

TRENDMACRO LIVE

On the US/EU Trade Deal

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Donald Luskin

It's game-over. The US and the European Union are ganging up against China on trade.



We're only going to say a few words about [the joint announcement on trade yesterday afternoon](#) by President Donald J. Trump and European Commission President Jean Claude Juncker. It's not that working toward a zero-tariff regime between the US and European Union isn't a very good thing (though at the moment it is really just a deal to make a deal). *But for us it isn't really news, so we don't expect a qushingly positive market reaction (and Facebook isn't helping). This is really just the logical result of negotiation dynamics we've been talking about for months, particularly five weeks ago when we made the following points* (see ["Is Trump Really Bluffing on Tariffs?"](#) June 22, 2018)...

- (1) *...that Trump's optimal play was to do a trade deal with Europe, so that the US and Europe could then gang up against China to force it to renounce its protectionist practices...*
- (2) *...that to get there, following the chaotic G7 meeting in Quebec, Trump had taken the [high ground](#) by adopting a Reaganesque "zero option:" "So you go tariff-free, you go barrier-free, you go subsidy-free. That's the way you learned at the Wharton School of Finance. I mean, that would be the ultimate thing"...*
- (3) *...that at the same time as that carrot, the stick was for [Trump to threaten Section 232 tariffs](#) against imported automobiles, striking at the heart of Germany's export machine...*
- (4) *...which, after [Daimler's tariff-driven earnings warning](#), got Germany's auto-makers floating a zero-tariff deal [first to the US ambassador](#), and when Trump signaled approval, [to Brussels](#)...*
- (5) *...which sent Juncker to Washington where, as though he had succumbed to [Stockholm Syndrome](#), [he said](#) in most Trump-like language, "I had one intention: I had the intention to make a deal today. And we made a deal today."*

Update to strategic view

US MACRO, EUROPE MACRO, ASIA MACRO, ASIA STOCKS, FX:

Yesterday's US/EU deal is great news, except that it's really just a deal to make a deal, and it's not really news, so we don't expect an exuberant market reaction. It builds on negotiating dynamics we've been highlighting for many weeks, key among which is Trump making the optimal play of allying the US with the EU to gang up on China. China may have hoped to make the same play with the EU against the US after Trump's contentious NATO visit, but that naïve hope is dashed, so it's game over. China's fragility in the face of credit risks and capital flight will force it to make a deal with Trump to avoid slipping over the edge into systemic failure. It's a positive that China's hand is being forced this way, but in the near-term it is risky to push China to the edge. When China caves, it and the emerging markets will be the biggest beneficiary of the relief rally.

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The irony is that autos may not actually be included, perhaps because [truth be told](#), high 25% US tariffs on imported pick-ups may be more precious to US automakers than a reduction of Europe's 10% tariff on their exports. And besides, a lot of European autos are already made on US

soil. But it's still wonderful news that, with only a few preliminary shots fired in what might have been a destructive trade war between the US and Europe, it seems we have agreed:

- (1) ...to "work together toward zero tariffs, zero non-tariff barriers, and zero subsidies on non-auto industrial goods"...
- (2) ..."to reduce barriers and increase trade in services, chemicals, pharmaceuticals, medical products, as well as soybeans. Soybeans is a big deal. And the European Union is going to start, almost immediately, to buy a lot of soybeans," which is to say that *we won't care so much whether China does...*
- (3) ...for the EU to be a "a massive buyer of LNG, so they'll be able to diversify their energy supply, which they want very much to do," which is to say *Europe won't be so helplessly dependent on Russian natural gas...*
- (4) ...*and then the big one*: "We will...work closely together...to reform the WTO and to address unfair trading practices, including intellectual property theft, forced technology transfer, industrial subsidies, distortions created by state-owned enterprises, and overcapacity," which is to say, *we will gang up against China.*

It's game-over. As we said last month (again, see ["Is Trump Really Bluffing on Tariffs?"](#)) and reiterated two weeks ago (see ["Did China Just Run Up the White Flag in the Trade War?"](#) July 10, 2018), China is being pushed to the brink of systemic instability – endogenously by escalating realization of long-deferred credit risks, and exogenously by Trump's tariff threats triggering markets to drive China's currency sharply lower in what may be a self-reinforcing cascade of capital flight.

- We think China is so fragile that it couldn't possibly have resisted making a deal with Trump, even without this EU deal.
- China might have held on longer, perhaps even to its own long-term detriment, if it had been able to isolate the US by allying itself with Europe. If China naïvely allowed itself to be fooled by the elite global media's coverage of [Trump's NATO visit two weeks ago](#) – headlines like "[America First is America Alone](#)" and "[Can the West Withstand Trump?](#)" – it might have thought that could work.
- China is surely re-evaluating now, finding that *it* is the isolated one.
- *It's all on China now to correctly read the new cards that have just been dealt, and drop out of this hand of poker before it's too late. Chances are it will, and when it does, there will be a relief rally of which China itself will be the primary beneficiary, along with other emerging markets that have suffered in sympathy with China.*
- *In the meantime, the US/EU deal ramps up the pressure, and moves China closer to the systemic edge. The risk is always greatest just before everything turns out just fine.*

Bottom line

Yesterday's US/EU deal is great news, except that it's really just a deal to make a deal, and it's not really news, so we don't expect an exuberant

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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

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