December 4, 2018

Trump Focuses on His Short Game, While Xi Plays the Long Game

What's Happening: After a nearly three-hour dinner meeting Saturday evening, President Trump and President Xi Jinping reached an agreement that will result in a pause to the expected increase in tariffs on January 1st while the two countries move towards an agreement. Trump has said that he will revisit that pause in 90 days and impose tariffs at that point if there is no progress. A full readout of the promises made can be found on the White House website here.

Why It Matters: Trump's decision Saturday to agree to a pause and further talks reflects his tactical decision making process. Although it has left China hawks worried that Beijing will be able to use the pause to further delay making any meaningful structural reforms, it allowed the president to change the media narrative from the Mueller investigation to Trump's deal making ability. It has also allowed him to declare a preliminary victory for the farmers and industrial workers in his political base, as the White House announced China has promised to purchase a "very substantial" amount of agricultural, energy, industrial, and other products from the US. Trump's announcement resulted in a tentative and hopeful market rise, but his short-term tactical victory has meant that he has struggled to maintain those gains. Because there was no joint statement from the meeting, US and Chinese readouts did not quite match up on their promises. Additionally, US officials have given reporters contradictory statements about actions China will take, who is leading the talks, and even what day the talks begin. Additionally, Trump has changed his tune a bit after returning home to media coverage that he was concerned made him look weak and too quick to cave to Chinese demands. This morning he tweeted, "I am a Tariff Man," causing markets to plunge once again.

What's Next: More formal talks are expected to begin quickly. The *South China Morning Post* reported that a delegation of Chinese officials will visit Washington, DC in mid-December. On the US side, talks are expected to be led by hardline protectionist US Trade Representative (USTR) Robert Lighthizer. White House Industrial Policy and Trade Director Peter Navarro, who aligns most closely with Lighthizer among all of Trump's officials, has said that Lighthizer is "the toughest

> negotiator we've ever had at the USTR. And he's going to go chapter and verse and get tariffs down, nontariff barriers down, and end all these structural practices that prevent market access.” There is no written expectation of what needs to be completed in the next 90 days, but if talks are going smoothly, then it is most likely that Trump extends the time frame for a deal to be reached. Because Trump is thinking tactically, we expect his decision to be based on the facts and narrative at the moment. Those who are looking for an overarching strategy from Trump are better served by looking at how he approaches his 2020 reelection campaign, which we expect to be the lens through which all decisions are filtered by mid-2019. At that point, Trump may choose to impose higher tariffs to demonstrate that he is taking seriously the concerns of his blue collar base in the Midwest, or if the economy is struggling and the stock market is suffering, he may decide to demonstrate his dealmaking skills by reaching an agreement with President Xi. Additionally, while investors’ focus most recently has been on whether the president would raise the tariff rate on $200 billion of the Chinese goods already subject to tariffs from 10 percent to 25 percent, there is also an option that Trump has left on the table to impose 10 percent tariffs on the rest of products coming from China. The administration also is expected to continue its crackdown on the export of so-called critical technologies to China and its intense scrutiny of deals that would result in Chinese ownership of US companies through the Committee on Foreign Investment in the United States (CFIUS).

Tactics Without Strategy

In an attempt to determine and understand the president’s trade war strategy with China, investors, the media, and foreign policy experts have been carefully examining President Trump’s every move in the lead up to, and readout from, his meeting with China’s President Xi Jinping last Saturday.

There are places to look for what that strategy might be — in March, USTR Robert Lighthizer finalized a report initiated by Trump under Section 301 that found “China’s acts, policies, and practices are unreasonable or discriminatory, and burden or restrict U.S. commerce.” As key areas of concern, Lighthizer specifically cited China’s unfair technology transfer regime, discriminatory licensing restrictions, and outbound investment regime, and unauthorized intrusions into US commercial computer networks and cyber-enabled theft of intellectual property (IP).

Another place to look for Trump’s trade strategy could be his own statements during the 2016 campaign season, where he often referenced the US-China trade deficit and accused China of currency manipulation. In a speech in June 2016, for example, he argued that “China cheated on its currency, added another trillion dollars to the trade deficit, and stole hundreds of billions of dollars in our intellectual property.”

