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Shake the Box

From Twitter on Wednesday:

> **David Rosenberg** @EconguyRosie · 11h
> Maybe Trump is a genius, after all. What if he finally gets the steep Fed rate cuts he has been demanding? After that, he ends the trade wars, tariffs go to zero, and the stock market surges to new highs -- just in time for the 2020 election!
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I'm sure Rosenberg, no fan of Trump, is being facetious. But I don't think he's wrong. But pushing the Fed off the fence is only one aspect of the emerging Trump approach of throwing caution to the wind. More a "shake the box" strategy than a detailed blueprint, policy activism and high-risk gambits will keep markets on edge for the foreseeable future.

Think about where President Trump was in April:

- Moving towards a soft deal with China that would cushion the economy but emasculate him politically on a key issue
- Nancy Pelosi was putting USMCA on ice to deny him a "signature accomplishment"
- Mobs streaming across the un-walled border
- North Korean unresolved
- Obamacare in place
- No infrastructure package
- Trump was also short a call on GDP growth to the Fed (they had only gone on hold because they believed they had cooled the economy to their preferred 2% growth rate).

In short, the President was looking at a pretty flimsy record, with even the improvement in GDP growth likely to be looking ephemeral by the summer of 2020. What was he supposed to run on, a couple of Supreme Court Justices and an S&P rally?

A conservative approach of avoiding upset and babysitting the economy would put Trump at risk of being a one-termer who accomplished little more than causing a ruckus on Twitter.

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The alternative is to "shake the box" by upsetting all the establishment apple carts the President was sent to Washington to upset. The political downside to this approach is that it turns out there actually isn't an electoral majority in support of apples strewn all over the place. But unlike the conservative approach, if Trump goes out a loser in 2020 after "shaking the box" at least he may have shaken things up in a way that could prove lasting in some dimensions (the approach towards China likely being one).

And shaking the box has an upside: a more favorable political and economic mix might just fall out in 2020. With upside comes downside, and for markets, extreme uncertainty.

A primary risk is that Mexico decides to play hard ball and dares Trump to keep ratcheting up the tariffs. The the odds of this went up a bit with the vocal opposition of Senate Republicans, amplified by a mainstream media salivating over the thought of a Republican Party rupture and stinging defeat for the President. That said, **I cannot envision Mitch McConnell taking his caucus on a political suicide mission**.

House Minority Leader Kevin McCarthy was correct in chiding his Senate colleagues that "we should support the president so we can get an agreement so we don't have tariffs. Them talking about not supporting him undercuts his ability to do that."

The Republican caucus seems to have gotten the memo. Check out this 180 from Wisconsin Senator Rob Johnson:

From Tuesday's NY Times:

> *Senator Ron Johnson, Republican of Wisconsin, said he warned the lawyers that the Senate could muster an overwhelming majority to beat back the tariffs, even if Mr. Trump were to veto a resolution disapproving them. "The White House should be concerned about what that vote would result in, because Republicans really don't like taxing American consumers and businesses," Mr. Johnson said.*

From The Hill on Wednesday:

> *Johnson, an outspoken critic of Trump's trade policies, says there won't be enough votes to override the president's expected veto of a disapproval resolution to block additional tariffs against Mexico.*
>
> *He said he informed Mexican Ambassador Martha Bárcena Coqui of the political reality on Capitol Hill in a phone call Wednesday morning. "I talked to the Mexican ambassador. I*

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> *wanted to make sure that she realized that if the president decides to invoke tariffs, I don't think there's a possibility for a veto override," Johnson told reporters after the call.*
>
> ***"I want to make sure that leverage is maintained,"*** *Johnson said of the pressure Trump is trying to put on Mexico to crack down on illegal immigration by threatening new tariffs.*

Still, it's not clear how seriously the Mexicans are taking the Trump threat. On the one hand, Reuters reports stepped up enforcement on Mexico's southern border on Wednesday. On the other hand, another Reuters report detailed AMLO's proposal as pie in the sky: shifting U.S. funding for military interdiction of migrants to "economic development" in Mexico's south, a U.S. "Marshall Plan" to develop Central America.

It's likely that 5% tariffs on Mexican imports go into effect on June 10.

Talk of Congress undercutting Trump's emergency tariff authority is little more than media wishful thinking. **Expect President Trump to remain committed to ratcheting Mexican tariffs until he gets a firm commitment** form Mexican to measurably slow the flow of migrants.

In the meantime, he can use the Fed's own flawed approach of targeting growth and the establishment's overwrought narrative of tariff disaster as weapons to **push the Fed into easing mode**. If tariffs are going to crush the economy, and the Fed is targeting GDP growth, why the heck aren't they cutting rates!?! Oh, and how about a little help with this existential fight against the rise of Communist Authoritarianism while we're at it!

Of course, anyone took Econ 101 will immediately recognize the flaw in this argument: tariffs are a supply shock that lowers *both actual and potential* GDP growth, and therefor do not warrant a monetary policy response.

