Weekly Market Insights

August 26, 2019

An unstable market, trade war, Jackson Hole, and China revisited

United States equity markets spent most of last week solidly in positive territory. But on Friday, remarks by Donald Trump caused the market to lose all the week's gains and then some. The Dow Jones Industrials was down 0.99%, the S&P 500 fell 1.42% and the NASDAQ lost 1.81%.

The comments, of course, were about China and the trade war. As almost everyone now knows, on Friday Mr. Trump announced he was going to add significantly more tariffs to the ones already mandated. The market opened on the upside Friday morning but fell into negative territory when China announced it would impose a tariff on $95 billion of U.S. exports to China. The market response was negative, but not dramatically so. Markets recovered with the speech by Federal Reserve Chairman Powell at the Fed's annual economic symposium in Jackson Hole. Powell's speech was well reasoned and relatively optimistic. Investors were left with the sense that if the global economy needed it, the Fed would surely ease again. The only question was by how much. Then the speech by Trump announcing he will impose higher tariffs on $250 billion on imports from China. As a side bar, he asked "who was the greater enemy of the United States, President Xi or Fed Chairman Powell?" - just wonderful. As one would expect, the markets fell.

Jackson Hole confirmed our view that central bankers around the world were prepared to take the necessary precautions to avert a recession. We are particularly interested in Mr. Draghi's attempts to revive the E.U. economy. His job is complicated by the uncertainty of Brexit.

This leads us to the interesting question of currency manipulation. Mr. Trump has repeatedly accused both China and Germany of currency manipulation. We find both accusations baseless. China has tried to keep the RMB above its stated rate of 7 to 1 against the U.S. dollar. Their efforts had nothing to do with obeying the WTO rules but their fear of currency flight. China has had a difficult history controlling currency flight by both wealthy individuals and corporations.

Germany, although a beneficiary of a soft eurodollar, seems an unlikely manipulator. First, Germany is part of the euro so it does not directly control its currency. Secondly, as anyone who follows currencies knows, Germany has long argued, to the detriment of some E.U. members, for a tight monetary policy which is the opposite policy that would weaken the eurodollar.

Last week, we ended our paper with a question - "is the slowdown in China due to U.S. tariffs or something larger?"

No one really knows, but it is an interesting question to examine. One problem is that the economic data reported by Chinese authorities is unreliable. But the direction is most likely correct.

The first point is the rate of growth started to fall long before the tariff war. Nicholas Lardy (PIIE) reports that growth moderated starting in 2010 from double digits to 6.2% in the most recent quarter. He brings out another very interesting point. China's dependence on exports to the United States is much less than most believe. "China's exports to the United States, before tariffs were imposed ran about $500 billion annually or 4% of its $12.25 trillion GDP…In fact, the percentage is far less. The potential impact of U.S tariffs on China's growth needs to be adjusted to measure ***only value added by China,*** (emphasis added). GDP is measured in value-added terms: U.S. imports from China are measured in gross sales. The value-added share in U.S. imports

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from China is about one-half, so the direct contribution to China's GDP from sales to the United States is about $250 billion or only 2% of China's GDP." We don't often make such a long quote but this is a very important point that few people, including many professionals, understand.

China, when it was coming out of emerging market status, had all the qualities for rapid growth: a large, reasonably educated population, very low wages, and form of government that had the ability to force economic issues. There have been many cases like this. Due to its great size, China is a much more noticeable example. Most successful emerging economies run into a slowdown as they transition to a developed economy. They can no longer just copy other countries' techniques, inefficient state funding begins to take its toll, upward pressure on wages makes domestic production costs less attractive, and domestic innovation becomes the most important part of growth.

It appears that a strong case can be made that China's slowing growth has far less to do with tariffs than the natural process countries go through when growing from emerging to developed.

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