FTN FINANCIAL

MAY 17, 2019

ECONOMIC WEEKLY

The Trade Fight and the Global Economy

The trade dispute between the US and China constantly shifts, and it is difficult to estimate the economic effects. Nevertheless, three threads emerge from the last two weeks:

1. The direct economic impact of tariffs — on the US at least — is small. Last year's tariff round failed to boost core inflation to 2% and appears to have affected GDP by less than a tenth of a percent.
2. The biggest danger to the US might well be the uncertainty as tariffs are imposed one day and delayed the next, all while trade negotiators are alternatively described as "close" or "miles apart."
3. Finally, trade negotiations and tariffs are part of a bigger battle between China and the US for global influence, so any short-term resolution will preview the next battle.

The stakes

The economic stakes are not as big as they are being made out to be. A recent *Financial Times* article predicted a 50bp boost to inflation and GDP impact on a par with the after effects of the Smoot-Hawley tariffs in 1930. For those unfamiliar with the Smoot-Hawley tariffs, many economists believe they triggered the Great Depression. Another more recent article put the cost of last year's tariff at $1.6bn a month, falling directly on US consumers.

And yet, core inflation failed to crack 2% last year and, while tariffs caused one-off price increases, the price effect faded over time and there were offsets elsewhere. A great deal of last year's acyclical inflation and this year's acyclical disinflation — the reason the Fed is resisting a rate cut — reflect tariff-related price increases hitting, followed by tariff effects fading over time. What

