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MACROCOSM

Is Trump Really Bluffing on Tariffs?

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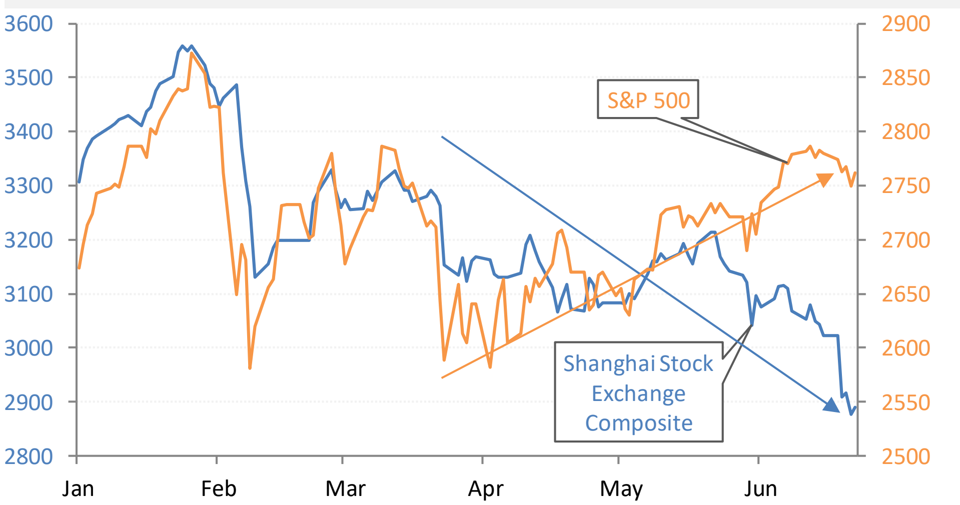
Donald Luskin

Yes. But it's good that you are beginning to doubt it. Let's hope China doubts it too.

From the very beginning we said President Donald J. Trump's tariff initiatives were a not a move toward protectionism for its own misguided sake, but rather a negotiating ploy designed to threaten our trading counterparties into lowering tariff and non-tariff barriers (see "Tariffs: How Scared Should We Be?" March 2, 2018). We think the consensus has come around to our view on that – almost to the point where nobody can even remember believing anything else. But that has created its own special risk, which he have already warned about (see "Risk-Back-On in a Week of Tape-Bombs" April 16, 2018): *if everyone knows that Trump is bluffing, the bluff won't work – so he has to actually act on some tariffs, and keep escalating the threat of more and more tariffs, in order to maintain a credible threat*.

Now, as time has dragged on, and with Trump's latest threat to tariff $450 billion out of $505 billion in US imports from China – pretty much the whole thing – the stakes are getting alarmingly large. Our trading counterparties are playing tit-for-tat, and that's the way trade wars start. And with yesterday's profit warning by Germany's Daimler AG – *the first of which we are aware that specifically anticipates a quantifiable harm from US/China tariffs (because of China's imports of Mercedes SUVs manufactured in the US) – there is now real blood in the corporate water, and it's a little scary.*

US and Chinese equities as the tariff war gets started Local currency



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US MACRO, US STOCKS, ASIA MACRO, ASIA STOCKS, EUROPE MACRO: Tit-for-tat tariffs are starting to get real, with Daimler's profit-warning Thursday the first real blood in the water. If it's all a bluffing strategy, how can it work when the consensus is that it's a bluffing strategy? We're seeing the consensus start to change on that, with clients challenging us on how we can be so sure. China must be beginning to wonder, with its equities in a bear market as US stocks recover. We take Trump's "zero option" on tariffs seriously, and there is preliminary evidence that Europe does as well – pushed by Germany's automakers. China would have to fold if the US and Europe presented a united front. In the meantime, tariff talk is buoying Trump's approval ratings, and no one is talking about a "Blue Wave" in the mid-term elections anymore – he may want to drag this out a while longer.

[Strategy dashboard]

