailed by a trade war, albeit temporarily. Moreover, sudden disruptions in the grain markets have historically had a significant impact on quarterly performance, and soybean tariffs could hit earnings harder than the typical marking-to-market of hedged positions, which tend unwind in subsequent quarters when the physical crop is commercialized. That's because a tariff could change the economics of the existing contract. If shipments (of soybeans, in this scenario) have already been booked at a locked margin and that shipment is then hit with a tariff, real losses could be incurred, but on a one-time basis that likely wouldn't repeat for future shipments.

Short-term trade could be disrupted and consequently could adversely affect profits. However, we believe future trade flows would likely normalize given that Chinese demand for soybeans is quite inelastic. According to the U.S. Department of Agriculture, China makes up about 60% of global oilseed imports, while the U.S. produces 25% of global oilseed production (excluding China's domestically consumed production), closely followed by Brazil (21%) and Argentina (11%). With so much Chinese import demand already being filled by the three major oilseed exporters, it's hard to see China finding another large trading partner to replace the U.S., particular this year when Argentina's crop has been hit hard by a drought. Therefore, we believe the U.S. soybean trade would likely continue in spite of any tariffs and future profitability would adjust to them after an initial and possibly severe one-time hit to profits.

Auto Manufacturers And Suppliers: Effects Are Likely To Be Limited

Nishit Madlani, New York, +1 212 438 4070; nishit.madlani@ spglobal.com

Lawrence Orlowski, New York, +1 212 438 7800; Lawrence.orlowski@ spglobal.com

Katsuyuki Nakai, Tokyo, (81) 3-4550-8748; Katsuyuki.nakai@spglobal.com

For U.S. automakers, we assume a limited direct impact on credit quality due to the tariffs. We estimate that Chinese vehicle imports make up a negligible proportion for GM and Ford currently, and that is unlikely to change over the foreseeable future. For auto suppliers, the impact will generally be more limited for original equipment (OE) suppliers than for aftermarket suppliers. U.S. OE suppliers will tend to source within the NAFTA region. However, some aftermarket suppliers now import most or all of their parts from China, typically smaller and lighter ones that ship more easily such as air filters, brake pads, spark plugs, and fuel pumps.

Certain auto suppliers have been subject to tariffs for years. In 2015 the U.S. finalized countervailing and anti-dumping duties of up to 100% on tires imported from China. In response, some U.S. tire makers that imported tires from China have shifted production closer to home. At the same time Chinese tire makers have set up tire facilities in other parts of Asia, such as in Vietnam and Thailand, to get around the tariffs.

Still, even if some imported auto parts from China are hit with tariffs, suppliers will adjust production over time to minimize costs. From a credit perspective, weaker suppliers would be more vulnerable to sharp increases in product costs and could encounter more difficulty securing new and cheaper sourcing.

We don't expect a material impact on U.S. automakers based in China or their large tier 1 suppliers because foreign automakers in China operate only in joint venture relationships and produce locally. Since the 1990s, China has required overseas automakers to form joint ventures with local manufacturers in which the foreign companies are capped at 50% ownership. However, escalating trade tensions could hurt negotiations to liberalize the caps on U.S. carmakers' participation in China. Retaliatory action against restrictions on Chinese investments into the U.S. could negatively affect the plans of auto companies (such as Tesla) that would prefer be the sole owner of their operations in China and that are working with the local government to permit assembly operations there.

China is the world's biggest producer of autos, but most of its sales are to the domestic market. Thus, we don't expect the tariffs to affect the creditworthiness of Chinese automakers and auto suppliers. For other Asia-Pacific automakers, the impact is also limited given that their production base in China is directed toward local sales. Nonetheless, we will be monitoring the supply chain to see if there are unexpected second-order effects and cost increases going forward. The pressure on ratings could become significant should a potential trade war weaken market demand in China and/or the U.S.

Building Materials: U.S. Toolmakers Could Face Cost Pressures

Donald Marleau, Toronto, +416-507-2526; donald.marleau@spglobal.com

In the U.S. building materials sector, about 20% (eight to 10) of companies somewhat rely on

Chinese imports, while two or three may rely on them even more. Most U.S. building materials and products are domestically sourced, but there are significant finished goods imported from China. Toolmakers buy a considerable amount from China and would face cost pressure from a tariff, although less so than those that are able to shift their supply chains. For small, low-cost and price-inelastic items where China is the largest producer, higher costs from even a 25% tariff could likely be passed on. Companies in the sector overall export very little to China, so a retaliatory tariff would have little impact.

