

MACROCOSM

Debt! NoKo! Irma! DACA! Cohn! ...and Other 4-letter Words

Thursday, September 7, 2017

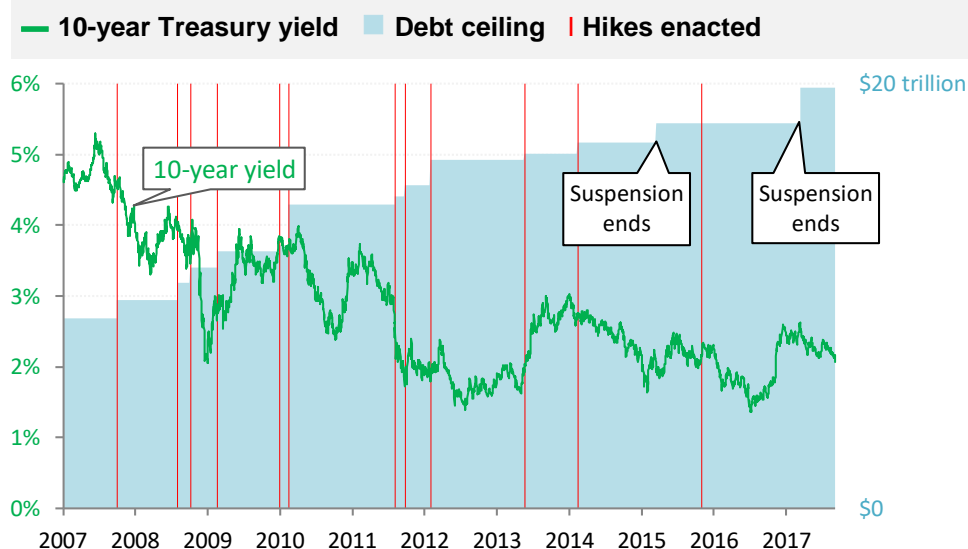
Donald Luskin

Just one Trump. So much chaos. So little time.

In no particular order...

BONDS We are surprised by the extent of the drop in the 10-year Treasury yield, to below 2.10% Tuesday. We don't expect it to continue.

- We don't see how it's explained by a likely more dovish Fed, driven to caution by uncertainties about the effects of Hurricanes Harvey and Irma (see ["On the August Jobs Report"](#) September 1, 2017), and by persistently low inflation readings as [highlighted by FRB Governor Lael Brainard Tuesday morning](#). Low inflation itself (to the extent it is a surprise) goes hand in hand with lower yields, but we think greater policy accommodation leads to higher yields, not lower (see ["Time for Taper Tantrum Two?"](#) April 6, 2017).
- Other than bond yields, we don't see consistent evidence of either systemic risk aversion or of macro weakness. Back-to-back historic storms and North Korea tensions are unsettling – but markets aren't generally reflecting big concerns about such things.
- We are inclined to think that the drop in yields corresponds mostly to the mounting urgency of either raising or suspending the statutory debt ceiling, as it has in most similar cases over the last



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US BONDS, US MACRO, US FED, ASIA MACRO:

With a hike to the debt ceiling now likely, long-term yields have probably seen the worst. With the legislative calendar cleared and Trump on a road-show with renewed political capital, pro-growth tax cuts are more likely than ever, and still not anticipated by the markets. Fischer's retirement is no surprise. Yellen may have disqualified herself at Jackson Hole, and Cohn is rumored to be out of the running. Appointment of a permahawk remains an overhanging risk. Trade threats against China aimed at securing help with North Korea risk a trade war in order to prevent a nuclear war. Kim may stage more demonstrations on the anniversary of 9/11. A negotiated solution is the most likely outcome, but it will take military and trade threats to get to it.

[\[Strategy dashboard\]](#)

several years (please see the chart on the previous page). We note that the present drop in long-term yields began on March 13, just three days before the expiration of the March 16 debt ceiling suspension enacted in October 2015 (the Treasury has been operating under “extraordinary measures” since). A coincidence – there was a Fed rate hike on March 15, so who can say?