Surprisingly, the Fed seems already to have thrown in the towel on this argument. Here was an exchange between CNBC's Steve Liesman and Fed Vice Chair Clarida on Tuesday:

> *STEVE LIESMAN: So, would you say your inclination, with more tariffs coming through is to address the back side of it, which is weakness in growth, or the front side of it, which is at least an initial impulse of higher prices?*
>
> *RICHARD CLARIDA: Again, I think that we will confront that when we get to it. But I think the way that I think about it, Steve, as one member of the committee is I think textbook macro would indicate that you would tend to look through the price level effect because it is not really telling you about long run inflation. And I* ***think that that would be my first instinct which would be to look through that on the price level. And then obviously slower growth means you want to do what you can to maintain growth at its potential****.*

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It's not entirely clear whether Clarida is deliberately downplaying the effect of tariffs on potential growth here or conveniently ignoring it. Either way, **he'll be arguing for rate cuts in response to tariff increases**.

Chairman Powell seemed to be subtly echoing Clarida in his opening statement on Tuesday:

> *I'd like first to say a word about recent developments involving trade negotiations and other matters. We do not know how or when these issues will be resolved. We are closely monitoring the implications of these developments for the U.S. economic outlook and, as always, we will act as appropriate to sustain the expansion, with a strong labor market and inflation near our symmetric 2 percent objective.*

The smart strategy for the FOMC would be to keep expectations for June contained and then drop a surprise cut for maximum effect. But betting on the Powell Fed to do the smart thing hasn't been a winner to date. More likely they want to see some deterioration in the economic data before entering easing mode. Ugh, I suspect that's what they'll get in coming months.

By the time the Fed gets around to cutting rates (July 31 by my guess) it's likely that the lagged effects of the Fed's 2018 tightening and heightened tariff uncertainty will have generated a noticeable deceleration in economic activity. Furthermore, even if Trump lifts the Mexican tariffs at some point, both economies (in particular Mexico) will remain infected with tariff uncertainty given the likelihood that any deal will remain contingent on Mexico's performance in slowing the flow of migrants.

All the while U.S.-China relations remain a slow-motion train wreck (6/4/19) with tariffs on the remaining $300bn of Chinese imports likely being rolled out over the course of 2019. While the media's claims that "China is a winner" from the Mexico tariffs, Trump can't possibly backtrack on *both* the Mexico and China tariffs. If the Mexico kerfuffle gives the Administration an excuse to roll out the $300bn on China more gradually or incrementally, that's probably something they want to do anyway. But the odds of a China deal have not increased.

When all is said and done, the Fed is likely to have been dragged into not one, but two or three "insurance rate cuts" over the course of 2019, after which they'll be hamstrung by election-year politics. **President Trump is likely to enter the 2020 election season with a Fed funds rate in the neighborhood of 1.75%**.

What else might fall out of a strenuously shaken political box?

- Using a deal with Mexico to pressure Nancy Pelosi into USMCA passage. The Speaker told us yesterday she's "trying to get to yes" on the deal.

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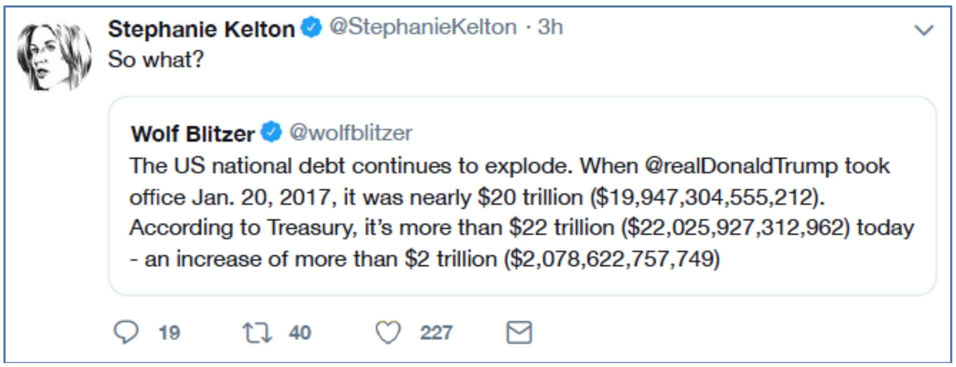
- Dropping a de-classification bombshell regarding the origins of the "Russian collusion" narrative. Even CNN's intelligence analyst calls Christopher Steele's decision to talk to the DoJ a "car wreck" and a "hot mess."

- If Trump can undercut the impeachment talk with declassification, why not pivot back to infrastructure? And with a 2.60% 30-year bond yield, how about some political triangulation by pushing for a debt-funded plan?



With all that I haven't even mentioned the anti-trust investigations into Google and Facebook!

By getting the economic hit out of the way early and eliciting a response from the Fed, **the President gives himself a shot at having his China-trade war with a 2020 economy that looks like its withstood the damage**. I'm not suggesting this is all a master plan. But Trump is clearly "shaking the box." I'm just speculating on what might fall out.

Conclusions:

- This is not a drill. We're witnessing a political high-wire act that is unprecedented, risky, and highly uncertain.

- Ditch the notion that Trump is "all bluster" and "obsessed with the stock market."

- Anticipate highly emotional, volatile summer markets, but a reasonable degree of responsiveness from the Fed can prevent a downside dislocation.