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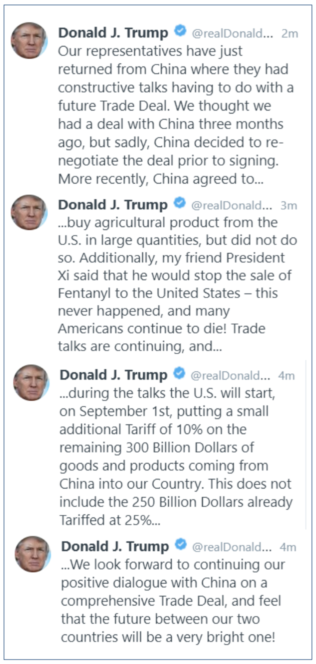
TRENDMACRO LIVE!

On the New China Tariffs

Thursday, August 1, 2019

Donald Luskin

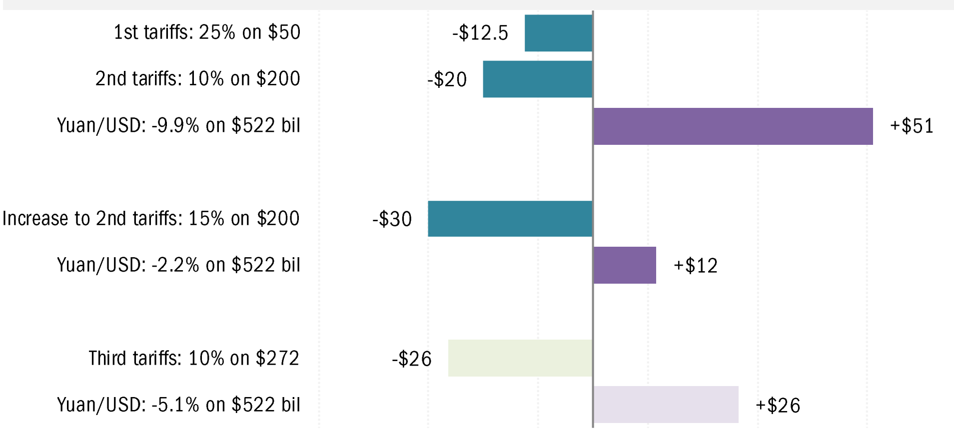
The risk isn't the tariffs – it's that they could push RMB through 7, and collapse oil prices.


Donald J. Trump @realDonald... 2m
Our representatives have just returned from China where they had constructive talks having to do with a future Trade Deal. We thought we had a deal with China three months ago, but sadly, China decided to re-negotiate the deal prior to signing. More recently, China agreed to...
Donald J. Trump @realDonald... 3m
...buy agricultural product from the U.S. in large quantities, but did not do so. Additionally, my friend President Xi said that he would stop the sale of Fentanyl to the United States – this never happened, and many Americans continue to die! Trade talks are continuing, and...
Donald J. Trump @realDonald... 4m
...during the talks the U.S. will start, on September 1st, putting a small additional Tariff of 10% on the remaining 300 Billion Dollars of goods and products coming from China into our Country. This does not include the 250 Billion Dollars already Tariffed at 25%...
Donald J. Trump @realDonald... 4m
...We look forward to continuing our positive dialogue with China on a comprehensive Trade Deal, and feel that the future between our two countries will be a very bright one!

This is just a quick note with our immediate reaction to the announcement today from President Donald J. Trump, by tweet, that the US will impose a 10% tariff on the remaining untariffed $300 billion of imports from China (we estimate it at $272 billion, but Trump likes to round *up*), starting September 1. With trade talks in Shanghai this week concluded with no apparent progress, and the next round in Washington not anticipated until September, *it appears Trump has lost patience, and has decided to make a big raise in this game of geopolitical poker. Trump's tweets call the 10% tariffs "small," – which on the one hand might be a sop to the US stock market, but more likely is a signal to the Chinese that this is only another move in a sequence of gradual escalation of pressure* – *much as Trump just said a moment ago in a South Lawn press gaggle. In that sense, there is nothing new here, no surprise except for the particular timing. It's just another move in the same old pressure game, with the same old pressure dynamics at work.*

While the tweets are polite – as usual, it's "my friend President Xi" – and

US tariffs on imports from China, costs versus FX benefits, USD billions, per annum



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US MACRO, ASIA MACRO, FX, OIL: Trump announced new tariffs of 10% on $300 billion in US imports from China, starting September 1. The tone was polite, but the theme was recrimination for China's past failures to deliver. By calling the tariffs "small," Trump is hinting they could be bigger someday. And by waiting a month t impose them, while citing China's failures, Trump is listing what needs to be done to keep the tariffs from kicking in. Markets reacted negatively, but we think they are getting used to the use of tariffs as diplomatic tools. RMB fell sharply, now only 0.70% from breaching the critical 7-level. Oil fell sharply, reflecting the threat to already stagnant Chinese demand-growth. The risk here is not the cost of the tariffs as taxes, but the possibility of inducing a disorderly hard landing in China, or a destabilizing collapse in the already glutted global oil market.

