



Global Political Drivers

## **US VS CHINA SHIFTS TO SIMMER**

Christopher Granville

- The trade war with China is well up there among the “certain policies and principles” to which Donald Trump attributed his “very Big Win” in this week’s election.
- Post-election, he will stick to the trade war agenda as a source of further political dividends – and all the more so given the standard effect of mid-term electoral reverses in focusing the White House focus more on foreign policy.
- Behind Trump’s apparently random trade-war walk, dialling tensions up and down at will, the most likely outlook hides in plain sight.
- Changes in direction are a tactical end in themselves, as this show needs to run for at least another year before a declaration of victory becomes politically opportune.
- This political logic for a more gradual pace of tariff escalation alternating with thaws – as in the forthcoming G20 Summit – is supported by economic incentives, as the cost of such escalation tilts away from China and towards the US.
- Underpinning our call that the continuing trade war moves from here on into a slower dynamic is the fluid interplay of contradictory US agendas towards China.
- These parallel agendas serve to drag matters out in various ways: as well as fitting Trump’s ‘showbiz’ style and, from China’s point of view, signifying US “insincerity” that precludes engagement, the underlying US goals on geopolitics and repatriating jobs are unattainable in a politically relevant timeframe – if at all.
- The main investment implication of this slower motion trade war outlook is a more limited RMB depreciation as a gentler tariff escalation path would allow the burden of adjustment to be spread more widely.

## Trump pivot to foreign 'friends'

A favourite face-saving rationale offered by defeated or frustrated politicians to explain their retreat from the fray is that they have chosen to “spend more time with their families”. A variant of this formula that fits Donald Trump after the Democrat capture of the House of Representatives in this week’s election is that he may henceforth be spending more time with his (foreign) ‘friends’.

**After losing control of the House, Trump will concentrate on foreign policy.** The new gridlock on Capitol Hill means that the path of least resistance for Trump now lies in the foreign policy arena where the president has more freedom of action. This prospect is underpinned by the clear electoral dividend from his signature foreign policies – in the sense of rallying the rural and small-town base that delivered victories in close-fought senate races for Republican candidates for whom Trump campaigned.

**The signature foreign policy that matters for markets is the trade war with China.** One such policy – the hard line on illegal immigration – has an obvious ‘foreign’ dimension, despite hinging formally on domestic legislation. In any case, this problem offers wide scope for the use of the president’s executive powers, as may well be seen in the response of US law enforcement and security forces to the column of Central American migrants advancing northwards through Mexico towards the US border. The other core foreign policy position is the one that matters for the global economy and markets: the ‘trade war’ with China.

**It was always a safe bet that Trump would escalate the trade war up to the mid-term election.** The political dividend could be enjoyed upfront while the economic costs – from increased tariffs – would not be felt until later. The main exception to this last point – the losses faced by US soybean and sorghum farmers from China’s retaliatory tariff hikes – has been mitigated by targeted federal government compensation schemes. Overall, however, that point about political gain without economic pain has been reinforced by the strength of the US economy this year, a factor that has clearly boosted Trump’s confidence as a trade warrior.

## Radical invisibility revisited

**Uncertainty about Trump’s post-election approach to China cements the position of this trade war as the top-ranked global political driver.** Our previous note on this topic in our Global Political Drivers series characterized that uncertainty as *radical invisibility* (17 August). By “radical” we mean that this trade war as carried on by Trump cannot be viewed as a standard decision tree which, however imponderable the choices, will make the outlook increasingly path dependent over time. Trump’s style instead involves arbitrary changes of direction. Viewed in isolation, each such reversal might be viewed as no more than a tactical negotiating ploy. Taken as a whole, however, this approach maintains options on fundamentally different outcomes.

