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MACROCOSM

The ("Phase 1") (Unpapered) (Unsigned) China Trade Deal

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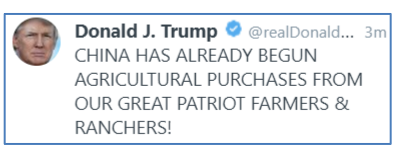
Donald Luskin

A political masterstroke: Trump gets to run as a trade war-time president who is winning.

Let's admit at the outset that Friday's news that the US and China have arrived at a tentative "phase 1" trade deal exceeded our low expectations for what progress could be made in the near term (see "Trump♥Muslims (In China)" October 9, 2019). *On the face of it, it seems that China blinked, at least a bit, implying that the escalating pressure President Donald J. Trump has subjected it to has had more impact on its strategic calculations, and sooner, than we had thought* (see "China's Currency Crisis is Over... Yuan to Bet?" September 10, 2019).

- As Trump explains it, the "phase 1" deal has – or may have, or may not have – lots of moving parts, including everything from intellectual property protection to market access for banks and credit card companies. The centerpiece, and the point of greatest certainty, seems to be Chinese resumption of agricultural imports from the US, and increases so great that, echoing the Roy Scheider character in "Jaws," Trump jokes you're going to need a bigger tractor.
- *Moving from an all-time high of about $19.5 billion in 2017 to promised levels of $40 to $50 billion phased in over two years may indeed be physically impossible for US farmers to deliver, assuming Chinese purchases indeed materialize. But in the meantime, it's a great political talking point for Trump, and one that will make itself manifest right away in real gains for US producers.* Other reform goals probably deferred for the future, such as intellectual property protection, wouldn't have their benefits felt by US producers for years, anyway. So this reminds us more of the last line of one of our favorite movies – "The farmers are the winners. Not us."



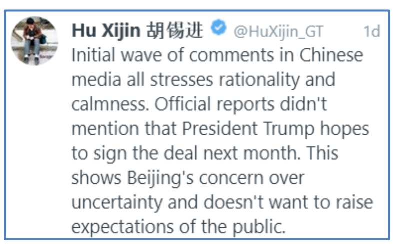
- *This is a political kill-shot,* *and Trump is thrilled about it.* We had argued that Trump wants to run for re-election in 2020 as a trade war-time president, with no definitive deal in place, still fighting for America's factories and farmers. *Now, like Franklin Roosevelt in 1944, he can campaign on the promise of finishing a war that it looks like he's winning.*
- Trump's relentless enemies in the mainstream media aren't happy about it. For example, for the third time in the year and a half since

Update to strategic view

US MACRO, ASIA MACRO, FX, US FED, US STOCKS, US BONDS: A "phase 1" US/China trade deal announced Friday isn't much, but it is more than we expected. Lots of moving parts are talked about, but the centerpiece seems to be resumption of Chinese agricultural purchases in exchange for deferral of the October tariff increase. That means China has withdrawn its retaliation for the 2018 tariffs, while those and more remain in effect – all the US has done is defer tariffs that aren't in effect yet. Phasing the negotiations prolongs the trade war, but Trump can now campaign as a war-time president, with salient and immediate evidence that he is winning. China still faces the risk of a disorderly first-ever recession, but that risk is now reduced somewhat, with pressure taken off RMB. The increased likelihood of Trump's re-election, and decreased risk of a China hard landing, are supportive at the margin of a risk-back-on posture. But Powell has predicated rate cuts on "trade uncertainty," rather than the Fed being too tight, so this may interrupt a much-needed easing regime.

the trade war began, the *Washington Post* recycled literally the same headline, that the deal is "less than meets the eye." But even assuming that China does nothing more than return to its prior levels of ag purchases – let's say that's all we get out of this – *what has Trump given away in exchange? Nothing*. All he has done is agree to defer next week's scheduled increase (from 25% to 30%) in tariffs on $250 billion of US imports from China.

