KWR International has begun to prepare a timely Macro-Outlook Bulletin, which is now in beta development. To be placed on the no-obligation trial subscription list or for questions and more comprehensive monitoring, advisory support and research, please email KWR-Macro-Outlook@kwrintl.com . Thank you for your interest and support!

The KWR International Advisor Macro-Outlook , Vol. 1, No. 6

August 19, 2019

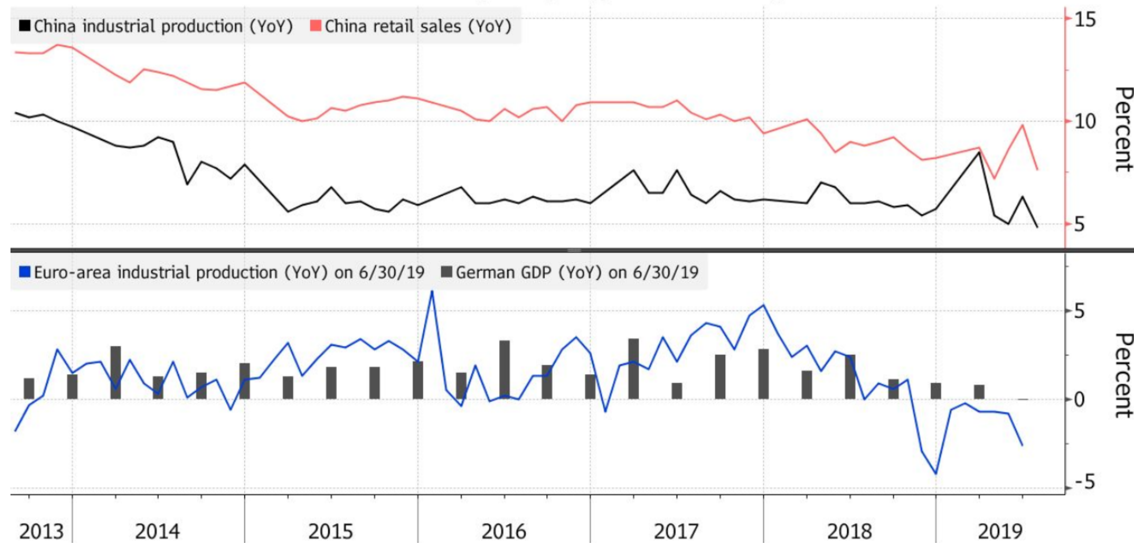
Scott B. MacDonald, Ph.D.

Keith Rabin

Credibility, Consumers and Hong Kong

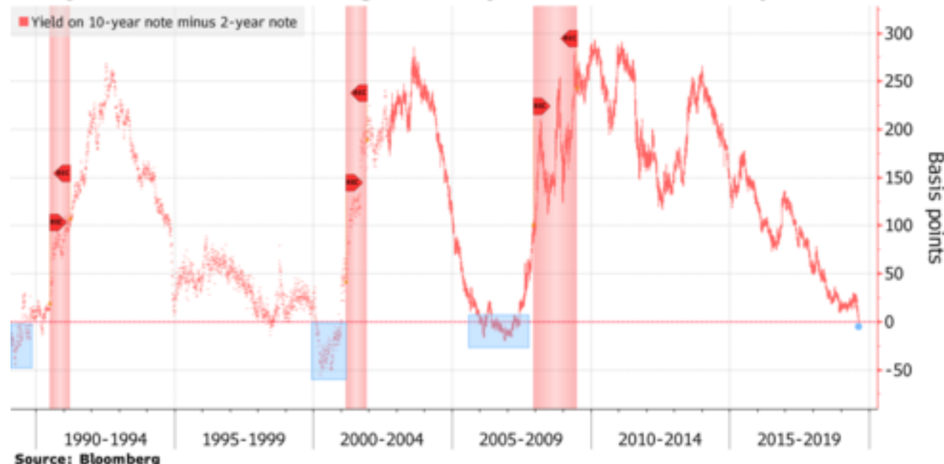
"Only thing we have to fear, is fear itself." Franklin Delano Roosevelt

