Current Market News

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Update on Tariffs and Trade with China: Mind the Gap

"We do not see things as they are, we see them as we are." *(Unknown origin)*

Summary

- China's swift response of proposed tariffs puts the ball back in President Trump's court
- The fundamental disconnect of who is the instigator makes negotiations difficult
- Base case is that cooler, economically motivated heads prevail
- The pessimistic scenario would be a "bigger button" approach by the U.S. and more digging in on both sides
- China's swift response has potential to accelerate the negotiation timeline
- Broader (negative) implications beyond trade if these frictions escalate and are drawn out

Where We Stand

We now have tit-for-tat, and another tit-for-tat. After the U.S. tariffs on steel and aluminum were announced on March 8, China's response came weeks later when it announced tariffs on 128 U.S. products such as fruits, nuts, pork, and wine that consist of approximately $3 billion in U.S. exports to China. Then on April 3, when the U.S. Trade Representative Office announced long-discussed tariffs on another $50 billion in Chinese goods (emphasizing industrial and hi-tech goods), China took only hours to respond with its own announcement of 25% tariffs on 106 U.S. products worth about $50 billion annually including soybeans (see Figure 1), aircraft, autos, beef, corn, wheat, cigarettes and chemical products.

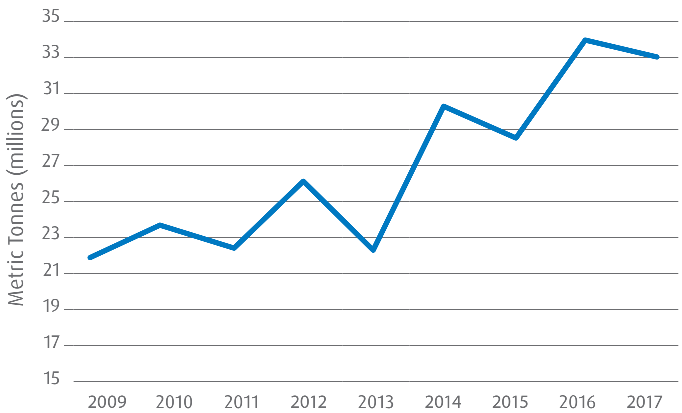
Following the announcement, the Chinese government's official news mouthpiece, Xinhua News, ran an article on April 4 titled, "China calls for constructive way to solve trade challenges," with China's Vice Finance Minister stating, "We don't want a trade war because that will only bring losses to both sides." Furthermore, China's implementation of this second round of tariffs will depend on the date of implementation of the U.S. tariffs. That timetable currently stands at May 22 for U.S. companies to voice concerns about the proposed U.S. tariffs, and then another 180 days for the administration to decide whether to go ahead. That basically lays out the negotiating period.

The Disconnect

"Mind the Gap" *(Hong Kong subway platform announcement)*

According to the Wall Street Journal, "[T]here remains a gap between what China is willing to offer and what the Trump administration will accept." From the Trump administration standpoint, the recent tariffs on $50 billion in goods from China are in response to decades of intellectual property theft. It is difficult to imagine that the narrative in China centers on correcting its long-standing misbehavior.

Figure 1: Chinese Soybean Imports from the U.S.



Source: Bloomberg

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To the contrary, the U.S. actions are more likely to be seen through a lens of America's attempt to keep China down, which is a common refrain in the Middle Kingdom. So, with each side viewing the other as the clear instigator, there is added difficulty in reaching an acceptable agreement.

The Path of Most Resistance

"I too have a Nuclear Button, but it is a much bigger and more powerful one than his..."
(President Trump, Twitter post on 1/2/2018 in reaction to North Korean leader Kim Jong-Un)

In the instance of trade with China, here too does President Trump have a bigger button because U.S. imports from China dwarf U.S. exports to China by a factor of more than three. President Trump could come up with a number that China simply cannot match. The recent $50 billion tit-for-tat represents about 10% of U.S. goods imports from China, but a whopping 38% of China imports of goods from the U.S. President Trump's fighting instincts may be inclined toward even greater escalation (or threat of escalation) before sitting down at the negotiating table. Such threats would likely rattle the markets further. Such a "bigger button" approach to the negotiations is also likely to be misplaced, because if push comes to shove the question is not so much who can dish out more pain (the U.S. can, clearly), but which side can take more pain (unclear, but a costly question to answer). Additionally, whereas in the U.S. there will be strong push-back from many industries and companies against the tariffs, in China the corporate pushback will be minimal. Further escalation would be unwelcome and increase the risk of a policy mistake.

Base Case and Conclusion

Our base case is for cooler, economically-minded heads to prevail. That would mean progress in negotiations that include commitments on China's part for more intellectual property protections, modest incremental purchases of U.S. goods, and the U.S. dropping the proposed tariffs. Greater concessions from China would probably require the U.S. offering up something that China values. This could come in the way of fewer investment restrictions, but could also involve questions relating to U.S. policies and legislation that pertain to Taiwan. An optimistic spin on the recent developments would be that China's swift response could lead to a quicker resolution of the trade and tariff issue than would have otherwise been the case.

The longer this trade and tariff issue remains unresolved and creates uncertainty for businesses, the greater the potential for harm to the broader economy. Continued frictions or escalations could lead businesses to take a wait-and-see approach to capital expenditures, which would dampen the positive effects of the tax package that are widely expected. A poor resolution to the tariff and trade issue would likely lead to the conclusion that President Trump's days of positive impact on the economy and markets are behind us now that the tax package and budget deal are completed, with negative implications for market sentiment. In the late evening hours that followed Trump's presidential election victory, the futures markets and international markets were down sharply before U.S. equity markets opened. Those concerns have re-materialized in the past few weeks and the risks to trade are now front and center. We continue to believe that ultimately the President's deal-making instincts will lead to an acceptable negotiated outcome, while acknowledging the increase in risks and the formidable gap that remains between the U.S. and China positions.

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