The Aerial View
Markets Update

Tariff Talk: Some Considerations

• Conventional wisdom is that a “hot” trade war will lead to a more dovish Fed, but don’t discount the inflationary impact of broad tariff hikes in the US

• We view the likelihood of Chinese retaliation via wholesale dumping of USTs as unattractive and unlikely

• While a trade war creates a bias for a weaker CNY, it appears that Beijing is committed to managing the currency’s volatility

Now that it’s been a few days since the latest rupture in the US-China trade negotiations, let’s take a moment to consider a few key questions that are top of mind in markets.

Impact on inflation and rates

President Trump has suggested that the Federal Reserve pursue aggressive rate cuts (even at one point suggesting another round of quantitative easing) to offset the drag that a trade war would have on the US economy and match any Chinese domestic stimulus measures.

However, comments from a number of Fed speakers this week (both doves and hawks) revealed a very clear message: the key consideration driving the current policy stance is inflation, specifically a lack of it. The Fed has been consistent on this since January, identifying low and stable inflation as justification to hit the pause button.

On trade, the Fed has been similarly consistent that uncertainty surrounding trade
disputes (not just with China) has held back investment and a negative outcome on trade could indeed represent a material drag on growth. Presumably, this implies that the Fed would indeed react if growth were imperiled by an actual “hot” trade war.

We were early adopters of a dovish view regarding the Fed, going as far as to assert in our 2019 annual outlook that it would be more likely the market would be discussing rate cuts in Q2 2019 rather than estimating how many more rate hikes were in the cards. We think that current market pricing – nearly three 25 basis point rate cuts during through 2020 - is a bit aggressive, though, given current the state of fundamentals at the moment.

In addition to representing a drag on demand, tariffs also have an effect on the US inflation outlook. Quite simply, higher tariffs are absorbed (and paid) by the importing country. These higher costs are either subsumed by importers in the form of lower margins or – if they can be passed on to the consumer – they get reflected in higher final goods prices. In addition, local producers who compete with imported goods have room to raise their own prices, as they don’t face being undersold by foreign competitors.

On the other hand, all things being equal, higher tariffs raise the value of the home currency (the USD in this case) and weaken the exporter’s currency. This would suppress import prices (see charts attached), offsetting the tariffs to some degree. The overall effect on inflation (and therefore the Fed’s policy response) is indeterminate.

So far, the tariffs in place have had only a modest impact on inflation – leaving the Fed free to stay on hold for now; a broader set of tariffs might raise prices in the aggregate. The New York and San Francisco Federal Reserve Banks estimate that the 25% tariff proposed by the Administration would add 0.3% to 0.4% to overall CPI. If this were to happen, the question would be whether or not the Fed looks through this price increase as a one-off shock and therefore concentrate on a broader set of macro variables.

**Impact on Demand**

Of course, the other variable in the policymakers’ reaction function is growth, and tariffs would unambiguously represent a drag on demand. This threat has been one of the dominant reasons for the dovish pivots we have seen around the world in recent months.

As long as inflation has remained muted, the balance of risks to the global growth story has been negatively impacted by the risk around trade (and other political uncertainty), leading central banks to retreat from any hawkish biases they may have held going into the start of 2019.

As the attached charts show, global trade is slowing. In particular, APAC-based economies have seen a significant weakening in exports. The two protagonists in the trade dispute have also registered declining exports. This doesn’t even consider the consumption drag that tariffs would engender in each economy due to decreased business activity and lower real incomes (should inflation pick up). For example, we have observed increasing pressure on the agricultural community in the US thanks to retaliation from China already.
Will China’s retaliatory tool box include “dumping” of its substantial holdings of USTs?

Much has been made of the possibility that China would exact revenge on the US by selling some or all of its $1.2 trillion stock of USTs. While this might seem like a plausible threat, we view it as highly unlikely because the costs to China itself would be significant and the upside would be limited.

First, a fire sale of US government bonds would cause their prices to plummet, impacting the value of whatever bonds they would still hold. Furthermore, a UST selloff would probably spread to other sovereign bond markets, marking down the value of the entire portfolio of China’s reserves. Second, the US treasury market is the deepest and most liquid in the world; China would have a difficult time finding alternative assets to substitute their reserve holdings. Third, selling dollars (which is effectively what would happen if China liquidated its USTs) would strengthen the CNY, tightening policy and eroding competitiveness.

As it is, China’s holdings of USTs, both in the aggregate as well as a fraction of its total foreign reserves, have been slowly but steadily declining. It’s not clear that the global marketplace couldn’t absorb an increase in USTs in the secondary market.

Here again, we see the risks as minimal and maybe even fanciful.

Will CNY weaken further as trade tensions escalate?

CNY has weakened from 6.73 to 6.87 (approximately 2%) since President Trump tweeted out his tariff threat on Sunday May 5th. In the last few days it’s steadied, hovering around 6.87.

The currency response is not surprising, both as the trade spat pertains to China itself as well as to the broader global risk picture. However, we view calls to see the yuan approach 7.00 relatively quickly as exaggerated. As we wrote earlier, it’s likely that the CNY rate will be volatile, and the balance of risks are on the side of a weaker exchange rate. But the global impact on risk sentiment of a rapid devaluation would only serve to imperil China’s sputtering recovery.

As the charts attached show, there are already fundamental reasons to argue in favor of a weakening yuan. There is evidence that policy uncertainty is a negative for the currency, and China’s declining export growth (even without additional tariffs) goes hand in hand with steady devaluation.

But the behavior of the PBOC in recent days around the daily fixing for CNY suggests that the authorities will tightly manage the currency even if it is to go lower. One of the three inputs that official policy takes into account when setting the daily fix is a “Counter-Cyclical Adjustment Factor” (CCAF).

Although its determination is opaque, its purpose is to dampen short term volatility and “lean against the wind” so that a spate of CNY weakness doesn’t turn into a rout. In the charts attached we show an in-house daily estimate of the CCAF. In the past few days, it’s been quite negative; the PBOC is working hard to stem the currency’s decline.
To see the related charts to this note, please click here.

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