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Pass the Popcorn, Mr. President

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The drama President Donald Trump has generated from his Oval office stage is almost without precedent in living memory. Still, the US model of the political economy has held up well thus far. No matter how heated the rhetoric or flaming the tweets, backward induction from the November midterm election shapes more tempered policy outcomes now. This is how we got tax reform last year and a budget deal in 2018. Going forward, the key consideration in financial markets is if this model also explains administration trade policy.

One way to understand drama is to look to the dramatic arts for inspiration. In fact, a handful of films from the past half-century may explain our current situation better than a subscription to *The Hill, Politico,* and *Roll Call* rolled together. This note will build on that explanation in pieces, from (1) our model of the political economy; (2) the most likely scenario of recrimination, rebuff, and recoil; (3) why the base case may not move markets all that much; and (4) how it may go horribly wrong.

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What Did You Do in the Trade War, Daddy?

Blake Edwards (of *Pink Panther* fame) directed a World War II farce in 1966, “What Did You Do in the War, Daddy?” that involved bluff and buster and a festival that is mistaken for a battle. The only difference between the movie and the current trade war is that, in the former, no one got hurt. This time round, equity investors were carried off the field of battle.

Part of the markets’ surprise is that investors never expect politicians to fulfill campaign promises. Contrary to expectations, the president stuck to script on tax reform, regulatory relief, and trade. Candidate Trump spoke of unfair trade practices and using the threat of high tariffs and ripping up the North American Free Trade Arrangement (NAFTA) as a lever to open markets. Note the two parts to his statement, suggesting threat and compromise. President Trump sicced US trade negotiators on their Canadian and Mexican counterparts to revise NAFTA. He also stated his intention to impose tariffs on about $50 billion of imported goods from China, with the number possibly going higher. Subsequent chatter was all about negotiations. This is the beginning of talk, not the end of trade.

There are two parts to our view of the political economy under President Trump.

For one, politicians work backward from the next election. Hot rhetoric may satisfy the voter base, but compromise is required before the midterm elections in November—only about 200 days away. This dynamic produced the legislation on tax reform and the budget. It also favors conciliation on trade, as resisting trade restrictions is a wedge issue between traditional Republicans and Democrats. (Remember that far more Democrats than Republicans on Capitol Hill voted against the implementation of NAFTA in 1993 contrary to their president’s support.[1])

For another, after two decades of the rapid trade expansion with partners on this continent and along the Pacific Rim, US industry critically relies on a global supply chain. A Republican president cannot intentionally put US industry at risk.

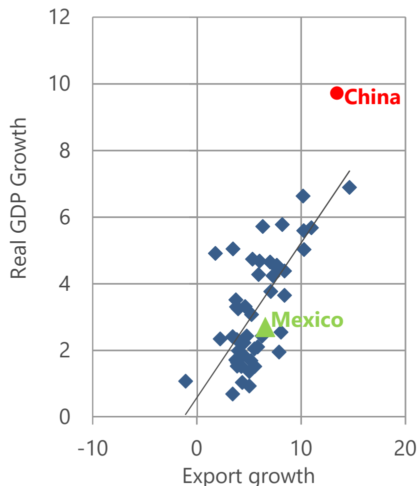
However, it takes two to tango (as in *The Scent of a Woman*), raising the issue of why foreign leaders would bend to the Trump wind. Easy, many of our partners have followed an export-led growth strategy for decades. The importance of trade is evident in the chart below. Plotted are the pairs of annual averages from 1991 to 2017

[1] Votes in the House are here and in the Senate here.

of the growth rates of the export volumes of goods and services (along the horizontal axis) and real GDP (along the vertical axis). For the 50 largest economies in the world, the growth of trade and real GDP move up together—about two for one. The green triangle represents Mexico, which has expanded exports but not done the trick of growing real GDP commensurately. Not so for the lone red dot in the upper right of the chart. China has the fastest real GDP growth over this sample and the second-fastest growth of exports.[2] Why might officials on the other side of the table put in jeopardy this ambition (Mexico) or success (China)?

Exports and Real GDP Growth for the 50 Largest Economies

average growth rates from 1991 to 2017, percent



Source: International Monetary Fund, *World Economic Outlook* (10/17) and AMNA calculations.

