Tariffs & Draining the Swamp?

Mr. David Malpass, at the US Treasury, will meet with Chinese Commerce Minister Wang Shouwen in late August. This is excellent news.

Dennis Gartman beat me to this on Thursday morning. I’m in complete agreement with Dennis’ assessment:

“Mr. Malpass, as everyone should remember, is an old Wall Street ‘hand,’ for he was at one time Bear Stearn’s Chief Economist. He served in the Reagan and Bush administrations in various positions of economic authority and has been a close economic advisor to President Trump before being given the position of Under Secretary of the Treasury for International Affairs. His are capable hands.”

Over the years I’ve spoken with David Malpass from time to time. He is and was always gracious. And his skill set is deep. He was a very early economist addition to candidate Trump’s team. He has made thoughtful policy arguments while carefully avoiding the political infighting.

While I personally do not agree with Peter Navarro’s broad tariff approach and believe it has done a disservice to POTUS and to the US, I have to confess some relief and new encouragement at seeing David Malpass now prominently added to the Kudlow and Lighthizer negotiating team which is now led by Treasury Secretary Mnuchin. The outlook is starting to offer hope for a positive turn in the US versus China trade war.

Why did I list the US first and not alphabetically in the previous sentence? Because we started the war, that’s why. We followed the Navarro script and now we have a mess which the new team must straighten out.

Below is a list of the top 20 countries ranked by GDP. Look at it and count all those involved in protectionism and tariffs that have been expanded or enlarged in 2018. Count the USA first, since we are now involved in tariffs and retaliatory tariffs with most of the globe (if we measure by GDP). Yes, some tariffs and trade barriers have been around for years. But, on the whole, the WTO had accomplished a global reduction. Until 2018.

Here is the chart, courtesy of Brent Donnelly of HSBC.

1	United States	20,412.87
2	China	14,092.51
3	Japan	5,167.05
4	Germany	4,211.64
5	United Kingdom	2,936.29
6	France	2,925.10
7	India	2,848.23
8	Italy	2,181.97
9	Brazil	2,138.92
10	Canada	1,798.51
11	Russia	1,719.90
12	Korea	1,693.25
13	Spain	1,506.44
14	Australia	1,500.26
15	Mexico	1,212.83
16	Indonesia	1,074.97
17	Netherlands	945.33
18	Turkey	909.89
19	Saudi Arabia	748.00
20	Switzerland	741.69

Is the tariff war peaking? We don’t know. Is it starting to show up in anecdotal inflationary evidence? Yes. Is it slowing growth? Yes. Is it exacerbating credit risk? Maybe.

The important thing to know is that the Mnuchin-led team has the skills to see and understand the dangerous effects of growing protectionism, and we may begin to see damage control and a shift away from the harmful direction in which we've been headed.

Time will tell, as preparations and negotiations leading to a Trump-Xi November summit unfold.

Let's move to an insightful post by Xi Sun, entitled "Will US-China trade war reshape global value chains?" We thank Lyric Hughes Hale for making it available via her EconVue site. Lyric is a longtime friend who has contributed economic and political affairs commentary to a broad range of publications and who, with her late husband, David Hale, coauthored the book *What's Next? Unconventional Wisdom on the Future of the World Economy*, as well as the influential article "China Takes Off," published in *Foreign Affairs* in 2003. She is a member of the Council on Foreign Relations and has served on numerous boards.

Here's the link to her site: https://www.econvue.com/pulse/will-us-china-trade-war-reshape-global-value-chains.

Tariffs beget tariff exemption applications; and as the following article in the *National Review* states, "Their proliferation has empowered government bureaucrats ill-suited to the task to pick industry winners and losers." https://www.nationalreview.com/2018/08/tariffs-bad-government-exemptions-worse/

The backlog of exemption applications has grown to over 20,000, and the swelling Dept. of Commerce bureaucracy must review and decide each one – but without the industry expertise necessary to balance the arguments being made (though they have plenty of input from Washington lawyers and lobbyists). What generally happens is that the players with the deepest pockets and most political clout prevail. The *Wall Street Journal* has remarked, “Far from draining the swamp, tariffs feed the swamp.”

