Trade Tensions: A Game Changer For Europe's Car Industry?

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Key Takeaways

- Trade tensions between the U.S. and China, focused on autos, is one of the negative factors already weighing on the earnings of carmakers globally. Fiat Chrysler, Daimler, Ford, and GM have announced they would miss their earnings targets for 2018.
- The threat of a U.S. 25% tariff on cars sourced in the EU and imported into the U.S. would hurt all automakers, but the severity depends on their production flexibility and sourcing options. Among EU-based automakers, we believe JLR and Volvo have fewer options to mitigate this risk.
- The escalating trade tensions add to concerns S&P Global Ratings has already expressed about the industry's profitability and earnings linked to the transition to electric mobility, full connectivity of cars, and autonomous driving.

In the latest salvo in escalating trade tensions, the Trump administration is preparing to unveil a fresh round of tariffs targeting about $200 billion in Chinese goods. The tariffs may not significantly directly impact auto shipments because they were previously the object of a 25% U.S. levy on China-sourced vehicles imported into the U.S. in July, but they reduce hopes for a policy reversal and add further geopolitical risk. The 25% levy hit the nexus of the global car industry. In a retaliatory move, China raised import tariffs for U.S.-made cars to 40% from 15% on July 6. And then, on Aug. 23, the U.S. president threatened 25% tariffs on EU-sourced cars.

The trade tensions and the threat of more have left automakers reeling. Non-Chinese automakers, like those in the EU, have heavily invested for years into raising production capacity in China--the world's largest auto market--not only to serve strong local demand but to use the country as an export hub. What's more, the worsening Chinese economic outlook and depreciation of its currency have clouded growth prospects for the country's auto market, which looks far less favorable than its solid first-half performance. For two consecutive months in a row, passenger car sales in China have declined (5.3% in July and 4.6% in August), bringing year-to-date unit sales growth to 2.6%, which is within the bands of our full-year forecast for China (1.5% to 3.5%) for 2018.

Because China accounts for roughly one-third of global annual light vehicle sales, a weakening Chinese market is bad news for the automotive industry in general, already confronted with a stagnant U.S. market and underperformance in Argentina, Turkey, and Iran. Beyond concerns about sales growth in the region, trade tensions are disrupting the role of China in global logistics for carmakers. Strategic sourcing as a means of securing competitive advantage for global automakers is at stake for those that use or had planned to use China as an export hub for specific models, like Volvo Cars, General Motors, and Ford. These manufacturers are likely to revisit their global production and supply chain strategies toward, presumably, a more localized footprint, which we believe would weigh on costs, at least during an adaptation phase. How about Europe as an export hub? That's now even more unlikely since President Trump threatened tariffs against the EU as well.

Table

So Far, Only U.S. Performance In The Chinese Passenger Car Market Has Taken A Hit

	Aug-18			Jan.-Aug. 2018		
	Units (000')	Share (%)	Year on year change (%)	Units (000')	Share (%)	Year on year change (%)
Chinese brands	68.41	38.22	-11.06	643.9	42.39	0.81
Japanese brands	35.74	19.97	7.23	277	18.23	4.28
German brands	42.42	23.7	5.44	327.75	21.57	8.16
American brands	19.15	10.7	-22.66	161.85	10.65	-10.17
Korean brands	9.1	5.08	19.74	69.23	4.56	19.98
French brands	1.98	1.11	-37.14	23.23	1.53	-5.45
Total passenger cars	178.99		-4.55	1519.3		2.6

Source: China Association Of Automobile Manufacturers.

At first glance, a 25% tariff on EU-sourced cars to the U.S. should primarily hit brands with no U.S.-based production. However, we believe it would have a negligible impact on price-insensitive luxury brands like Porsche, Lamborghini, or Ferrari, even though none has U.S.-based production facilities.

On the other hand, we see a significant impact for premium brands with no U.S.-based production like Jaguar Land Rover. An import tariff on cars to the U.S. would likely hit one-fifth of its global sales volumes. JLR's positive performance in the U.S. (3.6%) partly mitigated a 10.5% decline of units sold in Europe in the year to date in August. The U.K. automaker, which competes globally with BMW, Mercedes, Lexus, Porsche, and Audi may find it hard to pass through import tariffs on prices, in a market where ever-growing incentives since 2013 are no longer perceived sufficient to support unit sales growth. In addition, with the shift of U.S. consumer preferences toward SUVs, all new models introduced this and next year will focus on that same segment, raising competitive pressure.

Sweden-based Volvo Cars might not be better off than its U.K. peer, at least in the short term. Its factory in South Carolina is to start production late this year, but was conceived to be the global production home of one of Volvo's new sedans, a style that U.S. consumers increasingly shun. As Volvo's growth is driven by SUVs, in particular by the compact SUV XC50 sourced in China, Volvo would be exposed to U.S. import tariffs on what would be a popular model there, sourced out of China and potentially out of Europe as well.

Despite an already flexible production structure well distributed between the U.S., China, and Europe, BMW's profit guidance remains exposed to the risk of additional escalation in the trade tussle. For instance, BMW's U.S.-sourced SUVs exported to China are now subject to China's retaliatory 40% tariff. We expect a price increase on U.S.-sourced imports to China to somewhat lessen margin pressure, but not a substantial relocation of production, from what we understand. Daimler has already issued a profit warning to reflect the negative impact of SUVs produced in Alabama for export to China on both volumes and margins.

Volkswagen's exposure differs from that of its German peers as its production has become increasingly localized and tied to sales. Deliveries in China are almost entirely locally sourced, while units imported into the U.S. represent a low single-digit percentage of annual deliveries and are sourced mainly from Mexico, where VW has a strong footprint. The effect of the new bilateral agreement between the U.S. and Mexico, which is to replace NAFTA (with or without the involvement of Canada) is hard to estimate at the moment. In any case, our view for the car market is that the most critical issue is the requirement for 40% of assembly to be subject to a minimum labor rate of $16 an hour, which is higher than the average salary in Mexico. In addition, it appears free trade would be capped at 2.4 million tariff-free units imported from Mexico (with a 25% import duty to be applied after that threshold is reached).

Overall, although not disruptive per se, an escalating trade war between the U.S. and Europe would generate unnecessary costs that the European industry had hoped to earmark for compliance with its stringent environmental targets, which remain a challenge for most EU-based automakers. Only a few of them have managed to lower average CO_2 emissions in 2017 (Toyota, FCA, BMW) as a result of both growing consumer preferences for high-emission SUVs and petrol-fueled vehicles instead of CO_2-efficient diesels. A potential trade war adds to the concerns we already expressed about the industry's profitability, taking into account the high costs of the transition to electric, connected, and autonomous vehicles (see "Industry Top Trends 2018: Autos," published on Nov. 15, 2017). Furthermore, these tensions come at a time when the industry peak is behind us, despite overall supportive global macroeconomic conditions for the time being.

This report does not constitute a rating action.