Wine And Dairy Soft Targets In Latest US-EU Trade Dispute

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Key View:

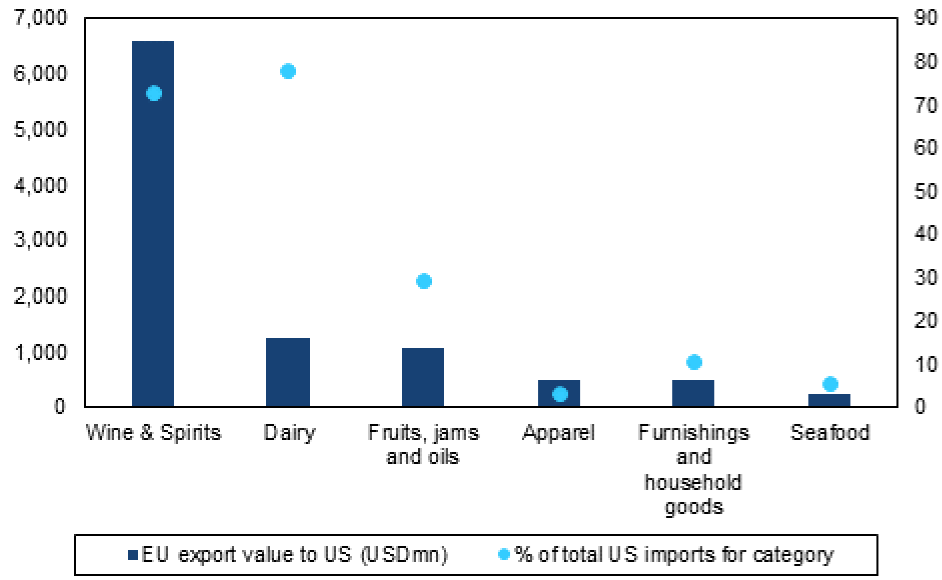
- US threats to impose tariffs on USD11bn worth of EU goods in recompense for European subsidies for Airbus risks increasing tensions between the two economic powers.
- Consumer goods, including food and drink, represent soft targets in trade disputes and designed to apply political pressure while limiting broader impact on the consumer.
- Wine and dairy are the most exposed food and drink sectors for the EU, with over 75% of total US imports in these categories originating in the block.
- he level of substitution available for both dairy and wine in the US means that the US consumer will not be out of pocket from any tariff increase. Imported wine and cheese are traditionally high price point products and so the consumer for these will reside in the higher income brackets and be able to withstand any increase in price before drastically reducing their consumption levels.

On April 8, the US Trade Representative announced a preliminary list of EU products that it is considering targeting, in retaliation for purported damage done to the US aircraft manufacturing sector by European subsidies for Netherlands-based **Airbus** (see: *Boeing/Airbus Subsidy Spat Heightening Risk Of EU/US Trade War,* April 10 2019). The list provided contains USD11bn worth of EU exports to the US, extending beyond the civil aviation sector to include food and drink items such as wine (USD4.4bn), dairy products (USD1.3bn), fruits/jams (USD1.0bn), and seafood (USD220mn), among other consumer goods (see chart below).

Our core view is that the Trump administration is using these tariff threats to put pressure on the EU ahead of planned trade negotiations over industrial tariffs and non-tariff barriers. Indeed, on April 15, one week after the list of tariffs was released, EU ministers formally approved plans to conduct trade talks with the US. However, there is still disagreement between the US and EU over whether agricultural products should be covered in any trade discussions. The current negotiating mandate given to the European Commission does not permit talks on cutting tariffs on agricultural goods contrary to US wishes. There is therefore still some risk that these tariff threats re-ignite wider US/EU trade tensions, including the US' threat to implement a 25% tariff on EU auto imports.

Wine And Dairy The Biggest Worry

EU-US Trade, export values (USDmn) and % of total US imports



Note: Categories only include products listed as targets by US Trade Representative on April 8 2019. Source: Trade Map, Fitch Solutions

Consumer goods carefully chosen as symbolic targets. In June 2018, the EU imposed its own tariffs on USD3.2bn worth of US goods in retaliation to president Donald Trump's decision to impose a 25% tax on imports on steel (see: *US Consumer Goods The Focus Of Retaliatory Tariffs*, June 5 2018). In particular, the EU targeted products produced in Republican areas of the US and other symbolic brands associated with 'Americana' such as bourbon whiskey, orange juice and peanut butter (see *'US Consumer Goods The Focus Of Retaliatory Tariffs'*, June 5 2018), with the aim of putting political pressure on the government and senators from key Republican states. This latest development in US-EU trade tensions represents a similar tactic from the US government, with proposed tariffs targeting products that are synonymous with the identity of a particular EU country or region including champagne, snails, olive oil, and specific varieties of cheeses (e.g. Roquefort, Gouda, Gruyere).

