
This past weekend, the Administration announced a tentative deal with China to temporarily postpone the burgeoning *"trade war."*•While the details of the deal are yet to be worked out, the concept is fairly simple - China will reduce the existing *"trade deficit"* by over $200 billion annually with the U.S. by reducing tariffs and allowing more goods to flow into China for purchase.•On Monday, the markets reacted positively with industrial and material stocks rising sharply as it is expected these companies will be the most logical and direct beneficiaries of any deal. Unfortunately, there are several reasons the whole scenario is quite implausible. Amitrajeet Batabyal recently explained the problem quite well.

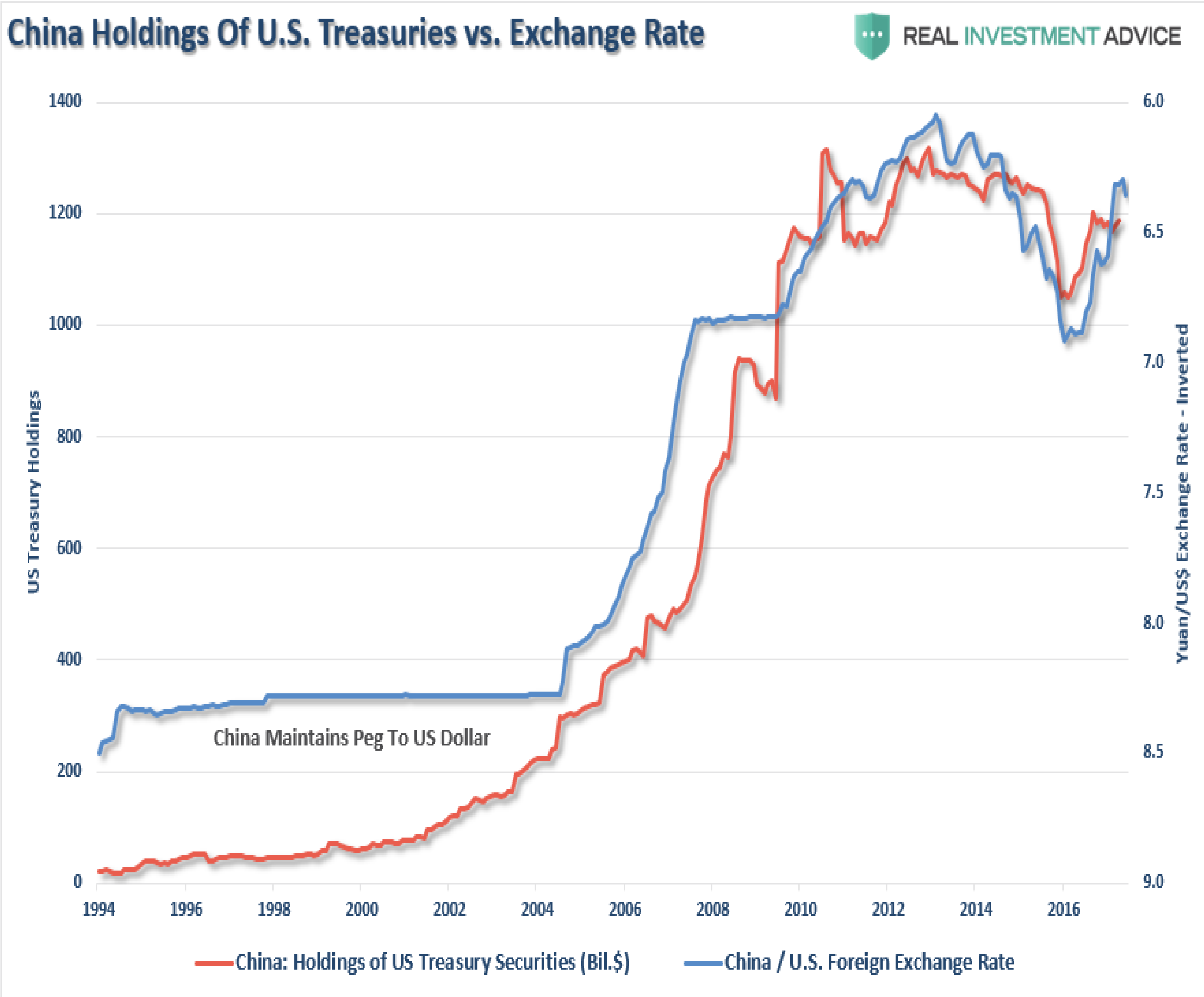
> *"With China,•the U.S. imports a whopping $375 billion more than it exports.•How could it whittle that down to $175 billion? There are three ways.*

- *First, China could buy more U.S. goods and services.*
- *Second, Americans could buy less Chinese stuff.*
- *Finally, both actions could happen simultaneously.*