Importantly, there is a coarse logic in the tumult. Despite the attention directed toward China and Mexico during the campaign, the president waited until this year to impose tariffs on the former and has not given notice to the latter of withdrawing from NAFTA.

The White House only stirred the pot on trade arrangements after President Xi consolidated power at the National Party Congress late last year. Before then, President Xi was not in the position to brook a foreign slight. Having consolidated power, more so than most would have thought ex ante, President Xi is a confident and commanding negotiator on the other side of the table. That is, someone who can cut a deal. Meanwhile, President Trump just asked if there was some virtue in the Trans-Pacific Partnership, eight months late to the table. Why? The other name for the arrangement is "us against China," leverage in a discussion hidden to the broader public.

Similarly, the US has not given the required six-month notice of ripping up NAFTA because it would intrude on the ongoing presidential elections in Mexico. This opens up windows, allowing Mexican candidates to rail against their erratic neighbor and the outgoing government to cut a deal in the fall, before the US midterm elections.

Go to the Mattresses

Our best guess is that it will be ugly, with threats and counter-threats. The headlines will concern for a time, but all the threats have a long-burning fuse. The president announces that his trade representative will issue rules on a tariff that, after a comment period, have a holding period before they come into effect. Our trading partners impose countervailing taxes coming into effect when ours do. All this obscures the backroom negotiations to get to yes—a world with a few more restrictions on trade and a little less trade, but not one hurtling toward mutual assured destruction.

President Xi has already walked down the path of conciliation, offering some room for market opening and protecting intellectual property rights. His remarks, however, had a hard edge, explaining that all this must be consistent with a longer-run growth plan. Simply put, do not get in the way of Chinese ambitions. Those ambitions may make Chinese leaders agree even as they plan to undercut the US position on the global stage over time.

When reading the point-counter-point headlines, remember the fundamental arithmetical imbalance in China-US bilateral trade. In round numbers, the US sends about $125 billion of goods to China and receives about $500 billion of imports in return. The next two tables list the top 25 goods sent to and brought back from China. Exports, not just small in total, are concentrated in a few industries.

Top 25 US Goods Exports to China
US Dollars and Percent

		Level in 2017 $ millions	Share of end-use imports percent
1	Civilian aircraft, engines, equipment, and parts	16,266	13
2	Soybeans	12,362	55
3	Passenger cars, new and used	10,526	20
4	Semiconductors	6,077	13
5	Industrial machines, other	5,442	10
6	Crude oil	4,434	20
7	Plastic materials	4,004	12
8	Medicinal equipment	3,454	10
9	Pulpwood and woodpulp	3,395	38
10	Logs and lumber	3,179	45
11	Chemicals-other	2,975	9
12	Measuring, testing, control instruments	2,764	12
13	Other parts and accessories of vehicles	2,715	5
14	Pharmaceutical preparations	2,680	5
15	Chemicals-organic	2,324	8
16	Electric apparatus	2,316	5
17	Copper	2,248	36
18	Other industrial supplies	2,086	8
19	Natural gas liquids	2,013	13
20	Cell phones and other household goods, n.e.c.	1,828	7
21	Laboratory testing instruments	1,828	16
22	Petroleum products, other	1,691	3
23	Industrial engines	1,661	7
24	Telecommunications equipment	1,405	4
25	Computer accessories	1,391	5

Source: United States Census Bureau, at https://www.census.gov/foreign-trade/statistics/country/index.html

[2]The fastest-growing exporter was China's near neighbor, Vietnam, which is following the same strategy from a lower starting point.

Our imports from China are not just big, they are important in our overall trade. Attempting to rein in imports through tariffs invites many diffuse targets but sparks targeted retaliation on exports, as has just been witnessed.

For Mexico, the deal would be NAFTA 2.0, with better protection of intellectual property rights and market access, lifted from the unsigned Transatlantic Trade and Investment Partnership, and a nod to increased domestic content (goals on which the US has already faded). The result is some near-term gain at the expense of longer-run pain. Mexico sees most of the benefits of NAFTA as already locked in, including an improved rule of law and better management practices for its domestic industries. Having demonstrated ourselves as a less reliable partner, Mexico will seek alternative outlets for its exports, which is especially threatening to US agriculture.

