What trade-offs will the US accept for a trade deal with China?

Weekly Market Compass: Assessing the state of trade, and six events to watch this week

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Two key risks – trade and central bank normalization – have had an outsized impact on global stocks for more than a year (sometimes positive and sometimes negative). This past week saw developments in each of these key issues.

How close are we to a trade deal?

In my travels over the past week, the most common question I received is, "How will the US-China trade talks end?" Recent reports suggest that the US and China are very close to a trade deal. That should be a real positive for stocks globally, especially Chinese stocks. However, I would caution that stocks could go down just as easily if the talks don't culminate in a true agreement – and I believe that is still a very real possibility.

Just last week, US Trade Representative Robert Lighthizer poured cold water on President Donald Trump's suggestion that a trade deal was close to fruition, cautioning Congress that significant hurdles remain. The ability to reach a trade deal quickly will ultimately depend on what the US is willing to take in terms of concessions from China – if the US only wants a reduction in the trade deficit, I believe a fast deal is in the offing. However, if the Trump administration wants real change in terms of intellectual property protections and access to markets policies, then I believe that will take time.

It seems that Trump is eager for a deal and would be satisfied with a reduction in the trade deficit; however, Lighthizer has been clear that, in his interactions with the president, Trump wants much more in terms of structural reforms. As Lighthizer explained in testimony before Congress last week, Trump is very patient and has given him instructions suggesting he is willing to wait for real structural reforms: "His instructions to me are: You have to get a great agreement. If we have no agreement, we'll just wait until we get a great agreement," Lighthizer said.[1]

As I've said before, I don't expect China to agree to significant concessions such as major intellectual property protections. Doing so would set a dangerous precedent where other large economies might try to play "hardball" with China in order to win trade concessions. I also believe that China is less willing to capitulate now that we have started to see some improvement in Chinese economic data. For example, we saw a rise in the Caixin China General Manufacturing Purchasing Managers Index (PMI) reading for February, which indicates that the massive Chinese stimulus (both monetary and fiscal) begun months ago has started to have a positive impact. Having said all that, if we get an actual deal – which I believe would likely be a specific commitment from China with regard to trade deficit reduction as well as a vague commitment from China with regard to structural reforms – I would expect stocks globally to rise significantly.

The Fed touts its data-dependent approach

Last week also brought insights into the Federal Reserve (Fed) and its recent change of heart in terms of balance sheet normalization. In his semi-annual Humphrey-Hawkins testimony before Congress last week, Fed Chair Jay Powell gave some explanation for the Fed's recent pivot toward more dovishness: Not only is the fed funds rate currently in the range of neutral, but inflation is muted and significant downside risks are present.

Powell reiterated that the Fed will rely on a "data-dependent" approach to monetary policy, and that it will be patient as it assesses economic conditions and determines the need for adjustments in the future. Powell was also sure to extol the virtues of this data-dependent approach, explaining, "This common-sense risk-management approach has served the Committee well in the past."[2] In my view, this should be positive for the stock market – and business sentiment.

We also heard from Fed Vice Chair Richard Clarida last week, who spoke about the Fed's ongoing review of its monetary policy strategy. He added one more thing to worry about for the future – as if we need to add anything to our list. He suggested that there are negative consequences to the flattening of the Phillips Curve – that it could mean that, just as it took more monetary policy accommodation to increase inflation than what we've historically needed, it may take more Fed tightening to tamp down higher inflation when it appears. This is a valid concern for the future and deserves further exploration.

Six events to watch this week

Looking ahead, there are a number of important events and data releases to pay attention to in the coming week:

1. **The National People's Congress (NPC).** The NPC opens in China this week and will set the economic policy agenda for the year. There are a number of topics on the agenda, including tax cuts and structural reforms, so we will want to follow developments closely.
2. **EU-US trade talks.** European Union (EU) Trade Commissioner Cecilia Malmstrom will be meeting with US Trade Representative Robert Lighthizer in Washington, DC, this week. This is a continuation of talks they have been conducting since the EU and the US reached an agreement in July to work together to reduce tariffs. However, there is some concern that these talks may get more acrimonious in the wake of the Department of Commerce's Section 232 report. This report, which the department sent to the president in February, details the results of a probe into whether imported cars are a threat to national security. Trump had 90 days to decide whether to take action on the report's findings – including potentially enacting further tariffs.
3. **More Chinese economic data.** The Chinese Services PMI for February will be released this week. I expect this to show slight improvement (as we saw with manufacturing PMI last week), corroborating the improvement we saw last week in the Caixin Manufacturing PMI reading and further indicating that China's substantial fiscal and monetary stimulus may be starting to have a positive impact on the economy.
4. **European Central Bank (ECB) meeting.** The ECB will meet this week. This is important because the ECB will be updating its economic forecasts, which are likely to be downwardly revised. The ECB is also expected to leave rates untouched, but it might explore other forms of accommodation, such as a new long-term lending facility (TLTRO) in the face of slowing growth in the region.

5. **Bank of Canada meeting.** The Bank of Canada (BOC) meets this week and is expected to keep rates at current levels in the face of economic challenges – although BOC Governor Stephen Poloz did say recently that the central bank needs further rate increases to get to neutral. But the BOC is between a rock and a hard place, as Canadian household debt has increased significantly in the last decade, making it more vulnerable to rising rates – hence the work the Bank of Canada has been doing recently around vulnerabilities in a rising rate environment. Perhaps the most important outcome from this meeting will be guidance on future rate hikes.

6. **The US jobs report for February.** Given the Fed's data-dependent monetary policy, it is important for us to closely follow many economic data points to understand the current state of the US economy – the jobs report is certainly one of them. For example, the employment situation plays such an important role in consumer sentiment and spending. We will want to pay close attention to wage growth in particular, given it has increased recently – if it were to rise enough, it might force the Fed to become less accommodative.

Source

[1]The New York Times, "Trump trade adviser defends china deal before Congressional skeptics," Feb. 27, 2019

[2]The Wall Street Journal, "Fed chief Jerome Powell says US economy 'is in a good place,'" Feb. 28, 2019