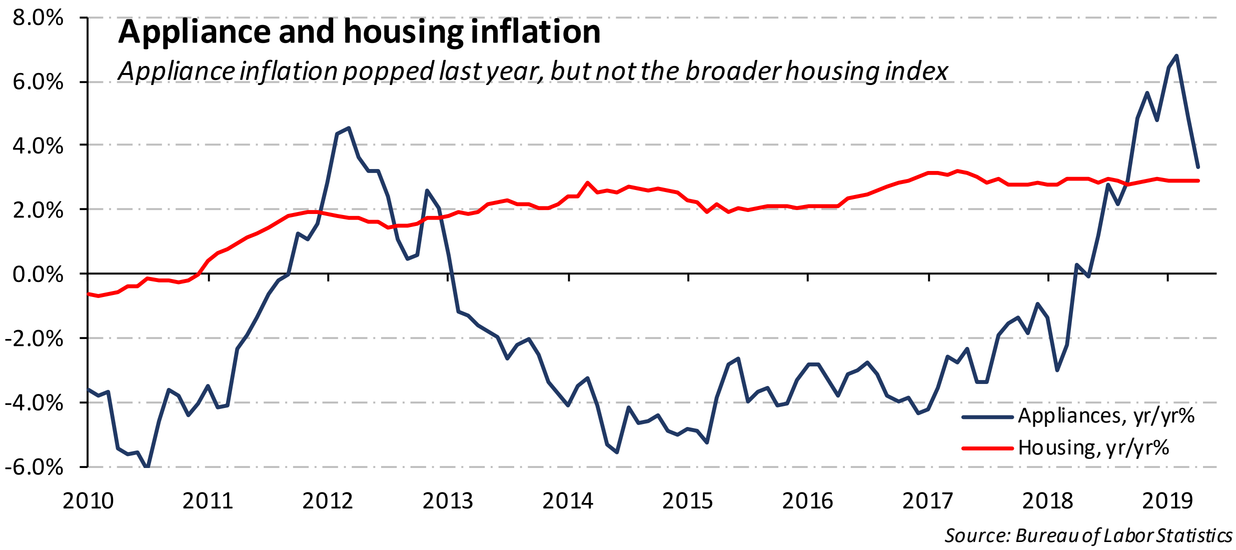
CONTENTS

ECONOMICS

Chris Low, Chief Economist
212.418.7909
chris.low@ftnfinancial.com

Rebecca Kooshak, Economic Analyst
212.418.7966
rebecca.kooshak@ftnfinancial.com

complicates the Fed's job, and their decision to ignore acyclical fluctuations and instead make policy based on movement in cyclical components, is cyclical inflation clearly retreated in the face of last year's acyclical increase, and reaccelerated this year in response to acyclical relief. **In other words, there appears to be a general restraint against faster inflation preventing tariffs from affecting general inflation rates, even though individual product prices have increased.** Here, you can see appliance inflation, which is higher than it was in 2017, but also housing — which includes appliances — where inflation is the same as in 2017. Appliance inflation disappears in part because we don't buy appliances very often. The combined weight of appliances and all other tariff-affected prices account for just 4.7% of the housing complex. Did tariffs affect consumer prices? Technically, yes. But considered from a higher level, not at all.



As for the Smoot-Hawley suggestion, it's dead wrong, primarily because China tariffs are directed at one country, while Smoot-Hawley was a tax on all imports. Companies and consumers can avoid the tax by sourcing elsewhere. That's not to say the tariffs will have no impact, but they are unlikely to shut down international trade as effectively as Smoot-Hawley did.

A tariff is a tax. Even if no one moved their supply chain and the tax were levied in full, a 25% tax on all of the $540bn imported last year would come to $135bn, or 0.6% of GDP. It's just not big enough to kill the expansion, especially because we know companies — including Chinese companies — are already moving production out of China to avoid the tax.

Miles apart

Despite a tweetstorm from President Trump insisting the trade deal is good for China and stands a great chance of being ratified, it is increasingly clear the deal is in jeopardy. Even if it is in China's best interest, making the most sensible decision is only one of several sometimes contradictory goals of Chinese trade negotiators — and of the US trade team, too, for that matter. Many factors will decide whether to return to the negotiating table and then whether to negotiate a deal both sides can accept. While China holds its cards closely, we know what American negotiators want, but not how much they are willing to compromise to get a deal.

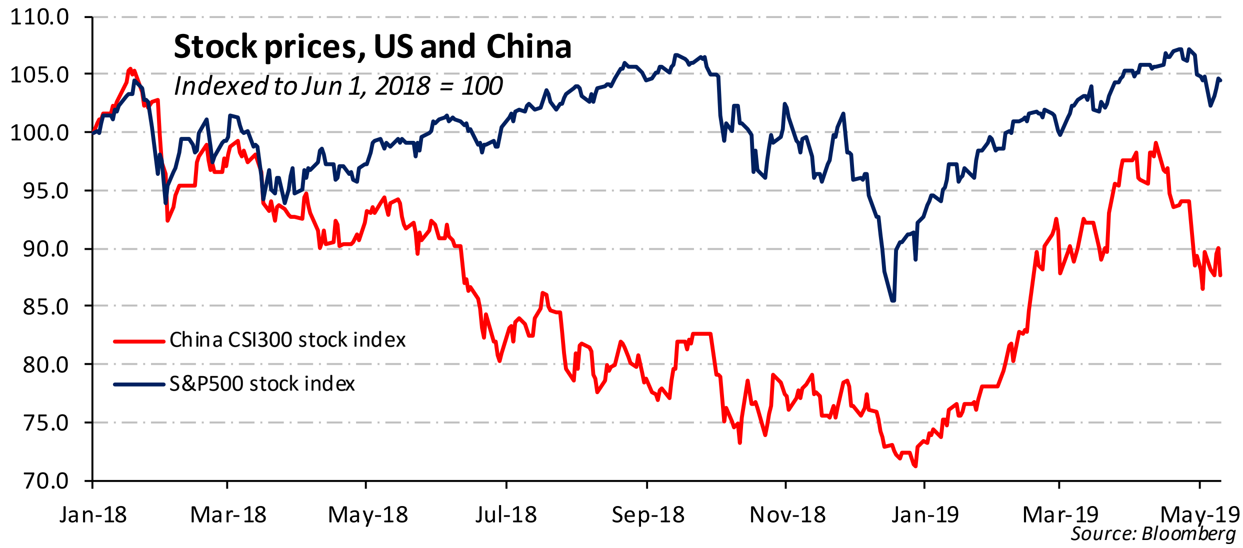
Even if we knew the most logical course, and knew that course would be acceptable to both sides, it is a leap to assume the negotiators will follow it.

