June 2019 Special Report China Trade War and U.S. Interest Rates

The two main issues the economy and markets are obsessed with are – 1. The outcome of the trade war with China 2. Will the Fed lower rates?

The markets believe that there will be a trade deal and the Fed will lower rates. This belief has led to a rally after the May market pullback.

I look at both issues in this Special Report. Valuations and the technicals of stocks and markets are better in helping to determine buy, hold or sell decisions. The trade war and the direction of interest rates can help.

China

I've read many reports, articles on our trade war with China. Here are the main points of these reports:

- There are lots of issues with trading with China that are complicated and negotiating a deal that both sides would agree on will take time.

- According to one report, China is considering:

Accepting higher tariffs rather than make changes to its new economic model

Wait until elections to determine if the President is re-elected.

How to maintain growth with or without a trade deal

- China is already in economic trouble and the trade war is making things worse

U.S., China Trade War

The President complains that the Chinese have been ripping off the U.S. for decades. The President overstates the problem. Companies don't have to do business with the Chinese. When they do, they want to be able to go after business in the second largest economy in the world.

Also, U.S. consumers buy Chinese goods because they're cheaper and it is hard to find goods made in the U.S. The U.S. economy is a service and knowledge based economy. Much of U.S. manufacturing has been outsourced to countries where costs and regulations are lower.

Below is a brief timeline of our trade wars:

- April 7, 2017, the first meeting at Trump's Mar-a-Lago estate between President Trump and Premier XI Jinping agree to a 100-day plan for trade talks.

- Jan 22, 2018 Trump imposes tariffs on all washing machines and solar panels, from all countries, not just China

- March 8, 2018 Trump orders 25% tariffs on steel imports and 10% on aluminum from all suppliers including China.

- Starting in June of 2018, the trade war escalates

- September 2018 the U.S. imposed 10% tariffs on $200 billion of Chinese goods

- April 2, 2019 China imposes tariffs of up to 25% on 128 U.S. products

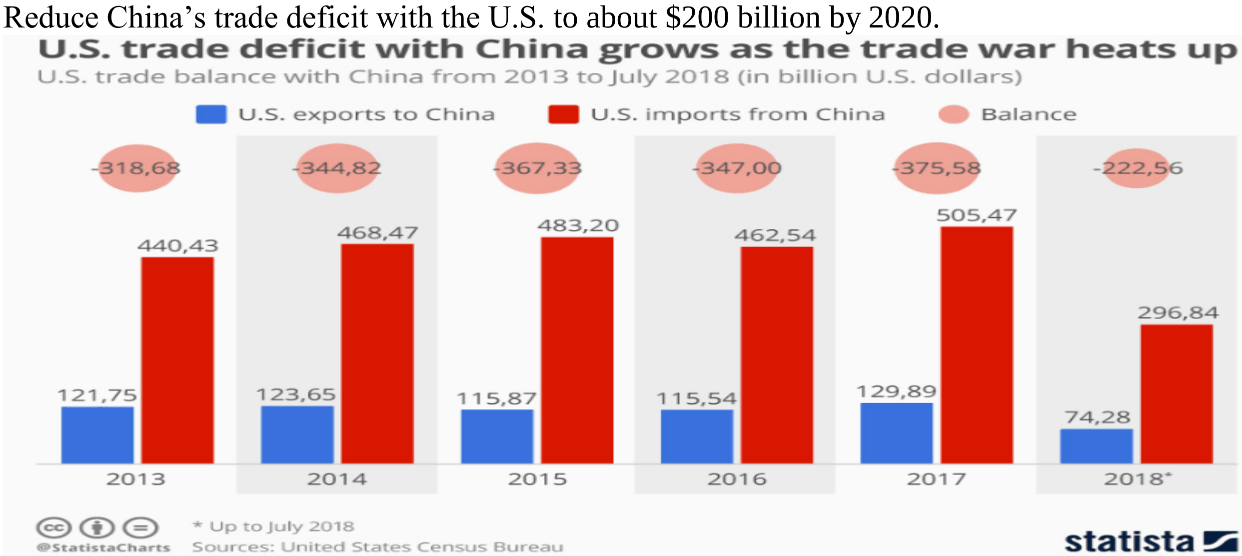
- May 2019 trade negotiations break down, again

- Trade negotiations with China have lasted more than two years and there is no trade agreement in sight.

The U.S. has made 142 demands, and the Chinese have responded by saying many of the demands would be difficult or impossible to meet.

