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The Uncertainty Narrative

Trade Uncertainty Clouds Global Growth Prospects, bemoaned a recent Wall Street Journal piece.

To the Wall Street Journal, I say "you are #FAKENEWS!"

The piece informs us that "Economists have for decades theorized that businesses react to uncertainty by pulling back on investment and employment." Sounds logical, right?

> *"We've got quite a bit of evidence now accumulated from many sources that this kind of uncertainty puts a damper on investment and to a lesser extent a damper on hiring," said Steven Davis, a University of Chicago professor who studies the impact of policy uncertainty on economic activity.*

Let's take a quick peek at Prof. Davis' research. He counts articles in 10 leading U.S. newspapers that contain the following triple of terms: "economic" or "economy"; "uncertain" or "uncertainty"; and one or more of "congress," "deficit," "Federal Reserve," "legislation," "regulation" or "White House." Thereby he creates an index of economic uncertainty that picks up on events like the Gull War, 9/11, debt ceiling crises, and Trump's election - **the types of events that affect everyone**.

Of course, these economic uncertainty indices are also picking up heightened readings as a result of the U.S.- China trade dispute. The problem is, for all the media attention on the U.S.-China trade war, **only a slender handful of U.S. companies are affected by it**. There is no sense in assuming a similar magnitude of response to an isolated uncertainty event as to the broad economic effects of a war, an election or a major fiscal policy change.

Imports to, exports from and corporate profits in China are all relatively small as a share of the U.S. economy. A gently sequenced **U.S.-China decoupling is achievable with minimal disturbance to the U.S. macroeconomy**.

I'll break this down with pictures and bullets for a quick read…

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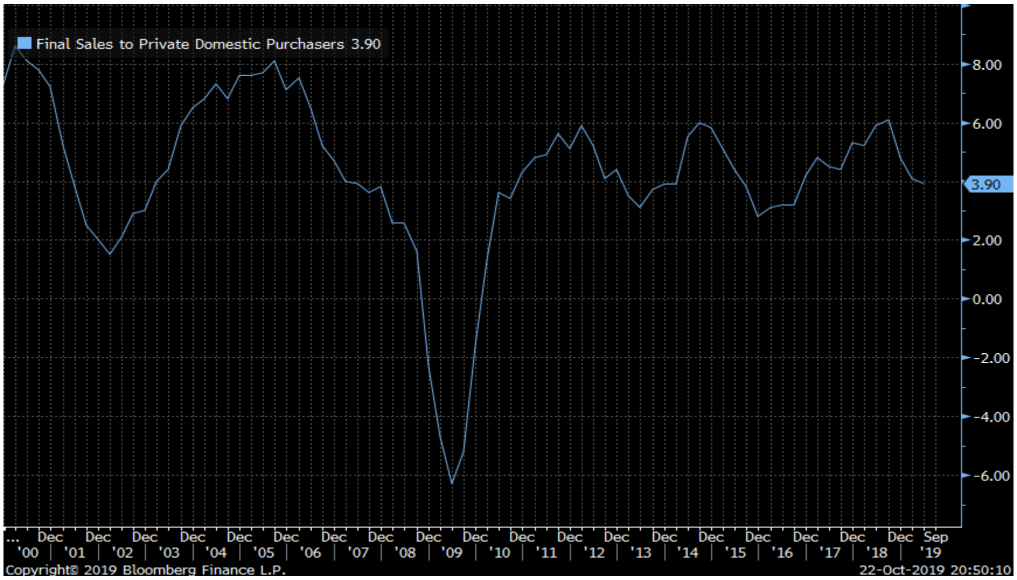
Economic Ebbs and Flows

- "Underlying" nominal GDP growth has ranged from 3%-6% throughout the cycle
- Each dip has been coincident with a tightening in global liquidity conditions
    - European crisis in '12
    - QE Taper & DXY rally in '15-'16
    - recently a series of rate hikes culminating in curve inversion
- This slowdown is not at all unusual given the Fed's over-tightening error

Nominal Sales to Private Dom Purchasers (GDP ex-Inventory, Trade & Govt)



U.S. Imports from China

- Full tariffs on ALL Imports from China, assuming an incidence rate of 100%, would be akin to a VAT of only 0.5-1.0%

