Weekly Economic Update

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The big stories this week all involve brinksmanship in politics and its ramifications for the global economy. The Big Kahuna is the Sino-US trade negotiations, which will impact roughly 40% of world GDP directly and virtually everyone else as collateral damage. The Brexit negotiations within the UK will alter the outlook for the EU, the world's second largest trading bloc. The current domestic economic woes in China, the US government shutdown, and the struggle for leadership of the UK are all integral part of these debates. The current deadlines for both Brexit and the Sino-US trade war imply that the world will look very different in sixty days – if the can is not simply kicked down the road. However, with the world economy slowing, the pressure on politicians to resolve issues is greater. The markets will be signaling their vote with strong volatility as tape bombs are dropped – and there will be many, like: Mnuchin's tariff rollback gambit and Treasury's denial, the President's DACA offer to Democrats, Labor's refusal to negotiate without a hard Brexit being eliminated, and the EU's skepticism about approving anything but a short Brexit delay, despite ardent British wishes.

The art of the tape bomb is in lobbing it at precisely the right time to generate maximum leverage via feedback in the markets, media or political polls. The Mnuchin offer to rollback tariffs as a show of good faith was apparently first discussed in late December, when China was offering to buy copious US goods and services. These facts were only revealed to the public Thursday, generating a nice pop in the equity and commodity's markets, and sending a message to the White House – where many believe the S&P is a major measuring tape of success. Treasury's quick denial -- and the ensuing market retreat -- show what a failure to resolve the spat might engender. Similarly, Trump's DACA offer came Saturday, on a three day weekend, ahead of the Sunday news programs. All sides have time to float their ideas through a full two day news cycle before US markets react. Faced with a firm public offer, Democrats must now accept, or take more responsibility for the shutdown.

Our take is that the economic weakness in China and Trump's exposure on both the shutdown and Syrian withdrawal have significantly increased the odds of a temporary truce in the Sino-US trade war. We say temporary, because we expect both sides to retest whatever agreements are made in the next six weeks as we move into 2020. It is highly unlikely both sides will agree that all their expectations have been fulfilled to the letter of the law (as each side reads it) as we approach the US Presidential election and the Party centenary. China is certain to grow faster than the US over the next two years, and to continue expanding its influence. The issue of a rising China will be at the heart of the US election and China's centenary celebration regardless of what is "settled" in the coming weeks.

We see the Chinese tape bomb offer of increasing US imports by over $1 trillion during the next six years as a classic "big number" play – comparing to a static baseline. On the surface it looks huge, given China took just $188 billion in 2018. An additional $166 billion a year would be a near double! But as always the devil is in the details of mathematical compounding. China' US imports rose a meager 0.7% in 2018 due to the trade war. Overall Chinese imports rose a hefty 15.6% – partially due to yuan devaluation and oil price hikes. Still, the US should expect an 8% growth rate in exports to China simply based on their nominal GDP growth rate. Allowing for a catchup on the $15 billion missed in 2018 (mostly sitting in Ag inventories), an 8% growth rate would boost exports $490 billion anyway – but exports would only increase by $16 in 2019 and $24 billion in 2024. The "big number" comes from comparing each year's level to the static 2018 baseline. Doubling to a 16% growth rate would lift exports by $1 trillion – with annual gains of $32 billion in 2019 (not counting the catchup) and $37 billion in 2020, compared to $16 billion and $17 billion at 8%. China could easily make these numbers – as an additional million barrels of oil a day at $50 is $18 billion a year. Bottom line, China's $1 trillion target is hardly a stretch near term given they want more US Ag and energy imports anyway.

The most heartening news on the Sino-US front is that the lead group from China, ahead of Liu He's visit, includes Liao Min, a Vice Minister of Finance. Liao is coming with Wang Shouwen, 52, the Vice Minister of Commerce, who has been China's lead negotiator (he was at the table at the G20). Liao's presence suggests the discussion has moved beyond how much (Ag, energy, etc…) China will buy to how financial markets (banking, insurance, and payment systems) will open up. Liao, 49, is a rising star in China. He was personally chosen by Liu to be his #2 after a year-long search. His background includes stints at Everbright, the PBOC and the CBRC. In the 1990s, while at school, he was a well-known folk singer with charted albums. His 1998 book, The Rising Euro, is considered the best analysis from China's perspective. In April 2018, he authored an article for the FT laying out a sound pro-reform view of China's trade stance, echoing Liu's thoughts. In May, he was selected for the negotiating team. In July, he was elevated to Vice-Premier when his predecessor retired. Fast track!