**Recent developments illustrate this radical invisibility.** The political logic of the midterm election result points, as discussed, to Trump sticking firmly to his trade war path – in the sense of continuing or even intensifying escalation. He trailed this explicitly when he said on 10 October that he was “100% sure” of going ahead with additional tariffs if the Chinese retaliate against the previous month’s tariff hike – “which they already have done”. Then, last week, came his market-moving tweet about a “long and very good” phone call with Xi Jinping, describing the trade-focused discussion as “moving along nicely” ahead of the G20 Summit in Buenos Aires at the end of the month. On the face of it, then, a major fork in the trade war road is approaching.

## Fork avoidance

**Down one prong lies escalation** – starting with the already-announced second leg of last September's imposition of protectionist tariffs on \$200bn-worth of imports from China, hiking the level of those new tariffs in early 2019 from 10% to 25%. This path involves continued escalation in response to Chinese retaliation. Although China will have run out of previously untouched imports from the US on which to impose higher tariffs, some asymmetrical retaliation is inevitable.

**Chinese retaliation could lead things to go further still.** The menu here ranges from further 'benign neglect' of a weakening RMB to various ways of disadvantaging US commercial interests in China (if only, on the divide and rule principle, by offering better access to foreign strategic investors from countries in Asia and Europe that are allies of the US). That would lead to the Trump administration bringing all remaining imports from China – i.e. another \$267bn-worth – into its tariff net. The most extreme escalation scenario would see all Chinese imports to the US subject to the (advertised) maximum 25% tariff by next spring.

This most intense escalation timeline allows for the 60-day consultation period with business between the announced intention to impose new tariffs and those tariffs going live. It also assumes that this final batch of Chinese imports would be hit immediately with 25% tariffs rather than an interim move to 10%, as seen in the batch that the Trump administration is presently working on.

**The alternative prong points towards a triumphant Trump-Xi session in the margins of the G20 Summit** producing a mutual political commitment to a deal addressing American concerns – stretching in the very best case to some broadly agreed heads of terms.

**We predict that Trump will chart a middle course between these alternatives.** Confident prediction may seem incompatible with 'radical invisibility'. In practice, however, this amounts to a different way of expressing our underlying view that Trump will keep his options open. On this view, the prospect is one of chronic, simmering tensions with China ostensibly focused on trade but in reality reflecting a much broader agenda – or rather an incoherent set of agendas (more on this below).

## Arguments: Formal, stylistic, agenda-related

### Case against the main prongs

**Politics and economics provide, respectively, the most straightforward reasons for Trump to steer clear of either a quick deal or an intense escalation.** We have already noted the political dividends on offer for Trump from banging the trade war drum. In the new post-election Washington landscape, Trump has a stronger incentive than ever to prolong this China campaign. By maintaining pressure on China, Trump signals to his base continuing commitment to the core message of his inauguration – that "the forgotten men and women of our country" – those living amid the "carnage" of the "rusted-out factories scattered like tombstones across the landscape of our nation [...] will no longer be forgotten."

**An eventual declaration of victory on a new deal with China looks premature for now.** The political logic here has all along suggested that gains from this campaign on the China front will be crowned at some point by Trump declaring victory in the form of a new deal with China. The optimal timing for this 'victory' would probably be no more than a year before Trump's prospective re-election bid in November 2020, especially since looking out twelve months or more, the trade-off between the political benefits of the campaign and its economic costs will have become more finely balanced.

**For now, the economic costs are imperceptible.** They will increase in line with further tariff hikes. This brings us to the economic reason why we expect future tariff increases to come more gradually. In his latest EM Monthly Strategy note, [Trade war is already past 'peak Trump' for EMs](#), Larry Brainard highlights the two economic factors at work here.

- Unlike the imports that were subject to the first wave of tariffs since May, the next batch will involve consumer electronics and core products like smartphones where Chinese imports have a much larger market share and, therefore, pricing power – resulting in a higher ‘tariff inflation tax’ on US consumers.
- Although assembled in China, relatively little of the added value in such products originates in China (the Apple iPhone being the classic example).

In short, as this trade war progresses, the economic costs will tilt away from China and towards the US. Here lies a strong incentive to put the trade war onto the slower burn that we now predict.

