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

TRENDMACRO LIVE!

On the US/China Trade Breakthrough

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Donald Luskin

This is the all-clear signal. Both nations made concessions, both saved face.

As we knew they would as soon as we heard the word "framework" coming from the Trump administration (see "On the Margin: In the Beginning was the Word 'Framework'" November 16, 2018), *the United States and China announced yesterday evening, from a summit dinner at the G20 meeting in Buenos Aires, a substantive breakthrough in resolving the trade war.*

You know it's the real thing, and a political triumph for President Donald J. Trump because, as of this writing, with only 12 hours having passed since it was announced, it is not even mentioned on the front page of CNN's website. You know it will be a positive for the US economy and for sentiment – which, politically, will redound to Trump's benefit – because Senate Democrats tried to prevent it by urging Trump to "stand firm," while the *New York Times* tried to inflame the Trump administration's most hawkish instincts by running its "China Rules" series, both celebrating and demonizing China.

There were official statements from both sides – one from the White House and two from China. *It is revealing to observe the items about which the respective statements overlap or differ.* We see no outright contradictions. The US and China are in agreement with each other as to the terms.

- *Tariffs will be frozen at present levels while detailed negotiations continue.* The great significance of this is, first, as we said, the Buenos Aires agreement between Trump and Chinese President Xi Jinping is only a "framework" – it is still subject to documentation, as it were.
- *Critically, while negotiations proceed, US tariffs of 25% on $50 billion of imports from China will stay in place, and tariffs of 10% on $200 billion of imports from China will not automatically jump to 25% at year-end. Nor will the US impose tariffs on an additional $267 billion of imports*.

Update to strategic view

US MACRO, ASIA MACRO, US STOCKS, ASIA STOCKS, EMERGING MARKETS STOCKS, FX: The US and China announced a breakthrough in trade negotiations, with the US suspending further tariff increases and the Chinese immediately resuming purchases of US agricultural products. Trump got the better of the deal, with China making immediate concessions while the US holds the status quo. At the present frozen level of tariffs, the cost to US firms is more than compensated by this year's weakness in the Chinese currency. There was no mention of currency policy nor privatization, Trump's two "big asks," suggesting that they have been conceded by the US. Negotiations over the next 90 days will no doubt be rocky, but this is the all-clear signal that nobody is going to walk off a cliff. That means we've seen the lows in equities, and the year should finish strong, especially for China and the emerging markets.

[Strategy dashboard]

- That means US tariffs on China will run, nominally, at about $32.5 billion per annum, and not jump to at least $62.5 billion at year-end, and then to as much as $130 billion.
- That $32.5 billion triggers all manner of dislocations and uncertainties in the US economy – not least of which is the overhanging global risk of the Chinese economy falling into a disorderly systemic collapse (see "On the Margin: China's Scariest Fragility" August 6, 2018).
- But just by the numbers, economic damage in the US is offset by firms' ability to minimize or avoid the tariffs by redirecting purchases away from China – which is, after all, the whole point of the tariffs (nobody is really supposed to pay them).
- *And for that matter, the weakening of the Chinese yuan from its highs early this year amounts to about a $50 billion per annum offset – thanks to that implicit discount, on average, US buyers today are actually better off than before the trade war began.*
- *So providing that further negotiations end up, at least, enshrining no worse than the present level of US tariffs, and that China itself holds together, we are not worried that direct economic impacts on the US represent immediate cyclical risk.*
- As a matter of tangential interest, we point out that China has agreed to tighten regulation of fentanyl, a synthetic opioid made predominantly in China, which was responsible for almost 30,000 deaths from overdoses in the US in 2017.
- We credit this, at least in part, to our friend Scott Adams (author of last year's TrendMacro holiday book, *Win Bigly*). After the overdose death of his step-son this year, he undertook a highly visible naming-and-shaming campaign against China, with the Twitter hashtag #FentanylChina.

There are several key respects in which the US and China statements differ. Those involve mention by the US of items about which the US is glad to brag, which are omitted by China presumably because it is embarrassed to have had to concede. *Assuming the US representations are not outright lies, we have to conclude that Trump got the better of this deal. But the Chinese still save face, because the Chinese people don't get to know anything leadership doesn't wish them to know – hence the missing items in the Chinese statements.*

- While the US is not reducing any tariffs that are already in effect, according to the US statement (but not those of the Chinese), *China is immediately reinstating halted purchases of agricultural products from the US*. In other words, China is backing down *now*, at least in one respect, while nothing about the *status quo* changes at all for the US.
- According to the US statement (but not the Chinese), the suspension of US tariffs at present levels will only last for 90 days, leaving a Sword of Damocles overhanging the negotiations.
- According to the US statement (but not the Chinese), China will agree to redress the US trade deficit with "very substantial" purchases of agricultural, energy, industrial, and other products

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On the web at
trendmacro.com

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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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from the US, much like the aborted deal from last May. The Chinese statements refers only to "the purchase of marketable goods" to "gradually ease the trade imbalance."

- According to the US statement (but not the Chinese), negotiations will include "structural changes with respect to forced technology transfer, intellectual property protection, non-tariff barriers, cyber intrusions and cyber theft, services and agriculture." The Chinese statements refer only to generic "reform and opening up in China."
- According to the US statement (but not the Chinese), China has agreed to have another look – presumably a more favorable one – at Qualcomm's purchase of NXP Semiconductors.
- The only item of substance in the Chinese statements (but not that of the US) is that negotiations will strive for the elimination of the existing tariff increases.
- According to the Chinese statements (but not the US), Trump and Xi will meet in each other's countries, Chinese students will continue to be welcome at US universities, and the US will respect the "One-China policy."