President Xi faces a decision likely to define the next several years of his presidency, whether he accedes to a deal or defies it. Since Deng Xiaoping opened China's markets to foreign trade, the legacies of China's leaders have been marked by economic achievements tied to the Chinese trade relationship with the US. There's little doubt Xi wants what is best for China, but he also wants to preserve face, preserve, power and ensure adequate future economic growth, too. And, don't forget, even if Xi knows exactly what's best for China, he has to convince China's entrenched bureaucracy to go along with reforms promised to the US. This could be difficult, to say the least.

On the other side of the table, President Trump has made Chinese-American trade a centerpiece of his first term, arguably as big as his fight to build the Great Wall of Mexico and fend off the Mueller investigation. Since the talks fell apart last week, Trump has flashed through a half dozen moods in a tweetstorm from the White House. The following are selected from tweets sent Monday and Tuesday of this week alone:

- "We are right where we want to be with China. Remember, they broke the deal with us & tried to renegotiate. We will be taking in Tens of Billions of Dollars in Tariffs from China. Buyers of product can make it themselves in the US (ideal) or buy it from non-Tariffed countries."
- "China is DREAMING that Sleepy Joe Biden, or any of the others, gets elected in 2020. They LOVE ripping off America!"
- "I say openly to President Xi & all of my many friends in China that China will be hurt very badly if you don't make a deal because companies will be forced to leave China for other countries. Too expensive to buy in China. You had a great deal, almost completed, & you backed out!"
- "There is no reason for the US Consumer to pay the Tariffs, which take effect on China today. This has been proved recently when only 4 points were paid by the US, 21 points by China because China subsidizes products to such a large degree."
- "In one year our tariffs have rebuilt our steel industry — it is booming! We placed a 25% Tariff on "dumped" steel from China and other countries, and we now have a big and growing industry. We had to save Steel for our defense and auto industries, both of which are coming back strong!"
- "We can make a deal with China tomorrow, before their companies start leaving so as not to lose USA business, but the last time we were close they wanted to renegotiate the deal. No way! We are in a much better position now than in any deal we could have made. Will be taking in Billions of Dollars, and moving Jobs Back to the USA where they belong. Other countries are already negotiating with us because they don't want this to happen to them. They must be a part of USA action. This should have been done by our leaders many years ago. Enjoy!"
- "When the time is right we will make a deal with China. My respect and friendship with President Xi is unlimited, but as I have told him many times before, this must be a great deal for the United States or it just doesn't make sense. We have to be allowed to make up some of the tremendous ground we have lost to China since the ridiculous one sided formation of the WTO. It will happen, and much faster than people think!"

The stock market rose after those last two tweets because traders interpreted them to mean the President expects a deal, but they imply the opposite. Language like "When the time is right" suggests not now, but when China is willing to meet Trump's terms. The bit about "taking in billions of dollars" until then sounds like the President expects tariffs to remain in place for some time. **We put the odds of a trade deal before next year's presidential election at 25%.**



China's response

Considering the possible next steps from President Xi and his top trade negotiator, Vice Premier Liu He, it might make the most sense to be constructive. Perhaps agree to return some of the already negotiated terms they redlined out of the agreement in early May, for instance. In a Hong Kong interview, Liu explained the talks will continue, with the next round in Beijing, but, "We are very clear that we cannot make concessions on matters of principle. We hope our US colleagues understand this."