Limited impact on US consumers. While the level of tariffs has yet to be confirmed by the US, we believe the average US consumer will be shielded due to the availability of substitute products and the premium positioning of European food and drink products in the market. Most of the products listed can be considered discretionary items, as opposed to everyday staples, and those typically purchasing the products will have sufficiently high disposable incomes to accept a nominal price rise. Suppliers of European products impacted will also look to limit passing on higher costs to consumers where possible in order to maintain competitiveness. Strategies likely to be utilised are, bringing forward orders before tariffs rise or taking a short-term hit to margins, with the hope that trade tensions will be resolved sooner rather than later (these are tactics US companies have used when navigating increased tariff environments during trade disputes and would likely be adopted by EU producers, for more information, please see : *How Are US Consumer Companies Responding To International Tariffs?*, 11 October 2018).

Wine

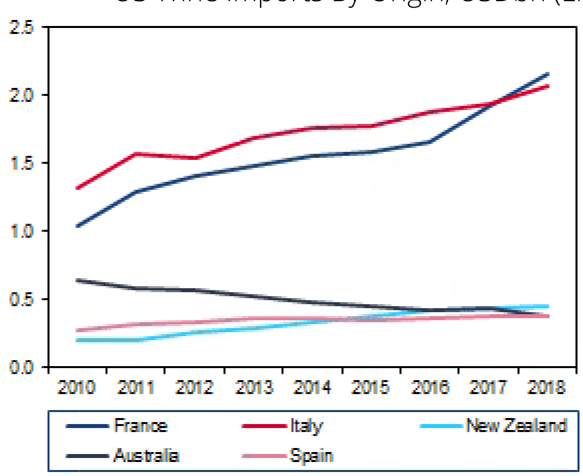
Value Of Targeted Products: USD4.4bn

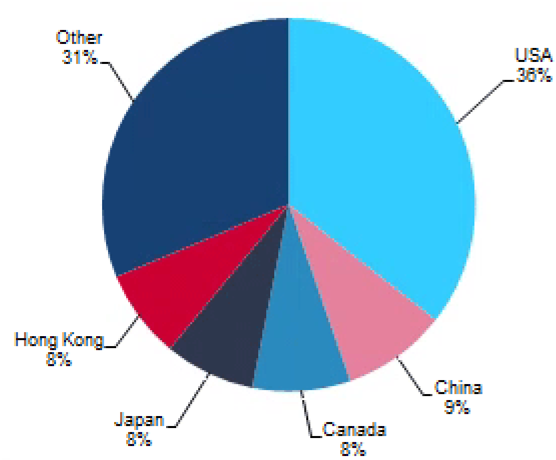
EU exporters most exposed: France, Italy, Spain

Global wine exports from EU member states totalled USD26.6bn in 2018, with the US by far the largest external trading partner (36% of these exports were bound for the US in 2018). While overall alcohol consumption in the US is declining, wine consumption continues to rise, buoyed by its perceived health benefits and premium, sophisticated image as consumers trade up on price points. This has fuelled demand for imported wine, particularly from France, which has seen exports to the US rise by 36% since 2015 on the back of the increasing popularity of sparkling wine and rosé (*see 'Rosé Revolution More Than Just A Fad', July 19 2017*). We forecast wine consumption in the US to rise by an annual average of 3.5% over 2019-2023, reaching 4,622mn litres by 2023, and expect France to be a major beneficiary of this trend.

US A Key Market For EU Wine Producers

US Wine Imports By Origin, USDbn (LHC) & EU Wine Exports, % of Total (RHC)





Source: Trade Map, US Census Bureau, Fitch Solutions

Tariffs more likely to hit suppliers, not consumers. If the US proceeds with raising tariffs on European wine imports, we believe US-based wholesalers and distributors, rather than consumers, would carry most of the burden, by absorbing cost increases and accepting a lower margin - at least over the short-term (6-12 months). Margins in the US wine market are not as tight as in Europe, where there is greater competition and retailers price wine more aggressively. Moreover, current US tariff rates on EU wine imports are fairly low (USD0.05 per bottle of still wine, USD0.14 for sparkling wine, compared to the EU which charges USD0.11 to USD0.29 per bottle), and so it would be relatively easy to limit passing on cost increases to the US consumer in the short term. It would require a substantial tariff rise (e.g. over 100%) for retail prices of wine to be impacted to such a level that would hurt demand for European wine. Depending on how long trade tensions persist, there is a longer term risk that importers choose to import less quantities of European wine, but in the short term we would not expect a drastic decrease in imports.

European wines positioned at the lower-end of the US market are most exposed, as discerning drinkers buying higher priced wine are less likely to be deterred by any price increase. Given that tariffs are applied according to the level of alcohol content, and not the actual cost of the wine, any increase in tariff will also disproportionately impact a bottle of wine at the lower end of the market (an imported wine with alcohol content of 13% receives the same tariff rate regardless of whether the bottle is worth USD5 or USD50). In this case, the threat of tariffs poses a greater risk to Spanish and Italian wine exporters, as they tend to be more expensive than French wine, which has a premium price point. US wine producers such as E. & J. Gallo, which paid USD1.7bn for 30 lower-end wine brands from Constellation Brands in April 2019, would be well-positioned to take advantage, as price-sensitive US retailers and consumers would likely substitute a bottle of Spanish or Italian wine for one that is domestically produced or from a New World market (Australia, Chile, South Africa).