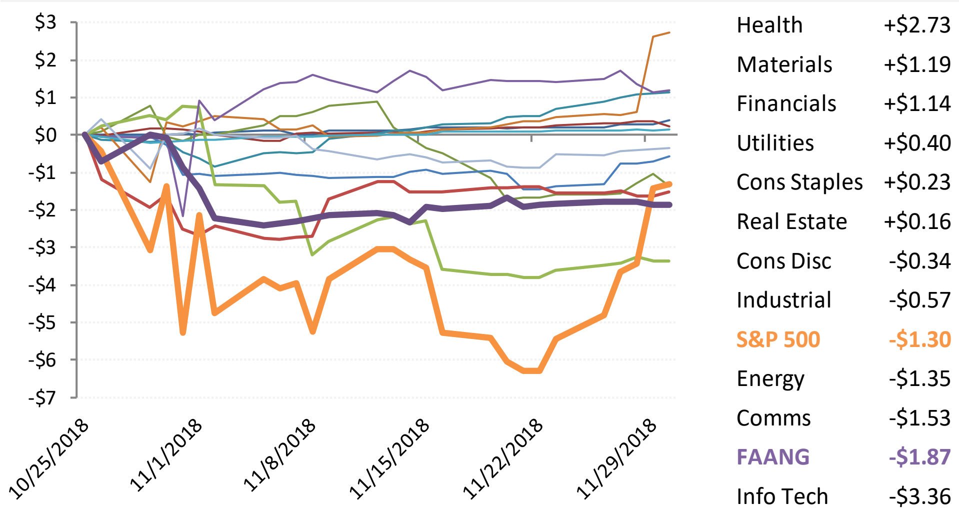
There are two key items not mentioned in either the US or Chinese statements.

- *There is silence on China's foreign exchange policies.*
- *There is silence on China's future privatization of state-owned banks and other state-owned enterprises.*
- *It would seem that these will not be part of the deal. Trump likes to save face, too, so they are simply not mentioned.*
- These two items have certainly been among the Trump administration's demands, and they are devoutly desired. But they are probably the two most difficult for China to concede, as they cut right to the heart of the "state capitalism" model.
- But remember – key elements of Trump's *Art of the Deal* negotiating playbook are the "big ask" and the "ask for lots of different stuff" stratagems. With the "big ask" you "frame" the negotiation upward, and with "ask for lots" you give yourself more ways to win. You won't get the maximum and you won't get it all, but you'll get more than otherwise.
- These omitted matters may yet come up. We suppose one might think they were obliquely mentioned in the US statement as "structural changes with respect to…non-tariff barriers." But we suspect at this point that, if they do come up, it will because Trump needs to use another "big ask" to get stalled negotiations moving.

What does this mean for US equities? We have said that among the many things that seem to be going wrong at once, the US/China trade war is the one that presents the deepest risks (see "One Sell-Off, So Many Causes" October 15, 2018). We have said repeatedly that it would be successfully resolved (see, among many, "Is Trump Really Bluffing on Tariffs?" June 22, 2018). But as we observed right on the day of the bottom for US equities, resolution would require deeply scaring China into making otherwise unwelcome reforms, which in turn, by necessity, would require scaring investors – and on that day we said that US equities were "smokin' cheap" (see "Chinese Tariff Torture" October 29, 2018). The secondary bottom occurred when Commerce Secretary Wilbur Ross's remarks downplaying – but at the same time admitting to – a "framework" for agreement hit the news (again, see "On the Margin: In the Beginning was the Word 'Framework'").

- In the meantime, the fear and uncertainty that was necessary to set the stage for the Buenos Aires negotiations has exacted a price on S&P 500 forward earnings (see "Recession Risk at Last?" November 20, 2018).
- We're happy to report that there has been some recovery, but for the moment, October 25 remains the high-water mark (please see the chart below).

Change in S&P 500 forward earnings from October 25 USD billions



Source: Bloomberg, TrendMacro calculations

- Brace yourself over the coming 90 days of negotiations for stall-outs in the process, or even out-right walk-aways. All that is a perfectly expectable and normal part of the theatrics of negotiation. But as an objective matter, the deal isn't really done until it's done.
- In the meantime, we've already said twice that the present correction in equities is only that – a correction (again, see "One Sell-Off, So Many Causes" and "Recession Risk at Last?").
- It's not like there aren't still other things that could go wrong. A mistake at OPEC's meeting next week that would collapse oil prices – as its mistake in November 2014 did – could trigger credit contagion (again, see "Recession Risk at Last?"). That doesn't seem likely. Reports that Saudi Arabia and Russia have agreed to renew their "pact" to stabilize crude markets suggests that OPEC is most likely to meet our expectation for re-imposition of production cuts (see "OPEC's Gifts to Trump" November 14, 2018).
- But the US/China trade war is the main event, and *Trump and Xi gave the all-clear signal* on Saturday night in Buenos Aires that

nobody is intentionally going to walk off a cliff here and take the global economy down with them.

- *Surely some of this has been anticipated by markets over the last week or two. But let's not overthink it – this is great news, and just what markets needed. Now equities are likely to finish the year strong, with Chinese equities and those of the emerging markets that have been dragged down by China leading the way.*

Bottom line

The US and China announced a breakthrough in trade negotiations, with the US suspending further tariff increases and the Chinese immediately resuming purchases of US agricultural products. Trump got the better of the deal, with China making immediate concessions while the US holds the *status quo*. At the present frozen level of tariffs, the cost to US firms is more than compensated by this year's weakness in the Chinese currency. There was no mention of currency policy nor privatization, Trump's two "big asks," suggesting that they have been conceded by the US. Negotiations over the next 90 days will no doubt be rocky, but this is the all-clear signal that nobody is going to walk off a cliff. That means we've seen the lows in equities, and the year should finish strong, especially for China and the emerging markets.