Below are some of the main U.S. demands from China. I've included comments from China regarding some of the demands

- Reduce China's trade deficit with the U.S. to about $200 billion by 2020.



Source: U.S. Census Bureau, Statista

China is willing to buy more goods and services from the U.S, but reducing the deficit to $200 billion by 2020 is not realistic.

Also, this could be a problem if the U.S. contributes to China's economic woes. Imports did increase last year, but exports increased even more. Some analysts believe that the prospect of more and higher tariffs caused U.S. companies to increase their imports for inventory building of Chinese goods.

- The U.S. wants China to stop the practice of forcing U.S. companies into joint ventures, where they hand over their valuable technology.

The Chinese are willing to stop this practice.

- U.S. negotiators are demanding that China end subsidies toward their high-tech sectors that China wants to dominate.

The Chinese believe the U.S. has no right to tell them how to run their country. Most countries do provide subsidies to their favored industries. The U.S. does through our tax code. Depreciation, depletion allowances that reduce their taxes to industries that have lobbied for them and that the U.S. Government deems important.

- China needs to reduce support for state owned companies. China will not give up how it runs its economy.

- The U.S. wants China to remove tariffs and stop retaliating against U.S. agricultural products especially with time consuming and difficult inspections at Chinese ports of entry.

- The U.S. would like quarterly reviews to confirm both sides are complying with their agreements. If China is not meeting its goals, the U.S. wants the right to impose additional tariffs or import restrictions as punishment without Chinese retaliation.

The Chinese will not agree to this request.

- Every commitment China agrees to in principle must be written in a final trade deal.

- China open up their internet. China would agree to selectively open some areas, but not completely open.

- Both sides not manipulate their currency. This would be hard to do because of market forces.
- China has stated they will not agree to certain demands and would rather face 25% tariffs or live with the consequences and is prepared for a failure to sign an agreement. They are implementing work arounds to U.S. tariffs. For example they have joint ventures and direct investments with many countries in the world and they are using them as fronts to export to the U.S.

The main concern of economists and investors is the potential that the President increases tariffs to 25% to most of China's exports to the U.S. This could be devastating to China, the global economy including the U.S.

At the time of this writing, some analysts believe a deal can be signed by the end of the year, others believe that an agreement could take years to negotiate. Also at the time of this writing, China said it would not agree to meet again unless the U.S. lifts its tariffs and back off of some of its technology global sales restrictions.

One of the issues of a trade agreement is congressional approval. The new NAFTA agreement was signed at the end of November, about 7 months ago and has not been approved by Congress. There are questions whether a China agreement needs congressional approval. The question of a China trade agreement could wind up in court and could take more time for final approval.

In summary, China would probably be willing to agree to opening its markets to the U.S. and other trading partners, intellectual property protection, as well as reducing its trade deficit. The rest of the U.S. demands will take more time to negotiate. And all the 142 demands will probably not be part of a deal.

Many of us thought that President's Trump's deal making includs asking for a lot, but willing to accept less but close to what is wanted. When negotiations fell apart in May 2019 we were surprised that the U.S. didn't compromise more. A sign that negotiations are difficult and complicated. If they accept the concessions China is willing to make listed in the previous paragraph, we could have a trade deal. This is still possible.

China's and International Economic Troubles

I've been watching the global economy and markets for over three decades and the U.S. always faces formidable competitors: Japan, the Middle East and its energy the world economy depends on, the creation of the European Union and the euro currency. In each case the worrying was overdone. The same will probably be true with China. It is a bigger challenge, especially in regards to their technology theft.

