LSR View

ROUGH TRADE TO BATTER MARKETS

Charles Dumas

- **Settlement of US-China trade disputes unlikely before US Mid-term elections**
- **Any deal would be unlikely to promise a big rise in US manufacturing jobs**
- **Extending the trade war to attack European surpluses could generate such jobs**
- **Continental European trade surpluses are the chief counterpart of US deficits**
- **Euro-Japanese savings gluts have caused consistent US$ overvaluation**
- **Uncertainties over trade wars could cause short-term stock market slump**
- **Voter response to trade wars unlikely to be fully clear before 2020 elections**
- **Breakdown from globalisation into regional trading blocs a long-term risk**

Summary

This LSR View looks at the interconnected US-China trade disputes, the likely extension of such disputes to Europe, and President Trump's policy and electoral strategy. A deal to settle the US-China issues, including intellectual property (IP) and North Korea, is feasible in time to be presented as a 'win' before November's Mid-term elections. But it is unlikely. Any such deal would be unlikely to achieve much for US manufacturing jobs, Trump's chief electoral goal. A continued battle with China on the key issues could be more likely to appeal to voters.

While a major revival of US manufacturing jobs is almost certainly a forlorn hope, the best chance of significant progress lies in reducing global imbalances that have led to persistent US trade deficits, with enduring overvaluation of the US dollar. For much of the past quarter-century excessive saving relative to their investment needs in Japan and German-centred Europe (as well as China until a few years ago) has kept their interest rates artificially low, leading to undervalued currencies and capital flows into the US. The counterpart of these US capital inflows has been the trade deficit.

Extending the trade war to Europe has greater economic justification than the US-China dispute; also both a better chance of success in reducing global imbalances and generating US manufacturing jobs, and lesser interim damage to the US economy while the disputes continue. Trump showed his eye for voter appeal by opening the attack with complaint about defence spending, where the US case is solid and the appeal to voters clear. (Mid-Western US voters focus little on European surpluses that nonetheless damage them.)

Short-term uncertainty about trade war creates a substantial risk of a summer stock market slump. In the longer term, a prolonged trade war could break the world economy down into regional blocks, at considerable cost to global welfare and asset values.

Introduction – trade war issues

The scope of this LSR View will be to cover what seem to be three separate, but in fact interactive, issues arising from the current escalating trade war(s):

- US v. China (the starting point)
- US v. Europe (so far only incipient)
- Trump's goals and strategy as initiator

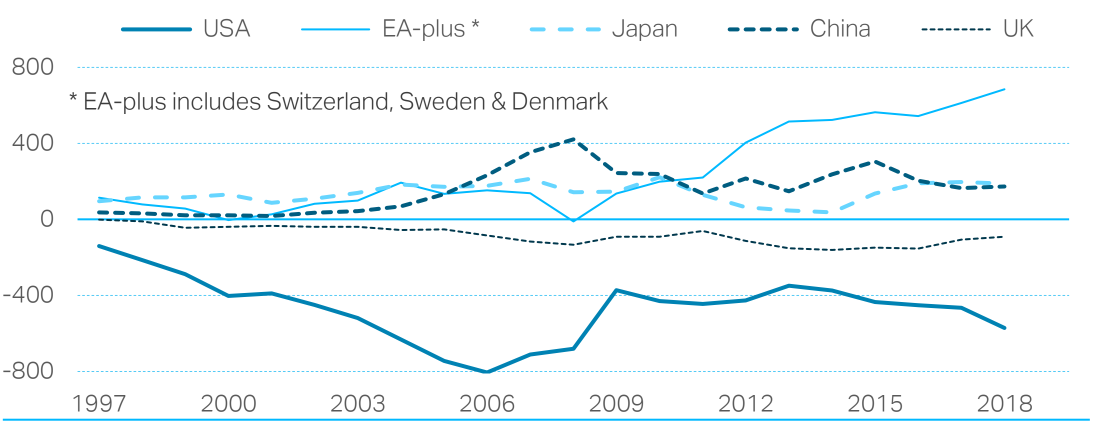
The US-China aspect concerns the competition faced by American labour with cheap foreign labour. It focuses on the bilateral Sino-US trade deficit. Three major ancillary factors include

- technology transfer – often referred to in the US as theft of intellectual property (IP)
- the issue of America's loss of primacy in a multi-polar world, and
- North Korea

Caught in the cross-fire to some extent are Japan, South Korea, and Taiwan – perhaps even ultimately, Hong Kong.

