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USD/CNY – Caving to China Probably Won't Help Trump's Re-Election

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Key Points:

- **Markets are anticipating a US-China Trade Deal**
- **But there's a big difference between a Real Deal and a Deal In Name Only**
- **Markets seem overconfident that the markets themselves have broken Trump**
- **But Trump says he wants a Real Deal with structural change**
- **Caving in to China will not help Trump win re-election**
- **If Trump caves, it'll be obvious to his base**
- **Due to the Shutdown loss, Trump may even double down and get *tougher* on China**
- **China seems to be calling Trump's bluff and relying on the old playbook of buy, buy, buy! to appease Americans**
- **But the anti-China sentiment in the US has hardened and become bipartisan**
- **Verification could be, as with North Korea, the key stumbling block**
- **If a Real Deal does not emerge expect trade conflicts to re-emerge, until China 2025**

The Latest

Markets appear to be anticipating a Deal in US-China trade talks

Markets (especially equities) appear primed for some sort of a US-China trade Deal, maybe even by a 1 March 2019 deadline. If there should be a 60-day deferment/extension as Bloomberg earlier reported (meaning the new deadline becomes 1 May), then a Deal is still only a matter of time. There seem to us reasonably heavy positioning in anticipation of the above.

But there is a big difference between a Real Deal and a Deal In Name Only

We always respect markets, which are so often right. But this is one time when we are suspect of majority opinion. We have been especially curious re how markets will differentiate, if at all, between what US President Trump has called a Real Deal and what we have called a Deal In Name Only (DINO – not to be confused with the pet dinosaur in “The Flintstones”). Now DINO might happily yap up to you when you come home from work, but you don't necessarily want DINO to drive the family car. We think a DINO has been partially priced but when we analyze what has to go into a Real Deal (to be covered in a companion note), we find prospects for the latter much dimmer and hence are more reluctant to chase the Happy Talk.

There are market voices thinking we have already broken Trump

Perhaps a key instigator of our doubts is that some of us in markets seem to have designated ourselves as the prime mover and resolver of US-China trade tensions. There are voices – and we don't think isolated ones – almost declaring that the stock market has broken Donald Trump. That's because he wants to win re-election in 2020, so he cannot allow the Dow Jones Index to falter at all because of the US-China Trade War (call this the Trump Put to the Trump Trade War). In other words, **Trump will cave**: Simply crumple and within six months all that tariff talk and wars will be only an unpleasant memory.

“... so he has to cave”

Consider one [Yahoo!](#) columnist:

Trump doesn't want another down year for stocks in 2019, as he's ramping up his reelection campaign. So he has to cave on his trade war with China. He'll certainly

get something, such as a Chinese pledge to buy more U.S. exports, and better access to the Chinese market for U.S. firms. That's not nothing. It won't be the historic trade deal Trump will surely claim it is, but markets will celebrate anyway ... Trade experts say China will never agree to certain Trump demands, such as relinquishing control of huge state-owned companies able to throw their weight around in global markets. Nor will China give up pursuit of global dominance in key industries of the future.

“... an unforgivable, decades-old neglect”

Or another [CNBC](#) blogger:

Beijing correctly believes that Trump, gearing up for a re-election run, will jump on such a deal, partly because Wall Street would love it — even though that would perpetuate an unforgivable, decades-old neglect of nearly one-third of the U.S. economy (the sum of exports and imports as a share of American GDP). The bottom line: The deal appears to be done. China will continue to run large trade surpluses with the U.S., and it will never accept Washington-imposed reforms of its trade and industry.

Except Trump himself said he wants a Real Deal with structural changes

There's only one problem with all this, what Trump himself has [said](#):

*President Donald Trump in his State of the Union address said a trade deal with China will have to address not only what he called the chronic U.S. trade deficit but also changes in Chinese policies to protect American workers and businesses – “... **it must include real, structural change to end unfair trade practices, reduce our chronic trade deficit, and protect American jobs.**” (Our emphasis.)*

He later told journalists at the White House he wanted “a real deal, not just a deal that looks cosmetically good for a year.” (*The New York Times*)

The Question

But does caving help Trump win re-election?