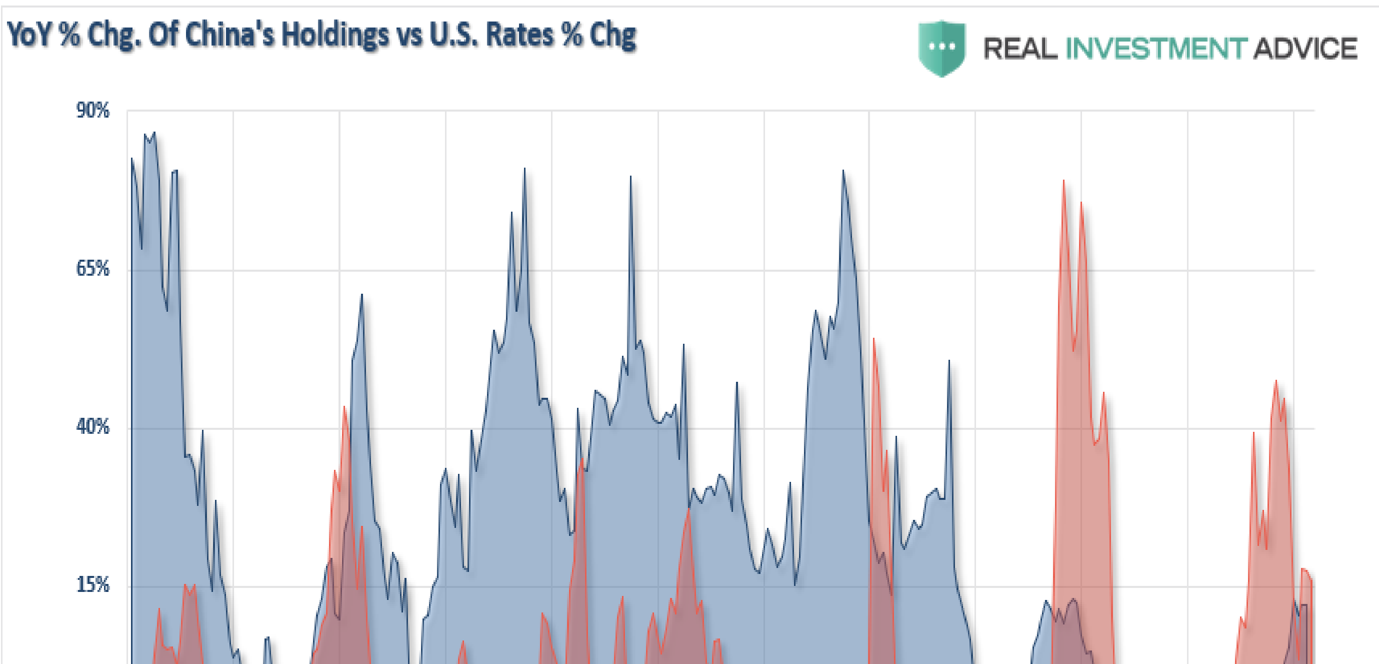
> *The kinds of Chinese goods that Americans buy tend to be relatively inexpensive consumer goods, so even a dramatic decline is likely to have only a trivial impact on the deficit. And since China explicitly controls only one lever ? its imports ? it?ll have to buy a lot more American-made things to achieve this goal. For this to happen, without upsetting other trade balances, the American economy would have to make a lot more than it currently produces, something that isn?t possible in so short a time frame."*

While the Administration will be able to claim a *"trade victory"* over a deficit reduction agreement, such is unlikely to lead to more economic growth as promised. If we assume China does indeed spend an additional $200 billion on U.S. goods, those purchases will increase flows into the U.S. dollar, causing dollar strengthening relative to not only the Yuan but also other currencies as well. **Since U.S. exports comprise about 40% of domestic corporate profits, a stronger dollar will counter the benefits of China's purchase as other foreign importers seek cheaper goods elsewhere.** For China, a stronger dollar also makes imports to their country more expensive. To offset that, China will need to *"sell"* more of its U.S. Treasury holdings to *"sanitize"* those transactions and stabilize the exchange rate.•This is not*"good news"* for Treasury Secretary Steve Mnuchin who would lose the largest foreign buyer for U.S. Treasuries.• This particularity problematic with the national debt expected to increase by at least one trillion dollars in each of the next four years. There has been a lot of angst in the markets as of late as interest rates have risen back to the levels last seen, oh my gosh, all the way back to 2011.**Okay, a bit of sarcasm, I know.**•But from all of the teeth gnashing and rhetoric of the recent rise in rates, you would have thought the world just ended.**The chart below puts the recent rise in rates into some perspective.***(The vertical dashed lines denote similar rate increases previously.)*

It is important to understand that foreign countries?*sanitize?*•transactions with the U.S. by buying or selling Treasuries to keep currency exchange rates stable. From 2014-2016,China was dumping U.S Treasuries, and converting the proceeds back into Yuan, in an attempt to stem the outflows and resulting depreciation of their currency. Since 2016, China has been buying bonds as the Yuan has appreciated.