As for Chinese accommodation, the US president may get victories on opening markets and reducing subsidies to exporters, but under the radar, Chinese authorities may:

- Increase subsidies for those same firms at the state and local level.
- Tighten environmental, health, or other safety requirements on some of those goods.
- Use finance to strengthen third-country trade (read the Belt and Road initiative), muscling the US out of its new global trading network.

Might those risks be enough for agreement on the protection of intellectual property rights? Perhaps, but perhaps not. To the frustration of outsiders, Chinese firms are an interlocking web of two organizations. There is a domestic management flow chart and a hierarchy of party officials. Any business decision answers to both. The former may satisfy promises about protecting intellectual property rights but the latter views themselves as agents directed to a higher cause.

Top 25 US Goods Imports from China
US Dollars and Percent

		Level in 2017 $ millions	Share of end-use imports percent
1	Cell phones and other household goods, n.e.c.	70,394	66
2	Computers	45,520	66
3	Telecommunications equipment	33,482	45
4	Computer accessories	31,612	53
5	Toys, games, and sporting goods	26,773	74
6	Apparel, textiles, nonwool or cotton	24,152	48
7	Furniture, household goods, etc.	20,667	56
8	Other parts and accessories of vehicles	14,418	14
9	Household appliances	14,146	49
10	Electric apparatus	14,073	27
11	Apparel, household goods - cotton	12,271	28
12	Footwear	11,537	62
13	Televisions and video equipment	10,726	42
14	Industrial machines, other	10,598	19
15	Semiconductors	9,596	18
16	Photo, service industry machinery	9,450	44
17	Industrial supplies, other	8,756	26
18	Cookware, cutlery, tools	7,161	72
19	Generators, accessories	7,037	30
20	Other consumer nondurables	5,658	37
21	Camping apparel and gear	5,453	42
22	Chemicals-organic	5,312	20
23	Industrial engines	5,092	21
24	Finished metal shapes	5,003	27
25	Apparel, household goods-nontextile	4,955	54

Source: United States Census Bureau, at https://www.census.gov/foreign-trade/statistics/country/index.html

Meanwhile, all this focus on trade flows forgets that those flows are paid by the capital account. That is, the US current account deficit mirrors its capital account surplus, reflecting the willingness of foreign investors to accumulate obligations of the US. When the dust settles, the lasting and most significant imprint might be some denting of the safe-haven status of our obligations. In such circumstances, smaller current account deficits would be more expensive to fund.

All this should sound familiar. When the crime families of *The Godfather* go to the mattresses, the result is elevated tension for a time, breathless bold-type headlines, and a few less mobsters in the medium term.[3] In the aftermath, organized crime remains organized, about retains its original structure, and the life of New York City moves on.

Follow the Money

The best advice for understanding finance is from "Deep Throat" in *All the President's Men*, follow the money. If trade friction, as in our base case, is more film than fact, then the net consequences for the economy should be limited, and there is not much money to follow.

Members of the Federal Open Market Committee seem to concur that there was not a lot there, at least for now. The latest minutes only tangentially mentioned a trade dispute as a downside risk to aggregate demand. This is the half the story, and FRB Boston President Eric Rosengren did a better job explaining the symmetric threat to monetary policy imposed by increased tariffs. Yes, demand takes a hit because retaliation probably reduces exports, but import prices are most likely higher too. Thus, two forces push in opposing directions relative to the Federal Reserve's (Fed's) goals—less demand to achieve full employment and more inflation to achieve price stability. Increased tariffs are similar to an oil price shock in the 1970s and 1980s (when we were net importers of oil by far), which led to the academic recommendation (from Ben Bernanke and coauthors, no less) to keep calm and carry on, holding unchanged the anticipated path of the policy rate. Again, not much there.

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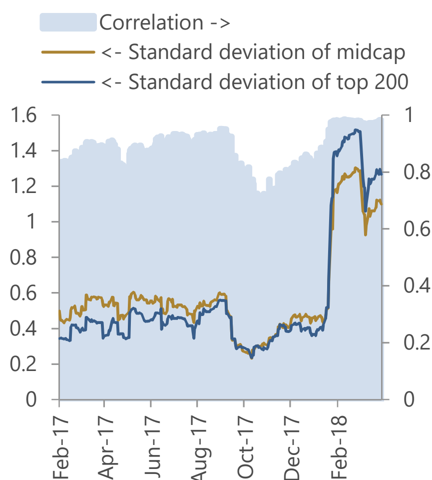
[3]As a note on location, the exterior shot of the restaurant where the dons of the major families meet is actually the Federal Reserve Bank of New York. The New York Fed's incoming president, John Williams, has to pick up his game if he wants to equal their standing in the hood.