We will lay out in a companion note what elements of a Real Deal might look like, based on publicly available reporting. But in this note we focus on only one question: **Will it help US President Trump to win re-election in 2020 if he were to cave to China in ongoing US-China trade negotiations?**

Parts of Markets Think Yes

We earlier alerted clients Trump's Trade War will hurt global and US economies and not achieve his objectives

As shown above, parts of markets think the answer is yes. We agree, but only to this extent: In previous notes, we laid out expectations for the Trump Trade War to [chip](#) away at global prosperity; to also hurt the US economy; and, to boot, to [not](#) achieve Trump's most desired trade policy objective of reducing US bilateral trade deficits. We have also told clients we think economic effects of the Trade War will be far more obvious in 2019 than 2018.

So we would be happy if he called off the Trade War

Personally, we are convinced free traders, so if President Trump were to wake up one day and decide to abandon his Trade War, we would rejoice and think it better for the US and global economies, for China and for Asia as well. But we're not in charge of US trade policy. We also don't, unfortunately, think that's what Trump will do.

We Hold a Contrarian View

But we're not Trump, and our primary (pun intended) judgment is caving to China will hurt Trump with his base

Our primary judgment is that caving in to China will hurt Trump with his base. At present, we think Trump is still using the Steve Bannon playbook of 2016 (*How to Win Elections and Become President* – note: this is a made-up title), reasoning that only by going through his base will he have a realistic chance of winning re-election in 2020. That is one key reason behind Trump's continuous campaign rallies since Inauguration (even though he won) – which is to continuously energize his base.

Far from weakening, Trump losses lead to doubling down, as it did after the Shutdown

While some might want to believe because Trump lost – and lost badly – on the Shutdown battle, defeat would weaken his resolve. Though we are not (as we'd written before) the Trump Whisperer, everything we have read so far on this President (and we've probably read more US politics – not our job – in the past two years than the previous 10 combined) shows his dogged commitment to always fight back, always double down, a strategy he reportedly learned from his one-time lawyer Roy Cohn. We can't guarantee this is the way he will act but we have now seen him declare a national emergency after losing the Shutdown battle. He is doing this, again, primarily to engage his base, some of whom had criticized him for the Shutdown compromise, even should his action throw up constitutionality questions that may have to go all the way up to the US Supreme Court. That's the extent to which he will go to engage his base.

If Trump caves and adopts DINO, it will be obvious to his base

So suppose Trump caves and gives in to China (as the Yahoo! blogger above suggested), the extent of his cave will be obvious to all observers including his base, similar to the defeat on the Shutdown (remember parties to the US-China trade talks have already agreed to put all final agreements into a transparent Memorandum of Understanding which can be studied). Consider one commentary on [Fox News](#):

*But nothing reported so far in the framework that could be headed to Trump's desk indicates the Chinese government has decided to straighten up and fly right. **It would be better to hit Beijing with higher tariffs and wait for them to come to us with a better deal in a second Trump term; a distinct possibility since China needs trade with America far more than we need it with them. There are six billion other people on the planet with whom we can trade, and our domestic economy is booming while China's is stumbling. Furthermore, as we have learned the hard way with China's ally, North Korea, improvements in conduct must be demonstrated before sanctions and tariff relief, not after, when they are unlikely ever to occur. That's just the way it works with communists.*** (Our emphasis.)

Losing on the Shutdown may mean Trump becomes *tougher* on China

Having lost on the Shutdown, our initial guess is that far from weakening his resolve in US-China trade negotiations, Trump's defeat will lead him to double down and try to become even *tougher* with China, to show his base and the world he remains the tough negotiator for whom he wants to be remembered. Having lost on the Shutdown, if Trump further caves he will look even worse to his base, some of whom already regard the Shutdown Deal as a treacherous betrayal. To put it most succinctly: **Donald Trump has no chance of re-election if he becomes Jeb Bush.**

How Trump behaves in US-China negotiations affects all other negotiations (North Korea, European autos, etc.)

Reputation is a critical element of strategy in non-cooperative games, and Trump has to think about how his caving in to China might affect the other hands he's playing. Though most important, China is not even the only trade hand Trump is playing (European autos, Japan and the USMCA all come to mind). In addition, North Korea has and continues to be intimately tied to the fate of US-China trade talks. Because this President insists on being at the center of each decision, it means how Trump behaves in each negotiation affects all the other negotiations, and *vice versa*.