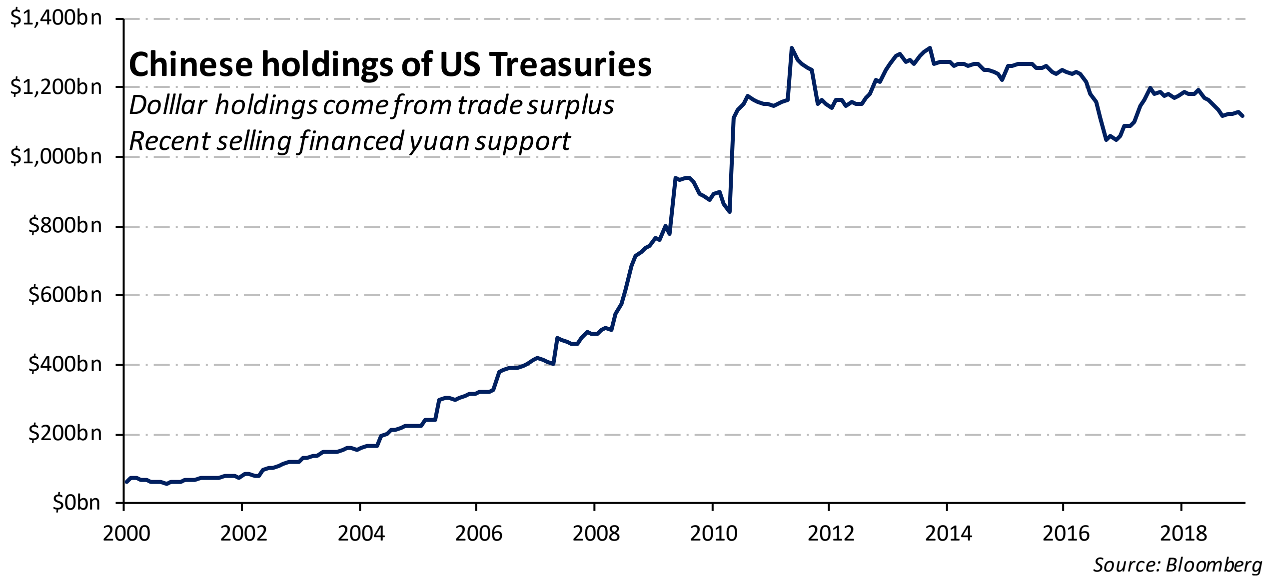
In the same interview, Liu explained primary points of disagreement are issues such as forced technology transfers, intellectual property protections, and state-sponsored enterprise. Ending forced technology transfers or enacting intellectual property protections are clearly not violations of principle, but it's understandable a Communist country can't end state-sponsored enterprise. Perhaps compromise is possible by agreeing to protect US technology in exchange for the US looking the other way while China props up zombie SOEs.

In the meantime, Liu's argument reveals volumes about China's negotiating stance. Trump is arguing for a level playing field, but Xi and Liu see the US President attacking China, damaging its economic prospects and threatening its economic health. This is evident in state media communication, too. Through the first quarter, the government restricted state media from fanning nationalistic ardor. They banned terms like "trade war" and insisted on euphemisms like "negotiating dispute."

The gloves have come off, however. Commentary is still tightly controlled by the state, according to *The Wall Street Journal*, but it is starting to sound defensive and confrontational. *China Central Television* concluded the trade dispute is "no big deal for China" because China will "turn peril into opportunity." But the *Global Times*, a tabloid published by the *People's Daily*, called the dispute the "peoples' war," and assured readers Beijing has ample means to resist America. A viral message on Weibo, China's Twitter knockoff, featured a clip from the evening news in which the anchor insisted, "If you want to talk, we'll talk, but if you want to fight, bring it on!"

The propaganda arm of the government is trying to save face. Officials, meanwhile, have maintained a measured tone. It can be difficult to tamp down nationalistic anger in China, however, as every Chinese schoolchild is taught about China's Century of Humiliation by foreign powers.