- The indeterminate drop-dead date – out there at some point this month or early next – has been brought forward to some extent by expenses associated with Hurricane Harvey relief, and will be brought forward again after Irma.
- It's not set in stone yet, but it appears that a crisis will be deferred, thanks to what seemed to be an offer yesterday by House Minority Leader Nancy Pelosi (D-CA) and Senate Minority Leader Charles Schumer (D-NY) for Democrats to cooperate in hiking the debt ceiling into mid-December, coupled with Hurricane Harvey relief spending. President Donald J. Trump indicated his acceptance of their offer yesterday afternoon.
- Other than limiting it to three months, this is precisely what Trump said he wanted, which he had announced on Sunday morning on Fox News through Treasury Secretary Steven Mnuchin: “The president and I believe that it [raising the debt ceiling] should be tied to the Harvey funding. Our first priority is to make sure that the state [Texas] gets money. It is critical. And to do that, we need to make sure we raise the debt limit.”
- Thus Pelosi and Schumer's offer was mostly an acceptance of Trump's offer. Obliging, the media got it precisely backwards, with the Washington Post's headline claiming “Trump sides with Democrats,” and the New York Times' purporting that “Trump Bypasses Republicans.”
- The Post's headline went on to say that Trump was “throwing Republican plans into chaos.” Quite the contrary. Trump was, in reality, helping the GOP two ways – first by signing up the Democratic votes in the Senate that are absolutely necessary, and second by providing political cover for cynical Republicans who can blame Trump when, at the end of the day, they have to vote to raise the debt ceiling despite their phony fiscal rectitude.
- Again, it's not set in stone. The GOP could balk. But with this way forward on hiking the debt ceiling, and the Fed more cautious than ever, we think the 10-year yield has likely seen the worst.

TAX CUTS A fairly drama-free debt ceiling hike will be a major political victory for Trump who, with this under his belt, will have demonstrated – for anyone who cares to look at it realistically – a growing mastery of his role in the legislative process. It comes at a moment when his approval ratings have recovered entirely from the blow delivered by the Charlottesville hysteria (see "The Charlottesville Hysteria" August 18, 2017). Obviously Hurricane Harvey helped, or at least it gave him the opportunity to show competence and caring in his response to it – despite the mini-hysteria over the First Lady's high-heel shoes.



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Donald J. Trump
@realDonaldTrump

Congress, get ready to do your job - DACA!

7:04am · 5 Sep 2017 · Twitter for iPhone

Trump’s decision to not renew Barack Obama’s expiring Deferred Action for Childhood Arrivals (DACA) executive order was surely timed to take advantage of the replenishment of his political capital. His deft solution plays to elements in his base who

oppose immigration, but by kicking the decision to Congress where it belonged all along, it anchors the decision as a principled response to [Obama’s self-admitted](#) executive over-reach. Trump gave Congress plenty of time to make it permanent if it wishes to do so. And his upbeat tone – for example, [he tweeted “DACA!”](#) in the same style as he often tweets “MAGA!” – suggests that he is willing to sign a bill extending it.

We’re seeing the same growing mastery with Trump’s efforts to promote tax cuts – efforts we never saw in the lost cause of repealing Obamacare.

- First, with a debt ceiling fight deferred to December, Trump has significantly lightened what [was advertised](#) as a prohibitively crowded legislative calendar. *No one thought he could do that.*
- Trump has begun a road-show to promote tax cuts, taking a page from Barack Obama’s playbook in 2010, when he promoted Pelosi and Harry Reid’s (D-NV) Patient Protection and Affordable Care Act in 2010. [Trump started last week in Missouri](#), the home state of swing Democratic senator Claire McCaskill. Yesterday Trump took the show to North Dakota, the home state of another swing Democratic senator Heidi Heitkamp – who put out [a press release](#) endorsing Trump’s tax cut ambitions, having been seduced by [a ride on Air Force One](#). As we predicted, we see him one by one picking off the Democratic Senate votes needed to make tax cuts permanent (see [“Trump’s Tax Cut Nuclear Option”](#) May 1, 2017).
- *Trump and his surrogates are saying all the right things about tax cuts – both in terms of pro-growth economics, and in terms of persuasion.* The message is simple and true, and it plays to both the growth wing and the protectionist wings among both the GOP [and Democrats](#).
- The focus on cutting the business tax rate [is framed](#) as “Making our tax code competitive” to put “the American economy and the American worker first.”
- As such, it is the opposite of a tariff, and indeed invites the opposite of a trade war – a tax-cut war – a salutary race to the bottom in terms of tax burdens.
- Trump and his surrogates are very clear that tax cuts only have to be “revenue neutral” when growth is taken into account. For example, [Mnuchin said Sunday](#),