Current account balances, $ billion

OECD forecasts for 2018



Source: OECD, TS Lombard

US-European trade-war threats highlight economic and financial imbalances – a longstanding theme of ours, illustrated in the chart above – with particular emphasis on the motor industry. Clearly China, as a contributor to global imbalances, has moved away from centre-stage over the past ten years, and its surplus is now well under 2% of GDP. While Japan's surplus is the same 4% of GDP as that of continental Western Europe (EA-plus in the chart) its smaller size – below $200 billion, versus nearly $700 billion for EA-plus – puts Europe in the sights of US trade hawks as the counterpart surplus to the US deficit.

The economic threat from Europe does not carry much credence in the US, even though it is in reality greater than China's. Trump's eye for populist appeal means he has tapped into this issue via complaint about inadequate defence spending by European countries, 'free-riding' on the US military. One effect of this is to broaden the US-European aspect of potential trade war into the question of the whole future of the Western alliance. This of course reflects back onto the insecurity of Japan in the context of the Sino-US dispute, given Japan's economic orientation towards China and its political and military alliance with, and dependence on, the US.

When it comes to Trump's goals and strategy, one point concerns the balance between his conviction that this issue is the central point of his Presidency and the more mundane business of winning elections – both November's Mid-term elections for the House of Representatives and some Senate seats, and 2020's Presidential round. Will Republican voters this November be more impressed by an actual achieved deal, or 'win', or by continued 'trade war' to enhance their presumed interests? And to what extent would the kind of settlement achievable this autumn with China compromise the pursuit of this presumed interest of US manufacturing workers in unwinding the unfavourable effects of globalisation?

The balance of factors suggest the answer to both questions points towards a big US-China deal being unlikely in the run-up to the Mid-terms – and US-Europe disputes have yet to develop to the point where there is anything to settle with a deal. A US-China deal that might be achieved in the late summer or early autumn would probably have visible drawbacks for the key Mid-West voters – it would thus be suboptimal for Mr Trump with respect to the Mid-Terms and his ambition to improve the position of America's middle-income manufacturing workers.

The key to this is the element of self-harm in US import restrictions, reinforced by the harm to US exporters of other countries' retaliation. The downside of import restrictions – higher prices for goods currently sourced from China, or crippling hold-ups in supply chains – are felt immediately. It follows that the best impact on voters, and the US economy, of a September-October deal with China would be achieved if import restrictions were 'traded away' in the negotiations for other US benefits.

These could include some specific concessions on trade, but most importantly consummation of a Korean deal, whose delay or destruction Beijing could, and may wish, to ensure if the trade war continues; probably also some (perhaps largely token) concessions on technology transfer. But while China might willingly reduce the incidence of IP theft, it will not budge on its primary goal, the China 2025 agenda, with its emphasis on technological catch-up, which does not necessarily require IP theft. Sceptics of the top-down directed approaches to development can reasonably question whether China will be successful in a 'home-brewed' tech catch-up. But there are precedents, such as Japan's development of the car industry in the '60s and '70s.

The trouble with such a deal in US electoral terms is that it would amount to an admission that the use of import restrictions to restore US manufacturing jobs cannot work. The 'win' for Trump would be chiefly over North Korea – far from a done deal at this point – some specific trade concessions, and progress on IP theft. This would be a good deal for America, especially US shareholders, but well short of the expectations that have been raised for manufacturing jobs. It would remove the chief populist thrust of the Trump programme – and not just for the Mid-terms. Whether US manufacturing jobs could be revived by other means than trade war is a question for a future publication, but the Trump approach, and also that of Bernie Sanders, would have failed: the middle-America votes they won would be seen as little more than protest votes.

The US-Europe trade-war 'front'

