

SPOTLIGHT REPORT

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Trump's Busy Trade Q1

What's Happening: The first quarter of 2019 will prove pivotal for a number of trade deals, as the Trump administration continues talks with China in an attempt to avoid a March 1st tariff increase; enters into talks with Japan and the EU; and negotiates with Democrats to pass President Trump's newly negotiated US-Canada-Mexico Agreement (USMCA). The Commerce Department is also expected to finish and send a report to the White House in mid-February recommending that the president impose a global tariff on autos for national security purposes.

Why It Matters: It has become increasingly clear that President Trump is ready to reach a "deal" with China's President Xi Jinping, and face-to-face talks in Washington, DC are expected to take place later this month at the ministerial level between China's Vice Premier Liu He and US Trade Representative (USTR) Robert Lighthizer. We expect that the two sides announce at least the framework of a deal by their self-imposed March 1st deadline. USTR Lighthizer will be keeping busy, since in addition to his talks with Liu, he is expected to initiate formal discussions to attempt to reach free trade agreements with both Japan and the EU this quarter. While things appear to be going smoothly with Japan so far, the US and EU are struggling to agree on whether or not agricultural goods will be covered in the scope of any agreement. In order to gain further leverage in these talks with China, Japan, and the EU, it appears likely that Trump will impose his long-threatened auto tariffs. We expect that he will be able to do so without a long-term adverse market impact by offering temporary exemptions or quota agreements to all of the major US auto trading partners. And in between Lighthizer's many international talks, he will travel to Capitol Hill to attempt to convince Democrats that he is negotiating in good faith with them over final touches on the USMCA -- despite President Trump's repeated threats to withdraw from the original North American Free Trade Agreement (NAFTA) -- and that he will ensure sufficient enforcement of the new deal.

What's Next: Trump remains a mercurial president, and although he is currently hemmed in by his desire for a strong stock market, significant risks remain. Both the US and China are keeping pressure on each other, both economically and geopolitically, as talks unfold, and a wrong move could lead to dissolved talks. If Trump pushes Xi too far through continued Department of Justice actions against key tech companies like Huawei or through military actions in the South China Sea, for example, something might snap. However, Xi could use a lever besides trade to

ensure that talks remain on track, for example by convincing North Korea's leader Kim Jong Un to cancel a planned meeting with Trump. President Trump could also grow frustrated with delays in talks with the EU, which have so far proceeded slower than Trump had hoped and have not yet resulted in any deliverables and choose to impose auto tariffs on the EU without any temporary exemptions. Closer to home, Trump could grow frustrated with Democrats' insistence on including stronger labor and environmental enforcement standards in the USMCA and, despite Lighthizer's attempts to prevent it, officially give notice to withdraw from NAFTA. This would start a six-month wait, at the end of which Trump could choose to withdraw or not, depending on how he feels negotiations with Congress over the USMCA are proceeding.

The Big Picture

China Talks Prove Fruitful: As Trump has been under political pressure from the shutdown, and as US-China trade tensions have substantially exacerbated market volatility in recent weeks, it has become increasingly clear that President Trump is ready to reach a "deal" with China's President Xi Jinping.

"I find China, frankly, in many ways, to be far more honorable than Chuck and Nancy," Trump told reporters at the White House this morning, as he headed off to the southern border to recommit to the shutdown over his wall. "I think China actually is much easier to deal with than the opposition party."

Despite Trump's faith in negotiations with the Chinese, there is still a gulf between the two sides, both on the top line issues and on the finer details. US officials, led by US Trade Representative (USTR) Robert Lighthizer, are pushing the Chinese on intellectual property theft, forced technology transfer policies, and opening the Chinese market to more foreign goods. "Globalist" officials like Treasury Secretary Steven Mnuchin, who hope to wrap the talks up quickly to calm the markets, are reportedly pushing for a \$1.2 trillion purchasing commitment of US products, particularly agricultural, energy, and manufactured products.