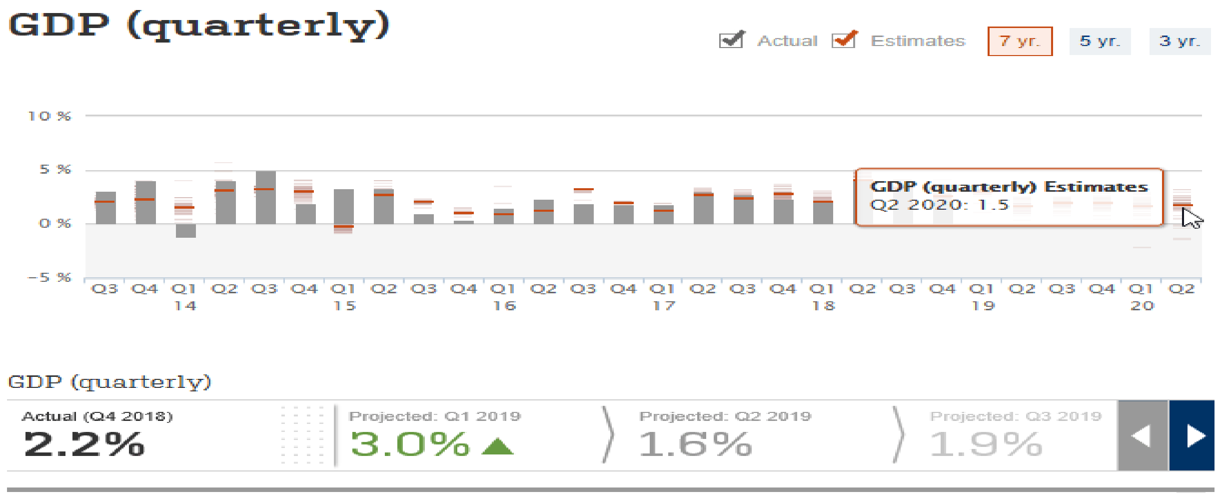
China is slowing down and is facing major economic headwinds before the trade wars began.

China's economy has been slowing for over a decade. Part of the slowdown is due to the law of large numbers. China is about a $15 trillion economy, it would be very difficult to grow double digit at its size.

Notice in 2015 to 2016 how the economy almost went into recession. In 2015, China announced their 2025 plan. The plan was to shift from an export, capital spending, manufacturing driven economy to a consumer and technology driven economy. The transition caused a deep slump in the Chinese economy and caused some of its major trading partners to go into recessions. It did slowdown the U.S. economy and we did have an earnings recession during this period.

Also notice the current growth rates. The 6.4% growth rate is the reported growth rate by the Chinese. The Chinese have a reputation for overstating their economic performance, so there are economists who do their own research and they see the economy growing at about 5%.

President Trump believes the U.S. has the upper hand because we have a stronger economy. What he misses we also have a very diverse economy with some of the strongest industries and its leaders in the world an advantage over our trading partners including the Chinese. But, we are also slowing down:



Source: WSJ

The economy is expected to slow below 2% by the end of the year. Theoretically, we would go into recession (2% growth) before China would (5% growth). The President shouldn’t be so confident.

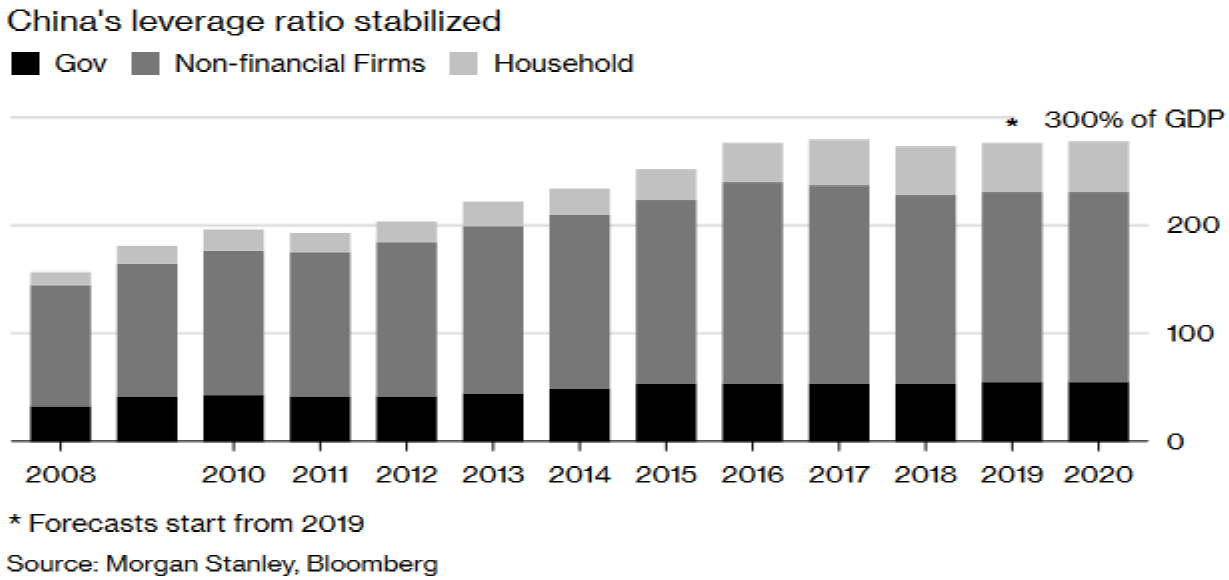
Below are some of the headwinds China’s economy is facing:

- China is hybrid of a capitalism and communism model. The Chinese economy is centrally planned, similar to a communist model. The problem with a centrally planned economy is the government does the planning and capital allocation and the decisions can be political creating bad capital allocation. Also, if mistakes are made at the top level, the problems created are amplified versus a company bad decision that mostly impacts that company and its constituents.