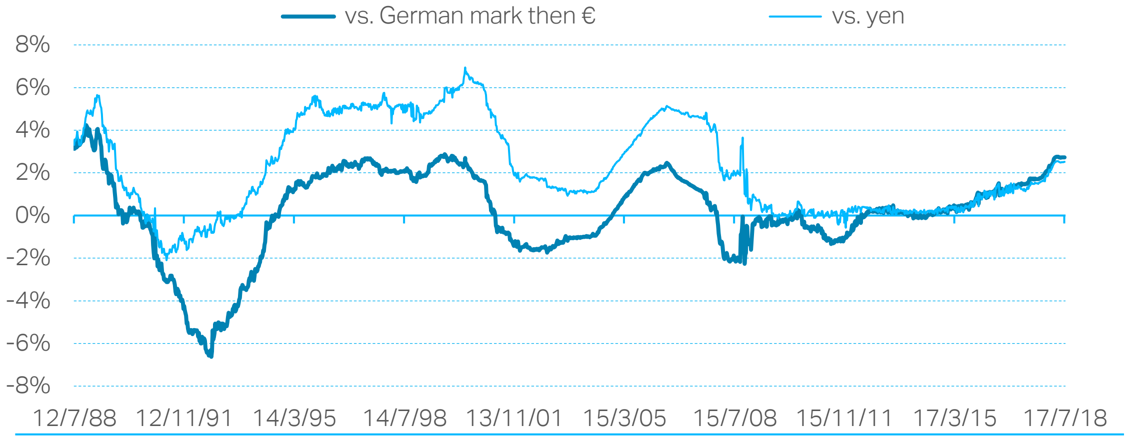
The route by which some relief for US manufacturing jobs might be achieved – though far from the full-blooded revival of populist hopes – is by reduction of global imbalances, whose long-term effect has been consistent overvaluation of the dollar – though only under the definition that the 'right' value of the dollar is the one that ensures long-run current account balance. This is an important qualification, as consistently attractive investment opportunities in the US, relative to the rest of the world, have tended to cause capital inflows that have driven up the dollar to a value that ensures the offsetting current-account outflows, ie deficit. (The overall balance of payments will always be zero.) Consistent, relatively attractive investments have in fact been there for decades – hence the net capital inflows and consistent current-account deficits, mostly in the form of trade deficits that have added to the downward pressure on US manufacturing jobs.

What is the form of this enduring attraction of US assets to foreign investors, the key to the consistent undervaluation of other currencies vis-à-vis the dollar? One important factor is that US financial markets have unequalled depth, breadth and liquidity. Another is that US growth has exceeded that of Japan and continental Europe for most of the past quarter-century. But crucially important have been the global imbalances summed up in the phrase 'savings glut'. This represents a structural tendency for a group, or a country or region, to save significantly more than can be profitably invested by that group, country or region.

The savings glut in a large portion of the world was a significant cause of the financial crisis, as the supply of cheap goods from countries with undervalued currencies – backed by cheap credit as interest rates were held down to keep the currencies cheap – induced a gross excess of debt in the US, Britain and Ireland, and Mediterranean Europe. The countries with a glut of saving were China, Japan, Asian Tigers and German-centred Europe (including Scandinavia, 'Benelux', Switzerland and Austria).

Continued inability to consumer their own product by savings-glut countries, China largely excluded, has dogged the recovery from the crisis, as debtor countries were also forced to cut back on borrowing and spending. One result has been monetary policies in Japan and the EA designed to hold down currencies by means of cheap interest rates, in an attempt to restore growth by means of enhanced export-cost competitiveness. For much of the post-crisis period, the deterrent of low rates elsewhere has attracted capital inflows to the US, holding up the dollar and ensuring a revival of the US trade deficits that shrunk after the crisis.

US 3-month Libor differentials, %



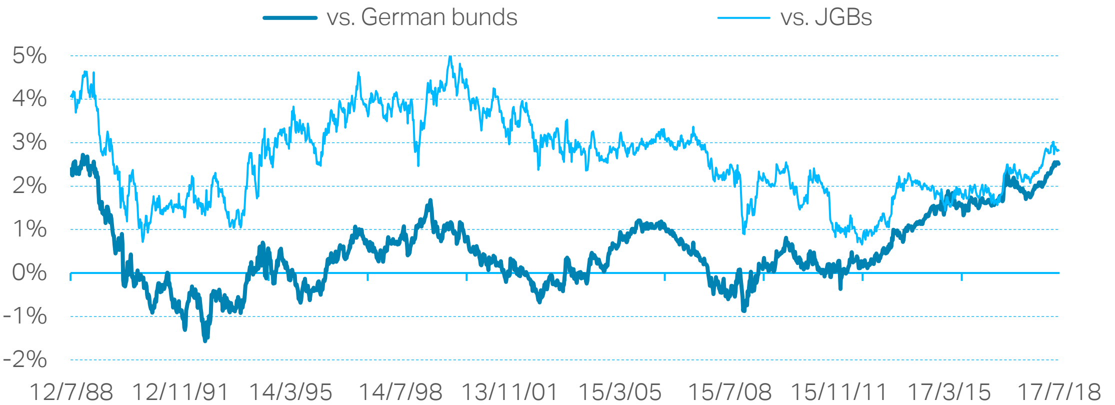
Source: Datastream, TS Lombard

This chart shows the 3-month Libor differentials between the US dollar and the yen and euro (using the German mark as a euro-proxy until December, 1998). The average differential against the mark/euro has been 0.4% over the past 20 years, and 2.1% against the yen. The last time the differential was seriously negative was at the time of maximum mark and yen strength in the early 1990s, when the US current account was close to balance (not by coincidence). When it comes to yield differentials for 10-year government bonds, the picture is similar. Versus German Bunds, 10-year US Treasuries' yield differential has averaged 0.7% over the past 20 years, while the JGB differential was 2.6%.