### The entertainer’s style

**This gradualist approach suits Trump’s ‘showbiz’ style.** The reality TV genre in which he previously flourished, if not found his true vocation, calls for a series of compelling episodes dialling up the suspense needed to expand and please the audience (in this case, the voter base). On the assumption that nothing game-changing comes of Trump’s discussions with Xi at the G20 Summit meeting, the present tweeted build-up to this encounter will most likely appear in hindsight as a good example of this style.

This ‘stylistic’ consideration is somewhat superficial in itself. We think it is still worth bearing in mind, however, as a factor that complements not only the above-noted substantive political and economic case for a more protracted simmering trade war but also what we see as the most important determinant of all – namely, the fluid interplay of underlying agendas.

### Slippery agendas

**The US agenda runs deeper than its stated goals.** Our coverage of the US-China trade war has all along highlighted the tension between the stated US goals and the deeper anxieties now gripping the bulk of America’s political class about the threat posed by China to the position of the US as global ‘top dog’. The struggle for geopolitical mastery is barely camouflaged in the statement of [US written demands](#) published in advance of the first abortive negotiations last May between Treasury Secretary Steven Mnuchin and Chinese Vice-Premier Liu He.

**American opposition is to China’s development model.** The heart of the matter comes in the language about the ‘Made in China 2025’ programme referenced in the graphic below. This avoids explicitly calling for China to abandon its development model – a state-led drive for the frontier in decisive new technologies – by being formally positioned among points to do with protecting US technology and IP. It is further dressed up as an economic argument about the global crowding-out effect of Chinese mal-investment that results in excess capacity.

But the geopolitical undertow is unmistakable. From the outset, it has been coming out loud and clear in the rhetoric of the administration’s trade policy hawks, notably National Trade Council Director Peter Navarro. The rhetorical baton has now been taken up by Vice-President Pence in his speech on 4 October amounting to a formal declaration of cold war.

**Trump himself nods toward this geopolitical agenda in his own rhetoric.** A recent example came in his speech to the UN General Assembly last September when he contrasted America’s previous course (i.e. before he came to power) as allowing “China to be bigger than us in a very short period of time” before delivering his pithy punchline: “that’s not going to happen any more.”

**US-China Trade War: US Agendas**

Stated agenda	Tacit agenda 1	Tacit agenda 2	Tacit agenda 3
<u>May 2018 demands</u>	'America (jobs) First'	Geopolitics (barely disguised)	'Unequal treaty' model
More balanced bilateral trade	More balanced bilateral trade		
China market access: Restrictions on investment and service suppliers	 <p><b>Contradiction!</b></p>	End of "Made in China 2025" subsidies causing excess capacity	
China market access: JV requirements and other involuntary technology transfer			
IP protections (inc. cyber theft)			
No retaliation against US tariffs (focus on agri) and inward investment restrictions			Deferring to US hegemony

**But his 'America First' drive is his main focus.** In general, however, Trump's public remarks focus less on geopolitical anxieties than on what amounts to yet another parallel agenda – namely, his 'America First' drive to repatriate lost manufacturing jobs. As also shown in our graphic, this agenda is all the more tacit in that it flies in the face of much of the stated agenda. Trump's formal demands that US firms should enjoy greater access to Chinese product and service markets (and without losing control of their technology and IP in the process) turns out to be not what he really wants at all. He would rather those same firms disentangled their production and supply chains from China and relocated more of their operations back home.