Capital Goods: Demand For Farming Equipment Could Wane

Ana Lai, New York +1 212 438 6895 ana.lai@spglobal.com

Hiroki Shibata, Tokyo +83 4550-8437 hiroki.shibata@spglobal.com

U.S. capital goods companies have modest exposure to imports and investment from China. Most issuers are diversified in terms of geographic exposure. However, for a few issuers focused on farm equipment, such as Deere, they could be more exposed if China imposes tariffs or limit imports on grains. Demand for farming equipment could also be affected. Similarly in terms of exports to China, U.S. corporates only have modest exposure to China. While many capital goods issuers are net exporters, their markets are fairly diversified.

Chemicals: A Modest Negative For Some U.S. Petrochemical Projects

Paul Kurias, New York (1) 212 438 4386 paul.kurias@spglobal.com

A trade spat with China is at least a modest negative for the large petrochemical projects on the U.S. Gulf Coast, and for the sector overall. China, as the largest chemical market in the world, exerts some influence on global commodity pricing and a trade dispute between two of the largest chemical producers in the world would ultimately be problematic for global commodity pricing. This is especially applicable to the large petrochemical capacity coming up in the U.S. Gulf Coast that is geared toward domestic and export markets. In addition, some U.S. producers of agricultural chemicals could be hurt by Chinese retaliatory tariffs on U.S. agricultural exports. While tariffs by the U.S. on the Chinese chemical sector could somewhat benefit American producers of certain types of commodity chemicals, unintended consequences for global chemical prices could undermine the gains.

The U.S. chemical sector doesn't materially depend on imports of raw materials or foreign direct investment from China. More pertinent is the import of finished products from China that compete with, and influence the prices of, domestically produced chemical products. U.S. tariffs on the import of Chinese chemical products (as opposed to raw material) may generate short-term benefits for U.S. domestic producers of some of these commodity chemicals such as nitrogen fertilizer. However, excess Chinese supply that was meant for a pre-tariff U.S. market may end up in the world market and depress global prices, eventually hurting U.S. chemical prices. The U.S. chemical sector doesn't have a material dependency on direct exports to China, and ,many chemical companies that sell into China have a physical presence there. They presumably wouldn't be hit by retaliatory Chinese tariffs.

Consumer Products: China's Consumer Products Makers Are Most Vulnerable

Sophie Lin, Hong Kong, (852) 2533 3544; sophie.lin@spglobal.com

Diane Shand, New York (1) 212 438 7860; diane.shand@spglobal.com

China and Hong Kong consumer product companies are among the most vulnerable to rising U.S. trade barriers. Some sector companies depend on U.S. exports for 10%-30% of revenues. Chinese agribusiness companies face higher costs in light of already threatened Chinese tariffs on U.S. agricultural products--which are more likely if the situation continues to escalate. U.S. consumer companies that outsource their durable goods supply chain could get hurt, especially small and niche players. Nonetheless, the specific details of the new tariffs are critical, for example whether the size of the tariff distinguishes between raw materials, intermediate, and finished goods. U.S. companies that outsource to China for apparel, toys, and other consumer goods could be feeling vulnerable. Their choices will be to try to lower the factory gate prices from China, pass through some of the additional costs directly to consumers, or scramble for new suppliers elsewhere. The majority of our rated Chinese consumer product companies have a low exposure to U.S. imports. Many of them source raw materials or semi-processed products from China itself, Southeast Asia, Australia, and New Zealand.

Some Chinese and Hong Kong consumer product companies depend on U.S. exports for 10%-30% of revenues.

Financial Institutions: Immediate Effects Are Unlikely

Liao Qiang, Beijing, (86) 10-6569-2915; qiang.liao@spglobal.com

Chinese banks are unlikely to feel any immediate impact from the bilateral trade tensions. However, a prolonged trade war that damages China's business environment could lead to monetary easing. This would have obvious knock-on effect to Chinese banks and the operating environment of their corporate borrowers. At the moment, policymakers have been pressuring banks to deleverage their balance sheets to reduce systemic financial risks. Large state-owned companies have also been shoring up equity and lowering their financial leverage. If Chinese policymakers fine-tune their tightening stance, this could also slow the pace of corporate deleveraging.