Summary: The week ahead is likely to serve up more corporate angst over the de-globalizing international business landscape, the direction of yield curves, and potential for a global economic slowdown. Last week's U.S. interest yield inversion (2's and 10's) left analysts claiming that recession in the U.S. is growing closer. This sentiment was countered by Bank of America's CEO Brian Moynihan, who stated in a Bloomberg interview, "We have nothing to fear about a recession right now except for the fear of recession." Said another way, the biggest risk facing the U.S. is the country talking itself into a recession. Although economic data from outside of the U.S. (see charts below) is trending negatively, U.S. economic data has largely held up, in particular real GDP expansion, low inflation, low unemployment, and most consumer data. Yet the yield curve inversion is not a positive omen, real estate is not robust, and one has to wonder if lower interest rates (pushed by the Trump administration) will be enough to keep the U.S. economy afloat. Moreover, the trade war with China is dampening corporate earnings, functioning as a brake to growth. A little less presidential tweeting and more policy continuity from the White House would probably help reduce uncertainty. And it is the uncertainty that drives fear, something for the trigger-happy President to think about if he wants to win re-election.



What to watch for the upcoming week: This week is noteworthy for the holding of the annual **Economic Policy Symposium, hosted by the Reserve Bank of Kansas City. Taking place in Jackson Hole,** Wyoming on August 22-24, the big speech for markets will be on Friday, when the Fed's Jerome Powell will speak. Considering the jittery nature of financial markets and the downward pressure on yields (see table below), his comments will be closely scrutinized as a clue to what the U.S. central bank will be doing in terms of its upcoming September FOMC meeting.

Since the late July FOMC the U.S. economy still points to momentum, inflation picked up a little and retail sales climbed in July. This has been counterbalanced by the deep uncertainty around the U.S.-China trade war, negative economic news out of China and Europe, and the inversion of the yield curve (which bond markets took to signal a recession on the horizon).



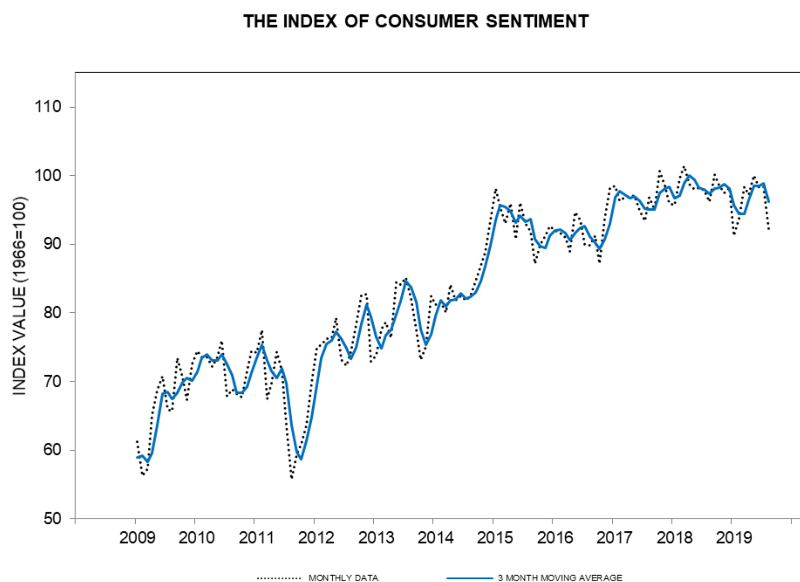
Will the Fed cut rates again in September as assurance it will not get out by deflation? Market sentiment already reflects a 25 bps cut in rates, but the White House wants a more aggressive rate cutting cycle in place. Will the Fed move beyond Powell's "mid-cycle adjustment"? We think that Powell will seek to calm markets and probably hint to another rate cut in September.