U.S. Imports From China as a Proportion of Total Retail and Wholesale Consumption

	Imports From China ($bn)	Total Consumption* ($bn)	Imports as a % of Total	Tariff Rate	"Sales tax" Rate	
Consumer Goods	275.2	8,908.7	3.1%	15%	0.46%	* Total HH Consumption Expenditure
producer Goods	230.0	5,557.9	4.1%	25%	1.03%	* Total wholesale sales

Source: U.S. Census Bureau, Macrolens categorizations of "consumer / producer goods," BEA

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U.S. Goods Exports to China

- U.S. Non-Agricultural exports to China amount to various pockets of chump change

U.S. Non-Agricultural Exports to China ($bn)	
Energy products	9.1
Steel, Copper, Rubber, pulp, Chemicals etc	23.3
Lumber, glass, shingles, flooring	5.6
Industrial Machinery	15.9
Telecom, business, medical Equip. & Semic	15.2
Civilian aircraft, engines, equipment, and pa	16.3
Autos, Auto parts & other transportation eq	14.0
Consumer products	6.8
Miscellaneous	2.6
Total as a % of U.S. Wholesale Sales	2.0%

Source: U.S. Census Bureau

- U.S. Agricultural Exports to China are predominated by soybeans
- Ex-soybeans, exports to China account for only around 4% of U.S. Ag production

U.S. Agricultural Exports to China

						Exports as a
Exports to China ($bn)			U.S. Ag Production ($bn)			% of total
Agriculture & Foorstuffs ($bn)	21.0		Total Ag Production	241.2		9%
of which soybeans	12.2		Total soybean Production	41.3		30%
of which other	8.7		total Ag ex-soybeans	199.9		4%

Source: U.S. Census Bureau

- Trump's "Soybean political problem" is overstated

Top 10: States That Produce The Most Soybeans				
U.S. Total		3,927,090,000	3,929,885,000	0.07%
Rank	States	2014	2015	Change
1	Iowa	498,270,000	553,700,000	11.12%
2	Illinois	547,120,000	544,320,000	-0.51%
3	Minnesota	301,705,000	377,500,000	25.12%
4	Nebraska	287,820,000	305,660,000	6.20%
5	Indiana	301,920,000	275,000,000	-8.92%
6	Ohio	246,225,000	237,000,000	-3.75%
7	South Dakota	229,950,000	235,520,000	2.42%
8	North Dakota	202,515,000	185,900,000	-8.20%
9	Missouri	259,935,000	181,440,000	-30.20%
10	Arkansas	158,400,000	155,330,000	-1.94%
Source: NASS/USDA (bushels)				

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- Trump won Iowa by 9.4 points in 2016. If soybeans tip Iowa to the Dems, Trump got much bigger problems elsewhere.

- The only other top-10 soybean-producing state that is up for grabs is Minnesota (Clinton won by 1.5 points in 2016). Minnesota is an "expand the map" play for Trump (note the big rally in Minneapolis recently) but not a must have.

- If China doesn't buy U.S. soybeans, they generally don't rot – they are sold into new markets at some discount.

- It's hard to envisions adjustment losses in excess of a few billion Dollars per year, yet U.S. agriculture will receive $28bn in trade adjustment assistance over 2018-19.

- **Shifting to a "soft on China" stance in exchange for increased Ag purchases would be politically stupid**.

Services Exports to China

- Tourism accounts for the bulk of U.S. services exports to China

- Chinese inbound tourism revenue accounts for 3.3% of total tourism revenue

- There is no "tourism tariff." Unless there's a boycott, Chinese tourism should slow only gradually as a result of reduced availability of foreign exchange

U.S. Services Exports to China

2018 Services Exports (2017, $bn)	58.9
of which tourism (2017, $bn)	36.4
Domestic & International Tourism Revenue (2018, $bn)	1,089.00
Chinese tourism as a % of Industry Total	3.3%

Source: Forbes: *China Trade War Costing U.S. In Tourism Revenue,* 8/28/19, USTravle.org. Macrolens Calculations

Empirical Assessment of the "Uncertainty" Theory

- Are there signs that uncertainty is behind the deceleration in nominal growth from 6% to 4% in the past four quarters?

