Global Political Drivers

TRADE WAR: RADICAL INVISIBILITY

Christopher Granville

- **Stating the obvious is worthwhile when the implications risk being overlooked.**
- **In the case of the US-China trade war now driving global markets, the obvious point is that this is an overwhelmingly political project that is made in America.**
- **The implication that should be kept in the front of investors' minds is that, with politics in the driving seat, this trade war may be switched on or off at will by the US as the instigator and prime mover.**
- **But who or what, for this purpose, is 'America'? The answer matters a lot for markets that are now pricing in continued escalation but could be squeezed by a sudden reversal of course – of the kind seen last May, when Trump put an end to the Mnuchin-Liu process.**
- **That turning point suggests that as far as this trade war is concerned, the answer is Trump himself.**
- **We search for more structural constraints and systematic patterns that may be easier to predict than Trump's decisions.**
- **The first part of this analysis – on the voter base – underpins at least one confident forecast: the escalation trend will continue until the mid-term election in November.**
- **The analysis continues through key advisers in the Trump administration – especially the China trade hawks – and the US political class: but all roads lead back to Trump.**
- **A notable finding in support of this conclusion is that Trump himself, while beating many other drums, has gone easy on the geopolitical hegemony angle that is the swing factor between trade war and peace.**
- **Faced with this Trump lottery, investors are left to scour the news for clues – such as the on-off talks cycle on this week's wires: but decisive talks would more likely be secret; and a change of course would anyway come as a vintage Trump surprise.**

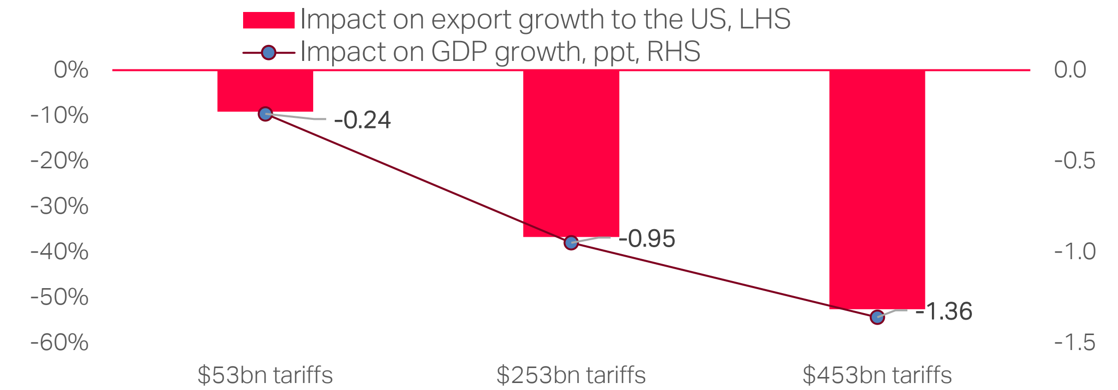
Trump's "great man" casting

Sophisticates have long disparaged the "great man theory of history". Important events and trends are assumed instead to have complex causes. On this view, the choices of individuals are regarded for the most part as surface phenomena: be they never so powerful, autocratic and capricious, rulers and political leaders do not operate in a vacuum.

Chinese policymakers might be forgiven for questioning this orthodoxy as far as 'trade wars' are concerned – and not only because in their own Leninist political system, huge centralized power is concentrated in the man at the top (with the present incumbent, Xi Jinping, reviving the purest traditions in this respect). In a trade war perspective, the main reason for ruler-focus has to be the man calling the shots in White House.

Political factors dominate trade wars. The point of these reflections is not to arrive at some verdict on how far Donald Trump with his trade wars fits the "great man" bill (and leaving aside also the question of how people might wish to qualify or modify that "great" epithet). This line of thought serves rather as a simple aide-memoire about the critical feature of this trade war story, now concentrated on China. Trade wars have not only become this year the single most important driver of the global economy and markets – at least, along with the US monetary tightening cycle (rate hikes plus QT) and its worldwide effects on credit and liquidity: the other key point about trade wars, in contrast to all such other "Fed"-related factors, is that they are an overwhelmingly *political* driver.