The Fed will also be in the news on **Wednesday** with the release of minutes from July FOMC.

Also during the week:

- Wednesday will see the National Association of Realtors release home sales data (we are looking to 1.5% increase in existing home sales); outside the U.S., South Korean reports on exports (key to its economy and hit by U.S.-China trade war);
- Thursday will see the Conference Board release its Leading Economic Index for July (which is supposed to see a slight increase from June's -0.3%). Also on same day the minutes from the last European Central Bank meeting will be released and Eurozone PMIs will be released giving further insights into European growth (or the lack of it). **Germany will be closely watched considering its Q2 real GDP contraction.**
- Friday is for the Census Bureau reports on new residential sales for July.

Credibility, Trade and Growth: Brian Moynihan's recent comments on Bloomberg that the major risk for U.S. economy is the U.S. consumer talking themselves into a recession is a valid concern. During the interview, the head of Bank of America was confident and willing to focus on rising worry for many Americans due to volatile financial markets, caused in part by bad economic data out of Germany and China as well as the inversion in the U.S. yield curve. Moynihan was confident the U.S. economy still had room to expand. However, the strength of Moynihan's performance reflects a declining level of confidence in the Trump economic team, especially if they could handle a recession. And the idea of a recession is not likely to go away any time soon, something brought home with August decline in U.S. consumer sentiment.



Source: University of Michigan. http://www.sca.isr.umich.edu/charts.html.

At the top of the credibility issue for the Trump economic team is Peter Navarro, the director of the Office Trade and Manufacturing Policy. He is a tariff hawk and a firm believer in the need to create a level playing field with China as to trade and copyright protection. Indeed, many Americans agree with the need to address what they perceive as China's unfair trade practices. Where Navarro and the vast majority of economists have sharp difference of opinion is who bears the costs of the tariff war with China. According to the Trump administration, and Navarro in particular, China has fully borne the costs and there is little impact on the U.S. consumer. As the presidential adviser stated on Sunday's *Face the Nation*, "We've had tariffs on for over a year. The Chinese have borne the entire burden of that by slashing their prices and reducing the value of their currency by 12%."

Navarro's credibility is not helped by his dismissive discounting of the International Monetary Fund's, Federal Reserve Bank of Boston's, and U.S. Department of Labor's conclusions that the tariffs are effectively tax hikes on Americans. His response to any contrary outlook is "That dog won't hunt."

Navarro also pooh-poohed concerns from Goldman Sachs, Morgan Stanley and a number of top-flight economists that the uncertainty generated by U.S. trade policy and the function of tariffs as taxes are bringing a U.S. recession closer.

Particularly damaging for Navarro in business and financial circles has been his fight with the *Wall Street Journal*, which he denounced as sounding like *The People's Daily*, the Chinese Communist Party's propaganda arm. Indeed, the *Journal* had the audacity to challenge Navarro's view of who was paying the costs of tariffs, asserting instead some are being passed on to the U.S. consumer. For his part, President Trump has sought to blame any economic bad news on the Federal Reserve; Navarro has echoed the criticism of the central bank.

The *Wall Street Journal*, hardly a leftwing publication, has not stated that tariffs would cause an immediate recession, but that the current policy line would eventually take the U.S. down the road to recession. As the newspaper's editorial opinion made clear (August 15, 2019): "We said they – and the climate of uncertainty they were creating for business – would chill global trade and undermine the surge in capital investment spurred by tax reform and deregulation. The growth momentum from tax cuts and a strong labor market were able to mask the impact of helter-skelter trade policy for a time. But that old economic disciplinarian, Adam Smith, sooner or later exacts a price for policy blunders."