Thus, the Navarro policy recommendations to POTUS have created an entire new, costly, and nonproductive government intervention into Americans’ businesses and lives. We can only hope the Mnuchin-led Kudlow, Malpass, & Lighthizer team can control and reverse this damage. We will close with a link to another instructive chart on the present and future global economy. Hat tip, Steve Blumenthal. Think about this trajectory and please consider how and where protectionism fits in. Or where it doesn’t. https://twitter.com/sblumenthalcmg/status/1031121108865622017

Asia Equity Markets: Solid Economic Growth Versus Political Risk

Asian economies have begun the year with continued solid – and in some cases robust –performance. Yet the major Asian stock markets have diverged, with some significantly outperforming and others underperforming. In this note we focus on Japan, China, and India.

As this note was written, President Trump announced his administration’s intention to impose tariffs on $450 billion of Chinese imports, lodge a WTO dispute against China, and impose restrictions on Chinese investments in the US. Global markets tumbled last Thursday and Friday as fears of a world trade war surged. We share those fears, regretting that the Trump administration had not done as US allies had urged and taken a less risky, multilateral approach, which would have had a better chance of success. Then China responded in a surprisingly moderate way, and over the weekend the US reported that positive talks with China were underway. Also, an important bilateral trade agreement was announced between the US and South Korea, covering steel, autos, and other areas. In addition the European Union, Brazil, and Argentina were exempted from the steel and aluminum tariffs, joining Canada, Mexico, and Australia in that regard. Global equity markets, including those in Asia, recovered since the weekend as fears of a trade war have receded. They then declined again, this time on concerns about the technology sector. We will be writing separately on global markets and trade developments.

While all the stock markets in Asia together do not reach the size of the US equity market, some of them are quite large. Using data provided by the World Federation of Exchanges for year-end 2016 domestic market capitalization (reported in millions of US dollars), China's equity markets, at $7,311,460 million, are the region's largest. Japan's equity market is second largest, at $4,955,300 million. Hong Kong's market, at $3,193,235 million, is third, with fourth place India being very close at $3,106,267 million. Fifth and sixth largest are Australia, at $1,268,494 million, and Taiwan, at $928,366 million. It is noteworthy that the aggregate capitalization of China, Hong Kong, and Taiwan's markets is about the same as the aggregate capitalization of all the European equity markets.

The Japanese economy has looked relatively robust in the first quarter, although the pace of improvement in business conditions appears to have moderated somewhat. In the manufacturing sector, output, new orders, and employment growth rates have all slowed. Looking ahead, firms are anticipating increased skill shortages in a very tight labor market. Yet according to the HIS Markit Japan Business Outlook for February, firms are optimistic about demand growth and profits and expect to increase their workforce numbers and capital expenditures. Despite some slowing in the first quarter, then, overall economic growth for the calendar year 2018, as measured by real GNP, could well surpass the 2017 pace, 1.8% versus 1.7%. While these growth rates look quite modest compared to those of many other advanced countries, they represent full-capacity growth for Japan, with its aging population. The forthcoming March Bank of Japan *Tankan* report should give further information as to whether business sentiment is becoming more negative.

The slight slowing recently in the still strong pace of economic activity in Japan probably is not the most important negative factor affecting business and equity market sentiment. Rather it has been the political storm winds confronting Prime Minister Abe and concerns about whether his economic policy, “Abenomics,” which has been very beneficial for the Japanese economy, is now at risk. The so-called Moritomo Gakuen scandal, which involved possible political influence exerted by Prime Minister Abe’s wife in a land deal, worsened when it was reported that Ministry of Finance officials admitted to a cover-up attempt by altering public documents. Abe’s voter support, as indicated by several polls, plummeted with this news; and fears grew that Abe might be forced out of office. Should that happen, he would very likely be followed by a more fiscally conservative successor. Abe’s expansive economic policies probably would not continue.

This is a risk confronting Japanese markets, and it is still evolving. However, we have not yet altered our base-case assumption that Abe will survive politically and be able to win his LDP Party’s leadership election in September. Moreover, and perhaps more importantly, the governor of the Bank of Japan has been reappointed to a second five-year term, along with two deputy governors, Masayoshi Amamiya and Masazumi Wakatabe. The three share a strong determination to continue the Bank's reflationist policy, which has been the most effective element in Abenomics. A continuing feature of that policy is the Bank's periodic significant purchases of Japanese equity ETFs in addition to bonds. ETF purchases by the Bank in March have been at a record level.