US trade tariff impact on China



Source: CEIC, TS Lombard

The reason why something so obvious bears repeating is the risk of overlooking its implications. In this case, natural and worthwhile analysis of trade wars' economic impact – notably on China itself – since the Chinese growth slowdown is a global driver in its own right (see chart above) – may camouflage the sheer unpredictability of such a politicized situation. This trade war arena offers none of the reassuring 'themes and variations' of monetary and business cycles. Even if damaging second-round economic effects might continue to be felt even after a change of political direction, political decisions will still be absolutely decisive. Put simply, the trade war with China can be turned on and off at will by the US government as the sole protagonist – with China itself, the Europeans and the rest of the world left merely to react and/or remain passive and anxious onlookers.

Chronology clue: The May go-away

A glance at the chronology of the US-China trade war to date shows this arbitrariness in action. The lines highlighted in red in the table below denote what, at least with the benefit of hindsight, proved a turning point. Until that moment in the second half of May, the situation appeared manageable.

Pre-emptory US demands were not an initial deal breaker. After landing some initial blows to soften up the counterparty in an "art-of-the-deal" spirit, the Trump administration opened negotiations in early May with a set of written demands. Parts of that document, which Treasury Secretary Steven Mnuchin and Commerce Secretary Wilbur Ross took with them to Beijing at that time, read like an ultimatum. This tone reflected and enflamed mutual sensitivities: while the US views itself as the aggrieved party seeking redress for serious and longstanding wrongs, China must have winced at the echoes in that document of the 'unequal treaties' imposed upon it by nineteenth-century western imperialists. For all that, the talks proceeded.

The implicit Chinese assumption here must have been that the US demands were a maximalist opening gambit in the negotiations. Beijing deployed its big gun – Vice Premier Liu He. Beforehand, and notably in Xi's speech at the Boao Forum in April, China had been signalling flexibility on several key fronts such as increasing imports from the US, improving US investors' access to Chinese markets, and enhancing intellectual property protections. This Chinese approach implicitly assumed that the US would accept limited concessions in return for China being able to go on with past practices.

US-China trade war timeline: The turning point

March 1	Trump announces steel and aluminium tariffs covering $3bn of imports from China
March 22	Publication of USTR's Section 301 report on China's abusive investment and IP practices. Trump announces retaliatory 25% tariffs on $50bn of imports from China
March 23	China announces tariffs on $3bn of imports in response to steel and aluminium tariffs
April 4	China threatens retaliatory tariffs on $50bn of imports from US – agri and aerospace focus
April 10	Xi promises to "broaden market access", Trump reacts positively.
May 3	Ross and Mnuchin fly to Beijing for talks with vice-premier Liu He. Mnuchin brings with him an extensive list of demands.
May 10	US puts tariffs on hold, after agreeing steps for reducing the trade deficit over time.
May 14 TURNING	**Liu He arrives in Washington for four days of talks. Mnuchin's conclusion: "no trade war"**
May 29 POINT	**The White House announces it is moving ahead with the 25% tariff on $50bn of imports.**
June 19	Trump threatens tariffs of 10% on a further $200bn of Chinese imports, if China proceeds with its retaliation.
July 5	Trump speaks of ultimately hiking tariffs on all $500bn of Chinese imports
July 6	US implements of 25% tariffs on $34bn of Chinese imports (first part of the initial "$50bn package"); instant tit-for-tat retaliation by China
Aug 1	Trump threatens to raise the planned 10% tariff hikes on $200bn of Chinese imports from 10% to 25%
Aug 3	China riposte to that last move: 25% tariff threat on a further $60 billion of US imports; meanwhile asymmetrical response of RMB depreciation intensifies
Aug 23	Entry into force of reciprocal 25% tariffs on $16bn of imports (second part of the initial "$50bn package")

Source: News agencies

For a while, this approach appeared to be working. In mid-May, a second-round of talks in Washington with the same principals (Mnuchin and Liu) ended with Mnuchin's reassuring public comment that trade wars were off the agenda. Trump thought otherwise. By the end of the month, he had re-launched the escalating tit-for-tat tariff hikes that continue to this day with no end in sight. This left China's leadership to rue its miscalculation in thinking it had a deal – only to be left now with no immediate fall-back position except reciprocal tariffs and casting around for an alternative long-term strategic response in which RMB depreciation will certainly play a role.

It would be logical for Beijing to conclude in the light of this experience that dealing with the US Treasury is futile, and that only Trump matters. They will also have gathered that Trump has lost interest for now in conventional negotiating give-and-take – if only from the message coming from Larry Kudlow, Trump's economic adviser and unofficial trade wars spokesman, that "Beijing only has to pick up the phone".