For anyone listening to corporate earnings calls, there is a growing chill to capital expenditure and forecasts. John Deere, a major producer of farm machinery, missed earnings and took down its forecast for the next quarter. The company's chairman and chief executive officer, Samuel Allen, noted: "John Deere's third-quarter results reflected the high degree of uncertainty that continues to overshadow the agricultural sector. Concerns about export-market access, near-term demand for commodities such as soybeans, and overall crop conditions, have caused many farmers to postpone major equipment purchases." The CEO also

pointed out that Deere is sensitive to steel prices (which went up with tariffs) and that it sells to farmers (whose exports to China have plummeted).[1]

John Deere was hardly the only company to cite trade wars as a cause of missing earnings or darkening forecast horizons. The agricultural sector has also been hard hit as have retailers. Indeed, the last round of tariffs announced for September 1, 2019 for the remaining $300 billion of Chinese imports (some of which were later postponed to December 15, 2019) would hit the retail sector hard. Even Walmart, the world's largest retailer, has warned of an increase in prices for shoppers due to higher tariffs on goods from China.

The news out of corporate America and the White House over tariffs is not the same. And the credibility issue on the Trump administration's economic management, including trade, is beginning to creep into opinion polls. An August survey by NBC News/Wall Street Journal showed that while a majority of Americans continue to approve of Trump's handling of the economy by a 49%-46% margin, that number of has dropped from 51%-41% approval in May 2019 and a 50%-34% in July 2018. Part of the reason for the change has been the rise in Americans who now say they approve of free trade by a 64%-27% margin. If higher costs are passed on to consumers, those numbers could grow and spell trouble for the President's re-election in 2020 (as he is perceived as a protectionist and likes his nickname of Tariff Man).

The poll results and similar readings probably factored into the administration's decision to postpone some of the new tariffs to December 15, 2019 as they would not then hurt the upcoming holiday sales season. This was done despite the administration's claims of no impact on consumers.

The Trump economic team has serious challenges. While a number of top people left early in the administration, Treasury Secretary Steven Mnuchin is not regarded as a policy heavyweight, Commerce Secretary Wilbur Ross has been derided for falling asleep in meetings, and Navarro is regarded as a shill for the president. The President's own understanding of economics is seen as questionable. Larry Kudlow is one of the strongest members of the economic team, but he has plenty of detractors and a heart condition.

The big question that is beginning to filter into markets is how is the Trump economic team positioned to deal with a recession? Considering that the current team does not have a high level of credibility (fairly or unfairly) in financial markets and, increasingly less in the corporate sector, confidence in the Trump administration's ability to maintain robust economic growth is likely to be increasingly questioned, which erodes confidence. That takes us back to President Franklin Delano Roosevelt's comment, "The only thing we have to fear is fear itself." U.S. economic growth should continue into 2020, but the wall of worry looming ahead and the administration's ability to handle it will determine whether the U.S. talks itself into a recession.

Hong Kong – Will There Be Another Week?: Hong Kong's protest movement has gone since June and shows little sign of letting up. It has disrupted commercial travel in and out of the city,

[1] According to a study conducted by the Peterson Institute for International Economics, global steel and aluminum import tariffs increased the steel products by nearly 9% last year, pushing up costs for steel users by $5.6 billion.

made a dent in its economic growth and left the political landscape between it and mainland China highly stained. In many regards, the Special Administrative Region (SAR) sits on a knife edge between maintaining some degree of autonomy and being swept under by a massive People's Liberation Army (PLA) intervention.

While the current protest movement is usually compared with Tiananmen Square, it also has an element of Czechoslovakia in 1968. The latter occurred when the local Czechoslovakian communist party began a political liberalization, which the Soviet Union ultimately could not let go unchecked due to fears of contagion to the rest of Eastern Europe. The final outcome was a massive military intervention into the country and a return to hardline communism.

There are three potential paths out of the current crisis. One is that China sends troops into the city, arrests a large number of protesters, and dismantles Hong Kong's autonomy. The cost of this action is high – ruining Hong Kong as a place to transact business upheld by the rule of law as well as being hit by international sanctions from the West (and further dividing the world into pro-China and pro-U.S. camps). It is also likely that stock market would collapse as would the local real estate market.