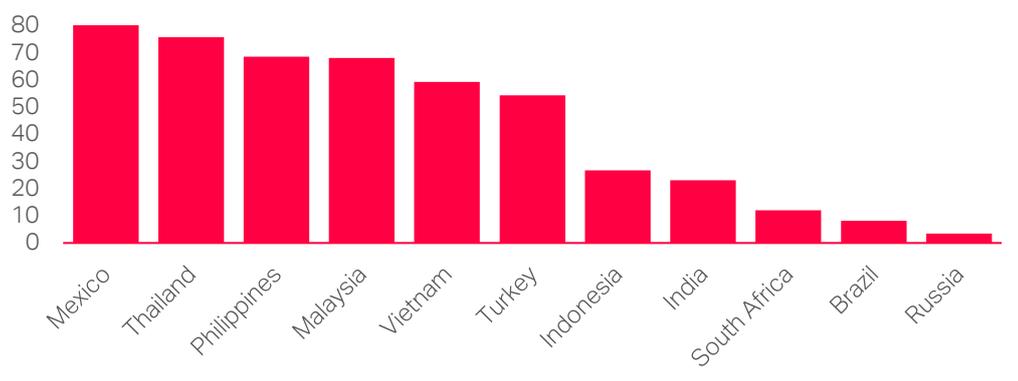
**The existence of these parallel agendas provides structural underpinning for our call that the trade war moves from here on into a slower dynamic.** This effect works in three ways.

- It provides ample scope for Trump's stylistic approach of keeping the trade war 'show' on the road by blowing hot and cold, or dialling the temperature up and down at will. This can be achieved by hopping between agendas.
- The same desired effect of keeping the trade war simmering stems from the inevitable Chinese response to these multiple agendas that are both contradictory and, from China's point of view, rage from the negotiable to the unacceptable. That response is not to engage until the US offers a clear negotiating track – or, as Chinese official rhetoric puts it, until the US demonstrates its "sincerity".

For example, in a major speech at this week's China International Import Expo in Shanghai, Xi Jinping outlined the scope of possible concessions: reduced tariffs; an easing of restrictions on inward investment in sectors such as healthcare, telecoms, education and culture; stronger IP protections and tougher penalties for violators. There was nothing new here. Some European officials in the audience complained about the lack of specific commitments. But China will not get into specifics with an "insincere" America.

- The final way in which promiscuous US agendas moves the trade war into slow-boil mode stems from the reality that the unstated agendas will never tee up the declaration of victory that, we may safely assume, Trump has in mind for some future date. On the geopolitical front, this is self-evident: Cold Wars run not for months or years, but decades. The 'hegemony' aspiration (the last of the tacit agendas shown in our graphic on the previous page) as expressed in the demand that China must renounce the right to reciprocate US tariff hikes and investment restrictions seems even more fanciful. As for Trump's goal of repatriating jobs, this will never happen.

**Aggregate potential supply chain configuration gain**  
 % US imports from China in which countries have comp. adv.



Source: US Comtrade, TS Lombard

**Companies' relocation strategies point not to the US, but to other third countries – notably in Southeast Asia.** Recent chamber of commerce survey data from Southern China show two-thirds of companies – Chinese as well as US and other foreign – now considering reconfiguring supply chains away from China to get around US tariffs. But with one sole exception on this [panel](#), the relocation destinations they have in mind are not the US but, for the most part, Southeast Asia. Our EM strategist Jon Harrison has analysed the revealed comparative advantage of countries in products that loom large in US imports from China. The chart above ranks countries that can be identified on this basis as potential beneficiaries of supply chain reconfiguration resulting from the US-China trade war.

**Investment conclusion**

**The pace of RMB depreciation is the most important investment implication of this prospect of the US-China trade war shifting down into slower motion.** As our China team recall in their latest [weekly round-up](#), the prospect of a 15% weakening of the RMB was predicated on the US escalating the trade war to a rapid pitch in the sense of slapping 25% tariffs on all \$506bn-worth of goods imported from China by Q2/19. The gentler tariff escalation path that now looks more likely would reduce the extent of exchange rate depreciation needed in response to the external shock coming from Washington.

This view depends more on the prospect of tariffs being increased over a longer timescale rather than making any assumptions that the Trump administration might eventually balk at completing the advertised programme (i.e. a 25% levy on all Chinese imports). Slower progress towards that severe destination would allow for the Chinese government's new stimulus measures – such as the tax cuts now in the works – to take effect, offsetting some of the need for a weaker RMB. By the same token, progress during the next year in the reconfiguration of supply chains would reduce the impact of higher tariffs on US imports and global trade.

