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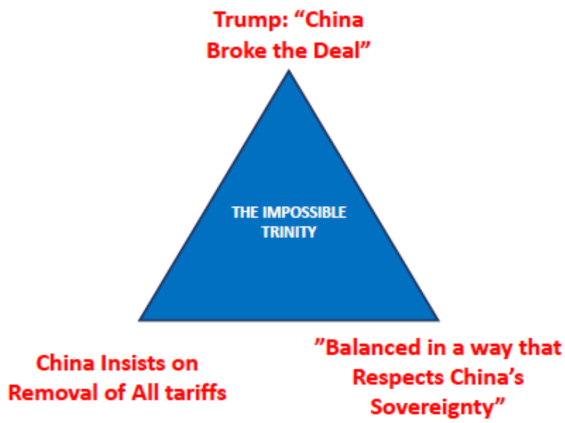
Markets in High Resolution

U.S.-China Trade: Strategies and Roadmap

The Impossible Trade Deal Trinity

I'm a big advocate of the "Impossible Trinity" as a framework for assessing China's economic stresses and challenges. It's also a great framework for assessing U.S.-China trade dynamics!

I present "The Impossible Trade Deal Trinity:"



The U.S. does not trust China to keep its word, particularly after it allegedly "broke the deal." Ergo, any deal MUST involve either an onerous unilateral enforcement mechanism or some process of China "earning" a reduction in tariffs through good behavior, as unilaterally determined, over some time frame.

But China has announced, in no uncertain terms, that removal of all tariffs is a sine qua non, and that any deal must be "balanced in a way that respects China's sovereignty", which precludes an onerous one-way enforcement mechanism.

China has laid down red lines that make a deal politically impossible. The General Secretary of the Chinese Communist Party does not lay down red lines, allow foreigners to cross them, and remain in that job for long.

These trade negotiations are all over but for the shouting.

Check Your Priors: "Trump Wants a Deal"

While the idea that "Trump wants / needs a deal' has become media mantra, we should not discount the possibility that a full slate of tariffs against China is where President Trump has wanted to end up all along. In fact, I believe this to be the case.

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This from the Washington Post yesterday:

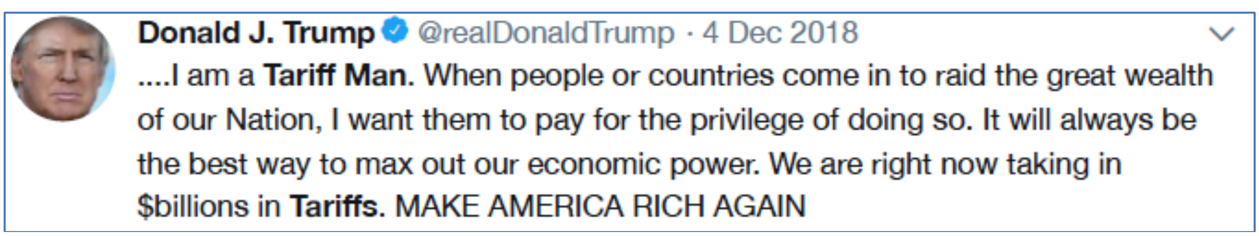
> *Stephen K. Bannon, the former White House chief strategist who once advised Trump on trade, said in an interview Tuesday that Trump's outlook on trade has not changed since they first met in 2010 at Trump Tower, and argued that it will be hard for any adviser to convince him to change. "Back then, he was watching Dobbs, reading the New York Times, following everything on China," Bannon said. "It's at the core of who he is."*

If President Trump was in fact determined to begin to disengage from and isolate China, what might the approach look like? He certainly wouldn't announce at the start of the process "my ultimate goal is to carve China out of the global trading system." The idea would be to decouple with as little dislocation to the U.S. economy as possible.