Leisure: The U.S. Toy Industry Will Feel The Effects

Emile Courtney, New York, +1 212 438 7824, emile.courtney@spglobal.com

The U.S. toy industry would be materially affected by the new tariffs given that the most toys are manufactured in China. For some companies, about half of their cost of goods sold would be affected. It is unlikely that all of the increased cost could be passed on to consumers.

For U.S. hotel groups, adverse retaliatory action by the Chinese authorities could affect some hotel operations in China, but it is unlikely to be a material credit concern at this stage.

Media: Tariffs Could Scuttle A Loosening Of Film Quotas

Naveen Sarma, New York, +1 212 438 7833, naveen.sarma@spglobal.com

For the U.S. media industry, the impact isn't from Chinese imports, but rather U.S. access to the Chinese market. The U.S. and China are in the midst of renegotiating an agreement which stipulates how foreign films can be imported into China. The agreement, which expired last year, currently allows for 38 films per year. The U.S. and the U.S. media companies want to increase that total. A trade war with China could scuttle any loosening of import quotas.

Metals And Mining: A Moderate, Indirect Effect On Sectors In China

May Zhong, Melbourne (61) 3-9631-2164; may.zhong@spglobal.com

Donald Marleau, Toronto, +416-507-2526; donald.marleau@spglobal.com

We believe there could be an indirect moderate impact on China's metals and mining sector if there are constraints on the country's exports to the U.S. from reduced demand for raw materials. This is because about half of China's exports to the U.S. are from products that draw heavily on metals as raw material--mainly machinery, home appliances and, to a lesser extent cell phones and computers. Foreign direct investments from U.S. into this sector are modest and the sector does not depend on imports from the U.S.

Midstream Energy Oil And Gas: Only Muted Effects

Mike Llanos, New York (1) 212-438-4849; mike.llanos@spglobal.com

Thomas Watters, New York (1) 212 438 7818; thomas.watters@spglobal.com

The new tariffs are unlikely to have much of an effect on U.S. midstream and oil and gas companies. Rather these companies' main area of concern for midstream issuers is the tariff on steel for pipeline construction. Steel could account for about 20% of the cost of a pipeline. While this will increase costs and capital spending budgets, overall we don't think it will be material to credit ratios or ratings. The midstream companies do not sell to China and their products (gasoline, distillate, etc.) are global, so any Chinese government "buy American last" stance is unlikely to have much impact. S&P Global Platts estimates that the costs for exploration and production companies that utilize oil country tubular goods (tubes used in oil and gas production) will increase by a de minimis 3% overall.

Retail: U.S. Retailers Could See Margin Pressures

Makiko Yoshimura, Tokyo, (813) 4550-8368; makiko.yoshimura@spglobal.com

Robert E Schulz, CFA, New York (1) 212-438-7808; robert.schulz@spglobal.com

The U.S. retail sector does have a material supply chain exposure to soft and hard retail imports from China, and we would expect retailers will attempt to pass the additional costs on to the U.S. consumer. This is unlikely to be fully successful and could lead to margin pressure. It remains to be seen what consumer-focused imports are actually the subject of U.S. tariffs--that will be the real focus.

For the Asia-Pacific retail sector, the direct impact of the impending U.S. tariffs is negligible. However, a trade war that sapped China's consumer sentiment, or slowed growth, would hurt retail sectors there, as well as in Japan and Korea. In the latter two countries, inbound Chinese tourists have materially boosted the earnings of department stores in recent years.

The U.S. retail sector has a material supply-chain exposure to soft and hard retail imports from China.

Technology: : U.S. Buyers May Have To Pay More

David Tsui, New York (1) 212 438 2138; david.tsui@ spglobal.com

Raymond Hsu, CFA, Taipei, (886) 2 8722-5827; raymond.hsu@spglobal.com

Chinese technology companies have material revenue exposure from exports to the U.S. That said, in the near-term, the new tariffs might not reduce sales because there are no immediate alternatives to the assembly capacity in China. Consequently, U.S. buyers may have to pay more. On the other side, retaliatory tariffs by China could affect the cost of U.S. imports, which for Chinese technology companies, we regard as material. For materials or components with alternative sources, the impact from the retaliatory tariff could be cushioned, while for components with little alternatives (e.g. central processing units), a Chinese company would have to absorb the full tariff cost. In terms of foreign direct investment, the investment either way does not appear to be significant. A possible remedy could be adding a foreign intermediary (i.e. Hong Kong) in any transaction involving the U.S. and China to bypass trade restrictions or tariff concerns.