We expect that Trump's main goal at this point is to trumpet an agreement on at least a framework for a broader trade deal and halt the planned increase of tariffs after the March 1st negotiating deadline. These moves should calm the market, which he continues to view as a barometer of his success, as well as give him a win that makes him look strong.

Japanese and EU Talks Get Started: But while negotiations with China have sucked all of the oxygen out of the room, the Trump administration is expected to also start up talks for trade agreements with Japan and the EU this quarter. USTR Lighthizer sent formal notice to congressional leaders in October informing them of his intent to embark on negotiations that will qualify for Trade Promotion Authority (TPA), which avoids amendments on trade deals and allows Congress only a straight up or down vote on the final deal.

US officials are closer to beginning talks with Japan than with the EU. The USTR sent formal notice of its negotiating objectives to Congress on December 21st, a move that is required at least 30 days before talks can start -- Lighthizer has still not sent negotiating objectives for the EU.

This is possibly because discussions with the EU have so far proved difficult. Talks to date have focused on technical and regulatory barriers to trade, which were supposed to be the low hanging fruit, making it concerning that there have been no announcements yet at all. There also does not seem to be agreement on what will even be covered by trade talks. The EU has said that agricultural products are off the table and that they expect the trade agreement to be "very limited," while US officials have said that any agreement must include agricultural products.

On Tuesday, USTR Lighthizer held a one-on-one meeting with EU Commissioner for Trade Cecilia Malmström. Although no announcements were made after those talks, the two trade officials met again today. An anonymous EU official told *Bloomberg* that EU officials plan to ask member states soon to formally start negotiations, and that the trade team has already begun drafting a report to cut industrial good tariffs for both sides.

The partial US government shutdown could also result in some delays for the start of both the Japan and EU trade talks. The USTR is waiting on economic reports from the US International Trade Commission (ITC) before it can start negotiating each deal. However, with ITC staffers out for the past three weeks, not much research has gotten done.

Auto Tariffs Likely: With Trump's desire for leverage in the upcoming talks with the EU (22 percent of US auto imports) and Japan (21 percent of US auto imports), we continue to expect that he will likely issue 20 percent tariffs on all US imports of autos and auto parts before the end of the end of the first quarter.

We expect the effects of those tariffs are likely to be largely mitigated though by initial, short-term exemptions for Japan and the EU, and potentially also China, to pressure each of their governments to make trade concessions to the US. Additionally, Mexico and Canada should be exempted from the threat of additional auto tariffs under the recently signed US-Mexico-Canada Agreement (USMCA), while South Korea will likely face a quota as a reward for renegotiating the US-South Korea Free Trade Agreement (KORUS) last year.

NAFTA 2.0 Talks Gets Rough: Although Trump has suggested he would rather withdraw than reopen talks on the new North American Free Trade Agreement (NAFTA) -- "I can live pre-NAFTA very easily," Trump said on Friday -- the first quarter of 2019 is going to be all about renegotiation.

Democrats, whose votes will be crucial to carrying the USMCA across the finish line, are demanding changes, and in particular are focused on stronger enforcement mechanisms.

“Without enforcement you don’t have anything,” House Speaker Nancy Pelosi (D-CA) told reporters in November.

While President Trump has been focused on pulling out of the agreement in response to the threats, USTR Lighthizer has been working to repair relationships and reassure Democrats that the US will be remaining in the agreement. His office opened a consultation with Peru over timber harvesting in the Amazon, the first step to enforcing action against Peru for failing to ensure that it is preventing the practice, which is barred under the US-Peru Trade Promotion Agreement (PTPA).

Lighthizer made this move after being urged by now-House Ways and Means Committee Chairman Richard Neal (D-MA), who wanted a demonstration that the USTR was willing to flex its enforcement muscle. “By taking this unprecedented step, the Trump Administration is making clear that it takes monitoring and enforcement of U.S. trade agreements seriously, including obligations to strengthen forest sector governance,” Lighthizer said in a statement about the case that not so subtly demonstrated that he would be doing the same with Mexico under the USMCA.

