Gaia Capital Management Inc.

Tit For Tat On Trade: Bludgeoning Our Way To Parity With China

Saturday's With Jim

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Dear Friends,

Behind the Trump tariff action lies a problem simmering for years between the U.S. and China and one that has emerged over the last couple of years. It has been U.S. policy for some 30 years to welcome an economically strong China as a counterweight to Russia in Asia, as a trading partner and as a way to forestall nuclear war, believing that relatively rich countries view open conflict as an unacceptable risk. U.S. consumers gained a source of relatively cheap goods in the process, helping to keep inflation at bay. But China's rise has been accompanied by open and massive state support for economic activity including directly funding state-owned enterprises (SOEs), suppressing the growth of consumer income while channeling effort at building a healthy export trade and forcing companies who want to sell in China to divulge intellectual property. All countries find ways to channel public money to their enterprises, but China has done it on a massive scale. China's success has led to the second problem – how to avoid the middle income trap – to broaden activity from exporting to realize a vibrant consumer economy.

Countries with excess export capacity like China can channel it several ways: colonize to add more consumers, start a war, suffer a severe recession or use infrastructure spending to open up new markets. Meanwhile, debt that has accumulated during the period of export growth needs to be reduced so that the economy can be stable. President Obama made a concerted effort to reign in China's "bad" behavior through the Transpacific Trade Partnership (TPP). Obama preferred a multilateral approach, with the U.S. a giant among equals. TPP would have worked except for the neglect that U.S. political elites heaped on those who lost relatively high paying factory jobs through globalization or just plain technology advance. Those people formed a hard core of support for their champion, Donald Trump, who was thrown over the top by miscalculation on the part of his Democratic opponent in the 2016 Presidential election.

The Trump Approach and How It Affects Us as Investors

"Make America great again" means using the multilateral institutions that the U.S. championed since the end of WW II when it serves Trump's needs and bypassing/rolling over them when it doesn't. Trump is essentially a one-on-one, single combat, kind of personality, so it is natural for him to eschew the World Trade Organization (WTO) in an effort to even the playing field with China (and others). As a deeply unpopular President, and having an innate desire to be in the spotlight of attention, Trump chose to use tariffs on Chinese goods as his preferred method of getting China to play "fair" and as a way to punish China for stealing intellectual property of U.S. companies. Tariffs are an action he can quickly take (unless Congress removes the trade authority it granted the Presidency decades ago). Tariffs make the headlines. WTO action, on the other hand, takes months or even years to gain resolution and does not give the President much publicity beyond the initial headline. Tariffs, of course, invite retaliation by the other side, hence the tit for tat title of today's note. Another thing about Trump – his negotiating style is to attack with a bludgeon, aiming for the pieces to form a negotiated solution he can live with.

Trump Tariff Effect So Far and Its Likely Conclusion

The additional $100 billion of tariffs on China that the President announced were in retaliation to China's retaliation on Trump's $50 billion of steel and aluminum tariffs he announced last month. Will his actions lead to disaster or to negotiated peace? His NAFTA tough talk and the apparent final settlement show the tough talk to be an attention getter and a tactic. While he will surely claim victory when NAFTA is successfully renegotiated, the final deal won't look anything like the initial U.S. position. Bargaining on trade by using tariffs is a lot riskier than renegotiating an existing trade pact. China has taken the tariffs as a threat to national sovereignty, upping the stakes. We could see a game of chicken in the trade spat where each side won't move from their positions until the other blinks. We can't say how the U.S. – China trade disagreement will end, but if history is a guide, it will get uglier before it gets resolved. And resolved it will be, because, if nothing else, the U.S. Congress could reign in Trump if he goes too far and too long with China. Xi has no countervailing authority in his country, but (probably) the U.S. holds the upper hand in the dispute.

The Takeaway

Expect more scary headlines and a great buying opportunity in stocks to emerge over coming weeks and months. Ed Yardeni (a long time independent investment strategist) sums it up thus in his latest blog post (blog.yardeni.com)[i]:

> "*Be an optimist, not a pessimist.* History shows that optimistic investment strategies tend to work better over time than pessimistic ones. Doomsdays occur from time to time, but they don't last as long as the good times. If you are going to be bearish, try to be so when everyone is too bullish. Then when everything falls apart, you can say, "I told you so." However, don't forget to turn optimistic once everyone else is pessimistic. Remember: don't worry, be happy, but stay informed!"

Thank you for investing with us.

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[i] "Excerpt from Ed Yardeni's New Book", Dr. Ed's Blog, April 8, 2018, http://blog.yardeni.com.