The wide swings in equity prices thus far this year seem to predict more significant economic dislocations than suggested by our line of reasoning. No doubt, the process may go off track (discussed later), and a change in investor sentiment might possibly explain the 7.5 percent decline in the S&P 500® price index from its 2018 high-water mark. However, the same index is about flat on the year. Is that evidence that there is not much to worry about, on net? The truth is there are too many parts turning in Washington DC to extract a coherent reading about policy direction from market prices, which have to average over the full range of possibilities. Moreover, by our reading, the movements in equity prices over the past few months lack their own coherence. What did equity investors do in the trade war? Panic.

Why do we think investors panicked? The next few charts provide the joint answer. First, as shown by a moving average of the standard deviation of the daily change in components of Russell share price indexes, volatility rose considerably at the beginning of this year and in lockstep. The bars give the rolling correlation of the top and middle—the largest 200 firms by capitalization in the Russell indexes and firms in the middle rank of capitalization. Initially, the possibility, followed by the reality, of tax reform made their day-to-day movement less correlated. Presumably, the big guys had funds to repatriate and could return more benefits to shareholders. After 2018 opened, the volatilities of the equity

Volatility of Russell Equity Price Indexes

Standard deviation (LHS) and correlation (RHS) of daily percent changes over moving thirty day windows



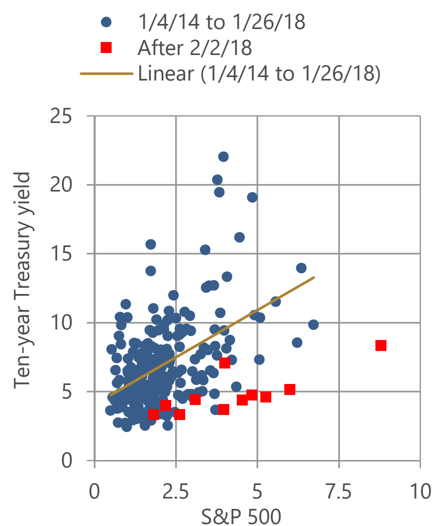
Source: Russell indexes, accessed via FRED, 4/14/18.

values of large and midcap firms rose significantly, in tandem (the left axis), and the correlation between the two slammed to one (on the right axis). This could not have been about trade restrictions, as they have an uneven incidence across the tech-heavy, trade-dependent large firms and midcap ones. This was a general retreat from risk taking in equity markets.

Why do we think this was idiosyncratic to equity markets? The chart below shows the intraweek trading range of the S&P 500 equity price index and the 10-year Treasury yield. Importantly, the range between the high and low each week in the equity price index and the Treasury yield disconnected this year. Realized equity volatility this year has been much higher relative to yield volatility (compare the red squares to the blue dots).

Intraweek Trading Range

High less low relative to last, percent

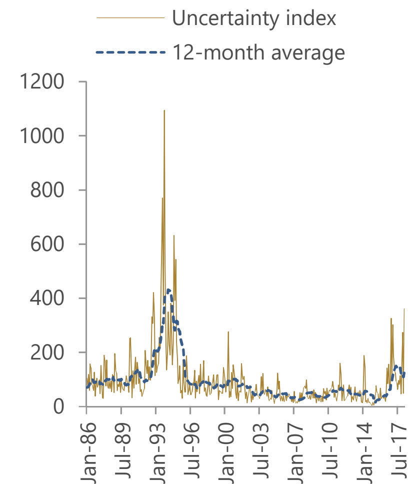


Source: Bloomberg, accessed 4/13/18.