However, the problem with this analysis is that Trump seems always ready to abandon his China strategy for tactics that help him win the battles of the moment. For example, this past weekend Trump agreed to hold off on increasing pressure on China in exchange for talks that could lead to a new agreement. “It’s an incredible deal. It goes down, certainly -- if it happens, it goes down as one of the largest deals ever made,” Trump told reporters on the return flight from Argentina. “China right now has major trade barriers -- they’re major tariffs -- and also major non-tariff barriers, which are brutal. China will be getting rid of many of them.”

Despite Trump’s positivity, China has not publicly announced any specifics of what it will agree to, and the US failed to obtain public promises from the Chinese on the details of what talks would encompass.

Consequently, it appears that Trump’s announcement was made as much in the service of demonstrating he can reach a deal as it was in actually achieving that deal. It gave him positive press at a time when the stock market was dropping, the Mueller investigation was circling closer, and the November election outcome had been mixed. Yet the decision does not appear to have moved him any closer to his goal of “defeating China” by any of the strategic plans we have seen.

Chinese General Sun Tzu wrote in his famous *Art of War* that “tactics without strategy is the noise before defeat,” but that does not mean that Trump cannot be successful with his tactics, at least when it comes to achieving less wholistic outcomes and shorter-term deals. For example, it is likely that China will soon begin to buy more soybeans from US farmers, reversing a severe drop in purchases after the imposition of a retaliatory tariff earlier this year.

However, increasing those purchases to the level Trump would want likely will require Beijing to use central-state mechanisms to require farmers to buy their soybeans from US producers, which contradicts the strategic goal of reducing China’s top-down, state-owned enterprise structure that disadvantages US business.

This contradiction was clear in Treasury Secretary Steven Mnunchin’s description of the deal to CNBC on Monday. "They put on the table an offer of over $1.2 trillion in additional commitments. But the details of that still need to be negotiated," Mnuchin said. "This isn't just about buying things. This is about opening markets to US companies and protecting US technology. Those are very important structural issues to the president."

But it is going to be difficult to get both the commitments and the structural fixes to which Mnuchin referred. As Brendan Greeley wrote in the *Financial Times*, “In an open market, China’s companies and hog farmers should buy oil and soyabeans from wherever they’re cheapest on the global market. Mr Xi shouldn’t have the power to compel them to buy from

Texas and Iowa. That he can is in fact the definition of the problem the world's free-market economies have with China."

Discordant Notes Stem from Confusion Between Trump, Advisors, and China

No matter the reasons, a deal to talk was reached last Saturday, and now the important question is what happens next. The problem here is that there has been rampant confusion, uncertainty, and contradictory statements, both between US and Chinese readouts of the meeting, and between Trump and his own advisors.

In part, that confusion can be explained by Trump's reliance on tactics and not strategy — as he reacts to the narrative of the moment, Trump's moves can be difficult to predict unless we know in advance what the narrative will be. The confusion can also be attributed to the lack of a clear agreement among Trump's own advisors about what the goals of a policy should be.

At times, Trump even creates that confusion himself. On Sunday night, he tweeted, "China has agreed to reduce and remove tariffs on cars coming into China from the U.S. Currently the tariff is 40%." China had not promised that in any public written statements and has yet to comment on specific actions it will take, including on auto tariffs.

China reduced its global tariff on autos from 25 to 15 percent over the summer, but this fall raised tariffs on US autos to 40 percent in retaliation for Trump's tariffs on Chinese products. In contrast, the US has a global tariff on autos set at 2.5 percent (with a 10 percent tariff on light trucks), but raised that to 27.5 percent for Chinese autos as part of the escalating tariffs imposed earlier this year. While both countries could remove their additional tariffs on autos bilaterally, under WTO rules China can only reduce its tariffs on US autos to zero without doing so far all other countries if it is part of a comprehensive free trade agreement, which appears unlikely at the moment.

Nonetheless, when asked about Trump's tweet on Monday morning, National Economic Council Director Larry Kudlow told reporters, "We don't yet have a specific agreement on that, but I will just tell you as an involved participant, we expect those tariffs to go to zero." He added, "I believe that commitment was made" during the meeting on Saturday.

Secretary Mnuchin later complicated the story when speaking to a gaggle of reporters outside the White House. "The first part was to reduce the surcharge, but yes there have been specific discussions on where auto tariffs will come down to, but I'm not prepared to talk about the specifics," he said.