This would require sequencing the imposition of tariffs so as to smooth out the effect on U.S. business and consumers. Tariffing the imported products with the most elastic demand characteristics first would make sense. Perhaps one might signal some risk of decoupling so as to motivate supply-chains exodus, but not so much as to spook markets or send the Chinese into full-on aggression. Supply chain movements would open alternative sources supply to smooth the way for eventual tariffs on products with less elastic demand functions initially.

In the meantime, why not make a big show of trying to "make a deal?" That could keep the Chinese off balance, and highlight to both political rivals and other trading partners that China ultimately doesn't have any intention of behaving according to the accepted norms of international trade, thereby building support for the disengagement effort.

Additionally, you might periodically pitch the benefits of tariffs as source of revenue. I don't know, something like this maybe:


Donald J. Trump @realDonaldTrump · 4 Dec 2018
....I am a **Tariff Man**. When people or countries come in to raid the great wealth of our Nation, I want them to pay for the privilege of doing so. It will always be the best way to max out our economic power. We are right now taking in $billions in **Tariffs**. MAKE AMERICA RICH AGAIN

Electoral Politics

The consensus views a "sellable deal" as the politically safe strategy for President Trump. I've thought this incorrect all along.

A tariff war with China offers Trump a highly effective wedge issue, framing Biden (the likely

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opponent) as the globalist, complicit in "letting China get away with ripping us off for all those years."

On the other hand, a trade deal renders China a non-issue in 2020 – at best. If Trump makes a deal, will the trade deficit have corrected meaningfully by next summer? Not likely. Will the media then be applauding China's newfound openness and some grand "reform" program underway? Also, not likely. Where's the concrete achievement here? What's the rallying cry?

Worse, a deal could prove a political trap. If China begins overtly cheating on the deal in 2020, what is Trump then to do: allow China to play him for a fool or blow up the deal (and markets) just before the election?

Tariffs on China put the Democrats in a pickle. They're either in favor of Trump's tariffs or of the status quo ante of China "running roughshod over U.S. workers and businesses." There is no political middle ground. While the neoliberal Twitterati may criticize Trump for abandoning TPP or not "working better with allies," think-tank talking points like these hardly make for inspiring electoral rally calls.

Lastly, no matter what Trump does, the U.S. trade deficit is unlikely to have been materially reduced come election time, absent a recession. Rather than having reduced the deficit, Trump can instead tout the extraction of $100bn in revenue from a strategic competitor for the privilege of trading with the U.S. (And no, the media is not going to beat him at the PR battle over "who pays the tariffs.")

But What About the Economic Fallout?

I covered this in depth in Trade War Costs (11/11/18)

- The costs of disengagement must be viewed relative to the *realistic alternative* in which China remains an unreformed, authoritarian, centrally-planned regime, not relative to some utopian fantasy of a harmonious, economically efficient globalized economy.

- We're in this "squabble" because China is highly closed to U.S. businesses. What the U.S. "has to lose" is macroeconomically insignificant.

- After accounting for demand elasticities, the effect of blanket tariffs is equivalent to a 40bp consumption tax. With the effect spread over 18-24 months, we should expect no more than a 20bp impetus to per annum core PCE inflation.

- Exports to China total 0.6% of GDP, much of that in the form of fungible commodities which can easily be sold into other markets

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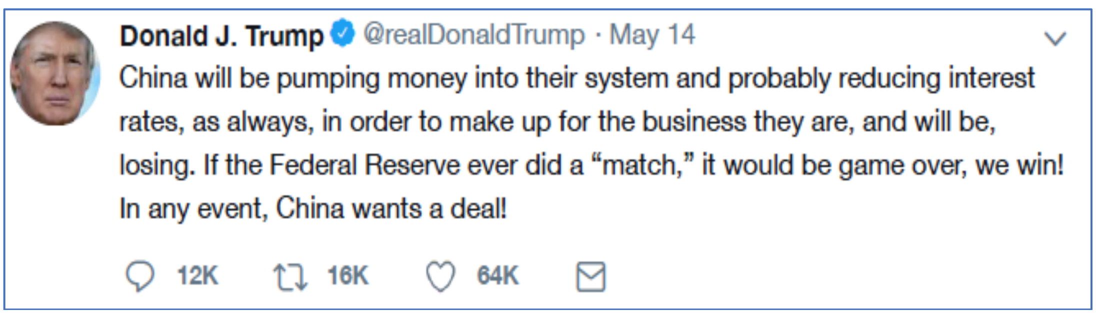
- China-sourced U.S. corporate revenue is estimated at $300bn per annum, or ~2% of total U.S. business revenue.