China Seems to Be Calling Trump's Bluff

One party to whom Trump might have appeared a half-beaten man could be China

One party to whom Trump might have appeared a half-beaten man could be China. Recent articles on negotiations featured past US interlocutors – such as Blackstone Chairman Schwarzman and former US Treasury Secretary Paulson – *pleading* (our emphasis) to China to give Trump something on which he can then declare a victory so both sides can find a way out of the trade imbroglio. But the underlying premise is China probably hadn't really offered anything of substance to the US side; US Trade Representative Lighthizer said as much in internal briefings to US legislators before leaving for Beijing in January.

China's non-offers could be taken as some expectation for Trump to fold

Early in the US-China Trade War, we had complained the US side seemed quite diffuse and non-specific on its asks when it came to complicated IPR issues. Though US officials sometimes denied that, early on this could have been true. But at this stage, the American side seems to have distilled their demands into specific issues that could be discussed further (reportedly, 142 specific issues). So it was amazing to us that when Vice Premier Liu and his delegation traveled to Washington, DC at the end of January, credible reports suggested Liu came with few specific offers, some four weeks before Trump's delayed deadline of 1 March 2019, when he may escalate tariffs from 10% to 25% on USD200bn of imports from China. Normally trade negotiations would have led to fairly detailed policy documents four weeks before a deadline, to be lobbed and parried back and forth in final horse trading. We had been trying to ask diplomats about the stage of completion of such documents and now we know why we never got very good answers.

China seemed to be calling Trump's bluff

So China, it seemed to us, was calling Trump's bluff. It seemed to be making an implicit assessment that the Trump of 2019 will not be the Trump of 2018, too weakened to live with the consequences of escalating tariffs from 10% to 25%. Flipping through the *China Daily*, China's English-language megaphone to the rest of the world (and maybe to the USA most of all at this stage), the front-page article that greeted American negotiators as they arrived in Beijing in February said:

- China is likely to propose "weightier" measures this week
- But the US should really cooperate with China
- The US should not regard China as a threat
- And the US should allow China to gradually reform (implicitly a plea for time)

What do these statements mean?

Beats us. They could have come out of policy documents from 2009, not 2019.

Those who expect a Real Deal have to believe the Chinese are only now offering real deals

Those looking for a Real Deal by the 1 March deadline will have to believe that the Chinese have now offered serious structural concessions in the final two weeks of February.

Verification

Verification will be the key litmus test on whether the US and China can achieve a Real Deal

If someone had told us two years ago we would be tracking US-China trade negotiations in a similar fashion to how we analyze North Korea, we might have thought them crazy. But parallels are, by now, way too obvious to ignore. As we argued with North Korea, we think **verification** will be the key litmus test for whether the US and Trump, to use his words, can achieve a Real Deal with China, or only a Deal In Name Only (DINO). It's clear USTR Lighthizer thinks a Deal with no or weak verification is not a Deal worth signing. China, to no surprise, reportedly is unwilling to do this, which explains why it has been slow-dancing its actual offers on even a framework. Because once you put down something specific in writing, you are going to need to agree on how to measure progress. Once you agree on how to measure progress, you need a verification mechanism.

China is setting a very obvious example for North Korea

Watching China negotiate (or maybe more accurate, not negotiate) has also on occasion made us wonder why Trump thinks China can help North Korea make better commitments if it itself is not willing to do so?

More Time Is Not Necessarily the Answer

At least things won't get worse, right?

North Korea is also the riposte to perhaps another view in the markets: Well, at least they're talking, so at least things won't get any worse, right?

USD200bn x Six More Years =
USD1.2trn, the Art of Appeasing
Donald Trump

Consider that this year is the 25th anniversary of the Deal former US President Clinton signed with Kim Jong Un's grandfather. We were living in Hong Kong then, watching live CNN footage (one of the lead diplomats in crafting that deal was also in town this week). Donald Trump's time horizon probably stretches out six years (surprise). We have some doubts whether he'll be satisfied with a future US President taking credit for work which he will view as rightfully belonging to him. When the current trade truce began, we noticed the Chinese were offering to buy USD1.2trn of American goods in the future. We wondered, why such a specific number, part of what Trump hopes will be the biggest trade deal ever (eclipsing last year's USMCA, which had been the Trumped up biggest trade deal ever)? Then we remembered Trump had wanted to slice USD200bn off of the bilateral US trade deficit with China. USD200bn x six years = USD1.2trn.