Chinese scholars are considering whether to sell China's US Treasury bond holdings and how to go about it, presumably to do the most damage to the US economy, according to a Chinese newspaper story picked up by *CNBC*. But there are better ways to damage the US, and China's US dollar holdings are enormously valuable to them. They are the reason state-sponsored enterprises can raise money in dollars — investors know the state has dollars to back the bonds should these companies fail — and they fund the intervention necessary to stabilize the yuan. China has sold Treasuries every month this year, with the exception of February, to prop up its currency. Ever helpful, *CNBC* suggests China should attack the US stock market by boycotting big American companies like Boeing and Apple.



Bottom line: What to expect

There is not likely to be a trade deal, but American and Chinese negotiators benefit from leading us to believe there will be a deal. After all, both Xi and Trump would benefit from announcing a deal resulting in strong, stable trade flows between the US and China, but any specific deal acceptable to one is highly unlikely to be acceptable to the other.

The problem is, they are negotiating from two different worlds. The US started by insisting China comply with WTO rules, which China joined 20 years ago, and build from there. China started from the current status quo, arguing they were given a dispensation from WTO compliance to allow them to catch up with the West. They want to keep the exemption. Xi and Trump both want a deal, but neither benefits from a deal acceptable to the other. Still, both can calm markets and bolster sentiment by implying a deal is close.

As a result:

1. **Expect volatility.** The US-China trade and tariff fight will continue to roil markets as waves of good and bad news alternate. One reason we have written so little about the fight is that significant, market-moving news is so frequent, "definitive" statements are obsolete within hours.
2. **China will retaliate.** Even when the US asks China to stop forcing technology transfers and end payouts for stolen intellectual property, China frames it as "bullying." Trump reinforces this perception with language like "moving Jobs Back to the USA where they belong" in his tweets. Chinese communications make clear power will be fought with power.
3. **The scope of this fight will escalate.** Just a few days ago, it looked like President Trump would be content to impose tariffs on all Chinese goods and then sit back and wait for China to come to its senses. Then he escalated the conflict by announcing a ban on sales of Huawei and ZTE products in the US and a ban on chip sales by US companies to either of the two. Kevin Wolfe, Assistant Secretary of Commerce under President Obama, called it "The trade equivalent of a nuclear bomb." China vowed to retaliate. We fully expect it will. Hyperbole aside, there's real hurt being inflicted here by both sides, and both sides appear eager to inflict more.

4. **This conflict is bigger than the US and China.** Is it any coincidence North Korea and Iran stirred up trouble for the US this weekend? North Korea is a Chinese client state. China is Iran's biggest trade partner, by far the biggest importer of Iranian oil. To the extent China thinks Trump will respond to discomfort, it will use its international partners to bring pressure to bear. By the same token, Trump has enlisted Canada in its fight with Huawei and is pressing Europe to get involved, too.
5. **Companies will move their supply chains.** US companies are already sourcing parts and assembly outside China. BMW and Mercedes both manufacture all of their SUVs in the US, including many sold in China. China has not — yet — increased the tax on US made cars, executives at both companies are already looking for alternative locations for their assembly operations.

Finally, don't expect this to end soon. Liu He, Stephen Mnuchin, and both Presidents Trump and Xi have occasionally suggested a deal is close, but Wilbur Ross's possibly accidental January admission that both sides are "miles and miles apart" looks most prophetic right now.

– Chris Low, Chief Economist

The Week Ahead

This Week's Numbers

		PRIOR	CONSENSUS HIGH	CONSENSUS LOW	CONSENSUS MEDIAN	FTN
Tuesday, May 21, 2019	Existing Home Sales - Apr	5.21m	5.40m	5.20m	5.35m	**5.37m**
	Existing Home Sales MoM - Apr	-4.9%	3.7%	-0.2%	2.7%	**3.0%**
Thursday, May 23, 2019	New Home Sales - Apr	692k	746k	625k	677k	**680k**
	New Home Sales MoM - Apr	4.5%	7.8%	-9.7%	-2.2%	**-1.7%**
Friday, May 24, 2019	Durable Goods Orders - Apr P	2.6%	0.1%	-10.0%	-2.0%	**-2.5%**
	Durables Ex Transportation - Apr P	0.3%	0.5%	-0.7%	0.2%	**-0.3%**
	Cap Goods Orders Nondef Ex Air - Apr P	1.4%	0.1%	-1.0%	-0.3%	**-0.4%**
	Cap Goods Ship Nondef Ex Air - Apr P	0.0%	--	--	--	**-0.1%**