- A tariff war could have an outsized effect on equity valuations relative to the macroeconomic effect, given that the bulk of the China exposure is with large multinationals. Further, some stocks may have embedded extrapolative expectations of Chinese consumption growth that will now be discounted. However, if the macroeconomy does not dislocate, there is no reason U.S. equities should.

- A sharp RMB devaluation could produce a global deflationary shock, but mitigating factors should be kept in mind:

    - The perceived correlation between RMB devaluation and "risk-off" is largely spurious: past episodes were driven by deflationary events *in the Dollar realm*. A China-specific episode may be less globally damaging.

    - The Fed could easily halt an episode of deflationary EMFX devaluations with a rate cut or two, which is what this is about:



<u>Agriculture Exports are a Red Herring</u>

U.S. Agricultural exports to China totaled $23.8bn in 2017, 52% of which was soybeans. No other agricultural commodity totaled more than 6% of total exports to China, so the rest is a potpourri.

Commodities are a particularly poor vehicle for Chinese retaliation. If China shifts all its soybean demand to Brazil, the Brazil-U.S. bean basis will widen until other soybean buyers find it more economical to buy the relatively cheapened U.S beans.

The $30bn in borrowing authority the Administration has immediately available via the Commodity Credit Corporation should be sufficient to compensate farmers many times over for

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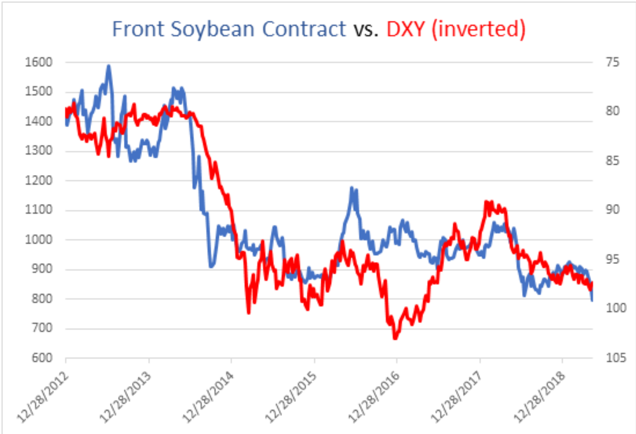
any price dislocations resulting from Chinese retaliation.

While "free market" Republicans will moan about subsidies, no U.S. politician is going to make a strong stand against supporting farmers.

Furthermore, distress in the farmland gives the President a potent weapon in his battle to keep the Federal Reserve from deflating him out of office. As detailed in Fed Memo: You Had One Job (12/18/18), commodities of all stripes were victimized by the Fed's stealth deflation in 2014-15. Here's beans vs the Buck (the Dollar Index inverted):



"The establishment" just beat back a Trump candidate for a Fed Governorship who advocated a policy of stabilizing commodity prices. I wouldn't be at all surprised to at some point see a Presidential tweet linking the issues of Fed policy, the farmland and the need to confront China.

The "Dance" May Continue for a While

There is a common criticism of President Trump that he "has no plan." This is somewhat justified, in that what he is endeavoring to do (if I'm right on what he sees as the ultimate end game) is inherently unplannable. It's a multi-dimensional game which he's navigating as he goes.

December's Buenos Aires summit is a prime example. Tariffing China would have been untenable if the Fed has remained stubbornly committed to hiking rates in 2019. With Jay Powell threatening to derail the economy, Trump needed to create a potential off-ramp with China.