“...we believe in dynamic scoring and under our growth models at the Treasury, this will pay for itself. And again, we may not get full credit for that. ...we may be in a situation where the administration believes we’ll get more economic

Recommended Reading

[Why Corporate Tax Reform Is a Bipartisan Cause](#)

Laura Tyson
Wall Street Journal
September 7, 2017

[In Defense of Amy Wax’s Defense of Bourgeois Values](#)

Jonathan Haidt
Heterodox Academy
September 2, 2017

[Opportunity, responsibility, and security](#)

AEI-Brookings Working Group on Poverty and Opportunity
Brookings Institution
December 3, 2015

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Donald J. Trump
@realDonaldTrump

Thank you for joining me in Mandan, ND Gov. [@DougBurgum](#), Lt. Gov. [@BrentSanfordND](#), [@SenJohnHoeven](#), [@RepKevinCramer](#) & [@SenatorHeitkamp](#).



Mandan, North Dakota- THANK YOU Governor Burgum, Lieutenant Gov

7:04pm · 6 Sep 2017 · Twitter for iPhone

growth than perhaps the models that come out of Congress. But we'll be working with them on that... But the way we're going to pay for things is with economic growth. The difference between 2 percent and 3 percent is trillions of dollars of revenue to the government... We need tax cuts and tax reform now."

- With the US corporate tax rate so high by global standards, the anomalous US claim on global corporate income so distortive, and corporate taxes being such a small part of the US tax take, we have absolutely no doubt that Mnuchin's expectations for self-financing tax cuts are entirely realistic.
- *We reiterate our contrarian view that significant tax cuts will be enacted this year. And we reiterate our view that this is indeed contrarian – that is, it is not in the market – which means there is a significant upside surprise if we are right, and little downside risk if we are wrong.*

FED LEADERSHIP There's nothing surprising but the exact timing about the [Fed Vice Chair Stanley Fischer's announcement yesterday](#) that he will retire in mid-October for "personal reasons." We suspect it was more "political reasons." [His letter of resignation to President Trump](#) wasn't as strident as his [Financial Times interview a couple weeks ago](#), but it had an ungracious air about it, seeming to lecture Trump about the importance of preserving the banking regulations put in place in the Obama years.

- We do credit a [May 2016 Fischer speech](#) (see "[Is the Fed Stuck on Stupid?](#)" May 20, 2016) for shifting the Fed away from its obsolete Phillips Curve framework, toward the superior idea of the "natural rate of interest" as put forth by 19th century monetary theorist [Knut Wicksell](#) (see "[Yellen's March to Neutrality](#)" March 6, 2017).
- But other than that, good riddance to Stanley ["in the ballpark"](#) Fischer. His work is done.

Chair Janet Yellen took a similarly pro-regulation position in [her speech at Jackson Hole two weeks ago](#), and may have put herself – perhaps deliberately – out of the running for reappointment when her term ends next February (see "[On Yellen at Jackson Hole](#)" August 25, 2017). Fischer was never a candidate to replace her, but his retirement yesterday sparked rumors about succession – specifically, that Trump was no longer considering National Economics Council Director Gary Cohn.