Unlike a communist country, they do believe in some private businesses and the private ownership of property.

It is the bad allocation of capital with debt wasted on poorly run state-owned enterprises and major infrastructure projects that aren’t utilized much will exacerbate their slow down.

- Too much debt:



Most of China's debt is from companies that is more troublesome than if it were the government. This means that China may bail out many of these overleveraged companies, especially their state-owned enterprises.

China will probably remain in a debt driven slump

- Car sales fell in 2018, the first time in more than two decades
- iPhone sales have slowed
- Tariffs are slowing Chinese factories
- Imports have plunged that will hurt the global economy
- High level of non-performing loans on Chinese bank balance sheets
- Inefficient and large state-owned enterprises, that have too much waste, too much debt, and there are too many of them
- Part of current slowdown has to do with government trying to constrain its use of debt.
- The bad allocation of capital is causing productivity to fall
- Adding more debt to increase growth with a $15 trillion economy would lead to a point of diminishing returns

Rather than use debt during this slowdown they are using taxes and lowering bank reserves.

China's slowdown is impacting the supply chains in Asia and is contributing to the slowdown in Europe.

Europe has its own problems: Germany is export driven, especially for high end products and those sales are declining, Great Britain is dealing with Brexit, Italy's GDP has gone negative. All three countries are dealing with populism and changing political leadership. The latest European GDP growth rate reported was .2%.

If and When Will the Fed Lower Interest Rates

Many market participants are complaining and mad that the Fed raised rates too much last year. I believe they're wrong.

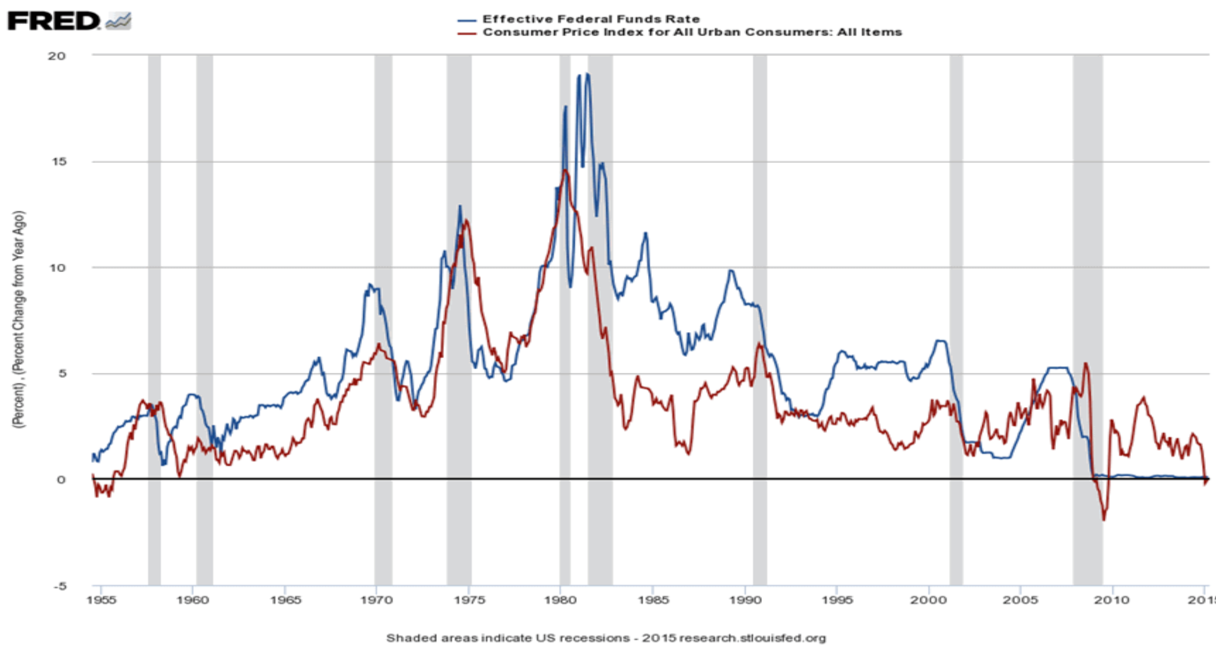
Here is what I wrote in my 2018 4th Quarter Outlook.