Higher production costs and product prices stemming from the tariffs could weaken demand for devices, electronics manufacturing services, components, and other intermediate goods from technology companies in Taiwan, Korea, and Japan. However, we don't expect this to materially weaken those companies' cash flow metrics at this stage, given their generally high profitability and business diversity.

For some U.S. hardware and semiconductor corporates, there is a material cost of good sales dependency on technology imports from China. However, on the low-tech end, the supply sourcing could migrate to lower-cost geographies. On the revenue side, a number of U.S. corporates (e.g. 20% of Apple's revenue is from China) have a material exposure to technology exports to China. What could be more impactful than China imposing tariffs on U.S. goods would be the Chinese government dissuading the purchase of U.S. goods, particularly consumer discretionary rather than more mission-critical technology.

Telecommunications: Domestic Focus Acts As A Shield

Allyn Arden, New York (1) 212 438 7832; allyn.arden@ spglobal.com

JunHong Park, Hong Kong, (852) 2533-3538; junhong.park@spglobal.com

We don't expect any ratings impact on Chinese and other Asia-Pacific telecom operators from the proposed tariffs, given the domestic consumption-oriented and relatively inelastic nature of the telecom industry. Similar to Asia-Pacific, we don't expect these tariffs to affect U.S. telecom operators' credit quality given their predominantly domestic focus; however, any material tariffs on telecom equipment imports could add materially to capital funding demands. For example, U.S. telecom providers could be indirectly affected (even if they don't directly import finished goods from China) if their network hardware providers' costs increase, unless they are able to find alternative providers. In the medium term, a greater risk to the sector remains any further escalation in trade controls that precipitates a decline in business and consumer confidence and demand.

Transportation: U.S. Freight Companies Could Feel A Small Sting

Graeme Ferguson, Melbourne, (61) 3 9631 2098; graeme.ferguson@spglobal.com

Philip Baggaley, New York +1 212 438 7683; philip.baggaley@spglobal.com

Reduced trade between the U.S. and China would reduce traffic for U.S. freight transportation companies, though we don't expect the effect to be substantial. For example, Burlington Northern Santa Fe railroad carries grain from the U.S. Midwest to ports in the Pacific Northwest for export to China. All of the large U.S. railroads carry intermodal containers of finished goods and other cargo from China. Companies that lease marine cargo containers and chassis that carry them from ports by truck would likewise be affected. Some of these traffic flows may be redirected to other sources (e.g. from other countries in Asia), but the net effect is still very likely negative.

U.S. transportation companies with operations in China are vulnerable to fallout from a trade war. FedEx Corp. and United Parcel Services Inc. (UPS) both have growing operations to and within China (the proportion of revenues is not disclosed), and they rely on permission from the Chinese government to operate. FedEx executives warned on the company's March 20 earnings call that the company would "advocate against any move towards protectionist trade policies that could slow economic growth and...undermine all the positive impacts from the tax reform legislation." Although we do not predict drastic measures against the package express companies (which to some extent facilitate Chinese exports), Chinese authorities could pressure them to cede more control or business to domestic partners or competitors over time. Another risk is that authorities hamper their plans to expand in China.

Global container and freight volumes could be disrupted. This comes just as the shipping sector's long-awaited recovery has started to gather momentum. Shipments of steel and aluminum products may suffer some displacement, but overall volumes will likely remain steady. U.S. steel production relies on scrap, which limits the impact on seaborne commodity trade. The biggest impact to dry-bulk shipping will likely be from reduced Chinese demand for raw materials. However, the tanker market is likely to remain steady but sensitive to output curbs by OPEC countries.

Chinese airlines have been seeking to capture a greater share of air travel between the U.S. and China. If trade tensions help them achieve this goal, we believe this could cause a noticeable but not large hit to some U.S. airlines' earnings. The large U.S. airlines, in particular United Continental Holdings Inc. and Delta Air Lines Inc., which operate routes to China, do not disclose the proportion of their revenues that these routes generate. We estimate these revenues are less than 10% of their total--but these routes tend to be among the more profitable.

