Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

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# On the China Tariffs

Thursday, March 22, 2018
**Donald Luskin**

**Trump didn't take yes for an answer from Li, so now comes China's threat of retaliation.**

As we've expected, today President Donald J. Trump is ordering US Trade Representative Robert Lighthizer to draw up, within 15 day, tariffs on US imports from China – which Trump said could apply to "about $60 billion" of goods, but no amount was actually officially specified – focused on redressing alleged abuses of intellectual property. The ongoing uncertainties surrounding the aggressive realignment of the terms of US global trade are extending the correction in equities (see, most recently, "Getting Away With an Act of Tariffism" March 9, 2018).

- These China tariffs should not be a surprise. Organized leaks foreshadowing them very accurately have been circulating for nine days now. Indeed, Trump first ordered Lighthizer to prepare a report on China's intellectual property abuses last August, under the authority of Article 301 of the Trade Act of 1974.
- Perhaps what's surprising, and so disturbing for markets today, are statements overnight by mid-level Chinese officials that they would retaliate with tariffs on US agricultural goods (sorghum and soybeans, mostly) and other products.
- These statements sharply differ from extremely conciliatory promises offered Tuesday by Premier Li Keqiang at the conclusion of the Annual People's Congress:

  *"A large deficit is not something we want to see… We want to see balanced trade. …Intellectual property rights will be fully protected. …We hope this important means to balance China-U.S. trade will not be missed because that would be missing the good opportunity for making more money."*

- *By proceeding with today's announcement, seemingly ignoring Li's olive branch, it would seem that Trump is not willing take yes for an answer. One could put the facts together to conclude that Trump actually wants a trade war. We strongly doubt that is the case. We are willing to bet that he has interpreted Li's earlier comments as a sign of weakness – which indeed they are. Trump is now pressing his advantage, as any strong negotiator ought to do in order to ensure that China actually delivers on Li's extravagant promises.*

**Update to strategic view**

**US MACRO, ASIA MACRO, US STOCKS:** Trump has announced tariffs against China to force intellectual property reform, to be specified in 15 days, despite Li's promises of such reform on Tuesday. Now mid-level Chinese officials have threatened retaliation, focused on US agricultural products. While we respect the risks of a trade war, we see this as a negotiating process that could lead to a long-overdue secular improvement to the terms of global trade, making it more fair and more fully free. Trump's negotiating style maximizes volatility, driving peace by going to the brink of war. Markets seem to generally understand this, but it entails both higher expected returns and higher expected risks.

[Strategy dashboard]

One may wish that Trump conducted the risky affairs of state in a more delicate manner, but the reality is that he does not. Navigating markets requires that we accept this reality and act accordingly. *We must (1) understand the method behind the madness (reasoning, as we do that there is indeed method); (2) understand that markets will be disturbed in the short-run by the madness, even assuming that the method plays out successfully over time; and (3) never forget that, even granting a great deal of method, we are dealing with risky matters that have some chance of going terribly wrong.*

- This is how we approached Trump's belligerency last year toward North Korea (see "Thoughts on North Korea, Fire And Fury Edition" August 11, 2017), *and this is how we are now approaching Trump's belligerency on trade* (see, most recently, "Getting Away With an Act of Tariffism" March 9, 2018).
- In both cases we start from the conviction that there is, in fact, a problem that needs to be solved. *The world would be a safer place without North Korean nukes and ICBMs, and the world would be a richer place if global trade, particularly with China, were more fair and more truly free.*
- It would be nice to believe that these problems could be solved with quiet diplomacy and through voluntary mutual submission to established institutions, but so far they never have been.
- It is very risky to threaten North Korea with "fire and fury" or China with tariffs, because such threats could conceivably have to be carried out, and in both cases they could lead to mutual assured destruction. *But there is a difference between threats and the carrying out of threats – indeed, the threats are means to force an intransigent counterparty to engage in the quiet diplomacy and submission to institutions that we would have wished for all along. In other words, to negotiate peace, you have to go the brink of war. That's where the incentives are.*
- *China's seemingly contradictory reactions – conciliatory on the one hand, in statements from a very high official, and belligerent on the other hand, from lower-level officials, is evidence not of chaos, but that the process if productively joined, through the display of multiple negotiating paths.*
- *It is an open door to more negotiating that Lighthizer has been given 15 days to actually come up with specific tariff targets – and the executive order signed today does not actually specific the rate of such tariffs or the value of goods to which they would apply.*
- Based on the way Mr. Market processed the roll-out of steel and aluminum tariffs – ending up higher than when that news cycle began, and as of this writing still above those lows – we have to conclude that they basically understand this paradigm. As we've said, *in an important sense this means Mr. Market has given Trump permission to proceed* (again, see "Getting Away With an Act of Tariffism").
- That doesn't mean there won't be sharp risk-off reactions like today's when a big risky next step is taken.
- Whatever Mr. Market thinks, as we've said from the beginning, *we have full respect for the actual risks here* (see "Tariffs: How Scared Should We Be?" March 2, 2018). *Very important and very large and*

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Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

[About us]

*very valuable established interests are threatened with deep changes to the ecosystem in which they have thrived.* The idea that the risks are in pursuit of a worthwhile objective doesn't mean that the risks aren't terribly real.

- Again, the low-volatility year of 2017 was all about picking the low-hanging fruit of pro-growth policy – deregulation and tax cuts. Now comes the risky high-hanging fruit. Realigning global trade to be more fully fair and free could be an epochal pro-growth step-function move. But it's risky to get up on that tall ladder and go after the high-hanging fruit.
- In portfolio construction terms, think of it as a re-optimization in which the securities in the opportunity set have, simultaneously, undergone upgrades in *both* expected return *and* expected risk.

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**Bottom line**

Trump has announced tariffs against China to force intellectual property reform, to be specified in 15 days, despite Li's promises of such reform on Tuesday. Now mid-level Chinese officials have threatened retaliation, focused on US agricultural products. While we respect the risks of a trade war, we see this as a negotiating process that could lead to a long-overdue secular improvement to the terms of global trade, making it more fair and more fully free. Trump's negotiating style maximizes volatility, driving peace by going to the brink of war. Markets seem to generally understand this, but it entails both higher expected returns and higher expected risks.

*Note: This report was modified several hours after initial distribution to reflect the fact the no tariff rate or total amount of goods to which it would apply was officially specified.*