This note opened with the assertion that the drama from the Trump White House is ***almost*** without precedent. On trade policy, we have been here before, and more so, which makes us a little more confident arguing that the rise in equity price volatility is overdone. The academics Baker, Bloom, and Davis have a cottage industry of measuring uncertainty about economic policy in the US and around the world. They even slice and dice the different types of policy when they count newspaper citations over time. Below is their index for searches keyed to words and phrases about trade policy from 1986 to now in major US newspapers. As is evident, President Trump got the ink flowing in national newspapers with the imposition of tariffs on steel and aluminum imports (invoking of Section 232 of a 1962 trade act on the national security of imports) and Chinese imports (using Section 301 of a 1974 act about unjustified, unreasonable, or discriminatory trading practices).

Uncertainty About Trade Policy

as measured from newspaper searches, mean of 100 from 1985 to 2010

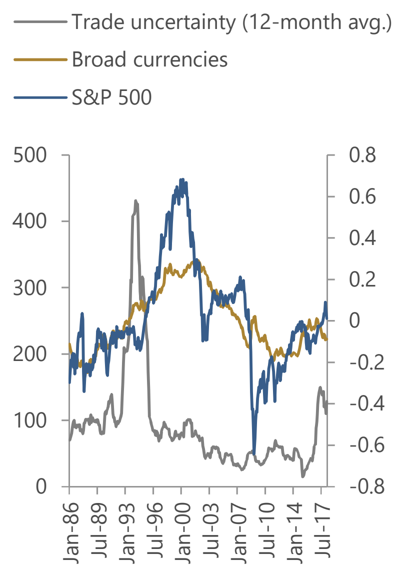


Source: Trade uncertainty from "Measuring Economic Policy Uncertainty" by Scott Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com.

In the event, the attention is a shadow of the volatility surrounding the election of 1992 and the ratification off the North American Free Trade Agreement a year later. Does anyone recall when candidate Ross Perot heard a "giant sucking sound" on trade? How about the pitched battle between Labor Secretary Reich and Paul Krugman on competitiveness and the benefits from trade? (Senators Brown, Schumer, and Warren might be confused on which side of the field the two were. Krugman was wearing his hat as a trade economist and downplaying the domestic consequences of trade opening.) And what alignment of the political stars led President Clinton to find more Republican than Democratic friends on Capitol Hill to secure passage of NAFTA?

This sizable variation in attention to trade, repeated in the panel below, leaves no obvious imprint on equity prices or the foreign exchange value of the dollar. (The two lines plotted of asset prices are logarithms of the underlying series, de-trended over the sample period.) Nor is the word-count on trade systematically related to the implied volatility of equity prices since 1990, not shown.

Trade Uncertainty, Equity Prices, and the Foreign Exchange Value of the Dollar



Source: Trade uncertainty from "Measuring Economic Policy Uncertainty" by Scott Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com. The logarithms of the S&P 500 equity price the Federal Reserve broad currency indexes are from Bloomberg (4/11/18) and detrended over the sample period.

Rebel Without a Cause

If our view of the political economy is right, the drama offers the opportunity to lean into risk. Fundamentals remain well maintained, anchoring spreads, so headline-related widenings are buying opportunities. But, it could go wrong, badly. By our description, trade negotiations are a game of chicken, classically memorialized in *Rebel Without a Cause*. The 1955 movie follows the sad end of a dare, when Sal Mineo drives off a cliff because his coat gets caught in the car door handle.

What goes wrong will show up in quantities, prices, the financing of trade, or some combination of them all.

One obvious concern is that we are at the beginning of multiple rounds of retaliatory increases in tariffs. A tariff is a tax, and its incidence depends on the rate and the base. If the process spins out of control, the World Trade Organization goes the way of that other Geneva-based international organization, the League of Nations, the effective tax rate goes up, and the base widens as nations pick sides in the dispute. Global trade slows (a distinct problem for the economies following export-led growth strategies), capital spending to support trade dries up, and world wealth declines as future growth prospects are trimmed and discounted at a higher rate because of heightened uncertainty. The indirect effect piles on multiplied losses to income from this adverse hit to aggregate demand.

Central banks presumably provide policy accommodation, with the Fed scaling back expectations of rate increase and the Bank of Japan (BOJ) and the European Central Bank (ECB) shelving its renormalization plans. Except, a higher tax rate puts upward pressure on prices and may serve as a coordinating device for large firms to fold in big price hikes. Thus, the Fed may be slow on the uptake and the net stimulus from the BOJ and ECB, looking at policy rates below zero, seems questionable. China presumably rotates away from the export market to boost domestic demand, but this comes at the cost of worsening the national balance sheet and crimping funding of foreign development projects.