- *Let us be as clear as possible about the algebra of what just happened here: China has given up the ag boycott that was in retaliation for Trump's 2018 tariffs. Those tariffs against which China had retaliated remain in place. All we have done is defer additional tariffs that aren't even in effect yet.*
- And we've left in place not only the 2018 tariffs, but also the new ones that took effect on September 1 – and sanctions against Huawei, and against other Chinese firms, government agencies and officials complicit in the repression of Muslims in Xinjian (again, see "Trump♥Muslims (In China)").
- Will this "phase 1" deal even happen? It is undocumented at the moment. That's a word that Trump associates with other policy domains. So he says it hasn't been "papered." Either way, it means it's not real yet. Trump expressed hopes it might be signed by him and Chinese President Xi Jinping at the Asia-Pacific Economic Cooperation meeting in Chile in December. We acknowledge the uncertainties, but it's nothing but politically motivated sensationalism that *Bloomberg* pushed a "news alert" early this morning to smart-phones world-wide warning that "China Wants More Talks Before Signing Trump's 'Phase One' Deal." The virtually news-free related story conveys only what we already knew – that the deal isn't "papered" yet.



- Chinese state-controlled media have played down Friday's news, and stressed the risk of US duplicity between now and a potential signing. That doesn't necessarily mean there won't be a deal – more likely, it's a face-saving maneuver for China's leadership.
- But in our model of the game-theoretic structure of this negotiation – in which a conclusion can only be reached at "the edge of chaos" at which China fears it is being pushed into a disorderly recession (see, among many, "RMB Breaks 7: Is this 'the Edge of Chaos'?" August 5, 2019) – *this partial deal lowers the chances of a robust full deal, because by deferring the October tariff increase, it takes some of the pressure off China*. Those tariffs would be worth about $13 billion per annum which, all else equal, would weaken the Chinese currency by another 2.5% on top of the 12% it has already weakened since the trade war began in April 2018.
- This gives China more staying power in "phase 2" and "phase n" of negotiations, which means those further phases are less likely to be concluded quickly. That is a necessary consequence – intended or unintended – of what appears to be Trump's political strategy, to

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have the trade war still ongoing during the 2020 campaign (but with the appearance that the US is winning). All that said, if we are right that this "phase 1" deal makes Trump's re-election more likely, that could move China toward faster resolution, having to give up hope that a more compliant Democrat will be its negotiation counterparty in the future. Perhaps China has come to believe that Trump will be re-elected anyway, so best to get ahead of it and, indeed, to help matters along (as a client quipped last night, _this deal may constitute China interfering in the election – for Trump!_).

- _All this means, on the one hand, that the ongoing risk that China will be nudged into a disorderly first-ever recession – with global systemic implications – stays in place as a Sword of Damocles overhanging the markets and the economy. On the other hand, that risk, while ongoing, is somewhat reduced._
- _We believe Mr. Market would like to see Trump re-elected – no matter what you think of him personally, we think there is no question that's what Mr. Market thinks. So this development is positive, at the margin, for risk-back-on, and requires that we moderate some of our pessimism of the last month or so. But it's not clear how much of that markets have already brought on board. Again, the threat of a China hard-landing remains, but at the margin it has been reduced, which points in the same positive direction. We'll be watching USD/RMB carefully for clues on this._
- Perhaps cutting the other way is the impact of this positive trade war development on the Fed, possibly reducing the likelihood of and expectations for future rate cuts. We have worried that Fed Chair Jerome Powell has boxed himself in by predicating rate cuts on "trade uncertainty" rather than admitting that market-implied evidence such as the yield curve mean the Fed is and has been simply too tight (see "On the June FOMC" June 19, 2019). It would be most unfortunate if this good news, at the margin, deflects the Fed from continuing its much-needed easing regime. We'll be watching the curve carefully for clues on this.

Bottom line

A "phase 1" US/China trade deal announced Friday isn't much, but it is more than we expected. Lots of moving parts are talked about, but the centerpiece seems to be resumption of Chinese agricultural purchases in exchange for deferral of the October tariff increase. That means China has withdrawn its retaliation for the 2018 tariffs, while those and more remain in effect – all the US has done is defer tariffs that aren't in effect yet. Phasing the negotiations prolongs the trade war, but Trump can now campaign as a war-time president, with salient and immediate evidence that he is winning. China still faces the risk of a disorderly first-ever recession, but that risk is now reduced somewhat, with pressure taken off RMB. The increased likelihood of Trump's re-election, and decreased risk of a China hard landing, are supportive at the margin of a risk-back-on posture. But Powell has predicated rate cuts on "trade uncertainty," rather than the Fed being too tight, so this may interrupt a much-needed easing regime.