[Strategy dashboard]

they end with how "the future between our two countries will be a bright one!" – the theme is recrimination for China's failure to follow through on past promises. Typical for high stakes coercive negotiations, and echoing China's June "white paper" making similar charges against the US (see "On China's Trade War 'White Paper'" June 2, 2019). *Trump's list of broken Chinese promises would seem to be hints as to what China needs to do over the coming month to keep the tariffs from kicking in.*

There was immediate carnage in markets, in all cases worsening what had already been experienced yesterday in the wake of yet another FOMC meeting mishandled by chair Jerome Powell (see "On the July FOMC" July 31, 2019). We're tempted to remark that it's almost surprising there wasn't more damage, and perhaps that reflects the extent to which markets have come to understand that tariffs are merely threats, designed to achieve worthwhile goals. *Trump's recent experiences have been positive – tariff threats got both Mexico and Guatemala to agree to participate in the control of illegal immigration* (see "Video: What you're not hearing about Trump's tariff gambit with Mexico" June 9, 2019). *Why shouldn't they work to get China to liberalize its trade practices?*

In the meantime, Trump continues to create a diplomatic safe-space for face-saving compromise by China's President Xi Jinping, yesterday adopting China's own characterization of protests in Hong Kong as "riots." Trump said, "that's between Hong Kong and that's between China, because Hong Kong is a part of China."

For the purposes of this quick note, we want to mention just two markets that were impacted today, both of which have special dynamics, and which we think are indicative of the real risks here.

- The Chinese currency instantaneously weakened by almost a full percentage point versus the US dollar. It's a big drop, about half as great as the day of the deliberate surprise devaluation in August 2015, which set off a year of China-growth worries (see "On the RMB Devaluation" August 11, 2015).
- We highlight this because, as we've said from the beginning, the only reason China is even negotiating with us on trade is because we have the power to damage their economy (see, among others, "Our Knife at China's Throat" October 8, 2018). One of the most risky points of damage is China's fragile currency, fragile because *China must constantly contend with the risk of capital flight on the one hand, and the cost of containing it through capital controls on the other hand.*
- *Since US tariffs were first announced in April 2018, RMB has weakened versus USD by 9.9%. This has had the effect of almost entirely offsetting the cost of the tariffs to US buyers* (please see the chart on the previous page, and, among many, "Sympathy for the Tariff Devil" May 17, 2019).
- *This equilibration is exactly what theory would predict as the tariffs reshape US demand for RMB, and does not require the additional rationale of possible Chinese currency manipulation. If the tariffs announced today take effect, a similar equilibration would weaken*

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Recommended Reading

"Quentin's Really Into Margaritas": A Guide to Tarantino's L.A. Secrets in 'Once Upon a Time in Hollywood'
Scott Huver
Hollywood Reporter
August 1, 2019

[Reading home]

by more than 7%.

- *A mere 0.60% is all it would take to breach the 7-level on RMB, thought to be a "Maginot Line" that must be defended at all costs, or a "Rubicon" which, once crossed, can't be crossed back again. It could open the door to capital flight, capital controls, and sudden catastrophic weakening of the Chinese economy which, already, is growing at the slowest rates in the history of the data.*
- *This is exactly why Trump is imposing these tariffs – to scare China with the possibility of it's first-ever recession, and possibly a very messy one. It's a pressure-job, pure and simple.*
- *As we have said over and over, it is for this reason that we argue that the macro risk from the US/China trade war has little to do with tariffs themselves, and everything to do with the risk of a China hard landing, should China not be wise enough to capitulate in time. Today's move amps up that risk.*
- The other market we are going to single out in this note is oil. WTI was already off 2% when Trump tweeted out the new tariffs, and ended the session down almost 6%.
- We believe that the global oil market is in glut, with OPEC-plus production quotas, and sanctions against Iran and Venezuela the only things keeping prices even in the 50's. *One of the reasons for that is the stall-out in Chinese demand, which has been flat since the US tariffs were announced last year. As the only nation in the world with any substantial demand growth over the last several years, without China, there isn't much global demand growth. With the new crude oil pouring forth from the Permian shale, that all adds up a global glut. Any prolonging or deepening of tariff pressure on China only prolongs and deepens the demand slump.*
- *This is another vector through which the US/China trade war imparts costs and risks to the global economy, other than the trivial direct tax-costs of the tariffs. A collapse in oil prices, as we saw in 2015-2016, has so many connections to the global financial system – such as the US high yield market – that a potential tightening of financial conditions could offset the consumer benefits of cheap oil, and lead to recession* (see "The Recession Caused by Low Oil Prices" January 8, 2016).

That's all for now. At this moment we don't have any prediction of how today's developments influence the probability or the likely timing of a possible resolution with China. Let's just leave it that the game is afoot, and this is just another move in it.

Bottom line

Trump announced new tariffs of 10% on $300 billion in US imports from China, starting September 1. The tone was polite, but the theme was recrimination for China's past failures to deliver. By calling the tariffs "small," Trump is hinting they could be bigger someday. And by waiting a month t impose them, while citing China's failures, Trump is listing what needs to be done to keep the tariffs from kicking in. Markets reacted negatively, but we think they are getting used to the use of tariffs as diplomatic tools. RMB fell sharply, now only 0.70% from breaching the critical 7-level. Oil fell sharply, reflecting the threat to already stagnant Chinese demand-growth. The risk here is not the cost of the tariffs as taxes, but the possibility of inducing a disorderly hard landing in China, or a destabilizing collapse in the already glutted global oil market.