Review

Last week, after negotiations broke down, the US restored tariff increases on Chinese goods. This week, China retaliated by restoring some of last year's tariff rate increases, and the White House delivered its third list of tariffs targeting the remaining $300b of Chinese imports. Weak retail sales reported by the US and China underscore slowing growth in both countries. Meanwhile, Germany and the EU became the silver-lining in the global economy, as GDP Q1 rose in line with consensus, ending concerns of Europe entering a recession. (In the first quarter, anyway.)

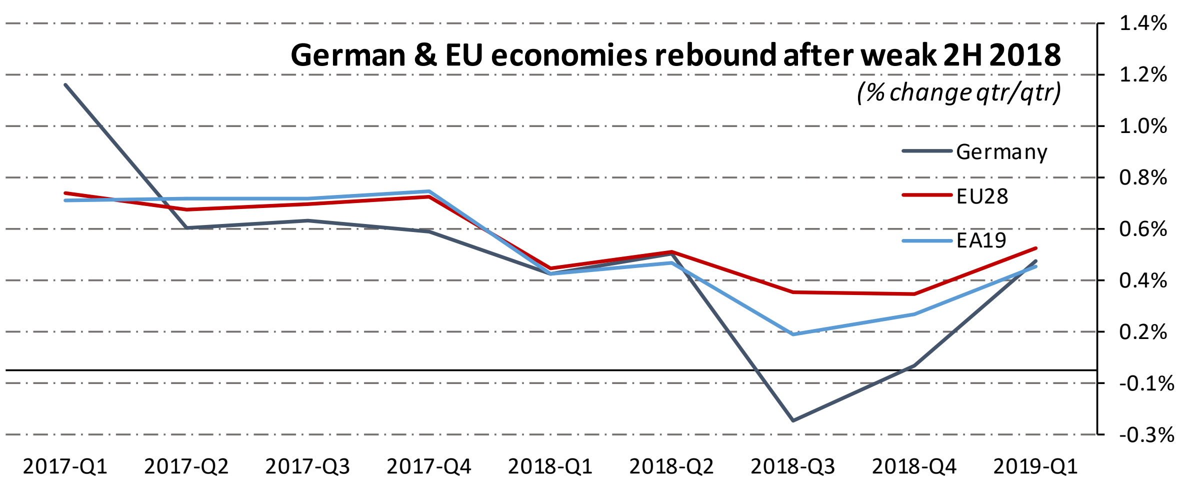
- China's State Council announced Monday it will raise tariffs on the previously announced $60b of US imports. Nearly all $120b of US goods exported to China have been hit with retaliatory tariffs. Rates on the $60b list will rise from the September 28, 2018, rates effective June 1 as follows:
  - Batch 1: 2,493 product lines, rates will increase from 10% to 25%
  - Batch 2: 1,078 product lines, rates will rise from 10% to 25%
  - Batch 3: 974 produce lines, rates will rise from 5% to 10%
  - Batch 4: 662 produce lines, rates will remain at 5%.

  China's Ministry of Finance will begin accepting product exclusion requests beginning June 3 from the tariff duties, but some products are ineligible for exclusion. (Note that 93 auto and auto part lines, which include electric vehicles and electric vehicle engine and parts, diesel vehicles, SUVs and SUV parts, are expected to be excluded from previously announced lists. Bluetooth and smart watches have already been excluded from the US list of Chinese imports.