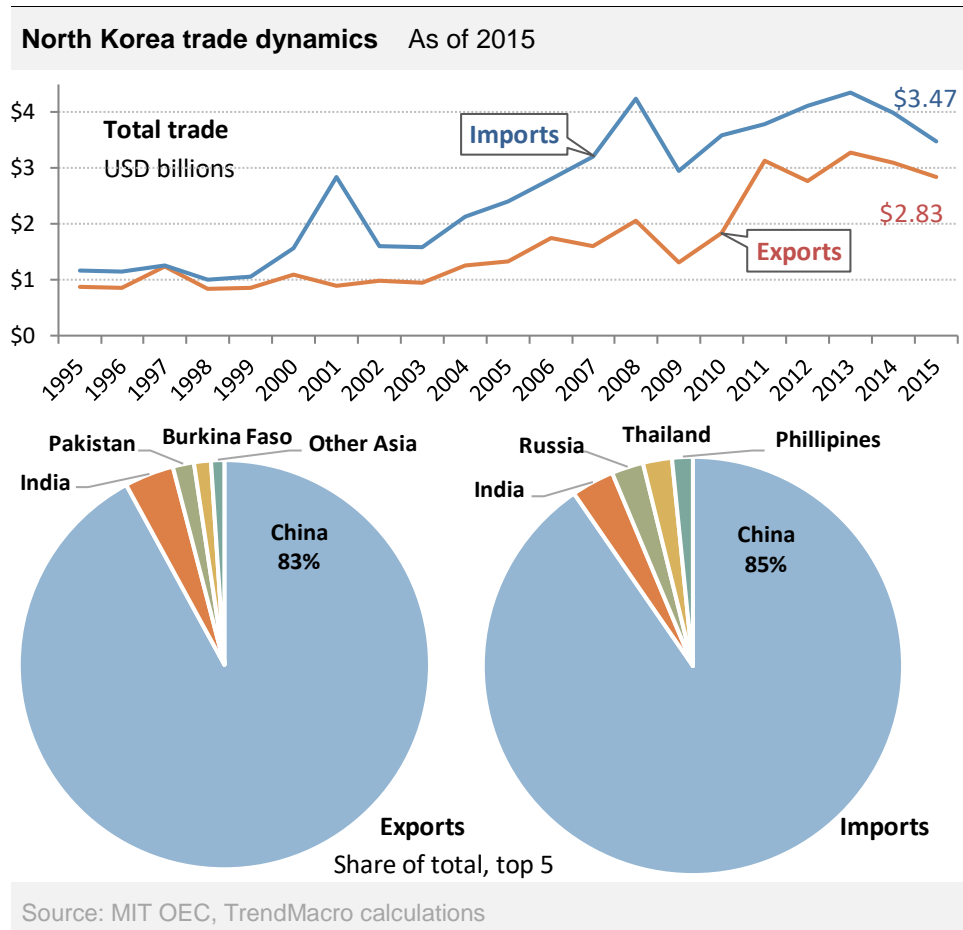
- [Supposedly](#), at least according to "people familiar with the president's thinking," Trump is unhappy with Cohn's critique of his statements after the violence in Charlottesville.
- Maybe, but we don't especially buy into this rumor. That said, we've never bought into the rumors of Cohn's inside-track for the Fed job in the first place (see "[On the July FOMC, and Cohn for Fed Chair?](#)" July 26, 2017).
- *We continue to be concerned that, if Yellen is not reappointed, Trump might appoint the kind of rigid permahawk seemingly*

preferred by the GOP establishment (see [“Trump’s New Faces on the Fed”](#) June 5, 2017).

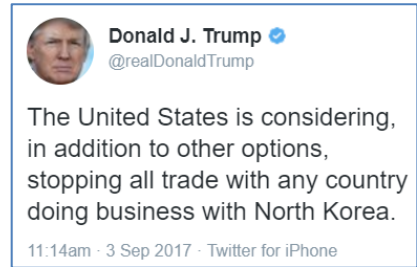
- When clients ask us “what could go wrong,” this is always our first answer. But there are good people on typical short-lists, especially former FRB Governor Kevin Warsh.

NORTH KOREA The apparent test of a hydrogen bomb by North Korea over the Labor Day weekend, following on an ICBM flyover of Japan, hasn’t triggered the risk-off reaction we saw after last month’s Trump statement about “fire and fury” (see [“Thoughts on North Korea, Fire And Fury Edition”](#) August 11, 2017).

