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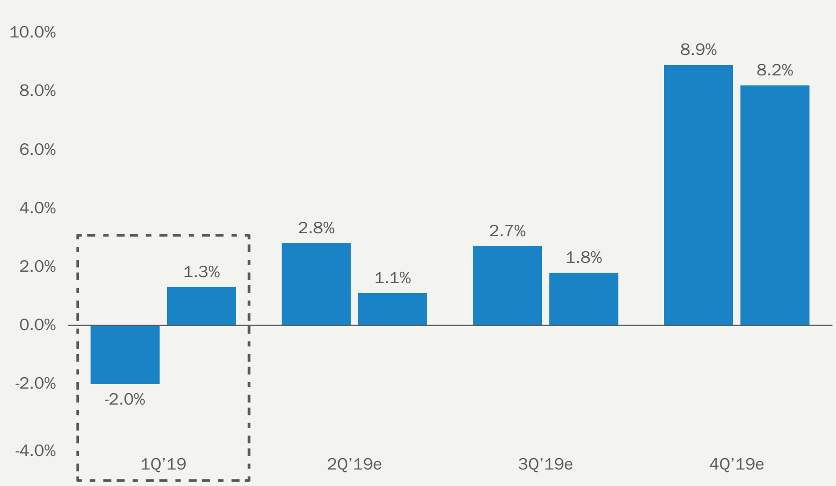
Handicapping the Outlook for US-Sino Trade Negotiations

Market pundits have doubted this bull market every step of the way. Each pullback put into evidence that the cycle had reached its endgame; each recovery off the lows furthered the disequilibrium caused by monetary malfeasance. There was just no way that equities, with the durability of the business cycle in doubt and the headwinds of political discourse stiffening anew, should continue to press to all-time highs—*and twice in seven months!* Right? Surely such moves illustrated just how misplaced investors' confidence had become. And yet, not more than two weeks ago the market stood as high as it ever has. Sure felt good. Much of the lingering concern that the economy was weakening too quickly was offset by fairly robust data for the first quarter. US real GDP for Q22019 was up 3.20%, significantly stronger than economists' forecasts. S&P 500 Index profits, which had been expected to decline 2.00% year over year for the quarter, are poised to come in up 1.30% year over year. And, the outlook has improved. Whereas the trajectory for US growth is likely to continue to slow, it is still growing. Though less optimistic at the start of the year, the Street has more recently moved toward our view—*that the US remains in the protracted slowing expansion phase of the cycle*—and has adjusted upward its expectations for the back half of the year. Then, in early May, US-China trade negotiations took an ugly turn.

What caused this public flare-up so late in the process?

In a communique outlining its concerns (and requirements) for a deal, China mandated that all tariffs must be removed. This runs counter to the US's position that some tariffs should remain in place as an enforcement mechanism and to compel the Chinese to comply with the deal terms. This

S&P 500 Quarterly EPS Y/Y Percent Change



Source: Strategas

has long been a sticking point, but one we felt could be resolved by the two presidents, one-on-one, working out the final details. Instead, it became the issue that broke the negotiators' trust.

What measures have the US and China enacted as talks have stalled?

The US runs a roughly $420 billion trade deficit with China (we import $540 billion worth of goods and export $120 billion worth of goods), which is roughly 4% of its GDP (China runs a trade surplus with the US that is about 2%-3% of its GDP). Most recently, the Trump Administration increased tariffs from 10% to 25% on $200 billion of goods from China. The new import duties will not apply to goods already in transit; rather, they will apply to those shipped after May 10. Under normal circumstances, it takes about three to four weeks for ships to make the journey. Furthermore, the Administration said it was preparing to impose 25% tariffs on an additional $325 billion of goods from China.

In response, China increased tariffs from 10% to 25% on $60 billion of US goods. This is a proportional response. Remember, China cannot retaliate dollar for dollar with the US, so it may resort to nontariff barriers for retribution. Most notable, China could either devalue its currency to offset the impact of higher tariffs, or it could sell US Treasurys. Vice Premier Liu, China's principal negotiator, has indicated the latter was an option, and some believe that China sat out a Treasury auction last week. We view the likelihood of either of these moves as remote. From there, China's menu of options thins. Among them are: enact export bans on goods the US cannot easily substitute; increase safety inspections and border delays; escalate the frequency of audits and heighten supervision of US companies operating in China; and, impose more stringent financial regulation.

What will be the impact of the latest round of tariffs?

The hit to US GDP is likely to be a drop of 0.10% point for every two months we go along with China's higher tariff rates—a decline of roughly 0.50% points per year. Slightly more than half of this, in our estimation, is through reduced confidence and lower investment. The hit to China's GDP should be substantial as well, though there may be offsetting local stimulus. President Trump has renewed calls for the Federal Reserve (the Fed) to lower interest rates. Though not our base case, the risk of a US recession rises if the Administration chooses to raise tariffs on all $540 billion of goods imported from China for a full year. The Fed could cut rates in this scenario, but would likely be stubborn given the current data profile.

Can the US economy withstand a protracted trade war with China?

Some clients have suggested to us that because US growth is solid (3.20% real GDP in Q1) and inflation is low, the President feels emboldened to ratchet up the intensity of the negotiations. As we mentioned above, the US economy is in decent shape and inflation has been low. The Strategas Economics team has laid out a number of reasons why global trade disruptions are never timely, particularly now:

1. Although US growth has been solid, 0.70% of the Q1 boost came from inventories, which should be paid back in future quarters.
2. US manufacturing employment has already started to slow, and US manufacturing PMI measures are still in a downtrend, following global weakness last year.
3. A key fear at the end of 2018 was that the Fed would overtighten against this global backdrop, which has been alleviated by the FOMC's pause in 2019. The

Yuan Per U.S. Dollar

Source: Strategas

economy is just starting to see the positive effects of this monetary policy pause, and another market hiccup now would tighten financial conditions. The Fed appears reluctant to ease at this point.

