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On the Margin: True Fake News on China Trade

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Developing items of interest and deeper color on themes from our regular reports.

Done deal? China has already conceded everything. Now Trump can ask for more.

Update to strategic view

US MACRO, ASIA MACRO, US STOCKS ASIA STOCKS, EMERGING MARKETS STOCKS, FX: A *Wall Street Journal* report that the US is considering dropping tariffs on China is both true and false. The implication is that tariffs might be dropped unilaterally to facilitate a deal, or to comfort markets, but that is false. The truth is that the US, quite naturally, would likely drop the tariffs once a deal is done (as opposed to keeping them in place as part of an enforcement regime). This distorted story nevertheless points to the increasing likelihood that a deal will get done, which markets have just begun to discount. As expected, Chinese and emerging market equities and currencies have outperformed those in the US so far.

[Strategy dashboard]

Markets had a moment yesterday afternoon when this item showed up on newsfeeds at 2:43 pm. Here's what you saw on you Bloomberg terminal:

*U.S. WEIGHS ROLLING BACK CHINA TARIFFS TO CALM MARKETS: WSJ

29 minutes later this appeared. Again, on the Bloomberg terminal:

*TREASURY DENIES REPORT MNUCHIN PUSHED TO LOWER CHINA TARIFFS

As Otto von Bismarck said, "Never believe anything in politics until it has been officially denied." But in this case, the news flash *and* Treasury Secretary Steven Mnuchin's denial are *both* fake. Yet taken together they are *directionally* accurate, and they point in the *direction* of a successful conclusion to US/China trade negotiations.

The headline of the *Wall Street Journal* story itself is only slightly less deceptive than the Bloomberg banner: "U.S. Weighs Lifting China Tariffs to Hasten Trade Deal, Calm Markets." It's written to make President Donald J. Trump look weak – like he's in a hurry to do a deal at any cost and get stock prices back up. At least, unlike the Bloomberg banner (which Bloomberg is shamelessly walking back this morning, blaming stupid investors for indulging in "FOMO"), it mentions that the story has something to do with getting a deal, not just market manipulation. But the reader is left believing that, for whatever reason, and for good or for ill, the Trump Administration is contemplating simply dropping existing sanctions on $250 billion of US imports from China, right here and right now.

This turns out to be a perfect example of what we call The Ninth Paragraph Rule – an essential discipline for investors trying to make sense of the news during the Trump presidency. *Yes, it's not until the ninth paragraph that the actual story is revealed: that the tariffs would be dropped if a deal is done, and maybe not even then:*

> Mr. Lighthizer has taken his oft-stated hard-line in trade talks, contending that China hasn't lived up to past agreements and can't be trusted to do so in the future. In the discussions with China, he has said the U.S. should remove tariffs only when China has shown it has carried out promises made during the talks.
>
> But Mr. Lighthizer has shown some signs of easing his position, say people involved in the talks, including raising the possibility that some tariffs could be eliminated if the U.S. strikes a favorable deal on March 1.

Well… but *of course!*

It would be idiocy to drop the tariffs *now* – before a deal is done. It is only the pressure on the Chinese economy exerted by the tariffs that causes the Chinese to negotiate with us in the first place. That pressure is so intense and so effective that it is China, not the US, that is dropping its weapons *now* – before a deal is done – that is to say: negotiating against itself. Even before formal negotiation began last week, 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. It is China that further undermined its own negotiating position by acting too eager when it declared it sought a deal "the sooner the better," admitted it was willing to "meet each other halfway" and sent Vice Premier Liu He to appear personally in a meeting of lower-level trade negotiators last week in Beijing.