  - How are domestic companies performing since tariffs were implemented? *The WSJ* reported Monday Whirlpool CEO Marc Bitzer lobbied the Trump administration heavily to impose tariffs on imported washing machines. Whirlpool reported softening sales due to increased costs and prices. The stock is down as well. It has fallen 21% since the tariffs were announced January 22, 2018. (A Federal Reserve economist and two economists from the University of Chicago published a working paper on the impact of production relocation and price effects of washing machines.)

Source: Bloomberg

- US retail sales fell 0.2% in April, but the biggest surprise was no growth in the sectors closely aligned with GDP spending calculations. It was expected to have increased 0.3%.
- US industrial production fell 0.5% in April. Manufacturing production also fell 0.5%. Both were expected to be unchanged. The implication is an inventory correction hitting at the same time as disappointing consumption.
- Germany's preliminary Q1 GDP rose 0.4% q/q, in line with consensus, driven largely by domestic consumption, construction and business investment. Government consumption fell, trade was mixed, with both exports and imports rising. In the euro area, GDP was up 0.4% q/q (1.2% y/y), and in the EU 28, it rose 0.5% q/q (1.5% y/y).



Source: OECD (2019), Quarterly GDP indicator

The Atlanta Fed revised its Q2 GDPNow forecast from 1.6% last week to 1.2%, primarily reflecting disappointing retail sales and industrial production. The NY Fed also revised its Nowcast lower, from 2.2% to 1.7%. Capacity utilization and industrial production accounted for the bulk of New York's lower revision.

Preview

Note: ★ = High Impact Event
All times Eastern Daylight

Sunday, May 19

- ★ 7:50pm – Japan: GDP Q1 P (Last Q/Q: 0.5%; Con: -0.1%)

Monday, May 20

- China: Shanghai Petroleum & Gas Exchange holds natural gas forum, which representatives from the IEA will attend.
- 2:00am – Germany: PPI (Last Y/Y: 2.4%)
- 8:30am – US: Chicago Fed National Activity Index
- 11:30am – US: $36b 3M and $36b 6M Treasury Bill Auctions
- 1:00pm – US: Fed Vice Chair Richard Clarida and New York Fed President John Williams discuss policy impact on broader economy in New York roundtable "Fed Listens" event with constituents. Register for the webcast.
- ★ 7:00pm – US: Jay Powell gives keynote speech at Fed financial markets conference on Amelia Island.

Tuesday, May 21

- ★ 4:30am – UK: BOE's Governor Carney speaks.
- 10:00am – EU: Consumer Confidence – May A (Last: -7.9)
- ★ 10:00am – US: Existing Home Sales
- ★ 10:45am – US: Chicago Fed President Charles Evans speaks on monetary policy and the economy. (FOMC voter)
- 11:30am – US: $26b 1Y Treasury Bill Auction
- ★ 12:00pm – US: Boston Fed President Eric Rosengren speaks at New York's Economic Club. (FOMC voter)
- ★ 7:50pm – Japan:
    - Machine Orders
    - Merchandise Trade