The second option is that the protest movement and Beijing (with the SAR administration) take a step back from the edge, both recognizing what can be lost by an ongoing head-to-head confrontation. Instead both sides attempt to reach some type of accommodation, which maintains an uneasy status quo, leaving the door open to Beijing later seeking to tighten controls and the protesters to push for greater political rights. This scenario functions more like a truce, buying both sides time.

The third scenario is Beijing (through the SAR administration) and the protesters reach an accord, allowing for a status quo. However, President Xi Jinping has no intention to honor this agreement, as he and other hardliners fear contagion of dangerous liberal ideas to the rest of China. As an autocrat, President Xi cannot be seen to look weak. When the world is more distracted, he will give the green light for imposing tighter controls on Hong Kong. Moreover, if Sino-American relations are still at a low point, Xi and others may believe they have little to lose by maintaining Hong Kong's status as a halfway house between China and the rest of the world. An outright military takeover may be worth eliminating any threat of long-term contagion.

Hong Kong looms as one of the most significant geopolitical flashpoints in 2019. Despite the threat in the minds of Beijing's hardliners represented by a more liberal Hong Kong, there remains considerable reluctance to pull the trigger to the massive use of force. The consequences are potentially substantial. As Stephen Roach, former chief economist for Morgan Stanley Asia and now a senior fellow at Yale University's Jackson Institute of Global Affairs, "It would be a devastating setback for China – a blow to the role it would play in shaping and driving the world economy." If nothing else it would raise questions over what type of political costs would be accrued by the Bridge and Road Initiative (BRI), especially by those countries that are geographically are close to China, like Myanmar, Laos and Cambodia.

The clock is ticking on Hong Kong's future. Hopefully cooler heads will prevail, but conditions are very polarized. We are hopeful that the tensions gradually subside, but risk is most likely to remain high through 2019 and a major disruption in Hong Kong will have global consequences.

Briefs

Argentina – No relief: In August, the ruling coalition of President Mauricio Macri suffered a major blow in a primary vote which was won by his Peronist opponent Alberto Fernandez (whose running mate is former president Cristina Fernández de Kirchner). Considering that Fernández had a major hand in parking Argentina into its current economic mess, investors massively pulled out of the South America's assets. The currency depreciated in one day by 15%, bond prices plunged and the local stock market lost 37% of its value (the largest drop in its history and according to the Financial Times, one of the biggest falls in any stock market in the past 70 years). The Macri government is implementing a new economic program, while seeking to negotiate with the IMF, which is due to approve the disbursement of the next tranche of its program of $5.4 billion by the end of September. The most recent development has been the resignation of finance minister Nicolás Dujovne and his replacement by Hernán Lacunza. We wish him luck. Considering the rise in political risk, advances on the economic front are going to be difficult, especially if the next government is one of the current opposition which has vowed to roll back many of the IMF-backed reforms.

Japan – Slower Exports: Exports from Japan slipped for an eighth consecutive months in July, down 1.6% year-on-year. Exports to Asia declined 8.3% year-on-year, with Singapore posting the largest drop, down 22.3%. Exports to China, Japan's largest trade partner, were also down by 9.3%. Tensions between Japan and South Korea probably did not help trade between the two countries, with the former's exports down to the latter by 6.9%. Needless to say, Japanese authorities are concerned by the export slowdown, especially as relations with South Korea remain tense, China represents a considerable amount of uncertainty, and Tokyo and Washington are seeking to reach a new trade accord (more to Washington's advantage).

Dominica – China and Education: China's charm campaign in the Caribbean has been in action for a number of years. While much of it has come in the form of building sports stadiums, roads and upgrading harbors and airports, another plank extended to winning hearts and minds has been through scholarships to study in China. In August, 12 students received scholarships, bring the number of Dominicans students who have received scholarships to study in China since the two countries established relations in 2004 to 150. Although a low-cost approach, providing young Dominicans with study in China potentially offers long-term dividends for both countries, especially as a time when access to the U.S. has become more limited.