DINO Is Not Necessarily a Winner for China

DINO is not necessarily a winner for
China, either, unless it wants to be
confronted over and over again with
the same issues

But DINO is not necessarily a winner for China, either. The IPR issues underlying the Section 301 investigations are serious. You can take them as symptoms of a larger geopolitical struggle but we don't have to be so fancy – they're serious issues in and of themselves. The Chinese are said to be worried that more time = more demands from the Americans, and they are right to be. If there isn't a good Deal that emerges from this process, the Chinese can expect to be confronted on the very same issues over and over and over again, all the way out to China 2025. And this won't have anything to do with Trump, especially after his time is over.

The Old Hymnbook

China is still using its old playbook with
the US

China's playbook with the US really appears to be the same playbook it had deployed, eg, in 2005, when it de-pegged its currency as a "gift" to George W. Bush before the Hu Jintao Summit. For American companies increasingly competing with China, they may want to weigh the benefits of that currency loosening against the gripes they have today. But here we are, in 2019, and USD/CNY is falling again.

"Hank, you're a real patriot. Why are
you helping China?"

Even though Trump has been in place for more than two years, our assessment is that top Chinese leadership, even now, do not understand fully (or chooses to ignore) just how bipartisan the anti-China sentiment has become within the US. Paulson's book (*Dealing with China*) came out in 2015 in which he reports an encounter he had in Boston with a group of sophisticated money managers where he was asked, "Hank, you're a real patriot. Why are you helping China?"

*The question pulled me up short. Three years before, when I first began planning to write this book, I don't think I would have been asked anything like that at a meeting of sophisticated financiers. They would have accepted that helping China to reform its economy, open its markets, protect its environment, and improve the quality of life of its people—all things I have been working on—would bring economic and strategic benefits to the U.S. as well. But that viewpoint has been changing as China has emerged as our biggest, most formidable economic competitor since the end of World War II and has started flexing its newfound military muscle in unsettling ways. As a result, many Americans, Americans, from all walks of life, have begun to view China with growing apprehension and resentment. Some would now prefer confrontation to cooperation. (Paulson, *Dealing with China*, p378)*

American attitudes towards China have
hardened since the time of Paulson's
anecdote

It's now four years since the time of this anecdote and American attitudes towards China have hardened further, not softened. This is something we began to sniff out in the mid- to late 1990s, and which has progressively grown to what it is today. If the Chinese are hoping to out-wait Trump, they will probably find even less sympathetic shoulders to cry on were a Democrat President to replace Trump. Regardless of party, China will find cold shoulders around Washington with China's traditional business friends (like us) pulling far less weight than before. This week we attended

a talk by three former US Ambassadors – we would describe them as key architects of the sort of approach to China which Paulson described – and even they are sounding cautious about US outreach to China. It's a new day.

But the Chinese are still offering buy, buy, buy!

One evidence of Chinese misunderstanding (or choosing to misunderstand) is the old reliance on buy, buy, buy! as a way to appease Americans. It is true that Trump, unique among all modern American Presidents, seems particularly fixated on bilateral trade deficits (*Asia Cross Current: Ctrl-Alt-Right, The Limitations of Donald Trump in Asia*, 8 December 2016), but he had already rejected a buy-US deal worked out between US Commerce Secretary Ross and Liu He in May 2018. That hasn't stopped China from continuing to dangle prospects of greater Chinese buys of US agriculture, energy and services as its *primary* means of assuaging the Americans.

So Consider This a Caution

So consider this a warning against over-optimism. There remains scope for disappointment

So consider this a warning against over-optimism. Despite the theatrics, the issues underlying the present US-China trade dispute are serious. They are also very hard to resolve, either by a 1 March or a 1 May deadline. There remains scope for disappointment in asset markets.

One Final Anecdote

"Can't we just donate some money to the school?"

But we wouldn't resist closing out with the following delicious anecdote, told to us by an old China business friend. At the firm where our friend works in China, many senior Chinese executives come to him – because he'd spent time abroad – for help whenever they are trying to get their children into one of the good international schools in the city where they live: To make introductions, set up appointments, etc. He says, however, that invariably when they initially sit down to discuss strategy – invariably! – the first thing his Chinese colleagues ask is, "**Can't we just donate some money to the school?**"

He says Chinese leaders have exactly the same instincts when it comes to the United States.

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