



## MORNING BRIEFING

August 7, 2019

### Tariff Man vs Mao Man

See the [collection](#) of the individual charts linked below.

(1) Deal or no deal? (2) Hardliners in China and in the US have the upper hand. (3) Escalating trade war. (4) Chinese checkers is a game with winners and losers. (5) Trade works best when there are no losers. (6) China has more at risk than US. (7) Currency war unlikely. (8) Xi wants Trump to lose the next election. (9) Trump expects Xi to do a deal once he wins another term in the White House. (10) Trumping the Fed. (11) Xi's homegrown problems. (12) For Trump, the endgame may be simply to push supply chains out of China, which is happening already.

**Trade War I: Chinese Checkers.** President Donald Trump started the trade war with China on 4/3/18, when his administration released its \$50 billion list of 1,333 Chinese products under consideration for 25% tariffs. The month before, on 3/2/18, Trump famously pushed back against a wave of criticism about steel tariffs that he had imposed in February of last year, saying “trade wars are good, and easy to win.”

He would have been right if the Chinese had concluded a deal in early May, as was widely expected thanks to Trump’s cheerleading. Most of the details had been worked out. However, the remaining big issue was the enforcement mechanism. Trump wanted the Chinese to change their laws to reflect the agreement, particularly on intellectual property rights. The Chinese balked at going that far.

Chinese President Xi Jinping’s hardliners on trade apparently convinced him that no deal is better than the deal that had been negotiated. Trump has his hardliners on trade too, including trade adviser Peter Navarro and US Trade Representative (USTR) Robert Lighthizer.

So on Sunday 5/5 of this year, Trump announced that the 10% tariff on \$200 billion of imports from China, which had been imposed on 9/24/18, would be raised to 25%. He also threatened to impose the 25% tariff on the rest of US imports from China. On Thursday 8/1, immediately following another round of talks, Trump slapped a 10% levy on \$300 billion of those goods and threatened to up it to 25%. All US imports from China now face a tariff of 10% for \$300 billion of imports and 25% for \$250 billion of imports.

China retaliated on Monday 8/5 by freezing all agricultural imports from the US and by devaluing its currency below 7.00 yuan per dollar. The prospect of a currency war along with a trade war sent stock prices reeling, with the S&P 500 falling 6.0% from its record high on 7/27 through Monday’s close.

In fact, it may be that the two hardest of the hardliners are none other than Xi and Trump. The

two leaders are playing a dangerous game of Chinese checkers. Chinese checkers isn't a variation of checkers, nor is it originally Chinese in origin. However, the object of the game is to win by moving all one's pieces into the star corner on the opposite side of the board before your opponent does the same.

Trade isn't a game, of course. When it is done right, both trading partners should benefit from the relationship. If it devolves into a trade war, there can be no winners no matter who claims that title.

Nevertheless, back on 5/28, I [wrote](#) that if the trade war escalates, "I expect it will do more damage to China's economy than to the US economy. As Debbie and I observed last week, nominal GDP in the US was up to a record \$21 trillion (saar) during Q1-2019. Over the past 12 months through March, US merchandise exports to China totaled \$114 billion while US imports from China totaled \$522 billion. Both are small relative to the size of our economy" ([Fig. 1](#)). Chinese exports to the US, in yuan, account for 18.4% of total Chinese exports, based on the 12-month average ([Fig. 2](#)).

Regarding a possible currency war, I wrote: "If push does come to shove and Trump slaps a 25% tariff on all Chinese goods imported by the US, the inflationary shock could be offset by a weaker yuan." The drop in the Chinese currency below the key psychological level of 7.00 yuan per dollar on Monday certainly unnerved stock investors ([Fig. 3](#)).

Stocks recovered some of their losses yesterday because the exchange rate stabilized after the Chinese central bank indicated that it isn't intent on starting a currency war. The Chinese already have a problem with capital outflows, which would worsen if they significantly devalued their currency. Our monthly proxy for implied capital outflows shows that they totaled about \$400 billion over the 12 months through June ([Fig. 4](#)). (We derive this proxy as the 12-month change in China's non-gold international reserves minus the 12-month sum of China's merchandise trade surplus.)