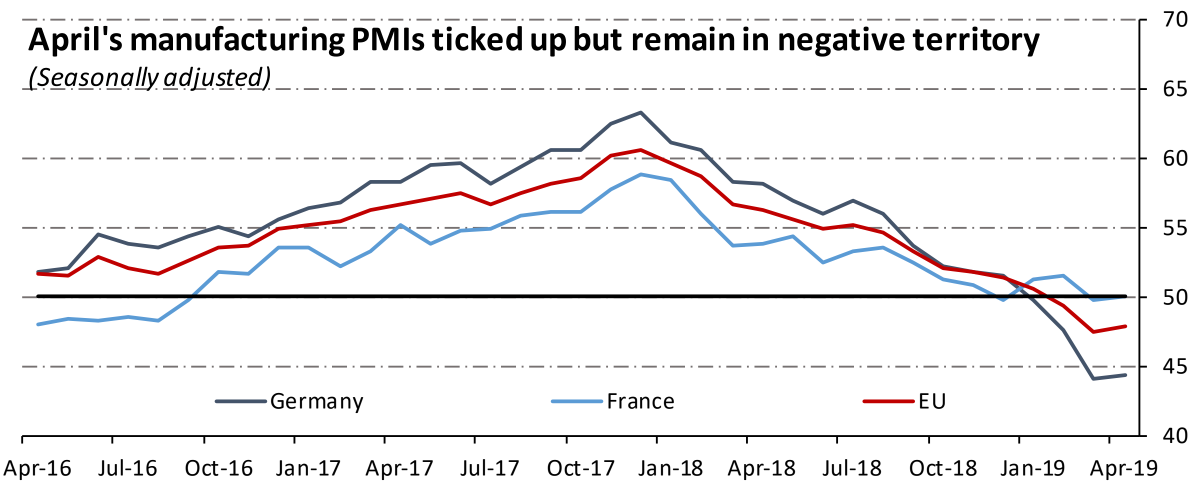
Wednesday, May 22

- ★ 1:00am – US: Saint Louis Fed President James Bullard speaks in Hong Kong on the US economy. (FOMC voter)
- ★ 3:00am – EU: ECB President Mario Draghi speaks.
- ★ 5:30am – EU: Chief Economist Peter Praet speaks. (His term at the ECB ends May 31.)
- 4:30am – UK:
    - CPI
    - PPI
- 8:30am – Canada: Retail Sales – May (Last M/M: 0.8%)
- 9:45am – US:
    - Markit Manufacturing PMI – May P (Last: 52.6)
    - Markit Services PMI – May P (Last: 53.0)
    - Markit Composite PMI – May P (Last: 53.0

- ★ 10:00am – US: New York Fed President John Williams hosts an economic press briefing. (Permanent voter)
- 10:10am – US: Atlanta Fed President Raphael Bostic gives opening remarks at Dallas Fed conference. (FOMC voter in 2020)
- ★ 2:00pm – US: FOMC minutes
- 8:30pm – Japan: Nikkei Manufacturing PMI – May P (Last: 50.2)

Thursday, May 23

- EU: European Parliament holds continent-wide elections. (Through May 26th.)
- India: General Election results due out. (Prime Minister Narendra Modi is expected to secure a second term.)
- 2:00am – Germany:
  - GDP Q1 F
  - Private Consumption – Q1
  - Government Spending – Q1
- 2:45am – France: Business Climate Indicator
- 3:15am – France: Markit Manufacturing, Services, and Composite PMI – May P
- 3:30am – Germany: Markit/BME Manufacturing, Services, and Composite PMI – May P



Source: Bloomberg, IHS Markit

- 4:00am – Germany: IFO Survey – May (Last: 99.2)
- 4:00am – EU: Markit Manufacturing, Services, and Composite PMI – May P
- ★ 7:30am – EU: ECB releases minutes of April's meeting.
- 11:00am – US:
  - New Home Sales (Last: 692k; M/M: 4.5%)
  - Kansas City Fed Manufacturing Activity
- 1:00pm – US: $11b 10Y TIPS Auction (Reopening)
- 1:00pm – US: Fed Presidents Mary Daly, Raphael Bostic, Tom Barkin, and Robert Kaplan participate in panel discussion on policy impact of technology disruption at Dallas Fed
- 7:30pm – Japan: CPI (Last Y/Y: 0.5%)

Friday, May 24

- 4:30am – UK: Retail Sales
- ★ 8:30am – US:
  - Durable Goods Orders – Apr P (Last: 2.6%; Con: -1.5%)
  - Durables Ex Transportation – Apr P (Last: 0.3%; Con: 0.3%)
  - Capital Goods Orders Nondef Ex Air – Apr P (Last: 1.4%)
  - Capital Goods Ship Nondef Ex Air – Apr P (Last: 0.0%)

– Rebecca Kooshak, Economic Analyst