If Trump and his advisors cannot agree themselves on a common readout of Saturday's talks, then they will face much more significant difficulties when it comes to taking on China over the next 90 days. This discord and confusion is a reminder that we are unlikely to see an easy solution and more likely to see volatility going forward.

“There are not more than five musical notes, yet the combinations of these five give rise to more melodies than can ever be heard,” Sun Tzu wrote in the *Art of War*. The problem for Trump is that he prefers the fight between advisors to win him over to their ideas, and he does not mind the discordant music that comes from it.

A Look Ahead: The Next 90 Days

The White House announced that Trump will increase tariffs on Chinese goods from 10 to 25 percent on March 1st next year if there is no agreement. However, with all of the complex issues in play on top of all the traditional difficulties of reaching a trade agreement with China, we find it highly unlikely that the two sides achieve an understanding within the 90 days set aside.

The goals of the talks also remain unclear — there have been no metrics or explanations of goals. US officials appear most concerned with ensuring the Chinese demonstrate compliance. On Monday, Kudlow told reporters, “Much of the credibility of this discussion will hinge on rapid movement and implementation of China’s commitments.”

White House Industrial Policy and Trade Director Peter Navarro suggested to NPR on Monday that the talks will revolve around a set of documents Beijing sent the Trump administration in November that included detailed responses to US demands. In those documents, Chinese officials broke out 142 specific demands US officials had made, and provided information on how it will respond to those demands. Navarro added that USTR Lighthizer is "the toughest negotiator we've ever had at the USTR. And he's going to go chapter and verse and get tariffs down, nontariff barriers down, and end all these structural practices that prevent market access.”

If the goal is to achieve what Navarro suggested, the size of the task before negotiators is enormous, meaning it is very likely that the talks get an extension on March 1st. Trump suggested as much himself this morning, when he tweeted that “unless extended,” the negotiations will end in 90 days — that “unless extended” gives Trump room to maneuver at the end of the agreed upon period.

If Trump does extend the time period, though, he will likely want to have something to show for it, because he will face significant pushback from China hawks who are worried that Beijing is playing its typical strategy, which is to delay its opponents with promises, but fail to deliver verifiable results.

Dan DiMicco, the former Nucor Steel CEO and one of Trump's top trade advisors on his campaign, tweeted after the Saturday announcement, "Is #Trump making a huge mistake? The devil is in the details! But I'd be lying if I didn't say at first glance this is very disappointing. I don't agree but I defer to the president." It remains to be seen how much he is willing to defer.

Trump did take at least one important action that could suggest some possibility of long-term strategy and a melodious team when he named USTR Robert Lighthizer as the lead negotiator on the talks with China. Lighthizer is a true believer in the message that China has used its market and political structure to disadvantage US companies and the US economy, threatening the entire American way of life. He also laid out a strategy for combating that in the original Section 301 report, as well as a 53-page follow up he published less than two weeks before the meeting claiming that China "failed to take any substantive actions to address U.S. concerns."

Lighthizer leads a faction within the administration that would push back on any trade agreement that comes up short of significant trade concessions addressing fundamental structural concerns. Over the summer, he responded to criticism of the China fight by Senator Brian Schatz (D-HI) with anger. "If your conclusion is that China taking over all of our technology and the future of our children is a stupid fight, then you are right. We should capitulate," Lighthizer told Schatz. "My view is that's how we got where we are."

However, Trump has already undercut Lighthizer's authority and made it clear that he will be forced to consider the opinions of other advisors, including "globalist" free traders. In a tweet this morning, Trump said that, "Bob Lighthizer will be working closely with Steve Mnuchin, Larry Kudlow, Wilbur Ross and Peter Navarro."

A Look Ahead: Beyond 90 Days

Trump may be moving tactically on his negotiations with China, but there is one place where he has an overarching strategy — his 2020 reelection campaign. As we saw during the midterms, Trump's plan appears to be to double down on his base and attack his enemies. That means he will need to find solutions for the farmers affected by tariffs while delivering wins for the Rust Belt blue collar workers who pushed him over the edge in key states like Ohio, Pennsylvania, and Michigan to a victory in 2016.