**Trade War II: Trump's Game.** What does Trump want? He wants to win another term on 11/3/20. What does Xi want? He wants Trump to lose. They both know that. Xi is president for life, so he figures he can easily outlast Trump, though having to deal with Trump through 2024 would be more challenging than through 2020. Trump must know that even if he gets a deal with China before the election, that won't mean much if he loses. He seems to be talking up the scenario of a post-election deal, perhaps believing that timing will yield a better deal from the Chinese, assuming he wins a second term.

The following is from a Friday 7/26 Bloomberg [article](#) titled "Trump Says China May Delay Trade Deal Until After 2020 Elections":

"President Donald Trump said China may wait until after the 2020 U.S. presidential election to sign a trade agreement because Beijing would prefer to reach a deal with a Democrat. 'I think that China will probably say, 'let's wait,' Trump told reporters in the Oval Office on Friday. 'When I win, like almost immediately, they're all going to sign deals.'"

In other words, Trump may have decided that he will get a better deal once he wins next year's election (if he wins). On Monday 7/29, USTR Lighthizer and Treasury Secretary Steven Mnuchin went to China for the first high-level, face-to-face trade negotiations since talks broke down in early May. The talks lasted just two days, with no progress, and on Thursday 8/1, Trump escalated the trade wars, as noted above.

Meanwhile, Trump is also playing Chinese checkers with Fed Chair Jerome Powell. So far, it's no contest: Trump is winning the game. Trump must figure that he needs the Fed to lower interest rates while he waits for the Chinese to come around on trade, hoping to strike a deal after the elections.

In the 7/11 [Morning Briefing](#), we predicted that Trump would force the Fed to lower interest rates by creating uncertainty about US trade policy. We noted that in his 7/10 [congressional testimony](#) on monetary policy, Powell mentioned the trade issue eight times. So Powell had been trumped by Trump, as evidenced by the Fed's decision to cut the federal funds rate by 25bps on 7/31 ([Fig. 5](#)). The very next day, Trump upped the tariff ante.

In response to Monday's stock market rout, Fed Governor Lael Brainard said at a forum at the Kansas City Fed, "I am certainly monitoring developments for their implications for the outlook and I will continue to be very attentive to them." The 12-month federal funds rate futures plunged to 1.17% on Monday ([Fig. 6](#)). That implies four 25bps cuts in the federal funds rate by August of next year.

**Trade War III: Xi's Game.** In addition to the trade war with the US, President Xi has plenty of homegrown problems. The country's economic growth is slowing. There is too much debt, and more zombie companies that can't service their debts. Large capital outflows have been a problem in recent years.

Xi's biggest immediate challenge is the unprecedented pro-democracy protests in the self-governing region of Hong Kong. How to respond is a test for Xi's leadership and has the potential to worsen US relations if he opts for a violent solution. The unrest in Hong Kong has become intertwined with US and China trade relations as Chinese officials have blamed the US for the protests, though there is no evidence to support it, [observed](#) the 8/2 *NYT*.

China certainly has taken unfair advantages of the US when it comes to trade. The problem now is that attempting to work out a win-win "free and fair" trade deal with a society that is not free or fair may prove futile. Consider the following:

(1) *The life of the party.* Xi is a communist. In many ways, he is Mao in a business suit. Since assuming power during 2013, Xi has ended term limits, securing his power as leader for life of the Communist Party of China (CPC). Nevertheless, "Xi has a legion of internal critics, including over his handling of relations with Washington," said Richard McGregor, an expert on the CPC and the author of a new book about Xi's leadership, according to an 8/3 [article](#) in the *Washington Post*. The internal [critics](#) may be getting more vocal, especially as China experienced its slowest annual growth in nearly three decades during Q2.

Long-time China scholars say that Xi's efforts to bolster the party and his leadership over it are rooted in insecurity. Taking an admission oath at the site of the first CPC National Congress during 2017, CPC leaders [chanted](#): "It is my will to ... strictly observe party discipline, guard party secrets, be loyal to the party, work hard, fight for communism throughout all my life, be ready at all times to sacrifice my all for the party and the people and never betray the party." Xi's values are heavily promoted throughout the country and taught to young children in schools.