# GLOBAL POLITICAL DRIVERS – OUR THEMES

Theme	Why it matters	Recent views	Risk
The squeezed middle	Squeezed lower/middle income households in DM countries might be inclined to look for radical solutions – whether to the left or the right.	Corbyn’s Labour <a href="#">is interested</a> not so much in redistribution, but in ideologically-driven supply-side changes.  A sympathetic ECB will be <a href="#">the most important factor</a> in determining Italy’s fate.	
Great Power conflict: East Asia	North Korea’s nuclear drive threatens to spark conflict in a region that already possesses its share of large-country tensions.	Kim Jong-Un’s “Gorbachev gambit” raises the possibility of <a href="#">a geopolitical realignment</a> .	
Cold War 2.0	The new US National Security Strategy implies a global geopolitical backdrop of great power tension.	The logic of Cold War 2.0 suggests that any truce will be temporary – US-China confrontation <a href="#">is here to stay</a> .	
Great Power conflict: Middle East	The Middle East is a flashpoint for conflicts – with potential for spillovers that could affect the oil price, European security or Israel – a key American ally.	The possibility of Chinese intervention means that oil markets <a href="#">might be overpricing</a> US sanctions on Iran.	
<p><b>Special reports:</b>  <a href="#">Peak Brexit Panic Timelines</a>, 27 September 2018  <a href="#">Grappling with Corruption</a>, 31 August 2018  <a href="#">Brexit: Rough Passage to Safety</a>, 5 July 2018  <a href="#">China Stability Risk: Post-Deng Chapter 2</a>, 7 December 2017  <a href="#">Japan: The Lessons of Ms Koike’s fizzle</a>, 12 October 2017  <a href="#">Shale Revolution: Russia’s missing trick</a>, 22 June 2017</p> <p><b>Closed theme: Great power tension: West-Russia</b>  <a href="#">Russia-West: Cool Peace</a>, 4 January 2018  <a href="#">Cyber wars: Add to the risk-off list</a>, 20 July 2017</p> <p><b>Closed theme: European Voter Revolt</b>  <a href="#">Europe and America fear factor review</a>, 24 November 2017  <a href="#">Labour participation unmasks political risks</a>, 14 September 2017</p>			

# GLOBAL POLITICAL DRIVERS: DEFINITION AND BENEFITS

Political and social developments are for the most part inseparable from economic drivers of risk and opportunity in the global economy and financial markets. But there are times when purely political factors play a decisive role. Global Political Drivers is a component of TS Lombard's macro research service that identifies and analyse such factors. As the title suggests, the selection criterion is the scale of the potential impact – that is, large enough to make the theme relevant for global asset allocators. The detailed insights on the subject matter of many themes should also offer value to portfolio managers and analysts focused on particular geographies and asset classes.

## What are these drivers?

The drivers fall into two broad categories:

### Geopolitical:

The risk of great power conflict in:

- Western Eurasia
- East Asia
- The Middle East

### Domestic politics:

- Voter revolts in Europe
- Trump risk

## Publication content and cycle

At any one time, we expect to have around six themes under active coverage. While we only focus on political drivers that we assess to be globally important, we occasionally challenge a consensus view on the high importance of some topic that, in our view, is less risky than widely believed.

GPD notes are published every other Thursday (alternating with Macro Picture). Each note leads on a particular driver, while noting more briefly any marginal changes in the risk profile of other topics on the service's current roster.

## Core team

The service is led by Christopher Granville, a former UK diplomat who has two decades of experience providing political economy analysis for investors on Russia and the rest of the former Soviet Union. The other lead analyst is Jonathan Fenby, the Chairman of LSR's China Research service and the author of several books on Chinese history and contemporary China. The core team also includes Marcus Chenevix and Constantine Fraser, specializing respectively in the Arab world/wider Middle East and Europe. The team draws systematically on the insights of our senior economists and market strategists.

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