"I often hear on the cable financial news that inflation is tame and the Fed should not be raising rates. There are other ways to look at why interest rates are rising. There are three main reasons.

Reason 1. Here is what I wrote in my 2018 Economic Outlook, "The U.S. is shifting from monetary stimulus (low rates and quantitative easing) to fiscal stimulus (tax cuts, infrastructure spending, reduce regulations)… this shift could be disruptive to the global economy and markets." The Fed has to reduce the stimulative impact of low rates because of the stimulus of fiscal policies, the lowering of taxes and increased government spending.

Rising rates have made our dollar stronger (we have one of the highest interest rates among developed nations). Rising rates and the stronger dollar is one of the reasons the global economy and markets are struggling.

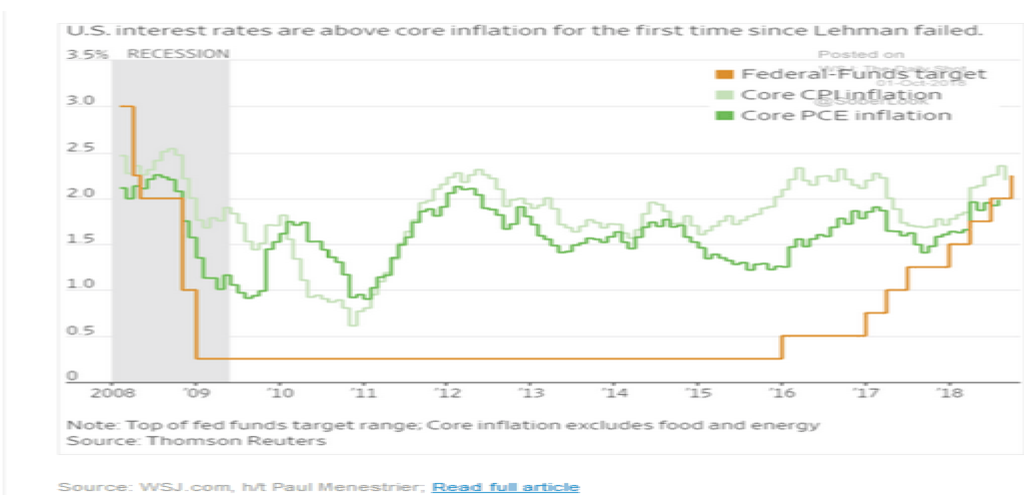
Reason 2: Interest rates need to reflect inflation. Below is one of my favorite charts (I've shown the chart in many past reports) that shows the relationship of inflation, interest rates and the economy.



Source: FRED, Federal Reserve Economic Data

Notice that most of the time the Fed Funds rate (blue trendline) is higher than inflation (red trendline), except for this cycle where inflation is above the Fed Funds rate. This is unusual, and the Fed was planning to "normalize rates" to reflect inflation once the economy was strong enough. The economy is strong enough so the Fed is "normalizing rates." Also notice that when rates and inflation move up, we normally go into a recession.

Below is a chart that updates the current trend of inflation and the Fed Funds rate:



