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Public Policy Economics

KEY INSIGHTS

February 14, 2019

Why Global Financial Markets Are Too Sanguine About a Trump-Xi Trade Deal

By: Robert Wescott, Ph.D., and Elizabeth Rust

Key Insights

- Global financial markets are increasingly optimistic that President Trump and President Xi soon will agree to a trade deal that will ignite financial markets.
- However, we are far less optimistic.
- In particular, we worry that Trump really wants to disrupt China supply chains, that the U.S. business community has now swung solidly behind a "stay tough" position, that Trump likes to keep balls in the air on trade, and that Trump believes his current tough stance is working.
- If a trade deal is announced, markets will have a great day, week, or month, but we believe that as players dig into the details, equity markets will remain under pressure, bond yields will remain under downward pressure, and any rebound in commodities is likely to be short-lived.

Many financial market players are optimistic about a Trump-Xi deal—we do not share this optimism.

Introduction It has been about a year since U.S. President Trump declared himself "tariff man" and started to impose tariffs on U.S. imports of steel and aluminum and a broad swath of goods from China. Indeed, we believe that nervousness about trade friction between the U.S. and China has been a central driver of financial market volatility over the past 4-5 months. We are struck now at how optimistic many financial market players have become about the possibility that President Trump will make a deal with President Xi to resolve the trade war. Are these expectations reasonable? Is there likely to be a grand trade deal that will reassure global financial markets and set the stage for them to possibly hit new highs? Unfortunately, we do not share this optimism. Here are four reasons why we worry.

What We Worry About

Trump Really Wants to Disrupt Chinese Supply Chains.

It is true that President Trump and his chief trade negotiator, Robert Lighthizer, are upset about the absolute size of the U.S. trade deficit with China—more than $400 billion in 2018. But even more significantly, they see the trade story as just one aspect of a growing geopolitical struggle between the two countries. Lighthizer has repeatedly talked about the need to "disrupt global supply chains" to break America's dependence on Chinese goods. Moreover, Trump and his economic nationalist advisers have serious concerns about China's "Made in China 2025" initiative that seeks to use state-directed credit flows, nontariff barriers, intellectual property theft, and any other means necessary to build the industries of the future—aerospace, artificial intelligence, high-speed rail, electric vehicles, etc. Ongoing American lobbying of foreign governments to discourage the use of Huawei technology for building out 5G networks is just one example of the Trump administration's effort to curb China's influence.

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President Xi knows his Made in China 2025 initiative is sensitive, so he has ordered references to it in news stories to be dropped to try to downplay its importance. However, the initiative is central to his future vision for China and he simply cannot walk away from it. Doing so would seriously undermine his political support at home. So quite simply what Trump wants—for Xi to commit to stop his main initiative—is not on the table.

The U.S. Business Community Now Supports the View That China Needs to Be Confronted.

Importantly, the bulk of the American business community and a solid majority of American citizens have come to share Trump's view that China must be confronted. This has been a major shift. Just two or three years ago, most American Fortune 500 firms saw enough market growth opportunities in China that they were willing to turn a blind eye to IP theft and other unsavory business practices. But this perception has changed. As growth prospects have dimmed in China, the calculus for American businesses has turned negative. There is a growing view that the world is going to have to stand up to abusive Chinese business practices, and the time might as well be now.

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- This view was captured in an op-ed piece in the *Washington Post* yesterday by pro-business Florida Republican Senator Marco Rubio, who argued that America must negotiate very tough with China on the IP theft issues and not let up now that the U.S. has leverage over the country.

- When we survey the field of Democratic presidential contenders, we believe that most of them also will take a tough stance on China as well, so it is wrong to see the current U.S. position as unique to Trump.

- In fact, when considering virtually all of Trump's policy positions—building a wall with Mexico, cracking down on immigrants, withdrawal from the Paris climate agreement, getting tough with NATO, reducing environmental standards, easing regulatory burdens, engaging in talks with North Korea, etc.—getting tough with China may be the only policy stance where Trump has the backing of a clear majority of Americans.

Delaying Trade Resolution Is Part of Trump's Strategy.

Delay, confusion, threats, hints about new tariffs, exasperation, and frustrated trade negotiators all serve Trump's purposes.

President Trump loves to keep balls in the air in his trade negotiations. He does not like for things to actually resolve. He believes that dragging out negotiations, keeping pressure on his opponents, constantly injecting new demands, and keeping the other country off balance is the way to win at trade. An off-hand comment to a reporter during the NAFTA trade renegotiations in early 2018 was very instructive. When asked to comment on why negotiations among the U.S., Mexico, and Canada were dragging on so long, Trump stated that the long drawn out haggling was actually part of his plan, saying that every month that went by without a resolution of the trade deal was another month when the CEO of a U.S. auto company would not make a billion dollar FDI investment in Mexico, and that that was a win for him. In other words, delay, confusion, ongoing threats, hints about new tariffs, exasperation, and frustrated trade negotiators heading home after another failed round of talks all serve his purposes. They forestall FDI decisions, cause companies to search for domestic sources of supply, and cause a further withering of global supply chains.