Xi believes that the risk to his authority is within his own country. "No exterior forces are able to take us down, as we are the world's largest political party; the only one who can defeat us is ourselves," Xi wrote on 7/31 for a CPC publication, according to the *Washington Post* article.

(2) *Hong Kong boiling over*. Xi has faced more and louder criticism from the semiautonomous region of Hong Kong, where pro-democratic tensions are growing. A proposed extradition bill allowing the detainment and transfer of wanted persons to the Chinese mainland has sparked an unprecedented level of protests, [noted](#) the 6/10 *NYT*; protesters fear the law would extend not just to criminals but to political activists too.

Hong Kong is out of control and may not be restored without a show of force by Beijing. On Tuesday, according to [NPR](#), more than 12,000 police officers conducted anti-riot drills in the southern city of Shenzhen, adjacent to Hong Kong—ostensibly to prepare for the 10/1 70th anniversary of the founding of the People's Republic of China, but the intimidation factor likely wasn't lost on anyone.

**Trade War IV: The Endgame.** An 8/2 [post](#) on *Foreign Policy's* website is titled "Trump Hired Robert Lighthizer to Win a Trade War. He Lost." The conclusion that Trump has lost the trade war is based on the pain inflicted by the tariffs: "The entire theory that had anchored the Trump trade policy turns out to have been wrong; it may live on zombielike, but the already minimal returns will diminish more. The United States will hurt itself and others with tariffs without even the prospect of meaningful trade deals."

But missing in the analysis is that the ultimate endgame for the Trump administration is to force manufacturers around the world to move their supply chains out of China. In that, it is succeeding. Consider the following:

(1) A 7/16 *Forbes* [article](#) is titled "Europe Joins U.S. Companies Moving Out Of China." It reported: "Make no mistake about it, the trade war is absolutely remapping global supply chains ... to the detriment of Chinese manufacturing. The percentage of China-leaving businesses surveyed by quality control and supply chain auditor QIMA was 80% for American companies and 67% for those based in the European Union."

While European companies are less affected by the trade war, they have their own reasons to reduce their dependence on China manufacturing. Most are diversifying throughout Southeast Asia and moving closer to home.

(2) A 7/18 *Nikkei Asian Review* [story](#) is titled "China scrambles to stem manufacturing exodus

as 50 companies leave.” It reported: “China is racing to keep foreign enterprises in-country, dangling special benefits so that the advantages of staying outweigh the heavy tariffs imposed by the U.S. A year into the trade war with Washington, more than 50 global companies, including Apple and Nintendo, have announced or are considering plans to move production out of China, Nikkei research has found. And not just foreign companies. Chinese manufacturers, as well as those from the U.S., Japan and Taiwan, are part of the drain, including makers of personal computers, smartphones and other electronics.”

(3) The 7/14 [WSJ](#) includes an article titled “Manufacturers Move Supply Chains Out of China.” It reported: “The moves by U.S. companies add up to a reordering of global manufacturing supply chains as they prepare for an extended period of uneven trade relations. Executives at companies that are moving operations outside China said they expect to keep them that way because of the time and money invested in setting up new facilities and shifting shipping arrangements. Companies said the shifts accelerated after the tariff on many Chinese imports rose to 25% from 10% in May.”

## CALENDARS

**US. Wed:** Consumer Credit \$16.5b, MBA Mortgage Applications, DOE Crude Oil Inventories, Evans. **Thurs:** Jobless Claims 215k, Wholesale Inventories 0.2%, EIA Natural Gas Report. (DailyFX estimates)

**Global. Wed:** Germany Industrial Production -0.5% m/m/-3.1% y/y, Japan Trade Balance ¥708b. **Thurs:** OECD Leading Indicators, Japan GDP (annualized) 0.6% q/q, China Trade Balance \$44.3b, Mexico CPI, ECB Publishes Monthly Bulletin, Lowe. (DailyFX estimates)