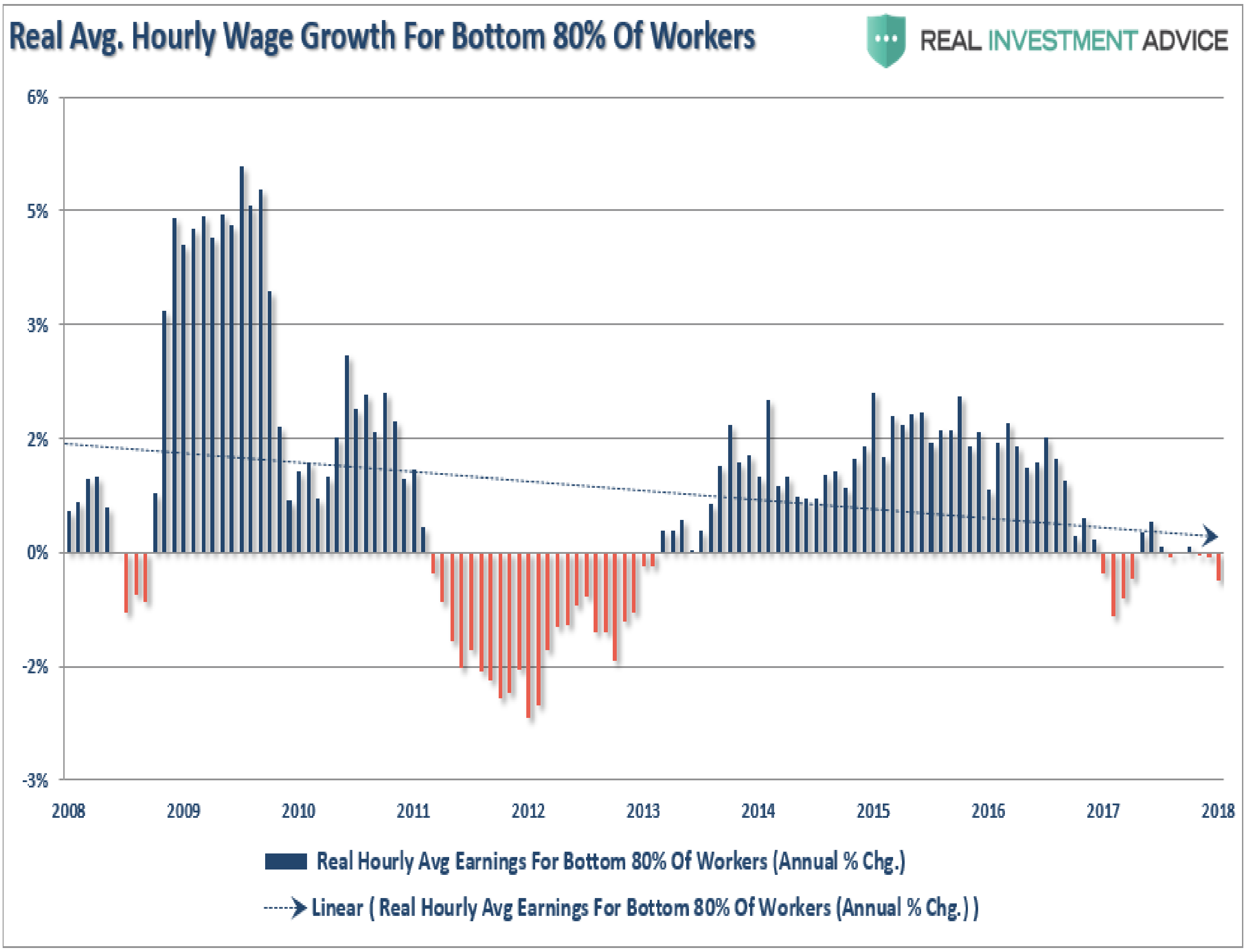

**If China does indeed increase U.S. imports, the stronger dollar will increase the costs of imports into China from the U.S. which negatively impacts their economy.** The relationship between the currency exchange rate and U.S. Treasuries is shown below.