The wild card is the foreign exchange value of the US dollar. It is worth recalling the line of argument by the advocates of a border-adjustment tax. We heard in 2017 that the domestic balance between saving and investment determines the current account. If a higher tax rate does not change that balance, then the exchange rate adjusts one-for-one with the tax change to keep the dollar price of imports unchanged. That is, the dollar appreciates on the tax hike. This sounded as implausible then as it does now, with a lack of attention paid to stocks of assets and liabilities. More likely, the higher tax rate and changed attitude toward trade makes foreigners less willing to hold dollar assets, weakening the dollar's value, putting more pressure on US inflation, and tightening financial conditions in Europe and Japan.

As for the domestic fallout, the table lists the shares of total US goods exports for the top 25 states. The concentration of our exports puts at risk those places specializing in agriculture, technology, and autos.

Goods Exports by State in 2017 (Top Twenty Five)
Share of US total, percent

		Manufactured	Non-Manufactured	Total
1	Texas	15.6	22.1	17.1
2	California	9.9	11.8	11.1
3	Washington	5.4	7.4	5.0
4	New York	3.3	6.0	4.9
5	Illinois	4.4	2.5	4.2
6	Michigan	4.6	1.5	3.9
7	Louisiana	3.1	11.5	3.7
8	Florida	3.7	1.9	3.6
9	Ohio	3.7	2.0	3.2
10	Pennsylvania	2.7	2.5	2.5
11	Indiana	3.0	0.6	2.4
12	Georgia	2.7	1.8	2.4
13	New Jersey	2.1	1.9	2.2
14	Tennessee	2.2	0.7	2.1
15	North Carolina	2.6	0.9	2.1
16	South Carolina	2.7	0.4	2.1
17	Kentucky	2.2	0.3	2.0
18	Massachusetts	2.0	0.8	1.8
19	Wisconsin	1.7	0.8	1.4
20	Oregon	1.5	1.2	1.4
21	Alabama	1.8	1.0	1.4
22	Arizona	1.1	1.3	1.3
23	Minnesota	1.6	0.7	1.3
24	Virginia	1.1	1.4	1.1
25	Connecticut	1.1	0.6	1.0