In recent years, the differences between Japan and the EA have largely disappeared. This is not because the EA economy is in such desperate shape as Japan's, which is entirely dependent on massive budget deficits as well as negligible, now-negative interest rates to generate any growth at all. But the imbalances within the EA, notably between Germany and Italy, and the damage caused by the euro crisis, have led the ECB to move the EA convoy at the speed (in this case real exchange rate) of the slowest: Italy.

Japan started its beggar-my-neighbour monetary/FX policy – known as Abenomics – in late-2012. After a foolish tax rise in April 2014 that the Japanese economy could not handle induced a double-dip recession, it engaged in round two of Abenomics from mid-2014. This was precisely when ECB President Draghi started to talk down the euro, instituting QE followed by negative interest rates the subsequent winter. The dollar differentials vis-à-vis the euro and yen have mounted steadily since, in parallel. And as argued on p.2 above, the simple fact that the continental European economy is 3½ times the size of Japan makes it the natural target for trade war manoeuvres.

10-year US gov't. bond yield differentials



Source: Datastream, TS Lombard

Several conclusions follow:

- Trade war with the EA, especially Germany whose surplus of $340 billion exceeds 8% of GDP, is on optimistic assumptions capable of improving the world economy if action results that lessens the global blight from internal EA imbalances, and boosts the euro
- The US has a much stronger case against EA conduct of trade policy than against China's – in particular, Germany has always implausibly resisted any steps to offset excessive surpluses, that can be as destabilising as excessive deficits
- Trade war with the EA involves less collateral damage to the US than with China, as the US is less dependent on trade with Europe
- The difficulties of resolving the US-China disputes in an electorally appealing pact mean the path of least resistance for the Administration is to segue into widening the scope of its incipient trade war to include Europe

Of course, there are enormous downsides too, quite apart from the general desirability of free trade, and international compliance with agreed rules and systems:

- Fighting wars on two fronts is always risky – the recent EU/Japanese trade agreement illustrates how the US may induce the rest of the world to gang up
- Trade war is clearly damaging in the short term, and removes Trump's claim to have benefited the stock market – soon it may be slowing the US economic growth
- Longer-term, trade war or fear of it may atomise the world economy into regional blocs that might prove consistently hostile to US interests, particularly business interests
- Trade war could prove to be a prelude to real war, most likely in the Far East – at the very least it puts Japan, Korea and Taiwan in a parlous position

Timing issues and the markets

Our view at TS Lombard is clearly that the trade war threat is not likely to be put to bed with a 'deal' in the run-up to this autumn's US Mid-term elections. Others may not hold this view, but the matter will certainly be in doubt for the rest of the summer. This raises the possibility that real-asset markets may slump over the next couple of months. This would be destabilising, even if there is an early-autumn deal that spurs recovery. In the more likely event that US pursuit of trade-war measures persists through the Mid-term elections, then there will be a genuine destruction of value in global stocks, particularly in the US. The invalidation of certain existing supply chains and other supply networks inevitably imposes costs.

Much will depend on voters' reaction to the Trump trade-war initiative. For now, he believes it is winning him support, though poll results on this point are unclear. But the voting results in the Mid-terms will constitute harder facts than such polls, important though they are is affecting policy. The Mid-terms will not be decisive, however. Most of the potential damage to the world economy, and particularly the US, its big international businesses and its stock markets, is likely to show up over a much longer time-frame than the 3-4 months to the Mid-term elections. So the decisive voter test will be in 2020, when it is assumed Mr Trump will be the Republican candidate. The potential damage from such major uncertainty and actual trade restrictions over a two-year period is huge.

In some ways, the Trump trade-war initiative already marks a parting of the ways from the free-market era inaugurated by the Reagan/Thatcher reforms of the 1980s. It appears to legitimise unilateral breaches of global agreements, in the form of an aggressive repudiation of US readiness to respect international law. Other countries may take note, and shift towards regional alliances or blocs, notably in the Far East – China, Japan, Korea, Taiwan and the Asian Tigers – and in Europe. This may not be too damaging to long-run prosperity in a benign scenario, but it raises substantially the risks of damaging future disputes and even actual war, both in the Far East and through weakening of the Western Alliance and NATO.

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