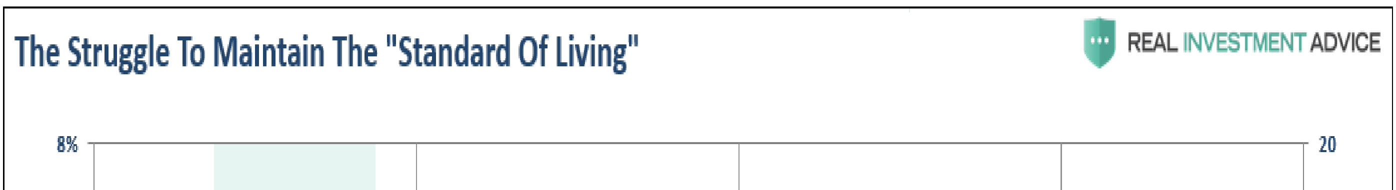


With respect to the *"trade deficit,"* there is little evidence of a sustainable rise in inflationary pressures. **The current inflationary push has come primarily from the transient effect of a disaster-related rebuilding cycle last year, along with pressures from rising energy, health care, and rental prices.** These particular inflationary pressures are not *"healthy"* for the economy as they are *"costs"* which must be passed along to consumers without a commensurate rise in wages to offset them. **Asia is the source of most global demand for commodities,** while also a huge supplier of goods into the US. Asian currencies have followed U.S. bond yields higher and lower since the 1990s, as well as followed commodity prices higher and lower over that time. There has only been one previous period when this relationship failed which was in 2007 and 2008. With the Chinese financial system showing signs of increasing stress, any threat which devalues the currency will lead to further selling of Treasuries. Rising import costs due to a forced *"deficit balancing,"* will likely have more of a negative impact to the U.S. than currently believed.

## Sum-Zero Game

While much of the mainstream media continues to expect a global resurgence in economic growth, there is currently scant evidence of such being the case. **Since economic growth is roughly 70% dependent on consumption, then productivity, population, wage and consumer debt growth become key inputs into that equation.** Unfortunately, productivity is hardly growing in the U.S. as well as in most developed nations. Further, wage and population growth remain weak as consumers remain highly leveraged. This combination makes a surge in economic growth highly unlikely particularly as rate increases reduce the ability to generate debt-driven consumption.



**With unemployment rates near historic lows and production measures near highs, the problem of meeting Chinese demand will be problematic.** As Amitrajeet states:

> *"That?s because when a nation?s economy is using its resources to produce goods efficiently, economists say that it has reached its production possibility frontier and cannot produce more goods."*

**This makes Chinese promises largely illusory given the structural hurdles in China to allow for increased purchases of American exports much less the sheer amount of goods the United States would have to produce to meet Beijing?s demand.** As stated, with the United States economy already running near its full productive capacity, it is virtually impossible to produce enough new goods to meet Chinese demands, especially in the short term. Sure, the United States could stop selling airplanes, soybeans and other exports to other countries and just sell them to China instead. Such actions would indeed **shrink the United States trade deficit with China, but the trade deficit with the entire world would remain unchanged.** In other words, it's a sum-zero game. More importantly, if the U.S. cannot deliver the goods and services needed by China the entire agreement is worthless from the start. More importantly, **China's *?concessions,?* so far, are things it had planned to do anyway.** As noted by Heather Long via the Washington Post:

> *"The Chinese have one of the fastest-growing economies and middle classes in the world. Chinese factories and cities need more energy, and its people want more meat. It's no surprise then that China said it was interested in buying more U.S. energy and agricultural products. The Trump administration is trying to cast that as a win because the United States will be able to sell more to China, but it was almost certain that the Chinese were going to buy more of that stuff anyway.* What Trump got from the Chinese is 'the kind of deal' that China would be able to offer any U.S. president,' said Brad Setser, a China expert at the Council on Foreign Relations. 'China has to import a certain amount of energy from someone and needs to import either animal feed or meat to satisfy Chinese domestic demand.'
>
> *China has been buying about $20 billion worth of U.S. agricultural products a year and $7 billion in oil and gas, according to government data. Even if China doubled ? or tripled ? purchases of these items, it won't equal anywhere near a $200 billion reduction in the trade deficit."*

**But where China really won the negotiation was when the United States folded and agreed to suspend *"trade tariffs."*** While the current Administration is keen on *"winning"* a deal with China, without specific terms *(such as a defined amount of increased purchases from the U.S. and the ability to meet that demand)* the *"deal"* has little meaning. **China has a long history of repeatedly reneging on promises it has made to past administrations.**

By agreeing to a reduction of the *"deficit"* in exchange for *"no tariffs,"* **China removed the most important threat to their economy as it will take 18-24 months before the current Administration realizes the problem.**

> *"Yes, it's good for both sides not to be in a trade war, but the Chinese had more to lose economically from the tariffs. The Trump administration rolling back its $150 billion tariff threat against China is a good 'get' for the Chinese."*

As with all things, there are always two sides to the story. While the benefits of reducing the trade may seem like a big win for America, reality could largely offset any benefits. If the goal was simply to be seen as the winner, Trump may have won the prize. But, it will likely be China laughing all the way to the bank.