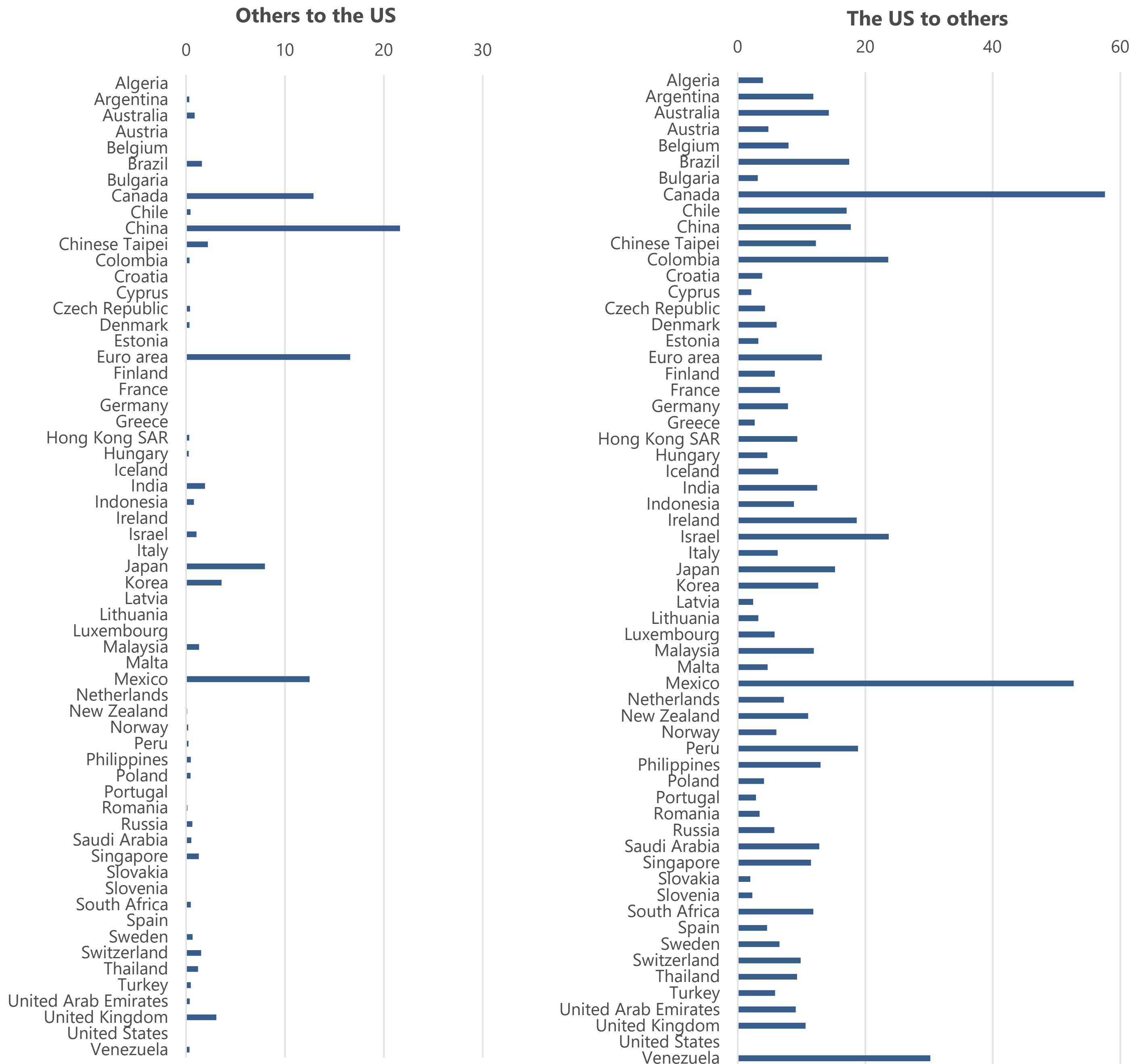
Source: https://www.census.gov/foreign-trade/statistics/state/index.html

The global dimension requires looking at bilateral trade from two perspectives, which we do by using effective exchange rate indexes from the Bank for International Settlements (BIS). The BIS calculates indexes for 60 economies using bilateral trade shares (the sum of exports and imports) from 2011 to 2013. The chart at the left plots the shares in the US index, or the places important to the US economy. Consistent with the lack of diversification of our trade, only four economies bulk on the horizon (with a share greater than 10 percent)—China, the Euro area, Canada, and Mexico. Note that we have currently picked fights with all four.

As a large economy, the US figures significantly in many more places, as in the right panel plotting the US weight in every other effective exchange rate index. The US has more than a ten-percent share in the bilateral trade of 24 other economies.

