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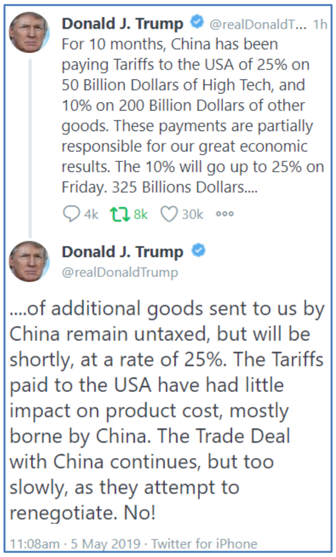
TRENDMACRO LIVE!

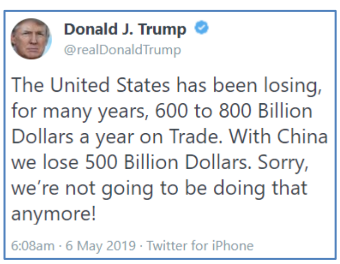
On Trump's Tariff Tweets

Monday, May 6, 2019

Donald Luskin

This is how deals are done. Trump has to act crazy and scare markets, or he won't scare Xi.





What to make of President Donald J. Trump's two tweets Sunday mid-morning, announcing that tariffs on $200 billion of US imports from China would rise next Friday from 10% to 25% – and that 25% tariffs could be applied soon to more than $300 billion of presently untaxed imports? He's at it again this morning. Quite the welcome-message for the Chinese trade delegation set to come to Washington on Wednesday for what have been thought might be the final round of successful talks. Chinese officials reportedly considered cancelling or delaying the visit, and then reportedly decided to proceed. It's better drama than "Game of Thrones," of which reportedly China's President Xi Jinping is a big fan.

- *Judging by market reaction as of this writing early Monday morning, it would seem to be a surprise*. Indeed, most press accounts the last couple weeks – even just minutes before Trump's tweets – have assumed a deal is all but final – so likely, in fact, that there has been nothing to do under the media's all-bad-Trump-news-all-the-time business model but to speculate as to how weak the deal will be (our favorite is the *New York Times*, which carped that a trade deal would fail to address the plight of persecuted Muslims in China).
- *But we have said all along that it is absolutely intrinsic to the nature of this negotiation that there be dramatic displays of power, histrionic threats, angry remonstrations and smug walk-aways, and that such things would intensify toward the end* (see, most recently, "On the Margin: China Trade Talks at the Edge of Chaos" February 19, 2019).
- There were warning signs last week, too. Treasury Secretary Steven Mnuchin, usually very much the optimist, told Fox, "There is a strong desire from both sides to see if we can wrap this up or move on," and Acting White House Chief of Staff Mick Mulvaney

Update to strategic view

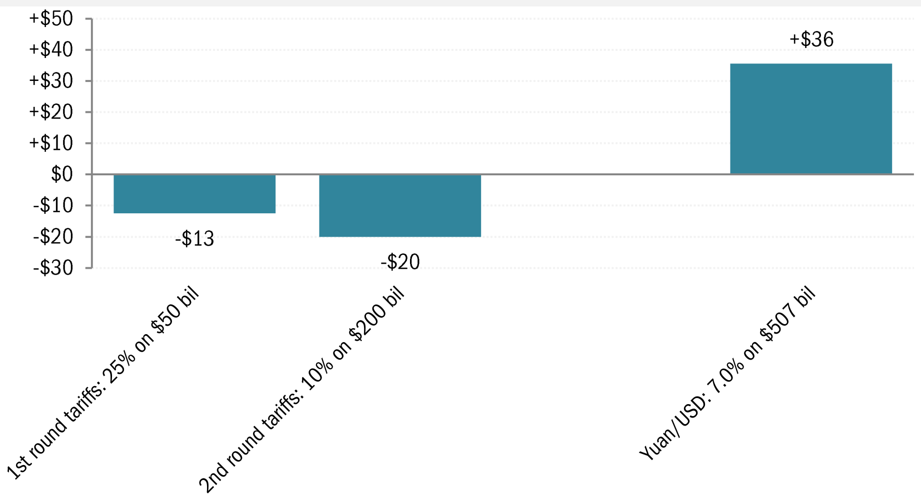
US MACRO, ASIA MACRO, US EQUITIES, ASIA EQUITIES: Trump tweeted Sunday that the deferred increase in tariffs on $200 billion of US imports from China from 10% to 25% will take effect Friday, and that 25% tariffs on untaxed imports are on the table. This should not necessarily be seen as a deal falling through, but rather entering the chaotic final stages when threats, retaliations, recriminations and walk-aways are to be expected. This is a negative-sum game in which China participates only because it is threatened. Trump must make threats, and appear crazy enough to carry them out even if they are costly to the US. It is scary to markets, but that's collateral damage – if it doesn't scare markets, it won't scare China. When this is done, the risk of a China hard-landing and associated global recession will be off the table, and a less protectionist China would be the core of a global boom.