Here we are 5 months later and the President's Fed problem has been solved, the markets and economy are faring well, and any effect of the previously enacted tariffs has been fully absorbed by now. Xi's "walk-back" on the deal presented the perfect pre-text to re-engage the battle, and

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it just so happened to be perfectly framed by Joe Biden's remarks that "China is not a competitor for us."

But from here, there is no reason for the U.S. to oppose another 4-5 month negotiating dance to allow markets to heal and for the newly-enacted tariffs to work their way through the system. But why would the Chinese play along?

What is China's Strategy?

It not clear that Xi Jinping has a tactical plan either. He does of course have a strategic objective, which has been laid out for us through the Belt & Road initiative, Made in China 2025 and other pronouncements of his visions for China's place in the world. There is no place in Xi's vision for letting Bob Lighthizer tell him how to run his economy.

The last-minute pull-back on the deal was probably China's strategy all along. With no intention of ever giving ground, tell the U.S. what it wants to hear to get President Trump politically invested in a deal and pump up the stock market. Then pull back at the last minute and hope that Trump feels so invested that he's reluctant to blow up the deal. I don't think this was so much a miscalculation on China's part as simply a hail Mary pass that fell incomplete.

There is no doubt a tariff war has the potential to do serious damage to China's already fragile economy. Take toys as an example. In 2017 China exported $54bn in toys & games, $18bn of which went to the U.S. If toy companies were to relocate out of China to avoid the U.S. tariffs, China doesn't just lose $18bn in exports, **they lose the entire $54bn.**

Perhaps more critically, a tariff war calls into question President Xi's vision for China's "move up the value chain" and his plans for technological self-sufficiency. Xi has no 'plan B' other than to ditch his own deleveraging campaign (in a further blow to his policy credibility) and resort once again to credit-fueled construction stimulus. The necessary liquidity easing would undoubtedly pressure the RMB, threatening a destabilizing break of the USDCNY 7.0 "line in the sand." More market credibility lost.

With $40t+ in credit assets, a real estate bubble, and a thinly-capitalized banking system all resting on the public's perception of the government's ability to somehow ensure everything works out, the Chinese financial system is facing a moment of grave uncertainty.

So why won't Xi relent? Because if ultimately faced with the choice of relenting to Western demands for liberalization of closing the doors and hunkering down a la North Korea, I believe Xi would choose the latter. It's how he was raised. He's a revolutionary true believer.

Hence, the quick resort to nationalism. Riling up the populace with anti-Americanism is a genie

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that is not easily put back in the bottle and it's not something China would resort to if it retained hope for a reasonably quick deal. As the Washington Post put it "by proclaiming that China will fight to the end and invoking the nation's experience with hardship over 5,000 years of history, the Chinese government is likely trying to shore up popular resolve for a long and painful trade war, should the Trump administration refuse to relent."

I would not expect full-bore consumer boycotts of U.S. goods between now and the G-20 meetings in late June. But barring some miracle of diplomacy at that gathering, it looks to be a long, hot summer for U.S. multinationals doing business in China.

As for domestic policy, I don't foresee any knee-jerk credit stimulus. The government is not messaging that things will be business as usual, but is instead putting the nation on a "war footing" and preparing the public for the need for sacrifice. With control and stability top of mind for Chinese leadership, expect the USDCNY 7.0 level to be defended by any and all means in coming weeks (inclusive of unannounced volume restrictions in the FX market). Post-G20 all bets are off.

Market Roadmap

Navigating volatile risk asset markets has been difficult, even with a clear and coherent view of events. I've been hoping for the clarity of a capitulation trade, but don't yet feel like we've seen one.

With a Bloomberg poll showing that two-thirds of economists still see a trade deal this year, I'm afraid that the risk of a longer-term process of disengagement is probably not adequately reflected in market valuations.

I'm still looking for that "buyable dip" to unfold, but with hope for a deal springing irrationally eternal, we may instead see a choppy, downward-biased range trade into the G-20 meetings.