The rapid rise of Liao reflects a significant trend in China, where Xi Jinping is promoting younger cadres born in the 1970s to significant positions of power. A recent South China Morning Post article notes a dozen Vice-Governors and Vice-Ministers have come from these ranks in recent months. They focus on the fact they are following Xi's path, with positions in Guizhou and Guangxi, similar to the experience of being sent down, as well as Fujian and Shanghai, where Xi was posted. We note that six of the twelve (not including Liao Min) were from a banking background. Two new posts to the Banking and Insurance Commission both came from the Discipline Commission (Wang Qishan's old stomping grounds). The 19th Central Committee was old by historical standards, as Xi concentrated on promoting those in his circle to replace existing careerists. Now he is consolidating his long term control with younger loyalists. No successor has been named – or is expected before 2022. The question remains whether Xi will season them for just five years, or ten, or more.

Across the pond, the UK is in the midst of a political meltdown as it closes on the March 29th deadline with "no deal" looming. Prime Minister Theresa May will present Plan B on Monday, but with scant negotiations with both Labor and the EU, it seems unlikely the Conservatives will resolve their own conflict enough to find a path to passage. As we see it there are three potential outcomes and a push. If nothing is resolved, the chaotic "no deal" could result, but few on either side of the Channel seem to actually support that option – though they all are using it for leverage. The other extreme is a call for a second referendum, perhaps offering no Brexit as an alternative to whatever Plan B is concocted. The third, and in our view most likely option (after the push), is a removal of the UK's request to invoke Article 50. The EU high court has already indicated this is up to the British Government, and it is expected the EU would agree with its Court (as usual). The push, is a request for a delay in the Brexit deadline. This takes approval by all 27 EU members, and many are unlikely to give anything but a brief delay – unless the UK can show significant progress toward A, B, or C.

No deal and a second referendum look like they will take far more consensus than we see possible in two months, though hardliners in both camps advertise otherwise. An Article 50 retreat, like a delay, is just kicking the can down the road – as the UK Government can always invoke it again using the old referendum as justification. The timing works nicely for the UK. Prime Minister May is solid in her position as she survived a vote of no confidence within her party weeks ago – and they can't call another for a year. At that time, lots more will be known – and a renewal of Article 50 could put the next UK election on May 5, 2022 within the two year negotiating period. Thus, the real deadline now appears to be next January, when Prime Minister May would face off against whoever thinks they have the next Brexit majority. Given we doubt the EU would give that much time -- unless May agreed to step aside now and let the battle begin – we feel a do-over on Article 50 is the most likely path.

We are big believers in cycles or pendulums, rather than expecting the future to follow a straight line in any direction. This effectively makes us a contrarian, as we see consensus primarily drawing those straight lines or at least pushing the cycle out beyond an unreasonable horizon. Globally, the economy is weak – and the disease is spreading. Recent events on the Sino-US front and Brexit indicate that even hardliners will start to drop tape bombs seeking resolution when the alternative is crisis. We doubt we get long lasting agreements on any political topic today. After all, the historic defeats in the UK legislature and the revisiting of only recently passed laws here, like Obamacare, indicate that many political rules are currently flexible if not broken. We continue to read this as a decline in the power of politicians as the power of multinational corporations rise. For us, recent anti-merger policies from economic nationalists and events like the Nissan-Renault debacle signal a near term grab for control by slipping politicians. In time, we expect multinationals will find new roosts from which to profit. For us, that makes emerging markets in the ASEAN, Eastern Europe, India and Mexico most interesting as a likely rise in global fiscal stimulus lifts all boats in 2019-20, but some more than others.