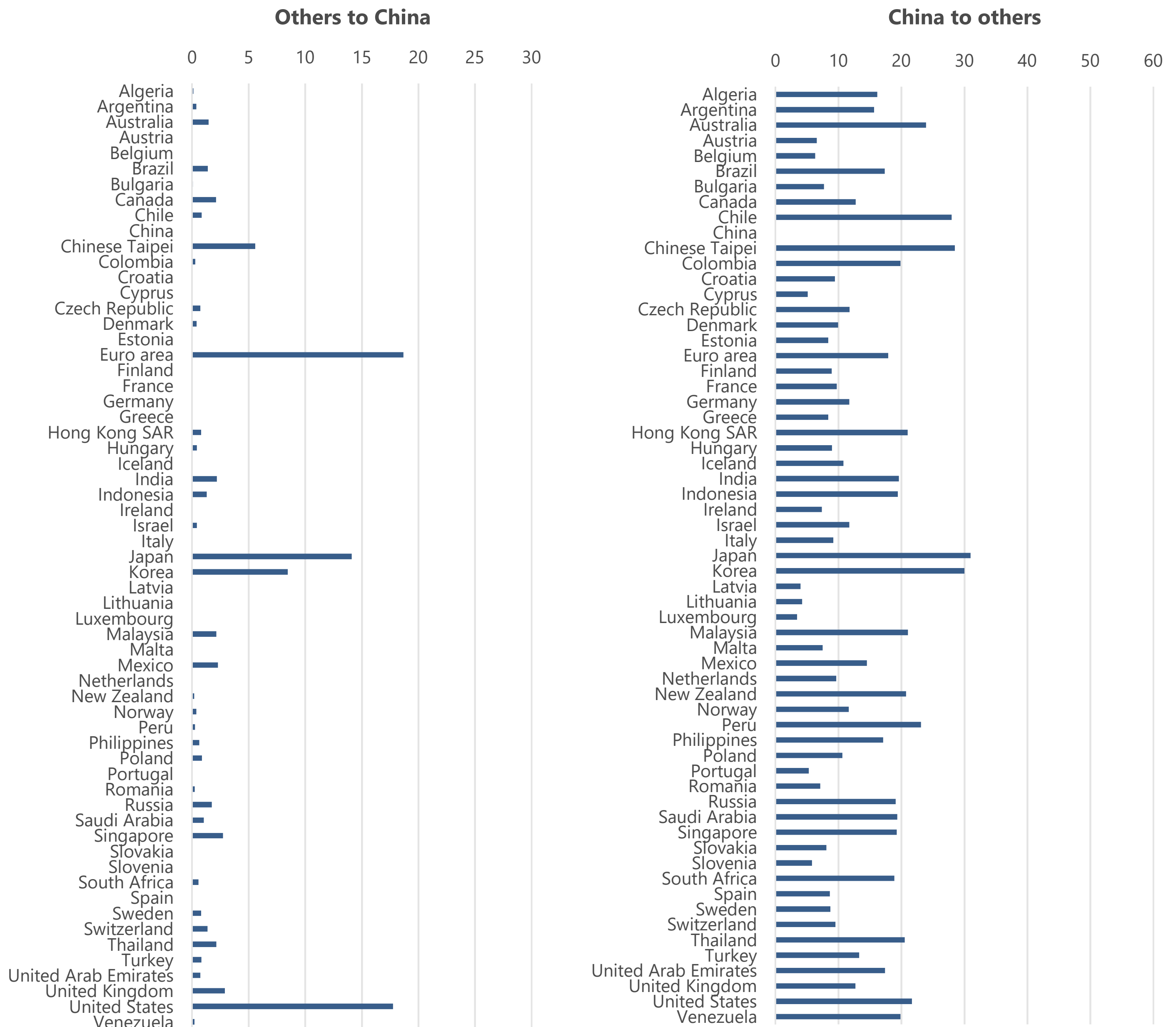
The two panels on the next page repeat the exercise for China. Yes, the US has a relatively large footprint on Chinese trade, but the opportunity to switch to the Euro area and Japan seems clear. As in the right panel, China matters just about everywhere, implying that a disruption in its economy casts a wide shadow.

Relative Importance of Trade Weights in Bilateral Exchange Indexes, 2011 to 2013



Source: BIS, accessed 4/11/18

Relative Importance of Trade Weights in Bilateral Exchange Indexes, 2011 to 2013



Source: BIS, accessed 4/11/18

The Phantom Menace

Outside of living memory, some presidents have been dramatic and not always dignified. After all, Andrew Jackson fired his pistol from the front porch of the White House, Grover Cleveland was followed by chants of "Ma, ma, where's my pa?" and Theodore Roosevelt routinely swam naked in the Potomac. The resilience of a market economy and a political system governed with checks and balances mostly kept really bad things from happening. That is our forecast. However, all forecasts have good and bad tails. The former is that, while the process is ugly, trade becomes freer and intellectual property rights get safer. The latter is a world in contraction with monetary policy makers hamstrung in providing sufficient new stimulus by having failed to renormalize their positions sooner, fiscal authorities with little space to do much, and the world wobbling on two poles of influence.

Oh, there is also a really bad thing that cannot be ruled out and was previewed in the weakest installment of a remarkable series. *Star Wars: Episode I—The Phantom Menace* gave us Jar Jar Binks, to be sure, but the movie also showed how a trade dispute between the Trade Federation and the Galactic Republic spiraled into interstellar war. That is, increased tariffs opened the door for Emperor Palpatine a long time ago in a galaxy far, far away.

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