Limited scope for US winemakers to boost exports to EU. In the wake of a visit to France in November 2018, President Trump used twitter to complain about the imbalance of wine trade between the US and France, claiming that high tariffs make it "very hard for the U.S. to sell its wines into France." While the US runs a USD3.9bn trade deficit in wine with the EU, we believe this is more a reflection of the longstanding reputation of Europe as a quality wine-producing region than any protectionist measures by the EU. European wine-producing countries such as France or Italy have always primarily consumed their own wines so the market for US wine, although growing, will remain small. Whereas in the US, domestically produced wine has less of a cultural influence, and millennial consumers are increasingly attracted to the exoticism and diversity of international offerings.

Dairy Products

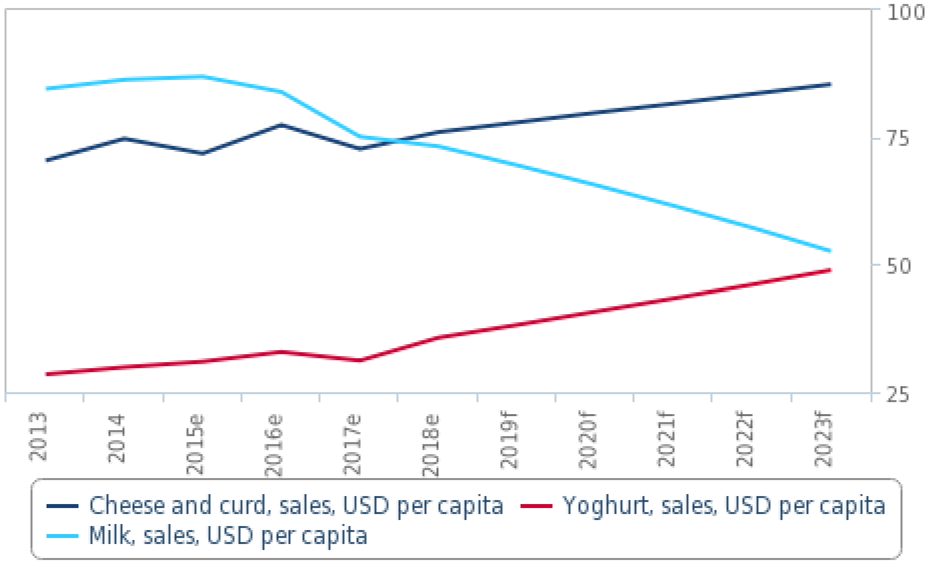
Value Of Targeted Products: USD1.3bn

EU Countries Most Impacted: Ireland (10.2% of total dairy exports), Italy (9.7%), Spain (13.6%)

US consumers are gaining a taste for value-added dairy products such as speciality cheeses and natural yoghurt, as they cut back on sugar and favour protein-rich diets. We forecast spending on dairy products in the US to rise from an estimated USD87.2bn in 2018 to USD95.5bn by 2023, driven specifically by cheese (3.1% CAGR) and yoghurt (7.3% CAGR) while regular milk consumption falls (see chart below). Growing demand for higher quality dairy products in the US has boosted demand for European cheese in particular, as there is a perception that these brands offer an authentic, healthier alternative to mass-market processed cheese traditionally produced domestically. The EU makes up 78% of all dairy products imported by the US, with Italy (USD341.6mn exported in 2018), France (USD241.7mn) and Ireland (USD231.8mn) among the top five trading partners. Cheese and curd represents over three quarters of all EU dairy exports to the US, with the total value surpassing USD1bn in 2018, up 9.9% y-o-y.

Consumers Gaining Taste For Premium Dairy Products

US - Dairy product spending by category



e/f = Fitch Solutions estimate/forecast. Source: National Statistics, Fitch Solutions

EU dairy exports are focused on premium cheese offering, which are difficult to substitute. Similar to wine, most of the EU's dairy exports to the US are positioned as a luxury within the American market. Given the premium price point compared to more typical cheese sold in US supermarkets, we believe demand for specialty cheese from Europe will prove resilient to the impact of higher import tariffs, as the profile of the US consumer typically purchasing these products would likely be affluent enough to withstand a price rise. Moreover, there is no direct substitute or cheaper alternative to European cheese varieties such as Roquefort, Pecorino, Gouda and Gruyere which have been targeted for higher tariffs.

What's Next:

While the impact of tariffs on USD11bn worth of EU exports to the US (representing 2.4% of total EU exports to the US) would be somewhat limited in the short term, should this spiral into a wider tit-for-tat trade war, it would be far more damaging. With the US the largest destination for EU exports outside of members of bloc, tariffs would further weigh on the EU's already struggling manufacturing sector.

Any action by the US is still several months away, with a public hearing set for May 15, and a written comments period ending May 28. The US is also waiting for a WTO arbitrator to rule on how much retaliation it can apply in respect of the Boeing-Airbus dispute. As always, we will be monitoring developments closely.