Search for predictors: 3 'structural' candidates

Recalling that turning point episode of last May has sobering implications for asset allocators. If the whole trade war orientation has once reversed course in that way, it can do so again. Global markets will be highly sensitive to any news suggesting such a change – in either direction, yet more escalation or reversion to détente. Like the proverbial bicycle rider, the US as instigator of trade wars must either push forwards or dismount: maintaining trade wars in a steady – stationary – state seems unrealistic. Yet the signalling of a change of course, with resulting market moves, will raise new questions. Might such a move be a feint? Or a prelude to (re-)opening another front such as Europe?

As things stand, conservative positioning may seem prudent – i.e. looking through the present indications of no more than a mild decline in global trade and discounting a more severe economic setback stemming from the direct and indirect (uncertainty) impact of trade war. For now, Trump appears set on doubling down. The risk, however, would be of getting caught on the wrong side of markets were Trump to come out one fine day and call off the trade war (doubtless by declaring a great victory).

A natural response is to seek patterns and frameworks underlying the blow-by-blow headlines and providing some basis for prediction. But where to look for an answer? This takes us back to the 'great man theory' – or rather the structural critique that would emphasize the importance of external influences that, in the end, should count for more in Trump's decision-making than his personal opinions, whims and moods. The three obvious structural factors are Trump's electoral base, his circle of close advisors, and the political class.

1. The base

Pleasing voters ahead of the mid-term elections on 6 November seems a good basis for predicting that trade war against China will remain on the escalation track at least until then. As Trump put it in a CNBC interview on 19 July, "I could have a quiet life" enjoying the strong economy; but he said that he remained determined to stick to the hard task of getting even with China to deliver on his campaign promise. This is particularly relevant to his electoral base. The rust-belt states that put Trump in the White House have borne the brunt of two decades of job losses that have been caused by Chinese mercantilism – or, when other causes also contributed, for which China may be credibly blamed.

The strongest argument for predicting continued trade war escalation for the rest of this year is the lag in any economic blowback. US industry lobbies have been registering their objections to the Trump administration's protectionist policies ever since the tariff hikes in the spring on imported steel and aluminium. However, as regards the balance of winners and losers involved in all trade policy shifts, it will take more time – perhaps a year or two – for sufficiently large numbers of domestic 'losers' to feel sufficient pain for this to become a political factor. For now, only soybean farmers have been offered explicit ($12 billion) compensation for the losses caused by retaliatory Chinese tariffs. The political dividend from taking a tough stand with China can be enjoyed up front without much risk of an economic backlash. Looking forward to 2019-20 with the approach of the presidential election, that trade-off could shift towards declaring victory (compromise) on China.

2. The advisors

Talk of 'victory' shifts the focus to the China trade and investment hawks on Trump's team. The leading figures here are Trade Representative Robert Lighthizer and National Trade Council Director Peter Navarro. Their influence is the most apparent 'structural' explanation for Trump's pulling the plug on the Mnuchin-Liu process last May. These hawks' agenda extends well beyond stopping Chinese (mis)appropriation of US technologies. As stated in plain text in the Bill of Demands that Mnuchin and Commerce took with him to Beijing in early May, The US requires China in effect to abandon its state-led political economy model.

China immediately will cease providing market-distorting subsidies and other types of government support that can contribute to the creation or maintenance of excess capacity in he industries targeted by the Made in China 2025 industrial plan.

The stakes here are geopolitical – ultimately, nothing less than a struggle for global mastery. As our China Research Chairman Jonathan Fenby has explained (Why China will not surrender), this part of the US agenda is non-negotiable for China, striking as it does at the heart of China's political economy and strategic goals. Given the evidence of Chinese willingness to offer concessions on the rest of the bilateral economic agenda, this geopolitical factor may be inferred as the decisive cause of the sequence of events last May.

Those developments reflect the ascendancy of the administration's China trade hawks: but they were not always so dominant. Different tunes were heard during Trump's first year in office, such as – when hosting Xi Jinping at Mar el Lago in April 2017 – that he would forbear on justified economic grievances against China in exchange for Chinese help with ending the North Korean nuclear threat. For the sake of clinching the progress since made towards a 'big win' on North Korea, that tune might be revived – or a similar tune sounded for some other reason. The hawks' star could yet wane.

There is scant explicit evidence to support that inference about US hegemony concerns now driving administration's handling of trade wars. That is saying something: for, by and large, Trump is nothing if not explicit about his ideas and feelings. While the 'hegemony' agenda clearly pulses through the federal government (as seen in the new Defence Act signed by Trump on 13 August envisaging a 'whole-of-government' stance against the Chinese threat), Trump himself does not dwell on grand strategy. Instead, he sticks in his tweets and public remarks to the goal of fair trade and bringing good manufacturing jobs home.