4. Although inflation has been low, there are still signs it is not dead (rising capacity utilization, rising wages, slowing supplier delivery times). The bond market is not providing a lot of cushion against even a small amount of inflation, with the yield on the 10-year US Treasury Note at 2.40%.
5. US bank lending standards, although still expansionary, do not look particularly easy. This is a leading indicator for payroll employment.
6. The US budget deficit is large for an economy at full employment. This is manageable if we see capital spending rise, which, in turn, would boost productivity and pay for higher wages. But businesses seem reluctant to start this process without some clarity on trade policy. Tangentially, global markets had a tough time last year. China has already seen weakness due to deleveraging, so the impetus to get a deal done is likely mutual.

Are we still on track for a deal?

China and US policymakers went out of their way to emphasize that trade talks did not collapse following last week's short negotiations. This helped stocks to finish last week on a strong note, but the near-term outlook does not look positive. Neither side indicated they would return to the negotiating table with the same terms that were in place before talks broke down. There is a possibility that Trump and Xi will see each other at the G-20 meeting in June, which provides an opportunity for some of the issues to get resolved then. But until that happens, the tariff increases will go into effect and stay in place.

The Chinese have expressed concern that their purchase of goods from the US must be in line with reality. The Strategas Policy team reads this as China saying the US was trying to front-load too many Chinese purchases of US goods into late 2019 and 2020. The Chinese also offered the ever-vague requirement of "balanced text that ensures the dignity of the two countries," which implies that China is against changing its laws for structural reform. The US will not agree to a deal that does not enshrine the changes into law. The path forward will likely require the US to remove all tariffs and for China to agree to the structural changes and memorialize them in its laws.

The stock market views the outcome as binary (yes/no) that the trade deal gets done, despite the fact that short of the last few—*critical*—implementation points, it largely has been negotiated. What is making this difficult is simultaneously bracing for (significantly more) near-term volatility while allowing for the fact that a "good" deal ultimately could be positive for investments in cyclicals. We remain confident that the outcome reconciles to the upside and a deal gets done. As Strategas' chief economist, Don Rissmiller, has noted, "This is not the best time for a trade war. It might be fair to say there is no good time for a trade war." We agree. Let's hope Presidents Xi and Trump do too. Hang in there.

Advisor Takeaway:

Surging GDP, a record stock market high, and solid corporate profits expectations appeared to hold sway over market naysayers—that is, until a breakdown in trade talks between the US and China took an ugly turn in early May. President Trump fulfilled his promise to impose hefty tariffs to bring down our $420 billion trade deficit, after China reneged on signing the agreement, in spite of having acceded to its terms. In a display of tit-for-tat, China increased its tariffs on goods the US sells to them, hinting it could devalue its currency, sell Treasurys, or increase regulatory demands on the US as further retribution. The standoff could result in a decline of .50% of GDP per year and pave the path to a recession. Slowing US manufacturing, the Fed signaling its reluctance to lower rates, hints of an uptick in inflation, and a bloated budget deficit all factor into the mix. On the other hand, China's economy is weakening, so both sides have an incentive to get a deal done and avoid a full-fledged war. Success will demand compromise from each country. We are optimistic a deal will get done, but until an agreement is signed, it may be a bumpy ride.

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Founded in 2006 by Jason DeSena Trennert, Nicholas Bohnsack, and Don Rissmiller, the Firm was acquired by Baird Financial Group in 2018. Strategas operates independently as a wholly-owned subsidiary of Baird and offers institutional securities services through Strategas Securities, LLC, a broker-dealer, and investment management solutions, including this commentary, through Strategas Asset Management, LLC, a registered investment advisor.

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Index Overview & Key Definitions
Fed, The Fed or FED refers to the Federal Reserve System, the central bank of the United States. **Fed Funds Rate**, the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **Gross Domestic Product (GDP)** rate is a measurement of the output of goods and services produced by labor and property located in the United States. **Real Gross Domestic Product (GDP)** is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year. **Nominal Gross Domestic Product** is gross domestic product (GDP) evaluated at current market prices. The **S&P 500 Index** is an unmanaged index comprised of 500 widely held securities considered to be representative of the stock market in general. The **Russell 2000 Index** is an unmanaged index considered representative of small-cap stocks. The **PCE (Personal Consumption Expenditure) Index** of Prices is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures; essentially a measure of goods and services targeted towards individuals and consumed by individuals. The **Producer Price Index (PPI)** program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services. **FAANG** is an acronym for the five of the market's most popular tech stocks, namely Facebook, Apple, Amazon, Netflix and Alphabet's Google. The **North American Free Trade Agreement (NAFTA)** is an agreement signed by Canada, Mexico, and the United States, creating a trilateral trade bloc in North America. The **Seasonally Adjusted Annual Rate (SAAR)** is a rate that is adjusted to take into account typical seasonal fluctuations in data and is expressed as an annual total. SAARs are used for data affected by seasonality, when it could be misleading to directly compare different times of the year. The **Atlanta Fed GDPNow** forecasting model provides a "nowcast" of the official estimate prior to its release by estimating GDP growth using a methodology similar to the one used by the U.S. Bureau of Economic Analysis. GDPNow is not an official forecast of the Atlanta Fed. Rather, it is best viewed as a running estimate of real GDP growth based on available data for the current measured quarter.

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