Source: WSJ

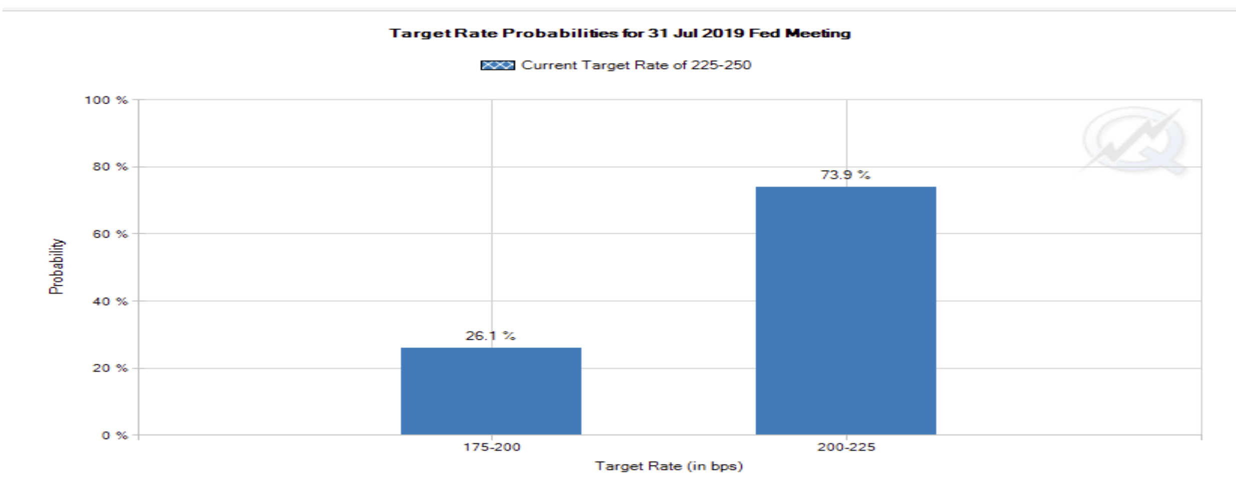
The Fed has been raising rates since 2015. The normal spread between inflation and the Fed Funds rate is normally at least 1%. This means the Fed Funds rate could rise to about 3%, if inflation is about 2%. There could be more fed rate hikes if the inflation continues to rise and if the economic growth stays at current levels. There are two more rate hikes expected in 2019.

Reason 3 – When the economy slows and we go into a recession, the Fed may not only stop raising rates, but they may start to lower them. This is another reason why the Fed needs to raise rates now, so they can lower rates later when we go into a recession.

Lowering rates is one of the best ways to stimulate an economy, but rates may not be high enough to drop to have a stimulative impact.

If you would like a PDF of my 2018 4th Qtr. Economic Outlook email me at danhassey@yahoo.com.

The market believes there is about a 73% probability there will be a rate cut of about .25% in July.



TARGET RATE (BPS)	PROBABILITY(%)			
	NOW *	1 DAY 26 JUN 2019	1 WEEK 20 JUN 2019	1 MONTH 24 MAY 2019
175-200	26.1%	24.0%	38.5%	0.8%
200-225	73.9%	76.0%	61.5%	17.4%
225-250 (Current)	0.0%	0.0%	0.0%	81.8%

* Data as of 27 Jun 2019 03:01:11 CT

Source: CME website

Earlier in the month, the market believed there would be a .50% rate cut by the end of the year. Two FOMC members poured water on this prospect.

The Fed has expressed that a rate cut is possible due to global weakness, and their mandate for full employment. They believe that if they could lower rates and keep the expansion going then there is a chance that more people can get off the sidelines of unemployment and find employment.

Even if there are rate cuts there are no guarantees that the cuts will help the economy and markets.

I believe cutting rates at this time is a mistake because of reason number 3 explained above. We will eventually go into a recession and the best stimulus tool is lowering interest rates. Lowering rates to 2% or below would make it difficult to lower rates more to stimulate the economy when we have a recession. We have too much debt to consider fiscal policies like government spending or more tax cuts. With rates so low now and the inability to lower them more could make a recession deeper and longer.

Summary and Conclusion

- At the beginning of the year, the markets believed that the second half would be better because a trade deal would be made and the economy would improve from the uncertainties created by the trade war. When it was announced in May that trade talks were stalled and the U.S. surprisingly raised tariffs with the threat of more, the markets sold off. Now the markets believe there will be rate cuts and a trade deal with China will happen. If this happens then the bulls believe the markets and economy will still be better in the second half of the year.

- U.S. demands for a trade deal are many. China will probably not agree to these demands and are planning on not having a deal. The negotiations are complicated and will take more time and they could end up not having a deal. A deal could be had if China and the U.S. were more willing to compromise.

- As I've written about in past Outlooks, the longer it takes to make a deal the more uncertainty there is and the more damage there will be to the global economy including the U.S.

- Lowering rates now would be a mistake and the stimulus of lower rates should be saved when we're actually are in a recession, especially because rates already are too low.

- A lot has to go right for the economy and markets to remain bullish and the markets are positioned for this. The markets aren't prepared for no deal, rates not stimulating the economy and a slower U.S. and global economy.
- Again, valuations and the technicals are better at helping with investment decisions. Trade wars create more uncertainty and global economic weakness, potential lower rates at these levels may not help much and add the advice that caution is warranted.

Next month I will do my normal Market Outlook, and I will probably issue my 2019 2nd Half Outlook in August.

If you would like a review of your portfolio, no charge, contact me at danhassey@yahoo.com