But despite all the talk, there may not even be any deadlines this quarter that force (or even allow) the issue to come to a head. Before the House and Senate vote, the US ITC is supposed to send a report on the economic effects of the new agreement to Congress. The deadline for that report is March 14th, but with staffers at the commission furloughed, it may be several weeks more before an agreement is reached.

The Big Risks

US-China Talks Fall Apart: Although both President Trump and President Xi clearly want to reach an agreement, they are also keeping the pressure on each other in various ways. From enforcement issues like the arrest of Huawei CFO Meng Wanzhou to a recent decision to send a US guided-missile destroyer within twelve miles of the Paracel Islands in the South China Sea that Beijing claims, many of these pressure points have the opportunity to break. We believe that both sides will do their best to keep the national security, geopolitical, and judicial squabbles separate from the trade talks, but there is no guarantee that everything goes right for the next 50 days.

Auto Tariffs Imposed Without Exemptions: Auto and auto part exports to the US are concentrated among a small group of countries -- Canada, Mexico, the EU, Japan, South Korea, and China -- which would make it simple for President Trump to impose global tariffs, but with exemptions, prevent those tariffs from actually having a significant effect on the US market. Nonetheless, he is a mercurial leader who can take issue with negotiating partners at the drop of a hat.

We expect that if anyone is at risk of not receiving an exemption, it is likely the EU. As described above, baseline talks between USTR Lighthizer and Commissioner Malmström

have been rough so far, and EU officials will not agree to discuss reducing trade barriers for agricultural products, which remains a top priority for Trump and his farm-belt base. Trump also has a natural dislike for democratically-elected EU leaders -- he is regularly at odds with German Prime Minister Angela Merkel and his former pal French Prime Minister Emmanuel Macron -- and also has a strong disdain for German auto manufacturers.

US Withdraws from NAFTA: President Trump has repeatedly threatened to withdraw from NAFTA as a tactic to force Democrats to pass the new USMCA. "I'll be terminating it within a relatively short period of time. ... And so Congress will have a choice of the USMCA or pre-NAFTA, which worked very well," he threatened on his return trip from the G-20 summit in Argentina at the beginning of December.

Trump would have the support of at least some power Republican members of Congress if he did so. Senate Finance Committee Chairman Chuck Grassley (R-IA) told reporters this week that he would rather President Trump withdraw from NAFTA than go back to the table if Democrats refuse to pass the updated version of the deal in its newly negotiated form. "If they're reaching the point where you've got to go back to the negotiating table, I would encourage the president to pull out of NAFTA and hope that they're smart enough to not let that happen," Grassley said, arguing that any issues the Democrats have can be dealt with in side letter agreements.

Although it is not our base case scenario, we continue to believe there is a real risk that Trump gives notice to withdraw from the agreement. Even if Trump does issue a formal six-month notice to Canada and Mexico, however, there is no automatic end to the agreement at the end of those six months, and he could choose to not actually submit his notice of withdrawal at the end.

If Trump does go through with his threat and officially withdraws at the end of the six months, that decision could potentially be blocked by a lawsuit. Congress and any businesses or states affected by withdrawal would have standing to sue if the US exited NAFTA, and there is no real precedent for how the courts would decide such a case.

Timeline/Breakdown

January 4th: USTR Lighthizer opened environmental consultations with Peru under the US-Peru Trade Promotion Agreement. The action was clearly taken by Lighthizer to demonstrate to Democrats that he is serious about enforcement, and that the Trump administration will take enforcement seriously under the USMCA.

Democrats are paying close attention to the consultations in Peru and are preparing to enter serious talks with Lighthizer and his staff about changes they would like to see to the new NAFTA. According to *Politico*, Rep. Rosa DeLauro (D-CT) is leading a USMCA working group of about 20-25 Democrats, and that Democrats have a whip team that is preparing to get the caucus in line.