- **Business Fixed Investment in GDP has decelerated from 8.4% y/y to 3.9% y/y** over the four quarters through 2Q2019.

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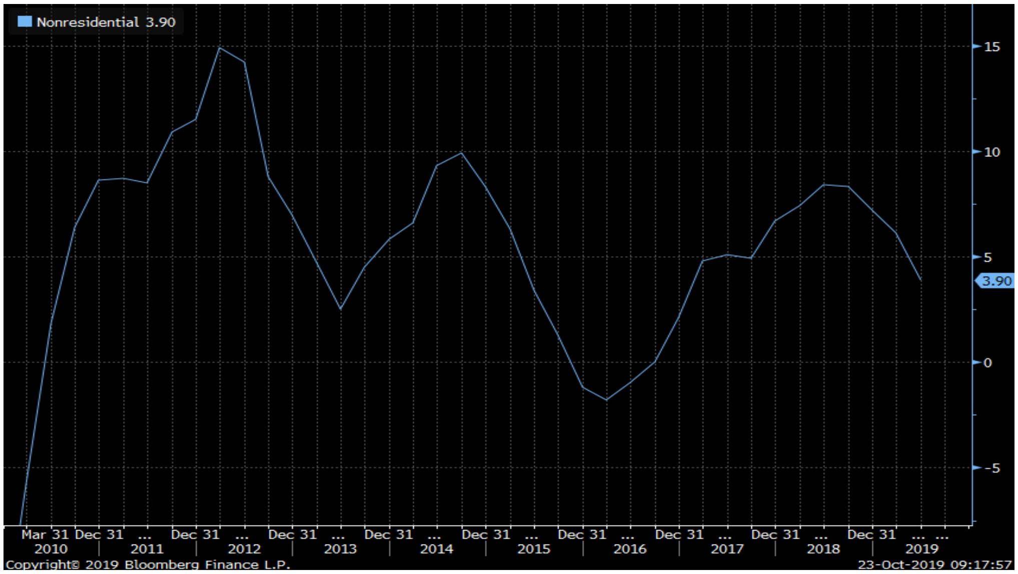
Non-Residential Investment, Nominal (y/y)



- What has driven the slowdown? The Bureau of Economic Analysis provides detailed breakdown on investment in both structures and equipment:

Table 5.4.5U. Private Fixed Investment in Structures by Type
[Millions of dollars; quarters seasonally adjusted at annual rates]
Bureau of Economic Analysis
Last Revised on: September 26, 2019 - Next Release Date October 30, 2019

				2019		Y/Y Change (USDmn)	Y/Y Change (percent)
	Q2	Q3	Q4	Q1	Q2		
Private fixed investment in structure	1,416,526	1,417,625	1,406,769	1,420,103	1,404,816	(11,710)	-0.8%
Nonresidential	639,966	641,676	635,212	645,804	633,197		-1.1%
Office	71,912	73,066	75,262	76,784	77,120	5,208	7.2%
Health care	36,713	36,522	36,945	38,751	38,864	2,151	5.9%
Multimerchandise shopping	23,727	21,629	18,875	17,077	15,309	(8,418)	-35.5%
Food and beverage establishments	8,391	8,083	7,960	8,965	7,823	(568)	-6.8%
Warehouses	34,854	33,830	32,890	34,481	33,505	(1,349)	-3.9%
Other commercial	13,538	13,432	12,901	13,273	12,716	(822)	-6.1%
Manufacturing	62,219	65,946	66,788	70,169	68,513	6,294	10.1%
Power	96,955	96,518	92,647	94,564	94,783	(2,172)	-2.2%
Communication	24,454	23,631	23,622	23,096	22,799	(1,655)	-6.8%
Mining exploration, shafts, and wells	143,312	142,875	139,949	140,089	134,359	(8,953)	-6.2%
Other structures							
Religious & Educational	22,691	22,324	22,745	22,190	19,919	(2,772)	-12.2%
Lodging	38,007	38,269	39,253	40,100	41,487	3,480	9.2%
Amusement and recreation	17,197	18,206	17,771	17,324	16,652	(545)	-3.2%
Transportation	16,810	17,476	17,418	18,275	19,347	2,537	15.1%
Farm	8,811	8,849	8,997	8,571	8,543	(268)	-3.0%
Other4	1,176	1,775	2,146	2,607	2,304	1,128	95.9%
Brokers' commissions on sale of stru	22,026	22,101	21,922	22,367	22,033	7	0.0%
Net purchases of used structures	(2,828)	(2,856)	(2,879)	(2,879)	(2,879)	(51)	1.8%
Residential	776,560	775,949	771,557	774,299	771,620	(4,940)	-0.6%