With all these concessions made by China, the deal could be seen as essentially already done. China has already given Trump almost everything he wants. It has done so without a single concession from the US – all the US tariffs that were in place at the time of the Buenos Aires summit between Trump and Chinese president Xi Jinping are still in place. *If the essence of the* Journal *story's ninth and tenth paragraphs is correct, it would mean that the Trump team is now aiming at getting additional concessions that China would only grant in exchange for removing those tariffs.*

In just two months the apparent evolution in consensus expectations for a trade deal has been remarkable. Using the headlines of the *Washington Post's* relentlessly anti-Trump economics writer Tory Newmyer as a barometer of sentiment, in mid-November "U.S.-China trade conflict is worsening". Then, upon the Trump/Xi summit breakthrough, "The U.S.-China trade 'deal' offers less than meets the eye". Days later, "'Tariff Man' sows

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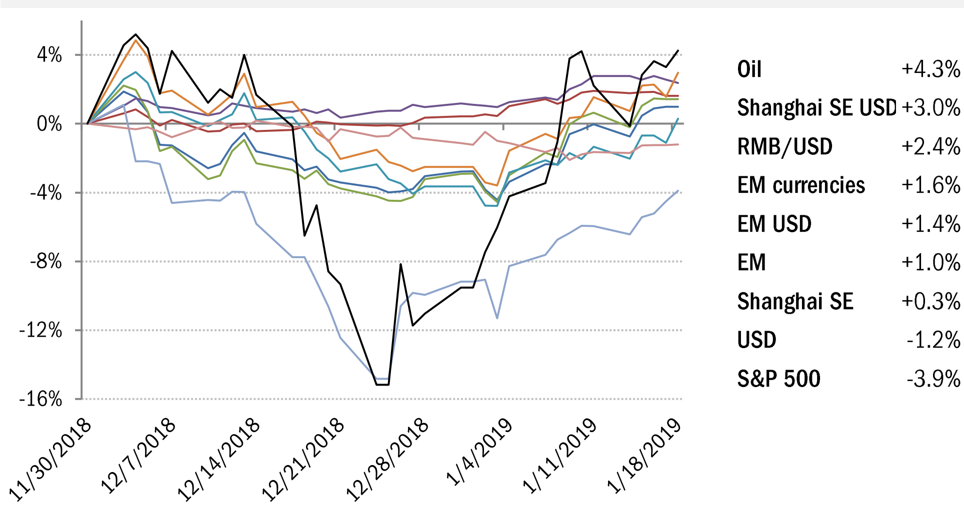
[confusion over U.S.-China trade"](). And now, apparently, there are worse sins on Trump's hands: "China standoff could end before U.S. government shutdown". *So it's not surprising that we're beginning to hear questions from clients about whether it's too late to bet on a deal – have markets already discounted it?*

We think they've surely started to, and it's playing out just as we predicted, with equity and currency markets in China and the emerging markets outperforming those in the US (see, among many, "Did China Just Run Up the White Flag in the Trade War?" July 10, 2018). How can markets not start to expect a deal, with China so obviously negotiating against itself to get one – all the while more and more desperately inventing new forms of easing and stimulus to keep its economy above stall-speed until the negotiations are complete and the crippling uncertainty ends (see "Death by China on the Way to Yes" December 17, 2018)?

But markets can't be sure about any of it. Yes, markets worldwide have had a much better tone so far in the New Year, and progress on a US/China deal is surely part of that. But since what we see as the real turning point in the negotiations – the Buenos Aires summit (see "On the US/China Trade Breakthrough" December 2, 2018) – markets got worse before they got better (see "On the Margin: Well, We Said 'Brace Yourself'" December 5, 2018). Even now, US equities are still lower, and Chinese equities only went green, cumulatively, this morning (please see the chart below). The recovery has only barely begun.

The risks remain very real. China is fragile and weak – a potential global systemic risk in and of itself – and at the same time, because of that very

Cumulative performance from before Trump-Xi Buenos Aires summit



Source: Bloomberg, TrendMacro calculations weakness, Trump's entirely optimal game theory posture here is to now ask for even more in the negotiations. That, by construction, moves the negotiation toward a risky landing on a short narrow runway at the edge of chaos. *Our modal expectation is still that everything will turn out well – but the downside risk in the event of an unexpected bargaining failure is quite severe, so we would estimate that there is still a large risk premium to be earned by sweating it out*.