U.S.-China air travel is governed by a bilateral aviation treaty that somewhat limits the number and destination of flights. We would not expect any move to renounce this treaty, but Chinese authorities could make operations more difficult and less profitable by, for example, denying requests by U.S. airlines to fly at optimal times during the day. Also, any populist Chinese backlash against the U.S. could shift some bookings from U.S. airlines to their Chinese competitors, or simply reduce travel to the U.S. These potential reactions would fit well into the strategic plans of Chinese airlines to capture a greater share of routes. Asia-Pacific airlines have also recently been dealing with overcapacity, which could worsen if global trade in goods and services is disrupted.

Transportation Infrastructure: Limited Effects On U.S. Ports

Kurt E Forsgren, Boston (1) 617-530-8308; kurt.forsgren@spglobal.com

Abhishek Dangra, Singapore, (65) 6216-1121; abhishek.dangra@spglobal.com

For U.S. ports, we had previously highlighted several key risks including tariffs or changes in U.S. trade policy. We believe most of the direct effects from announced tariffs will be limited. Larger credit concerns would be the potential for retaliation that escalates into a trade war. We believe this would depress trade volumes, hurting port revenues and credit quality. U.S. port operators operate as enterprises with covenants that require other revenues be increased or expenses decreased to generate positive cash flows, and many larger container ports benefit from minimum annual guarantees from their largest shipping line tenants. However, in our view, a significant disruption in trade could impair or limit management's ability to make adjustments or enforce provisions in existing terminal operating agreements.

For Asia-Pacific, we believe overall impact of the announced tariffs would be limited. Contained trade tariffs will have limited impact on port traffic, though a protracted trade war could affect global trade. However, for most Asia-Pacific ports, trade volumes are predominantly within the Asia-Pacific region, limiting the impact of changes in global trade volumes. Origin and destination ports in the region (such as India and Indonesia) are expected to have greater resilience to tariffs, but some trans-shipment hubs such as Singapore may be more affected.

Utilities: No Significant Immediate Effects

Todd A. Shipman, CFA; Boston +1 617 530 824; todd.shipman@ spglobal.com

For U.S. utilities, potential tariffs on industrial machinery wouldn't be significantly affected. The utilities industry imports much more from Japan and Korea, albeit Chinese firms do provide components like heat exchangers, air condensers, and even steam generators.

Related Research

- Economic Research: What Will Be The Likely Impact Of U.S. Steel And Aluminum Tariffs On Latin America?, March 20, 2018
- S&P Global Economists Release A "Field Guide" To A Potential Sino-U.S. Trade War, March 19, 2018
- Credit FAQ: Japan's Top Steelmakers Can Withstand U.S. Tariffs And Increasingly Aggressive Investments, March 12, 2018

- Global Trade At A Crossroads: U.S. Steel And Aluminum Tariffs Raise Risk Of Retaliatory Spiral, March 9, 2018
- Global Trade At A Crossroads: U.S. Steel And Aluminum Tariffs Will Likely Have Small Direct Impact But Risk Larger Knock-On Effects, March 9, 2018
- Trump Tariffs Forge Better Credit Quality For U.S.-Based Steel And Aluminum Producers With A Protectionist Stance, March 2, 2018
- De-Globalization Could Disrupt U.S. Supply Chains, May 30, 2017

*The views expressed in the Macroeconomic Impact On China box are those of S&P Global Ratings' economics team. While these views can help to inform the rating process, sovereign and other ratings are based on the decisions of ratings committees, exercising their analytical judgment in accordance with publicly available ratings criteria.

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Contact List

PRIMARY CREDIT ANALYST

David C Tesher
New York
(1) 212-438-2618
david.tesher@spglobal.com

PRIMARY CREDIT ANALYST

Terry E Chan, CFA
Melbourne
(61) 3-9631-2174
terry.chan@spglobal.com

PRIMARY CREDIT ANALYST

Paul R Draffin
Melbourne
(61) 3-9631-2122
paul.draffin@spglobal.com

PRIMARY CREDIT ANALYST

Christopher Lee
Hong Kong
(852) 2533-3562
christopher.k.lee@spglobal.com

SECONDARY CONTACT

Jose M Perez-Gorozpe
Mexico City
(52) 55-5081-4442
jose.perez-gorozpe@spglobal.com

SECONDARY CONTACT

Paul Watters, CFA
London
(44) 20-7176-3542
paul.watters@spglobal.com

GLOBAL CHIEF ECONOMIST

Paul F Gruenwald
Singapore
(65) 6216-1084
paul.gruenwald@spglobal.com