Our current base case is that this desire to appease both sides of his base and maintain a healthy economy leading into 2020 will keep him bounded. He will be reluctant to take actions that are likely to cause major and sustained market swings, and he will need to find markets and buyers for the soybean and other farmers affected by his trade war. But he would need a serious economic crisis to abandon his pressure on China entirely, since his blue collar base is counting on him to bring back manufacturing jobs from overseas, or at least make a show of trying.

Consequently, we expect continued volatility in 2019 and even potentially another manufactured crisis. However, we also expect the market to rein in Trump's strongest tariff instincts, and eventually lead to a resolution, or multiple small resolutions, to show his ability to make deals and fix any crisis.

Additionally, while the focus has been on whether Trump will increase tariffs on the existing list of imports from China worth approximately $200 billion, investors should also remain cognizant of at least two other avenues for action.

First is Trump's repeated threat to impose tariffs on all remaining imports from China, worth approximately $257 billion. In this case, Trump would have the option to impose the tariffs at 10 percent, which he may find more palatable and be less concerned about the economic impact than the increase to 25 percent on the existing list.

Second, investors should watch administration actions on regulatory barriers to Chinese investments in US companies and technology exports, which we do not expect to slow or be removed even if talks result in an agreement.

Just before Thanksgiving, the Department of Commerce's Bureau of Industry and Security (BIS) released a request for comment on a new rule that would expand the list of technologies that are export restricted for national security concerns to include emerging and critical dual-use technologies. Although the rule does not explicitly target China, it was written with the aim of limiting China's ability to acquire technologies that would further its Made in China 2025 policy.

Commerce announced it will collect comments on its proposal for only 30 days. The short turnaround time, with the request dropped just before the beginning of the Thanksgiving holiday, means that there is very little time for stakeholders to provide in-depth comments. Unless there is an extension, it likely means the administration has chosen its preferred list and will not later change its planned scope.

The request for comment was part of the implementation of the Export Control Reform Act, which along with the Foreign Investment Risk Review Modernization Act (FIRRMA), passed as an amendment on the National Defense Authorization Act (NDAA) in August. The list of technologies targeted by Commerce in its final decision will also serve as the basis for "critical technologies" that will be subject to review by the Committee on Foreign Investment in the US (CFIUS). Commerce is expected to also issue a request for comments on a proposal to restrict exports of so-called foundational technologies.

China's Leverage

The White House statement after Trump's meeting did not begin with trade, but fentanyl. "Very importantly, President Xi, in a wonderful humanitarian gesture, has agreed to designate Fentanyl as a Controlled Substance, meaning that people selling Fentanyl to the United States will be subject to China's maximum penalty under the law," the press secretary wrote.

Fentanyl contributed to 29,000 overdose deaths in the US last year, and China is the number one source of fentanyl and fentanyl-like substances imported into the US. Trump has repeatedly blamed China for the crisis and for shipping opioids into the US, and getting China's assistance is a major win on a concern for him, although it remains unclear how much Chinese officials will actually be able to achieve.

But including this issue at the top of the list of concerns also gives Beijing another leverage point in trade negotiations as well. Because opioid anesthetics are rarely used in China, many people had not realized the extent of the crisis in the US nor felt that it was particularly important. Now, officials can offer to take further action on opioids as another benefit to Trump, without having to make any significant or serious changes at home.

Similarly, the White House trumpeted the fact that the US and China will work together with Chairman Kim Jong Un "to see a nuclear free Korean Peninsula." Trump emphasized this point in a tweet about the negotiations, saying, "A solution for North Korea is a great thing for China and ALL!"

We have already seen how China has been able to use North Korea as leverage over Trump. Soon after the US sanctioned ZTE earlier this year, North Korean leader Kim Jong-un threatened to pull out of his much-anticipated June 12th summit with Trump, likely at the suggestion of China. Even Trump made that connection, telling reporters that President Xi is influencing Kim to get the upper hand on trade talks with the US.

In the end, Trump was forced to relent on the ZTE sanctions in order to hold his meeting with Kim. Trump's second meeting with Kim is now expected to happen in Q1 2019, and it would not be surprising if China is able to align the date of the next Trump-Kim summit with the March 1st deadline for the next round of US-China negotiations.