- It is just a reality that North Korea is a nuclear power (see [“Some Thoughts on North Korea’s Nukes”](#) July 10, 2017). To be a nuclear power you need three things. You need nukes. You need missiles. And you need to let people know you have them. North Korea has all three now.
- Sanctions won’t make much difference, unless China can be engaged.
- China is the buyer of 83% of North Korea’s exports (the largest single trade good is charcoal briquettes), and provides 85% of its imports. India is a distant second (please see the chart below).
- Historically, nations seeking to evade the sanctions already in place have done so [by working through Chinese middlemen.](#)



- Trump had this in mind when [he tweeted](#) on Sunday that he is considering “stopping all trade with any country doing business with North Korea.” *Yes, the new risk is that we may try to prevent a nuclear war by starting a trade war.*
- Trump has unambiguous authority to unilaterally order a complete cessation of US trade with China, under either the 1917 [Trading With the Enemy Act](#), or the 1977 [International Emergency Economic Powers Act](#).
- Surely, despite his tweet, and for all the bellicosity of his anti-China rhetoric during the presidential campaign, Trump realizes that an all-out trade war with China has mutual assured destruction dynamics not unlike a nuclear war with China.
- This is why Mnuchin failed to declare China a “currency manipulator” in [April’s semi-annual Treasury currency report](#), despite Trump’s promise he would do so. And for China’s help with United Nations sanctions against North Korea after the July ICBM test, [Trump called off](#) opening an investigation into its violations of US intellectual property rights.
- But after the “fire and fury” war-of-words between Trump and North Korea’s Kim Jong-un – though [China helpfully let it be known then](#) that it would remain neutral if North Korea attacks the US and the US retaliates – [Trump went ahead](#) and initiated the investigation.
- While a nuclear North Korea in some senses [embarrasses China](#) and in other senses [complicates its ambitions](#) as a regional leader, it seems to us that China wants a buffer state between it and South Korea, and is not uncomfortable with an aligned nuclear neighbor – having lived for decades with three non-aligned ones, Russia, India and Pakistan.
- So we doubt that China has any interest in ceasing “doing business with North Korea,” which if it actually did, would probably succeed in completely capsizing the North Korean economy and destabilizing the Kim regime. Even if this didn’t raise for everyone what ought to be prohibitive issues of custody of Kim’s nukes, for China it courts unacceptable risks of mass migration across the Chinese border, and/or the loss of North Korea as a buffer state if its people should decide to align with South Korea.
- Considering the high cost of the US actually deploying the trade weapon against China, we think *the most likely course of events is for Trump to apply small and gradually increasing trade restrictions, aimed at China using its influence to broker a negotiated solution – which would have to include US and Chinese guarantees for the perpetuation of the Kim regime.*
- Failing that, we don’t see how the US would want to put San Francisco at risk to offer a nuclear deterrent for Japan – nor for Japan to trust the US to do so, even if it were to be continued to be promised. *The game-theoretic stability of the mutually assured destruction matrix would be best served, for all concerned, if Japan developed its own nuclear deterrent, which we predicted it would do, just for this reason, more than four years ago* (see ["The Abe Restoration"](#) May 10, 2013).



- In the meantime, this isn't going away. *Kim likes to stage nuclear demonstrations on US holidays – the upcoming anniversary of the September 11, 2001 terrorist attacks might seem apropos to him.* Just remember that negotiated solutions are most likely to happen right at the brink of war.

Bottom line

With a hike to the debt ceiling now likely, long-term yields have probably seen the worst. With the legislative calendar cleared and Trump on a road-show with renewed political capital, pro-growth tax cuts are more likely than ever, and still not anticipated by the markets. Fischer's retirement is no surprise. Yellen may have disqualified herself at Jackson Hole, and Cohn is rumored to be out of the running. Appointment of a permahawk remains an overhanging risk. Trade threats against China aimed at securing help with North Korea risk a trade war in order to prevent a nuclear war. Kim may stage more demonstrations on the anniversary of 9/11. A negotiated solution is the most likely outcome, but it will take military and trade threats to get to it. ▶