

Chatting with Stevie: Trade Talk

Stevie was the neighborhood's precocious child who grew into a high school wiz-kid, then never stopped lapping the field until landing a job on a Wall Street bond desk. While probably not the brightest mind on Wall Street, Stevie may be the brightest one we know. We caught up recently.

Let's get right to it. I want to ask about what's going on in Washington, particularly the trade issue.
Stevie: You mean the trade war?

Is that what it is? Most people don't want to go there.

Semantics. Call it a spat or a tussle if you wish. We are engaged in battles on multiple fronts -- Mexico and Canada, Europe, and China. And it is not just talk. Tariffs are being imposed and our targets are firing back at us. This sounds like a trade war if ever there was one. Then again, as the Bard wrote, what's in a name...

Ah yes, poet, playwright and economic philosopher.

Anyway, this is real and is happening as we speak. It's no longer posturing or campaign rhetoric.

Okay, we agree on what to call it; tell me, what is the sense of it all?

I don't want to get too deep into Trump's brain, or condone his methods, but we can see where he is coming from. The US consistently runs large trade deficits, on the order of 600 billion dollars per year. Now in a 20 trillion-dollar economy, that amounts to roughly three percent of GDP -- gross domestic product. But it's not as if all Americans suffer equally. In fact, most of us benefit from lower cost goods and services imported from overseas. But certain industries are hurt, and the White House seems to view trade as a zero-sum game; if one side is winning, the other must be losing.

They never taught us this in college.

Right, the one thing almost all economists agree on is the benefit of trade for all parties, so long as the trade is fair. Think of it domestically, where regions of the US specialize in certain goods. Texas gives us cotton, Iowa grows corn, and Washington state provides lumber. None of the three could be as efficient in producing the other two commodities, so they specialize. Then a form of domestic trade takes place, where they all swap goods in exchange for dollars.

This is all domestic, neat and tidy. Everyone uses dollars and plays by the same rules.

Right, but the concept is easily expanded to international trade. Europe greases the wheels by using

a common currency, so they have one less problem in trade within Europe. Still, the overall concept of competitive advantage in global trade applies.

But not everyone plays by the rules, and low-cost labor is a big advantage to China and Mexico.

True. On the rules, the World Trade Organization is supposed to mediate complaints, it's all well organized and deliberative. Trump decided to side-step that process; it is too methodical for him, with disputes taking months and years to reach partial resolutions. As for cheap labor, this has always been the case in less-developed nations. They cannot offer much other than cheap labor, so that's what they provide. In exchange, we end up with lower-priced goods. Plus, as these nations grow, they can purchase our higher-valued products. New markets open up to us. It's a win-win game most of the time.

Then what's the problem?

A small faction in the Administration sees the playing field as tilted, and it ends up they are correct. China can easily send its goods to the US, or buy US companies, gaining assets and intellectual property they could not develop themselves. But they place heavy restrictions on US companies trying to do the same. Just recently China blocked a merger agreement between Qualcomm, a US technology company, and NXP Semiconductors, a Netherlands-based firm. China was the last holdout in approving the deal and the merger basically collapsed. Now it's fair to ask, in a merger of a US and Dutch company, what say does China have?

Another example, China is a huge auto market, the biggest in the world; but when US auto companies want to sell in China they need to establish a local partner; they can't simply enter on their own.

The big tech companies, Google and Facebook among them, face similar problems, including censorship and the threat of intellectual property theft. They can't just go in, offer their product to the masses, and compete with China's national interests. It goes on and on.

Okay, you've convinced me that China is a problem, but this trade war goes much further.

European auto makers -- think Germany -- can export their cars to the US and face a two percent tariff. When US auto makers try to send product to Europe, the tariff is 20 percent. In response, we protect our domestic auto companies by imposing a higher import tariff on light trucks. Ford, GM and Dodge make a fortune on their light trucks and SUVs, and it is a rigged market. It all stems from the original high tariffs in Europe, a protectionist mentality, which extends well beyond autos.

Better to blow it all up and start over?

That's what the trade hawks believe. It's a form of economic brinkmanship.

Most knowledgeable commentators say nobody wins a trade war. Isn't this a dangerous ploy by the hawks?