"We certainly want to work with the president on this," Rep. Tim Ryan (D-OH) told *Politico*, but added that enforcement remains a serious concern. The current deal contains "no real mechanism for quick enforcement" of the labor provisions, he noted, adding, "There's gotta be penalties, there's gotta be ramifications" for violations of those provisions.

January 7th - 9th: Deputy USTR Jeffrey Gerrish led a team of economic and trade negotiators to Beijing for the first face-to-face trade talks between US and Chinese officials since President Trump and China's President Xi Jinping agreed last month to pause planned tariff increases and attempt to negotiate a deal.

Although both sides have remained quiet about the details, this week's talks appear to have gone very well. China's Vice Premier Liu He unexpectedly attended a meeting on Monday, showing a strong commitment from Beijing. "There's a very good chance that we'll get a reasonable settlement that China can live with, that we can live with, and that addresses all the key issues," Commerce Secretary Wilbur Ross told CNBC Monday after Liu attended the meetings. The talks also extended unexpectedly into a third day, indicating that talks were going well.

Liu, who has led talks for China, confirmed today that he will be travel to Washington, DC for meetings later this month. The [South China Morning Post \(SCMP\)](#) had reported that Trump would meet with China's Vice President Wang Qishan at Davos, beginning on January 22nd, but neither side would confirm the meeting and [Trump tweeted today](#) that he is cancelling his trip to Switzerland due to the shutdown.

January 10th: Today is the final day for interested parties to fill comments with the Department of Commerce's Bureau of Industry and Security (BIS) 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. The specific technology categories covered can be found [in the request for comment here](#). They cover a wide range of products, from biotechnology to artificial intelligence to robotics.

This new rule is being implemented by Commerce as 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). Additionally, Commerce is expected to issue a request for comments on a proposal to restrict exports of so-called foundational technologies.

The practical effects of these changes are already being felt by Chinese companies. Today, the [Wall Street Journal](#) reported that Chinese telecom giant Huawei has been blocked from exporting telecom technology and software from its research and development lab in Silicon Valley since July, after Commerce refused to issue a necessary license. Expect more actions like these throughout the quarter and beyond.

January 20th: To qualify for the Trade Promotion Authority that eases the passage of agreements, USTR Lighthizer can officially begin negotiations with Japan on a free trade agreement thirty days after he sent [his negotiating objectives](#) to Congress on December 21st.

The USTR's key negotiating objectives include reducing the US-Japan bilateral trade deficit, which was \$69 billion in 2017, by lowering Japanese tariffs and regulatory barriers to trade. The Trump administration is particularly focused on lowering barriers for the automobile, agriculture, and services sectors. The US would also like to impose more restrictive rules of origin on auto parts in vehicle exports from Japan to reduce Japanese auto competitiveness in the US.

The timeline for talks remains unclear. The USTR has been able to continue despite the government shutdown with existing funds, but has said that the office will need to begin furloughing staffers next week if the shutdown continues. Additionally, the USTR is waiting for a report from the US ITC on the US-Japan economic relationship, but the ITC has been shut down since the government closed in December.

Additionally, in its negotiating objectives, the USTR said that they may pursue negotiations in stages, meaning there could be multiple agreements, or at least multiple announcements as each successive victory is declared.

January 29th: President Trump will ask Congress during his State of the Union Address to pass new legislation, known as the US Reciprocal Trade Act, that would increase his ability to impose unilateral tariffs in response to restrictive tariffs from other countries, according to [Bloomberg](#).

While that legislation is dead on arrival -- "We ain't gonna give him any greater authority," Senate Finance Chairman Chuck Grassley (R-IA) told reporters on Wednesday -- there could be new legislation to restrict presidential tariff powers. In the last Congress, Senators Rob Portman (R-OH), Doug Jones (D-AL), and Joni Ernst (R-IA) introduced the bipartisan [Trade Security Act](#), which would make it more difficult for Trump to impose Section 232 national security tariffs. Of course, this legislation also won't go anywhere unless Trump does something that would cause true, irreparable harm the economy, such as imposing Section 232 tariffs on all foreign autos and parts without any exemptions.