Trump Thinks He Is Winning the Trade War.

Finally, President Trump believes that he is winning the current trade war with China because of mounting evidence of an economic slowdown in China. He likes the path he is on. The one wrinkle to hit him was the U.S. stock market's sharp declines in December, with many observers saying that his trade war with China might have been at least a partial cause. (For those who have not noticed, Trump loves to brag about the soaring stock market on his watch.) But in general, Trump feels that his tough-guy approach toward China is working.

What is Likely to Happen? We believe that the U.S. stock market wobbles of December mean that Trump will try to make some accommodation with China to provide some reassurance and boost U.S. financial markets. However, we believe that while financial markets are expecting a comprehensive, "clear the decks-type" deal that will put global companies back on a pre-2017 path of global supply chains and nearly endless market potential in the Chinese market, the reality will be something much more minimalist.

We are sure that financial markets will soar on the day that an agreement is announced. However, we believe that in the days, weeks, and months that follow, it will become increasingly clear that Trump has no intention of really "resolving" U.S.-China trade frictions, and that a wave of pessimism will pervade world markets as this perception spreads.

Here are some possible outcomes:

- Trump announces that China will buy tens of billions of dollars more in American soybeans and Boeing aircraft and Caterpillar equipment, and that China will pass new laws to stop IP theft and forced IP transfers. In return, Trump says the U.S. will delay the next round of tariff increases (from 10% to 25%) from March 1 to say, September 1, 2019. Trump will say he will use the 6-month window to observe whether China follows through on its commitments, and almost by definition, China will not be able to do so.

- Or Trump announces on March 1 that trade matters are not yet resolved, and that in response the U.S. will hike tariffs to "keep pressure on China to negotiate", but that the U.S. will hold off on other tariffs to "see what China does next."

- Meanwhile, the U.S. will continue to put in place measures to block Chinese FDI into the U.S., with increasingly smaller foreign ownership shares of high-tech firms triggering investigations.

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- President Trump will use Twitter as a platform for criticizing U.S. firms planning to make investments in China and will threaten them with negative social pressure.

- The U.S. will identify other Chinese technology firms besides Huawei that it thinks might have stolen U.S. IP or that it worries could be used to spy on global firms. It will try to organize global boycotts for their sales or heightened scrutiny of their deals, all with the goal of undermining Chinese technology development.

- The U.S. will develop and enforce increasingly tough export controls on sales of U.S. technology to China, to the point where U.S. firms will begin to lose interest in Chinese markets, and Chinese firms will view the U.S. as such an unreliable supplier that they try to shift to European suppliers and redouble efforts to promote indigenous technology.

- There will be a general increase in retaliatory commercial restrictions between the two countries, with growing delays getting normal regulatory approvals, licenses, etc. In some cases, sanitary inspections of food and agricultural imports will be delayed and cause product spoilage. U.S. technology firms will find their applications to supply data, news, and information services denied on national security grounds. There may be an increase in retroactive tax cases where U.S. firms are suddenly told that they have underpaid tax bills from years earlier that need to be investigated. Meanwhile, the U.S. will increasingly charge Chinese firms with violations of sanctions against Iran, Russia, or other countries.

- Trump announces a series of increasingly unfriendly social, cultural, and educational measures to block more Chinese students from studying at American universities, put restrictions on so-called Confucian academic centers at American universities, and make it increasingly difficult to get travel visas. China retaliates with like measures. It also is not hard to imagine tit-for-tat arrests of American and Chinese business travelers in high-profile cases, which would quickly have a chilling effect on cross-country business.

Bottom Line: What Does It All Mean for Financial Markets? After an initial boost to global financial markets after the first announcement of a "trade deal", companies will find that business conditions remain difficult. They will continue to reassess their long-term strategic plans based upon global supply chains, potential market growth in Chinese markets, etc., and mark down their expected future profits.

After an initial boost, business conditions will remain difficult and world economic growth will slow.

- Equity values in U.S., China, and European and Asian markets will be squeezed.

- Slower growth is likely to cause bond prices to rise and yields to decline, at least for the first year or two. Over a longer horizon, the potential slowing of Chinese purchases of U.S. debt may cause a general rise in U.S. interest rates.

- The U.S. dollar is likely to rise due to safe harbor effects.

- Global commodity prices would be lower due to expected slower world economic growth.

KEYBRIDGE
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3050 K Street NW, Suite 220
Washington, DC 20007
Phone: 202.965.9480
Web: keybridgedc.com