This one may be winnable.

You're beginning to scare me.

Here's why.

As I said earlier, the US trade deficit is roughly three percent of GDP. If we look solely at exports, the number is less than ten percent of GDP. Now, let's consider our major trading partners.

For Japan, exports account for 14 percent of GDP; in Europe it is 16 percent; China is at 19 percent; Canada is at 25 percent; Mexico is at 36 percent.

All higher than the US.

Right, most of them much higher. Trump sees this as other countries winning at our expense, which is a fallacy; but he also sees that they all have more to lose. Our economy is far more self-supportive, less trade-reliant. We grow our own food, build our own houses, develop our own medicines, build our own cars and aircraft, to say nothing of our military assets, and pretty much supply our own energy. We could make our own clothing and electronics; it would just cost a little more. We are playing a much stronger hand.

But it's not all upside for us. Plenty of US companies are upset at where this is going.

Understandably so. Their costs are rising and competitive positions in the global market are falling. We see the pushback in so many areas. Look at the effects of higher US tariffs on imported steel and aluminum. The auto companies are all facing rising costs. Now, we may just assume they can pass along these costs with price increases, but that is never easy. Some buyers will balk, meaning lower volumes. Harley Davidson is accelerating its move into global manufacturing -- outside the US. The company might manage its way around higher costs, but with fewer American workers. A nail manufacturer in Missouri is complaining it cannot compete when its cost of steel wire includes a 25 percent import tariff. So now it has an idle plant and laid-off workers. Beverage firms, packaged food and household product companies are all facing higher packaging costs, and must choose between price hikes or lower profit margins. All this is due to steel and aluminum tariffs we imposed on ourselves. And we have not even touched on Boeing, Caterpillar, Deere, washing machines, energy pipelines... the list goes on.

I want to step back for a moment, why not just let it be? Let the status quo continue? Our economy is strong; recent GDP growth was over four percent; unemployment is low. If it's not broken, don't fix it. Most everyone prefers that, except the people in charge. Let me take the other side, for argument's sake. We have a two-tiered economy, the well-off and everyone else. If we slice Americans' income into quintiles, the top quintile, the highest wage earners, are gaining all the added income. The upper middle class is losing out, the middle class, the lower middle class and the lower class are all losing. Their share of total income is dropping. That's 80 percent of wage earners in some way missing out, and we are talking about people with jobs, not a retiree, or someone on welfare. Now, this trend is nothing new, it has been ongoing for five decades, through expansions and recessions, Republican administrations and Democrat. And nobody has tried to fix it.

How does this fit in with trade?

Stay with me on this. We can cede the steel and aluminum business to China; and autos to Japan and Germany; and basic manufacturing to China and Mexico; and textiles and apparel to other Asian or Latin American nations. When we allow all these industries to leave the US, what are we left with?

A bunch of unhappy workers who vote for something new. That's what we got.

Okay, but we are left with a service economy and a shrinking middle class. Not everyone can make a fortune at trading stocks and bonds and real estate, at providing legal advice or accounting services. For every one of these successful service workers, there are a bunch of people waiting tables, flipping burgers, ringing up sales at a cash register; and these workers make far less money. Someone in America needs to build things, or the middle class gets gutted. It's already happening.

Look, you can go from just west of Philadelphia, straight across the nation until you hit coastal California, and almost all the counties in between voted for Trump. With few exceptions, they can all be described as middle America. These people suffered through the farm crisis of the '80s and the steel mills closing, and now they are feeling it in manufacturing. They need help.

You said you were taking the other side for argument's sake. How much of this do you believe?
Sorry if I make a strong argument.

And if the trade war is unsuccessful, how does that play out?

China refuses to flinch. Nobody likes to get bullied, and China's government has an image to protect. So China cuts trade deals with Europe and other parts of the world. This is already taking place. Then they weaken their currency to make their goods more attractive, a classic trade war/ currency war maneuver. This is also taking place. They ease banking conditions in one form or another, to make sure the financial system is supportive of their domestic economy. This too is occurring. Then they wait it out, still boasting the fastest growing large economy in the world. China grows a bit slower with a touch more inflation, and the world agrees it is America's fault. But this is unlikely.

Why so?

