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The Daily Deck

- **Scared by small numbers**

Scared by small numbers

Once again the market has arrived at the wrong conclusion

The market remains panic-stricken by the machinations of global trade with the S&P 500 now off about 5% from the nearby highs. If this is not a case of overreacting to small numbers, we don't know what is. It all started of course with the Trump tweet last week that on September 1st tariffs on the remainder of about $300b in Chinese goods will move up 10%. Simply on the face of it (and by way of understanding the size of the numbers being talked about), this is equivalent to a 0.1% impact on the $21 trillion US economy through the pricing channels. Yes, this adds on to the roughly $70b annualized tariff estimate following the escalation of tariffs around 2Q.

The problem with gauging economic impact from tariffs is that, thus far, it has not worked out quite that way. Indeed, given currency devaluation, the bulk of the tariffs are being offset. With the recent down-move in the CNY, we are now looking at a more than -11% depreciation in the Chinese currency since the trade war rumblings began back in early 2018. If we take the trade volumes at that point, note that this means it now takes about $455b to buy the same volume of Chinese goods that it took $510b to buy about 18 months ago. This essentially offsets about 80% of the tariff impact through the end of 2Q19 when Trump implemented the additional 15% on $200bn of goods, taking the effective tariff rate (on all Chinese imports) to about 13%. To be sure, many US imports are invoiced in USD, thus a devaluation strategy could take some time to flow-through. But it is puzzling nonetheless to see the Trump administration push back against a CNY devaluation that in the medium term could very well offset all of the tariff increases at the expense of Chinese citizens' global purchasing power.

Thus, viewing the currency devaluation as a retaliation for the latest Trump tariff escalation seems wrong. It is more akin to an effort to try and offset the impact of tariffs on US consumers of Chinese goods, so as to protect market share.

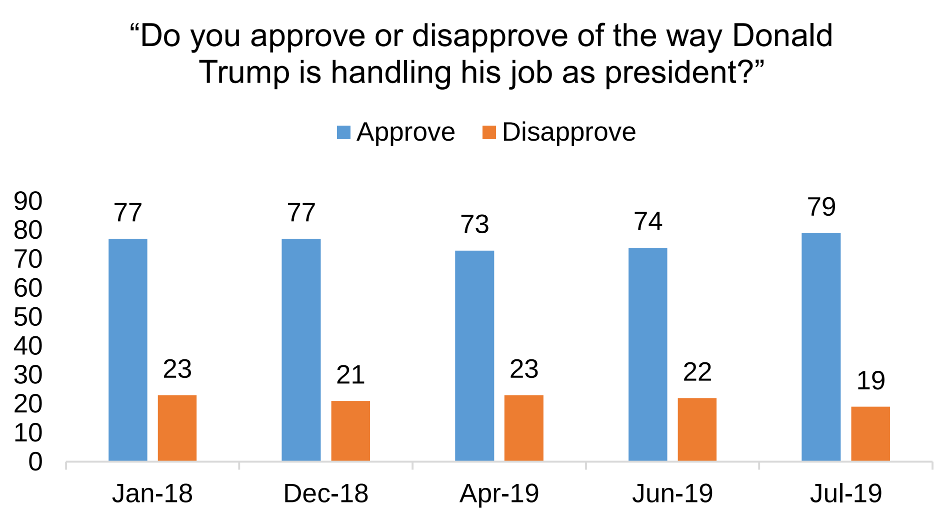
Speaking of retaliation, the suspension of US agricultural product imports by China also seems relatively insignificant. Note that US agricultural exports to China had already plunged in the wake of trade tensions. China imported about $7.5b in US ag in 2018, down from $16.2b in 2017…that's "b" as in billion. Given the morning round of utterly frightened commentary you would think the numbers were many many multiples as big. Even with the uptick in June (see chart below), the monthly average of US ag exports to China was sitting at $400m, down from $1.3b back in January 2018. Are we suggesting that $7.5b is the make-or-break point for a $21 trillion economy?

(continued)

Source: Census, RBC Capital Markets US Economics

Even for the farming industry, the impact will be significantly blunted by various aid packages put forth by the Trump administration. In 2018 alone, there was a package for farmers on the order of $12b. And just a few short weeks ago details of another $16b package were out from the administration. So the ag import suspension is small on the face of it, but even more insignificant when we consider multiple bailouts of the industry in the offing. Indeed, put the size of these aid packages in the context of the paragraph above showing the total value of exports to China.

And for those that believe this latest China move will act as a political pressure point on Trump with his all-important farming base, we suggest taking a look at recent polls from the farming community. A July 1 poll from Farm Journal had farmers' support for Trump at 79% (up from 74% in early June) and with 53% "strongly approving" of the job Trump is doing. As long as the administration continues to offset the impact of lower China imports of ag product with substantial aid packages, this key political constituent is unlikely to be derailed.



Source: Farm Journal Pulse

We get the idea that beyond the dollar impact, the trade war effect on "animal spirits" could lead to a more dramatic slowing in growth. But how long do we need to see the minimal effects of tariffs thus far on the real economy before we are convinced that the US is coming through this mostly unscathed. The softness in the manufacturing space has failed to spill over in any significant way into the remaining 90% slice of the private economy. The US consumer remains on as good footing as ever with de-levered balance sheets, elevated savings, and accelerating wage growth. This sector kept the economy humming (with weaker fundamentals than they have today) through 2015-16 when one could make a much stronger argument that an industrial recession was afoot.

We now have very healthy household fundamentals with the prospect for the Fed to embark on an easing cycle as they continue to react to the very real deterioration in China-linked European economies. While our baseline view is that the committee will cut one more time in September and call it a day, if US 10s remain in the neighborhood of 1.75% (or lower) it is hard to see how the committee doesn't react to this by trying to "re-steepen" the curve via front-end easing. Without any notable bubbles (at the moment) in the household/corporate space here at home, this is a free option for the Fed in the immediate term. They clearly believe they can attempt to run the economy hot without any near-term consequences of blowing bubbles.

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