Even if Trump did appear to be more engaged personally with the geopolitical agenda, that would be a poor reason – given his track record – for ruling out a future change of tack. But Trump's *avoidance* of that agenda might be reckoned as marginally favouring the possibility that, further down the road, he will re-engage in a more conventional negotiating process with China.

3. The political class

The broad consensus in Congress in favour of standing up to China has clearly influenced the direction of trade wars. Congressional objections to trade tensions with allies have extended to various legislative initiatives designed to prevent the president from imposing protectionist measures against friendly countries on national security grounds (Section 232 of the 1962 Trade Act). This political factor must account in part for last month's trade truce with Europe (Kudlow: "the U.S. and EU will be allied in the fight against China"), and may also have contributed to the more constructive atmosphere around the NAFTA renegotiation.

This political consensus increases Trump's personal freedom of manoeuvre on the China front. This point emerges best by comparison with other foreign policy areas – notably Russia – where Trump's preferred (conciliatory) approach is at odds with the large majority of the political class that wishes to confront Russia. The broad-based support for a tough China policy may be somewhat more qualified than in the Russian case by the dense tissue of US economic interests in and around China. China policy is a rare example of an area where the US political climate would be unlikely to change even if the Democrats were to win control of one or both houses of Congress in next November's election.

It's down to Trump

Boxed in on Russia, Trump has a much freer hand on China – and this brings our analysis full circle. On each of those three 'structural' drivers, the conclusion is that Trump personally retains the political space and cover to flick the switch in either direction on the China trade war. Unlike the first two factors, which may at times act as a constraint Trump's discretion, the last factor – i.e. the China consensus in the political class – turns out not even to be a constraint but to ensure instead a supportive backdrop for Trump to do as he pleases.

As far as the US-China trade war is concerned, it looks therefore like the "great man" theory wins out. Many economists' bracing insistence on "radical uncertainty" generally refers to long-term outcomes. In cases like trade wars, where political factors predominate, the equivalent principle – as flagged in our report title – would be the lack of any real visibility. Our conclusion that the specific dominant political factor in this case is the unpredictable choices of Donald Trump can only mean *radical invisibility*.

Postscript: Clues from the news

Faced with this pure version of the Trump lottery, all that remains is to scour the newsflow for advance signs of any such reversal. This week has produced – and the market has reacted to – one possible sign: the announcement that China's Deputy Commerce Minister Wang Shouwen is heading to Washington for talks with the undersecretary for international affairs at the Treasury, David Malpass. The Chinese Commerce Ministry's press release rehearses the official position that –

China welcomes dialogue and communication on the basis of reciprocity, equality and integrity.

For "integrity", read "good faith". The plain text message would be that trust has gone; and it seems impossible that it can be restored by such 'talks about talks' between technocrats. The two traditional paths to diplomatic breakthroughs out of an impasse like this would be back channel ("track two") exchanges between trusted representatives out of the public eye or secret high-level overtures. Neither genre seems natural for Trump. On the other hand, the second route was used on North Korea in the form of an undisclosed visit to Pyongyang by Mike Pompeo in this then capacity as Director of the CIA.

Still, the most likely scenario for change remains a bombshell Trump announcement. There seems no escape here from acute event risk and the associated volatility – including upside risk.

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 is interested not so much in redistribution, but in ideologically-driven supply-side changes. The new Italian government could be an unexpected safety valve for discontent.	
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 geopolitical realignment.	
Trump Risk	Donald Trump has cultivated a reputation for unpredictability –from military intervention to trade disputes.	"Trade war" tensions have key geopolitical components – both in the case of China and in that of Europe.	
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.	A North Korea-style approach with Iran is impossible – and risks perpetuating US quagmires.	

Special reports:

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China Stability Risk: Post-Deng Chapter 2, 7 December 2017
Japan: The Lessons of Ms Koike's fizzle, 12 October 2017
Shale Revolution: Russia's missing trick, 22 June 2017

Closed theme: Great power tension: West-Russia

Russia-West: Cool Peace, 4 January 2018
Cyber wars: Add to the risk-off list, 20 July 2017

Closed theme: European Voter Revolt

Europe and America fear factor review, 24 November 2017
Labour participation unmasks political risks, 14 September 2017

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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