Because China needs us more than we need them, and both sides know it.

Then it all makes sense, the higher tariffs and the pissing-off our allies and risking that it all backfires?

A wise man said, "There are no natural allies, only mutual interests". This is where Trump is coming from... if I scratch your back and you never reciprocate, we are not allies.

It's not what I would choose to do, but it's not crazy. It has a fair chance of working, better than even odds. We might gain a partial victory and call a truce. If it really goes haywire, we will have a long trade war and a recession and a new President to put the pieces back together again. That's what elections are for.

They Said It

“I feel like the bottom has to fall out at some point, and by the way, I’m hoping for it. I think one way you get rid of Trump is a crashing economy. So please, bring on the recession. Sorry if that hurts people, but it’s either root for a recession or you lose your democracy.”

-- Almost-funny comedian and talk show host Bill Maher, revealing the fallout when Trump Derangement Syndrome collides with a booming economy.

“We are not going to make America great again. It was never that great.”

-- New York Governor Andrew Cuomo, displaying a severe case of Trump Derangement Syndrome, while committing hara-kiri on his long-shot presidential aspirations.

“Well, unemployment is low because everyone has two jobs. Unemployment is low because people are working 60, 70, 80 hours a week and can barely feed their kids.”

-- Alexandria Ocasio-Cortez, Democrat-Socialist Congressional candidate, trying to explain to ‘Firing Line’ host Margaret Hoover why capitalism is failing. Ms Ocasio-Cortez may have set a record for most misstatements -- four? -- in a ten second sound bite.

“In speaking with some of the world’s top business leaders I asked what it is that would make business (jobs) even better in the U.S. ‘Stop quarterly reporting & go to a six month system,’ said one. That would allow greater flexibility & save money. I have asked the SEC to study!”

-- President Trump in a recent tweet, floating a trial balloon on what may be the worst idea of his administration: changing public company reporting requirements from quarterly to semi-annually; a proposal that would lead to less market transparency, greater opportunity for insider trading, lower equity valuations; and supports the mistaken notion that US companies are so myopic as to neglect long-term investment in their businesses, at the peril of undermining their own futures.

Tidbits...

International Monetary Fund forecasts global growth of 3.9 percent this year and next, best consecutive years since 2010 and 2011; warns of trade war dangers.

US and Mexico agree on revised trade agreement to replace NAFTA pact.

OPEC and Russia agree to boost crude oil production by as much as one million barrels per day.

Energy Information Agency forecasts US will become world's largest crude oil producer in 2019, at 12 million barrels per day.

Cities' lawsuits against big oil companies, seeking to recover costs of global warming, are tossed out by courts in New York and California.

Far-fetched political grandstanding.

Disney wins bidding war for Fox film and cable TV assets, in major media consolidation move.

US Justice Department, having lost its suit to block AT&T purchase of Time Warner, files appeal.

Government plays sore loser.

Tesla, facing ever-growing cash crunch, asks suppliers for refund of prior payments.

Tesla chief executive Elon Musk suggests possible deal to go private in largest buyout in history, then slams brakes on proposal.

US regulators open investigation into Tesla over communication, market manipulation concerns.

Never a dull moment, but the buyout numbers simply do not work.

Venezuela devalues its currency, the Bolivar, by 95 percent.

International Monetary Fund projects inflation in Venezuela to reach one million percent this year.

Ontario, Canada plans to scrap basic-income program, calling it expensive and unsustainable.

Despite the repeated failures of socialism, people keep trying.

Beer consumption in US is surpassed by wine and spirits.

Canada's Molson Coors to market cannabis-infused beverages, as marijuana use becomes legal later this year.

Brookstone, mall-based retailer of massage chairs and novelty items, files bankruptcy, again.

Time to give up on this concept.

Turkey's economic struggles, spat with US, spark emerging market currency and equity sell-off.

US economy grows by 4.1 percent in second quarter, fastest pace since 2014.

US corporate profits approach record high, double levels of recession trough.

Youth unemployment in US drops to five-decade low as job market continues to strengthen.

US economy flexes its muscle.

Source:
Bloomberg
CNN.com
J.P. Morgan Asset Management
PBS.org
The Wall Street Journal