[Strategy dashboard]

saying at an event last week, "at some point you throw up your hands and say 'this is never going anywhere.'"

- *Just because we are seeing such things now does not mean the deal is falling apart. To be sure, it might mean that. Mistakes can happen. But more likely it signals the highly turbulent edge of chaos – the existential interface between "yes" and "no" – that all negotiations have to pass through before they end.*
- *And you must understand that this negotiation is not the usual transaction.* Most negotiations, such as buying a car from a dealer, are voluntary exchanges that are positive-sum games: if a deal can be struck at all, it will be experienced as win-win by both players. *This negotiation is an involuntary exchange, like a robbery. It is a zero-sum game: the robber's win is the victim's loss, and the victim stands to gain nothing under any circumstance. So the victim won't even play the game unless he is forced to do so under threat. But such a threat is always costly or risky for the robber to carry out* (see "China is Losing the Trade War with Trump" July 29, 2018). *So the robber must convince the victim that he is crazy enough to do it anyway.*
- It's just a metaphor. The US is not "robbing" China in this situation. Indeed, we think Trump is very much in the right in trying to force China to be a less protectionist economy, and to deal more fairly with all its trading partners. If China is a "victim," that is only to say that *China does not wish to comply with a single one of the US's demands for changes in its trade practices – if it did, it would have already done so, all on its own, and the US would not have to demand it. And China wants nothing from the US in this negotiation. In the end, the scoreboard will just be a list of things China agreed to that it didn't want to agree to.*
- *So the US makes threats*. In this case, the threat is tariffs. They are costly to the US because they are, after all, at least on paper, a tax on US firms and consumers who buy imports from China. So far, the weakening of the yuan after the tariffs were announced has

Per annum tariff costs, versus yuan depreciation from tariff announcement



Source: Bloomberg, TrendMacro calculations

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more than made up for the tariffs from the US buyer's perspective – so Trump is correct in his second tweet yesterday when he says the tariffs are "mostly borne by China" (please see the chart on the previous page).