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- **The biggest drags on structures investment have been shopping malls** (which have been in decline for a decade) **and "mining, exploration, shafts and wells,"** which is driven by the oil price collapse in Q4 last year (with the Fed's over-tightening a contributing factor to both).

- Investment in offices was up 7.2%. **Investment in manufacturing structures was up 10.1%.**

No sign of U.S.-China trade uncertainty there. Let's check out investment in equipment:

Table 5.5.5U. Private Fixed Investment in Equipment by Type
[Millions of dollars; quarters seasonally adjusted at annual rates]
Bureau of Economic Analysis
Last Revised on: September 26, 2019 - Next Release Date October 30, 2019

	2018				2019		Y/Y Chang (USDmn)	Y/Y Chang (percent)
	Q1	Q2	Q3	Q4	Q1	Q2		
Equipment	1,201,786	1,214,317	1,227,863	1,246,372	1,249,046	1,252,859	38,542	3.2%
Information processing equipment								
Computers and peripheral equipe	117,167	120,054	120,197	117,710	119,389	126,072	6,018	5.0%
Communication equipment	132,935	129,893	135,565	131,957	137,803	131,455	1,562	1.2%
Medical equipment and instrume	98,857	99,713	101,780	102,039	101,858	104,212	4,499	4.5%
Nonmedical instruments	41,881	42,785	43,794	44,440	43,499	43,885	1,100	2.6%
Photocopy Office and Accounting	13,535	13,325	13,494	13,331	13,403	13,393	68	0.5%
Industrial equipment								
Fabricated metal products	21,635	21,658	22,139	23,162	22,882	22,725	1,067	4.9%
Engines and turbines	15,347	13,782	14,632	16,021	14,095	14,439	657	4.8%
Metalworking machinery	39,385	37,758	37,543	36,615	37,697	37,155	(603)	-1.6%
Special industry machinery, n.e.c.	38,605	39,754	40,651	42,954	43,273	46,440	6,686	16.8%
General industrial, including mat	87,567	88,155	89,770	90,464	90,769	88,453	298	0.3%
Electrical transmission, distributi	40,609	40,991	42,121	42,427	42,117	43,212	2,221	5.4%
Transportation equipment								
Trucks, buses, and truck trailers	198,512	207,044	212,322	215,952	221,615	224,396	17,352	8.4%
Autos	30,298	27,883	24,481	24,099	25,916	24,926	(2,957)	-10.6%
Aircraft	47,323	48,693	44,846	53,173	43,178	37,699	(10,994)	-22.6%
Railroad & Shipping equipment	18,786	17,862	18,006	17,803	18,654	18,928	1,066	6.0%
Other equipment								
Furniture and fixtures	49,307	49,210	49,819	52,271	51,052	51,436	2,226	4.5%
Agricultural machinery	36,376	39,116	39,134	41,254	41,221	39,946	830	2.1%
Construction machinery	48,045	49,436	50,301	50,738	52,631	54,292	4,856	9.8%
Mining and oilfield machinery	22,923	24,473	23,078	22,151	21,691	23,298	(1,175)	-4.8%
Service industry machinery	40,208	40,554	40,640	42,545	41,743	41,017	463	1.1%
Electrical equipment, n.e.c.	8,394	8,725	8,515	8,945	8,710	8,950	225	2.6%
Other	63,437	63,494	65,663	67,366	66,747	66,797	3,303	5.2%

- **The biggest drag on equipment investment was aircraft** – obviously Boeing-related

- A spurt of investment in computer equipment in Q2 may have been spurred by the impending tariffs (imports of computers and accessories from China totaled $77bn in 2017).

- Investment in trucking and construction equipment – good cyclical indicators – were up nicely

In short, **no sign of a trade-uncertainty related slowdown in business investment** yet – just a broad deceleration in response to tightening liquidity, exacerbated by special factors.