## STRATEGY INDICATORS

**S&P 500 Q2 Earnings Season Monitor ([link](#)):** With the Q2 earnings season nearly 83% complete for the S&P 500, the results compared to the same point during Q1 show that revenues are beating by a greater amount; a higher percentage of companies is reporting positive revenue surprises; the earnings surprise is a tad smaller; and y/y earnings growth is only 1.4ppts lower despite Boeing’s dismal Q2 results. Of the 414 S&P 500 companies that have reported through midday Tuesday, 74% exceeded industry analysts’ earnings estimates. Collectively, these reporters have averaged a y/y earnings gain of 2.1% and exceeded forecasts by an impressive 6.3%. Ex-Boeing, y/y earnings growth improves 1.8ppt to 3.9%. On the revenue side, 59% of companies beat their Q2 sales estimates so far, with results coming in an impressive 1.5% above forecast and 3.5% higher than a year earlier. Q2 earnings growth results are positive y/y for 66% of companies, versus a lower 65% at the same point in Q1, and Q2 revenues have risen y/y for 68% versus a similar 65% during Q1. Looking at earnings during the same point in the Q1-2019 reporting period, a slightly higher percentage of companies (76%) in the S&P 500 had beaten consensus earnings estimates by a slightly higher 6.8%, and earnings were up a higher 3.4% y/y. With respect to revenues at this point in the Q1 season, a slightly lower 58% had exceeded revenue forecasts by a sharply lower 0.2%, and sales rose a higher 5.0% y/y. Compared to 2018’s stellar results, these mid-season readings for Q2 indicate a continuation of a marked slowdown in revenue and earnings growth

and a slight deterioration in profit margins. But that should come as no surprise to investors. Q1-2019 had marked the 11th straight quarter of positive y/y earnings growth and the 12th of positive revenue growth. However, earnings growth trailed revenue growth during Q1-2019 for the first time since Q2-2016. That has happened just five times in the 42 quarters since the bull market started in Q1-2009. As more companies have reported, it's now looking more possible that Q2-2019 will make the sixth.

## US ECONOMIC INDICATORS

**JOLTS** ([link](#)): Job openings in June fell for the fourth time in five months, though were still within 278,000 of November's record-high reading of 7.626 million. Openings fell 36,000 in June and 277,000 over the five-month period to 7.348 million. June's ratio of unemployed workers per job opening was below 1.00 for the 16th straight month, at 0.81, with job openings exceeding unemployed workers by 1.4 million. Hirings sank 289,000 during the two months through June to 5.702 million, while separations fell 206,000 over the two-month period to 5.481 million; both hirings and separations had jumped to record highs of 5.991 million and 5.687 million, respectively, in April. The latest hiring and separations data yielded an employment advance of 221,000 in June, 28,000 above June's payroll gain of 193,000—overstating the increase for the seventh time in eight months. Those quitting their jobs fell 83,000 to 3.433 million since rising to a record high of 3.516 million in April. June's private-industry job openings (4.9%) rate continued to hold just below its record rate of 5.2% posted in October and November, while the quit (2.5) rate held just below its cyclical high of 2.6%—bouncing between 2.5% and 2.6% since mid-2018. The hires rate was unchanged at 4.2%, fluctuating in a flat trend between 4.2% and 4.4% since reaching a cyclical high of 4.4% last May.

## GLOBAL ECONOMIC INDICATORS

**Germany Manufacturing Orders** ([link](#)): German factory orders in June rebounded after sinking to its lowest level since September 2016 in May. Total billings jumped 2.5% during June—boosted by a 5.0% increase in foreign orders; domestic orders fell for the fifth time in six months, contracting 1.0% m/m and 8.0% ytd. Billings from outside the Eurozone increased for the third time in four months, by 8.6% m/m and 12.6% over the period, with capital (12.3% and 17.5%) and consumer (2.4 and 17.9) goods orders up big over the comparable periods—the latter to a new record high. Meanwhile, orders from within the Eurozone remain depressed, falling for the fifth time this year, by 0.6% m/m and 5.7% ytd. All the main industry groupings show billings falling ytd: capital (-7.9%), consumer (-5.1), and intermediate (-2.7) goods, though the latter did shoot up 6.1% during June.

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