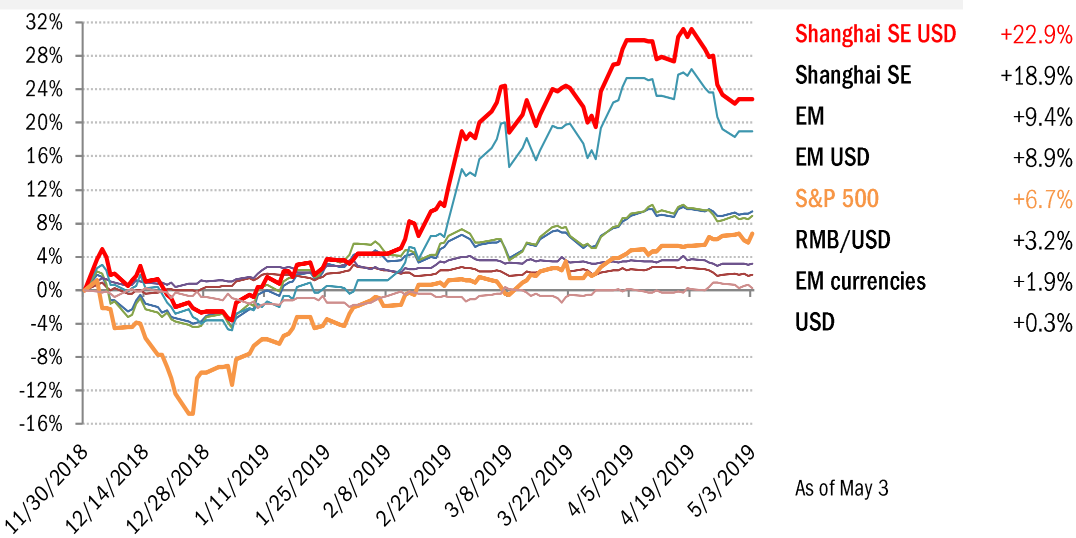
- So what's the cost to the US that Trump has to seem crazy enough to pay? *It is that the tariffs, the weakening of the yuan, and the associated long-term risk that developed-market trading partners will have to disengage China from their supply chains – as, say*, *Apple is already doing by shifting iPhone production to India* – *threatening the Chinese economy with fundamental destabilization. China, in forty years has never even had a recession – who knows if it can handle one? The cost to the US is the very real risk that such a destabilization would be highly disorderly, triggering what would likely be a global recession* (see "Death by China on the Way to Yes" December 17, 2018).
- To grasp these dynamics in action, just remember the history of this affair so far. It's been one crazy-seeming move after another. At first, when the tariffs had just been announced, but not put in place yet (see "On the China Tariffs" March 22, 2018 and "On the March Jobs Report, and New China Tariffs" April 6, 2018), China quickly moved to end the matter by offering to buy more US exports (see "China Trade: A Deal Takes Shape" May 21, 2018). Mnuchin went on the Sunday talk shows and declared the trade war was over before it had begun. And then the next day Trump killed it with a tweet, and the tariffs went into effect in two rounds over the next four months.

- After that, China walked away – claiming pridefully that it would not negotiate with the US while we held "a knife to its throat" (see "Our Knife at China's Throat" October 8, 2018).
- That seeming stalemate was surely a major contributor to the market volatility and economic slowdown (in the US, China and everywhere else) of Q1-2018 (see "Chinese Tariff Torture" October 29, 2018). We said it would begin to resolve when the US and China started to negotiate, and announced not a solution, but just a "framework" (see "On the Margin: In the Beginning was the Word 'Framework'" November 16, 2018). Trump threatened more tariffs – the same 25% on the same untaxed imports that he threatened again yesterday – and what do you know? – China agreed to a dinner meeting between Trump and Xi in Buenos Aires on December 1 (see "On the US/China Trade Breakthrough" December 2, 2018).
- Just in case you've forgotten – in order to contextualize the seeming high-drama of Sunday's tweets just when you thought peace was at hand – remember that at the very moment of the dinner in Buenos Aires, Canada was arresting at the behest of the US Meng Wanzhou, the chief financial officer of Chinese telecom giant Huawei, and daughter of its legendary founder. Markets had rallied after news of the cordial dinner, and then they crashed as

soon as Meng's arrest became known (see "On the Margin: Well, We Said 'Brace Yourself'" December 5, 2018).

- *The Meng arrest was a very bold and risky move. China might have retaliated with arrests of US executives in China, which could have led to a global panic. But Trump seems to have played it right – the move was crazy enough to make China afraid, instead. So instead of acts of vengeance, formal trade negotiations began in January. But even before the first session, China had already removed its retaliatory tariffs on US autos, resumed buying US soybeans, promulgated a law eliminating forced technology transfers, walked back its inflammatory Made In China 2025 program – and even began buying rice from the US*.
- In light of these concessions, at the February 28 deadline for increasing the tariffs on $200 billion of US imports from China from 10% to 25%, Trump did a not-crazy thing: he extended the 10% level indefinitely to give the negotiations more time (see "Extending the Tariff Deadline, Moving the Goalposts" February 25, 2019). His kindness was betrayed when he got sandbagged the following week at his summit with North Korean Supreme Leader Kim Jung-un in Hanoi. After Trump had received private assurances from Xi that Kim would be conciliatory, he turned out to be just the opposite. Trump walked away in Hanoi. *We said then that this was, as much as anything, a signal to Xi that Trump is willing to walk away from unsatisfactory deals – and we warned again that markets need to brace themselves for the possibility that Trump would walk away from Xi himself – just as he did with his tweets on Sunday* (see "Fail in Hanoi, Win in Beijing" March 4, 2019).
- And we suppose the timing for this is perfect in market terms. With US stocks having finally recovered last week to make new all-time highs, Trump may feel he has some room to cause a little volatility. As he once said about such opportunities to reinvest political capital, "We're playing with the bank's money."
- Perhaps Trump felt he had to send a message to Chinese