February 10th: Lighthizer and EU Trade Commissioner Malmström met again today, despite not having been originally scheduled to do so, suggesting that they may be getting closer to an agreement for the framework for the talks that they will use to eventually attempt to reach a trade deal. If Lighthizer sends Congress his negotiating objectives tomorrow, he will be able to start negotiations 30 days later, on February 10th.

Major issues still remain, though, particularly on what issues both sides are willing to discuss. After meeting with EU Trade Commissioner Cecilia Malmström earlier this week, Senator Chuck Grassley said, "I don't know how anybody in Europe that wants a free trade agreement with us and expects it to get through the United States Senate if you don't want to negotiate agriculture." Malmström told reporters that she remained unpersuaded by her meeting with Grassley, however. "Europe is not able to negotiate agricultural products," she said.

February 17th: The Department of Commerce wrapped up the public comment period of its Section 232 national security investigation into auto and auto parts imports with a hearing last July at which all except one witness – the United Auto Workers – said they opposed tariffs. Days later, President Trump and EU President Jean-Claude Juncker reached an agreement to avoid imposing new tariffs on each other, and Commerce has been sitting on its report since then.

However, the report is due to the White House 270 days after the investigation is initiated, meaning Commerce Secretary Wilbur Ross should be sending it to the White House. Trump has 90 days from when he receives the report to announce his decision on whether to impose tariffs, and they would go into effect 15 days later if he announces that he will impose them. Unless talks with the EU and Japan move very swiftly, we expect that Trump will in fact announce tariffs, with quotas for Canada, Mexico, and South Korea, and temporary exemptions for the EU, Japan, and China.

This timeline could be pushed back by the shutdown, which has included the Department of Commerce. Although the report appears to have been completed months ago, Commerce could argue that it needs more time due to the furloughs, buying the White House more time to decide if and when it wants to impose tariffs.

March 1st: If there is no deal with President Xi Jinping by this date, then President Trump has said he will raise tariffs on \$200 billion worth of imports from China from 10 to 25 percent. As discussed, we believe that both Trump and Xi are itching for an agreement to get their respective economic figures (for Xi the economy and for Trump the Dow Jones) back on track, and so we believe a deal will be reached, likely even before this date. If no concrete details are known yet, Trump still has the option to extend his delay, likely for another 30 to 90 days.

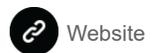
March 4th: The enforcement case with Peru will move to its next stages at this point, if the

two countries do not reach an agreement to improve oversight of timber exports from Peru. In and of itself, this enforcement action is not particularly exciting for those outside the timber industry, but it is an important component of Lighthizer's plan to win Democrats to the USMCA. Consequently, it is likely that he will continue enforcement action against Peru at this point unless there have been significant concessions already made.

March 14th: Under Trade Promotion Authority, the US ITC is required to send a detailed report on the economic effects of the USMCA to Congress by the Ides of March. The commission actually began its work early, before the trade agreement was officially signed, in an attempt to complete the exhaustive research and report early. The government shutdown, however, has forced a pause for commission. ITC staffers, already stretched thin by an unprecedented number of trade cases and agreements, may let this deadline slip if the shutdown does not end soon.

March 29th: The official Brexit date comes at the end of March. In October, Lighthizer alerted Congress that talks with the UK will begin "as soon as it is ready after it exits from the European Union on March 29, 2019," although it may be some time after that when the UK is actually ready to talk.

As with Japan and the EU, Lighthizer will need to send his negotiating objectives at least 30 days before beginning talks with the UK. However, we expect the USTR will wait until there is more clarity on the relationship between the UK and EU before embarking on their own serious analysis of bilateral trade goals.



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