- This morning there are leaks to the effect that the Trump administration is trying to restart talks with China – played in the media, naturally, as evidence of a "split in the White House."
- But all week clients have been asking us: *when do we think this bluffing ploy is going to work, and when we can put this whole thing behind us?* We have no idea, but we know it will happen when our trading counterparties believe it's not a bluff.
- *Clients are also starting to ask how we can we stay so certain that Trump's tariff threats are really just a ploy?* To be sure, to use the parlance of professional wrestling – one of the subjects of this year's TrendMacro summer reading book – it's hard to tell whether this is "a shoot" (real) or "kayfabe" (fake).
- How do we know it's not the worst side of Trump coming out at last, the fulfillment of all those 2016 stump speeches in the heartland touting the virtues of protectionism (see "Which Trump Will Americans Get?" November 10, 2016). *Ahhh – this is all to the good! Trump has got you wondering again about whether he's really bluffing. Now all we need is for China to think the same thing.*
- Just because initial rounds of negotiations seem to have failed, and just because the Section 301 tariffs are now scheduled to take effect on July 6, that doesn't mean the real goal all along was to impose tariffs, or that that's where it will end up. No one should have ever expected China to fold its hand right away just because Trump reaches for his chips.
- *China has to be getting a bit afraid that the US has the stronger hand in this game of poker.* Chinese officials can't fail to be noticing that US and Chinese equities have gone very much different ways since mid-March, as the tariff talk has heated up. In the US stocks have pretty much recovered from their late January/early February mini-crash – which even at worst had the S&P 500 off not quite 12% – while Chinese stocks are now off more than 21% from the year's highs (please see the chart on the previous page).
- *We continue to think that the tariff threats are indeed just a ploy, that is, not an end in themselves, not directed toward the simplistic one-dimensional goal of narrowing the US/China trade deficit.*
- If Trump were really interested in that kind of nakedly mercantilist agenda, he could have taken yes for an answer a month ago when China offered to buy $200 billion per year more of US agriculture, energy and semiconductor products. Then it looked like the trade war was at least "on hold," in Treasury Secretary Steven Mnuchin's words. But then for reasons that have never been articulated, Trump tweeted "in the end we will probably have to use a different structure" – and the deal fell apart, and we're moving ahead with the first tariffs. What would that "different structure" be? We can't know what was in Trump's mind, but our guess is that he is playing for the positive-sum outcome of China *structurally* opening up its economy to foreign participation, not just the zero-sum reallocation of some finite amount of its command-and-control purchases to the US from some other country.
- And then there is Trump's radical proposal at the G7 meeting in Canada:

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"No tariffs, no barriers. That's the way it should be ...And no subsidies. …That's the way you learned at the Wharton School of Finance. I mean, that would be the ultimate thing."

- We'd understand if you thought we were a bit gullible for taking this classic "high ground maneuver" of persuasion seriously – but we do. No one took it seriously when Ronald Reagan said in 1987, "Mr. Gorbachev, tear down this wall." Twenty-nine months later, it was down.
- Trump's tariff "zero option" (we allude to another radical Reagan idea, to completely eliminate US and Soviet missiles from Europe) wasn't taken especially seriously after G7, except by a couple of editorial writers. The news was instead obsessed exclusively with Trump's spat with Canadian Prime Minister Justin Trudeau.
- But serious or not, it is persuasive. We note that German auto-makers have been persuaded. The CEOs of Daimler AG , BMW AG and Volkswagen AG came out this week in support of the mutual abolition of auto tariffs – even though Europe's tariffs on US autos is higher, at 10%, then US tariffs on European autos, at 2.5%. Reportedly the German government is on board. *This is a high-leverage development – as one potential key to getting China to fold its hand would be for Trump to heal trade rifts with Europe, and then gang up together against China.*
- Finally, again addressing the question of how long the threat of a trade war will drag out, we must note that surely Trump regards that threat (if not the reality) to be a political winner going into the November mid-terms. Indeed, considering the massive oppositional pushback Trump gets for seemingly everything, both from Democrats and from #NeverTrump Republicans, this appears to be an issue that very few really want to speak out against. Whenever Trump moves to compromise – as with his decision to help China get ZTE back into business – the dominant narrative is that he is "soft on China."
- While the tariff flap has played out, Trump's approval ratings have been weirdly buoyant. And as congressional primaries have moved along, GOP candidates in vulnerable districts are doing better and better, and Trump's endorsement seems to be a positive with voters. *We haven't heard anyone talk about a "Blue Wave" for quite a while now. So Trump probably wants this to play out a bit longer.*
- We've said from the beginning that the present correction in global equities won't really be over until there is more visibility on the tariffs issue (again, see "Tariffs: How Scared Should We Be?"). But happily we've also noted that markets seem at least to be getting used to it (see "Getting Away With an Act of Tariffism" March 9, 2018, and again "Risk-Back-On in a Week of Tape-Bombs").
- But it could be more than just getting used to it. Markets may be seeing – correctly – that it is in the nature of turn-based games with the tit-for-tat structure for risks to proceed only in steps, each one of which is reversible. *By their very nature, tariffs are written in pencil, and everyone has an eraser.*
- But that's just to look at the expected-risk side of the equilibrium. On the expected-return side, if we're right that the underlying

agenda here is to force China to make deep *structural* reforms – and if Trump can force them to do it – that would ignite a generational surge of new global growth as China completes the only half-completed task of bringing itself into the 21st century.

Bottom line

Tit-for-tat tariffs are starting to get real, with Daimler's profit-warning Thursday the first real blood in the water. If it's all a bluffing strategy, how can it work when the consensus is that it's a bluffing strategy? We're seeing the consensus start to change on that, with clients challenging us on how we can be so sure. China must be beginning to wonder, with its equities in a bear market as US stocks recover. We take Trump's "zero option" on tariffs seriously, and there is preliminary evidence that Europe does as well – pushed by Germany's automakers. China would have to fold if the US and Europe presented a united front. In the meantime, tariff talk is buoying Trump's approval ratings, and no one is talking about a "Blue Wave" in the mid-term elections anymore – he may want to drag this out a while longer.