Cumulative performance from before Trump-Xi Buenos Aires summit



Source: Bloomberg, TrendMacro calculations negotiators who might have gotten a bit more intransigent for similar reasons, with the Chinese stock market the best performing in the world, year-to-date (as we predicted, because though a trade deal would be a loss for the power of the Chinese Communist Party – it is the "victim" in the "robbery" – it would nevertheless be a large gain for the Chinese economy; see the chart on the previous page, and "Did China Just Run Up the White Flag in the Trade War?" July 10, 2018).

- We would advise the Chinese to understand that their equity markets have recovered not because the Chinese economy is stabilizing – it's not (see "Video: What you're not hearing about Chinese growth" April 17 2019). They've recovered because China had the good sense to see the macroeconomic risks it faces (see "On the Margin: China Sees the Cliff" October 19, 2018) and reverse its position that it would not negotiate with the US (again, see "Our Knife at China's Throat").
- As of this writing, Chinese equities are off more than 5%. Surely Chinese officials can see the connection between equity prices and the perceived likelihood of a deal. One has to wonder who is doing the selling and why, though. The Chinese press and social media have completely blacked out the news of Trump's tweets.
- And whatever the other reasons, Trump's tweets served another purpose. Looking "tough on China" is not a politically crazy thing do to exploit rival Joe Biden's ill-advised remarks Thursday that China "is not competition for us."
- For all our sense that the tweets signal a dramatic climax to the negotiations – not their end – obviously we can't rule out the risk of a bargaining failure, in which both sides would benefit from a resolution, yet don't get one because of some irrational human element of pride or greed or ignorance.
- *And at the end of the day, we can't rule out that Trump never wanted a trade deal to begin with, but began his trade war to break China's economy before it overtakes the world – indeed to break China itself, the way Ronald Reagan broke the Soviet Union. Perhaps Trump sees himself as Winston Churchill in 1938, alone in his belligerent willingness to take on Hitler while it was still possible to do so. Churchill was subject to the same suspicion and loathing that Trump is – narcissist, imperialist, racist, unfit to serve – and yet he became the statesman of the century.*
- *But remember the fundamental truth here. Trump wants you to worry about just that kind of possibility. He wants you to think he's crazy. He wants to you to fear him. Because if you aren't afraid of him, Xi Jinping won't be either. And if Xi isn't afraid, he has absolutely no reason to give a millimeter on trade.*
- *We're just collateral damage, as are the equity markets.*
- *But if that's true, then the bet here is that a tolerably small short-term dent in markets will be enough to drive Xi to a deal. When it's done, the risk of a China hard-landing (and a global recession) will be off the table. But beyond that, then China will be liberated to act like a fully engaged developed market, not the protected overgrown emerging market it is now. That would be the core of a global boom.*

Bottom line

Trump tweeted Sunday that the deferred increase in tariffs on $200 billion of US imports from China from 10% to 25% will take effect Friday, and that 25% tariffs on untaxed imports are on the table. This should not necessarily be seen as a deal falling through, but rather entering the chaotic final stages when threats, retaliations, recriminations and walk-aways are to be expected. This is a negative-sum game in which China participates only because it is threatened. Trump must make threats, and appear crazy enough to carry them out even if they are costly to the US. It is scary to markets, but that's collateral damage – if it doesn't scare markets, it won't scare China. When this is done, the risk of a China hard-landing and associated global recession will be off the table, and a less protectionist China would be the core of a global boom.