Last week Japanese equity markets joined the global market pullback in response to increased fears of a possible trade war. Foreign investors were reported to have sold over 2 trillion yen of Japanese stocks during the week.The iShares MSCI Japan ETF, EWJ, fell about as much as the 3.8% drop in the benchmark MSCI All Country Ex United States ETF, ACWX and is participating in this week's global recovery. Before last week, Japan's equity markets had been underperforming other Asian markets since the beginning of the year, with EWJ's increasing barely 0.025%, compared with the 4.29% gain for the iShares MSCI All Country Asia ex Japan ETF, AAXJ. The political scandal, the softness in some economic indicators, and the almost 7% year-to-date strengthening of the yen have all been headwinds. We are maintaining our Japan positions in our International and Global portfolios, as we anticipate stronger economic performance in the coming months and a continuation of Abe's and the Bank of Japan's expansionist economic policies.

China, Asia's largest economy, continues to expand at a rapid rate, contrary to predictions by some for a sharp slowdown. China's macroeconomic fundamentals remain robust. Economic growth has accelerated in the opening months of this year and looks likely to average 6.7% for the year, just slightly below last year's 6.9% pace and above the government's target of 6.5%. Strong global trade momentum will permit exports to continue to support the economic expansion. The government is taking measures to gain better control over excessive credit growth and to reduce financial risks, which have been an area of concern. Yi Gang, China's new central bank chief, has stressed his intention to address the challenge of the high debt levels of state-owned companies, local governments, and households. Reforms to further open the economy to promote competition and to cut excess capacity are continuing.

Up to last week’s global equity tumble, China’s stock markets had been outperforming strongly this year. For example, the iShares MSCI China ETF, MCHI, was up 8.5% year-to-date. Last week it dropped 7.5% in the wake of Trump’s announcement of trade measures against China. This week China’s stocks joined in the recovery as trade war fears eased but then joined the tech sector swoon that started in the US.

India’s economy is likewise expanding rapidly. Indeed, it led the globe in the final quarter of 2017 with a growth rate of 7.2%, an expansion to which all sectors except mining contributed. The economy is recovering from a marked slowdown in the first half of 2017, triggered by a new goods and services tax and the government’s demonetization action in November 2016, which required most cash holdings to be deposited at banks. The latter move was intended to reduce India’s huge informal economy. Growth in the first half of this year looks likely to accelerate further to a 7.8% annual pace and then possibly moderate to a 7.6% rate in the second half of the year and in 2019. This growth performance would still lead the globe.

There have been some indications that business confidence among Indian firms softened in the first quarter, despite the strong macroeconomic prospects. That may have been one factor behind the underperformance of India’s equity markets in the first quarter. The iShares MSCI India ETF, INDA, was down 5.4% year-to-date before last week, when it lost an additional 2.8%. Probably more important was the unexpected return of the long-term capital gains tax in the budget. Also, there was a major fraud case involving the second largest state-run bank. This scandal countered the positive effects on market sentiment of a $32 billion capital infusion for state-run banks. We are maintaining our India positions in our

International and Global portfolios.

We are also our maintaining our positions in the iShares MSCI All Country Asia ex Japan ETF, AAXJ. This ETF provides wide exposure to Asia, excluding Japan and Australia. Over the past 12 months, including this year's volatile period, this ETF gained 19.9%, much better than the benchmark ACWX's gain of 12.2%. The country weights in AAXJ for the top six markets are China, 39%; South Korea, 17.5%; Taiwan, 13%; India, 10%; Hong Kong, 5.75%; and Singapore, 4%. Note that China's 39% weight appears to consist of about 7% Chinese firm stocks listed in Mainland China markets and 32% Chinese firm stocks listed in Hong Kong. We use this ETF to add to our China market exposure while diversifying risk. In last week's market swoon, the positions in less volatile markets such as Taiwan, India, and Hong Kong certainly helped moderate the fall in AAXJ. Going forward, the substantial South Korea position should benefit from the US–South Korea trade agreement and the appearance of some easing of the political tension with North Korea.

Overall, Asian economies are likely to continue to play a leading role in the global economic expansion, which we expect to remain robust despite some recent signs of deceleration, mostly due to seasonal and weather-related factors. Asian equity markets should benefit from fundamental growth forces, but individual national markets will continue to have differing performances due to domestic developments. We expect market volatility in the emerging markets of Asia to continue to be relatively high.

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