U.S.-China Trade: A Time Out Ahead?

- *China has no intention of meaningfully changing its behavior.*

- *Plausible outcomes on U.S.-China trade are "faux deal" or "economic disengagement." We lean strongly towards the disengagement outcome.*

- *The costs of disengagement to the U.S. economy are greatly overblown and outweighed by potential benefits. We see it as net-bullish for U.S. assets. (Read more: https://macrolens.com/wp-content/uploads/2018/11/Trade-War-Costs.pdf)*

- *But prepare for renewed hopes for "faux deal" at G-20, as the Trump Administration may see tactical value in delaying the scheduled January 1 increase in tariff rates from 10% to 25*

The "establishment types" are taking another shot at a trade deal, perhaps encouraged that the equity market rout and midterm losses leave Trump more amenable to a deal.

- Trump himself fostered this perception by *initiating* the pre-midterms call to Xi and coordinating the G-20 sit-down at month's end

Disengagement from China is manageable *so long as the process unfolds gradually* and is coordinated with allies. The more quickly the tariffs are rolled out the more likely they are to create a dislocation (particularly in core PCE inflation which could exacerbate the President's "Fed problem").

Domestic and international factors both now argue in favor of a tactical "time out.

Domestically…
- The Fed seems determined to slow growth
- Stock markets are wobbly
- There is increasing angst about a recession in 2019 or 2020

Internationally…
- Europe trade talks aren't progressing; auto tariffs remain a live threat.
- Democrat control of the House complicates NAFTA/USMCA
- Progress on North Korea has stalled

Keep in mind why the China disengagement strategy was not rolled out earlier in the first place:
- The economy needed to be shored up with tax reform and deregulation first

- China needed to be drawn out of its bunker on NK
- The strategy requires trade appeasement with G-7 allies

All of these areas look like they could use a little renewed "tending to."

And a "time out" suits the Chinese, who are trying to stave off financial crisis and prevent formation of a U.S.-led trade coalition against them in the hopes of a favorable shift in the political winds in 2020.

Yet reports suggest China is prepared to bring only small potatoes to the G20 table - incremental purchases, empty promises and token gestures. They remain committed to the strategy of creating political pressure through U.S. multinational corporations and financial institutions via a "carrot and stick" approach.

- Michael Pillsbury, Trump's favorite China-watcher, characterizes the recent "billionaires summits" in Shanghai and Singapore as China dangling the prospect of trillions of Dollars in services imports in coming years and sending American executives home with "carrots" to coax the Administration into standing down

- Peter Navarro's rant at CSIS last week about "unpaid foreign agents" was explicitly designed to scuttle any attempts at a "faux deal." The headline-grabber: "if Wall Street is involved and continues to insinuate itself into these negotiations, there will be a stench – a stench around any deal that's consummated because it will have the imprimatur of Goldman Sachs and Wall Street"

- The Wall Street Journal describes a diplomatic dance over whether China will make a concrete offer before the G20 meeting (as the U.S. is requesting) or arrive in Argentina merely looking to talk about having more talks

China will have to make some concessions to provide the political cover for a temporary cease fire, although they will be reluctant to offer up anything that can't readily be taken back in the event of renewed deterioration in relations. That needle can probably be threaded with a gradual renewal of Chinese purchases of U.S. agricultural products and some vague commitments to discuss a framework for preventing intellectual property theft.

While a temporary cease fire (which solidifies China position as the "frog in the pot") is our base case for G-20, comments from Vice President Pence to the Washington Post remind us that an immediate move to Defcon 1 on trade can't be ruled out either.

> *Pence told me in an interview that Trump is leaving the door open for a deal with Xi in Argentina, but only if Beijing is willing to make massive changes that the United States is*

> *demanding in its economic, military and political activities. The vice president said this is China's best (if not last) chance to avoid a cold-war scenario with the United States.*
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> *In addition to trade, Pence said China must offer concessions on several issues, including but not limited to its rampant intellectual property theft, forced technology transfer, restricted access to Chinese markets, respect for international rules and norms, efforts to limit freedom of navigation in international waters and Chinese Communist Party interference in the politics of Western countries.*

China needs to bring something beyond "soybean demand" to the G-20 table. If they do, the Trump Administration is likely to postpone the January 1 tariff rate increases in favor of a period of negotiations. The alternative – a second rebuff of Chinese overtures – would mark a point of no return that the Administration may not yet be ready for. The frog is in the pot, but the water just hasn't reached a boil yet.

Alas, a trade "time out" will only serve to turn down the heat a notch. The simmer will continue, particularly if a defense of the RMB is a prerequisite for talks. Holding up the RMB prevents resort to full-blown stimulus (as China's extremely weak October credit data suggests), leaving sentiment in China's credit and real estate markets susceptible to further deterioration – and potential non-linearity.

While the time out scenario would be bullish for risk assets, the Fed policy path is the predominant factor in the recent volatility episode. If a "trade time out" is coupled with some indication that a rate hike pause is within shouting distance, markets could bounce sharply into year-end.

Ultimately, China's strategy of waiting Trump out through 2020 is acutely vulnerable to its own financial frailties. If U.S. economic growth remains robust into 2019, the U.S. will likely again increase pressure on China's tottering financial foundations. To maintain that as a viable policy option, President Trump may well focus his pugilism in coming months less on Xi Jinping and more on Jay Powell.