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ISM Overstates the Downward Momentum

From this month's ISM report on manufacturing (contracting industries listed in order of worst to least bad):

> *Of the 18 manufacturing industries, three reported growth in September: Miscellaneous Manufacturing; Food, Beverage & Tobacco Products; and Chemical Products. The 15 industries reporting contraction in September — in the following order — are:* ***Apparel, Leather & Allied Products****; Printing & Related Support Activities;* ***Wood Products; Electrical Equipment****, Appliances & Components;* ***Textile Mills; Paper Products; Fabricated Metal Products; Plastics & Rubber Products****; Petroleum & Coal Products; Primary Metals; Transportation Equipment; Nonmetallic Mineral Products; Machinery;* ***Furniture & Related Products; and Computer & Electronic Products****.*

- **ISM does NOT represent a broad cross-section** of our $19T economy
- ISM is a good cyclical indicator because it **represents a small but cyclically sensitive subsection** of the economy
- That subsection - apparel, leather, textile, paper, fabricated metals, furniture etc – also happens to be **disproportionately exposed to U.S.-China trade**
- Ergo, current **weakness in ISM is likely to over-state the cyclical weakness** of the economy.

Also note, the "Services ISM" shorthand commonly used for the ISM Non-Manufacturing Index is a misnomer. There is some scope for this index to get downward-skewed a bit by trade as well:

> *The 13 non-manufacturing industries reporting growth in September — listed in order — are: Utilities;* ***Retail Trade****; Construction;* ***Mining; Agriculture, Forestry, Fishing & Hunting****; Accommodation & Food Services; Public Administration; Management of Companies & Support Services; Finance & Insurance;* ***Transportation & Warehousing****; Information; Health Care & Social Assistance; and Professional, Scientific & Technical Services. The four industries reporting a decrease are: Educational Services; Other Services; Real Estate, Rental & Leasing; and Wholesale Trade.*

- Don't get freaked out by ISM "at post-crisis lows."
- ISM overstates the effect of U.S.-China trade on the broad economy

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If You Want Some REAL Uncertainty to Worry About

It's way too early for this, but there may be some serious policy uncertainty on tap for 2020. Here are some of Liz Warren's policy planks from a recent profile by Axios:

- **Wealth tax:** Proposed 2% tax on wealth exceeding $50 million and 3% tax on wealth above $1 billion.
- **Green New Deal:** Co-sponsor.
- **College debt:** Proposed eliminating $640 billion in student debt and free public college
- **Medicare For All:** Co-sponsored Bernie Sanders' bill in 2017.
- "**Economic patriotism:"** Her plan for "creating and defending good American jobs" leans on green manufacturing and industrial policy for clean energy.
- **Capitalism:** Identifies as a "Democrat capitalist," rather than a "Democratic socialist," and told Pod Save America she sees "the value of markets ... if they have rules."
- **Big Tech:** Proposed breaking up Google, Facebook and Amazon, prohibiting companies with over $25 billion in revenue from acting as operators and users of a platform and installing regulators to break up already-closed mergers.
- **Corporate tax:** Proposed a 7% tax on companies' profits over $100 million.
- **Public lands**: Proposed requiring more electricity generation from renewable sources and end to drilling offshore and on public lands.
- **Immigration:** Wants to repeal law that criminalizes unauthorized border crossings.
- **Trade**: Countries must meet specific standards as a precondition for any trade agreement.
- **Private equity**: Proposed a bill that would kill much of the leveraged buyout industry.

Now THAT'S the kind of uncertainty that could put a crimp in business investment. But that's a story for Q2 or Q3 of 2020. In the meantime:

- One more Fed rate cut should cement curve dis-inversion. Fade recession fears based on "trade uncertainty.
- Markets like trade détente because it reduces the risk of a China-related tail event.
- Regardless of the outcome of U.S.-China "Phase One," the U.S. economy is likely to enjoy some upswing as we head into 2020.
- The risk-asset outlook is for a moderate grind higher subject to China/HK event risk.
- I still like being long risky assets with low-cost hedges against the evident tail (buying HSI or FXI puts funded by the sale of puts on a U.S. index for instance).