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CNY – The Limitations of Donald Trump in China, Part 1

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Key Points:

- **The US-China trade battle has begun**
- **Trump has an election to win in Pennsylvania, but there could be 35 more months of protectionism**
- **And we haven't even discussed Section 301**
- **Stocks reacted as expected but the news may have been leaked**
- **Very clear steel/aluminum won't solve US bilateral trade deficits**
- **Higher prices, lower volumes = bad for growth (and AUD, BRL)**
- **In key sectors, China growth (Vietnam, too) will be crimped**
- **More voices against de-leveraging and restructuring, and maybe higher USD/CNY, too**
- **Canada and Europe should retaliate first, ahead of China**
- **Chinese retaliation may be in agriculture**
- **Trump is still trying to go Back to the Future**

What Happened?

The US-China trade battle has begun

If the past year had been one of moving chess pieces onto a chessboard and [January tariffs](#) on solar panels and washing machines were P-K4 (pawn to king's four, using old chess notation), US President Trump's overnight pre-announcement of a 25% tariff on imported steel and a 10% one on imported aluminum (formal order to be signed next week) was the equivalent of a slashing gambit attack right from the start.¹ (There may be others who view last night as the equivalent of Germany invading Poland; more on that below.)

It's the Base, Stupid

Trump jumped the gun because he has an election he wants to win in the former steel state of Pennsylvania

For a President whose personal style doesn't seem well-suited for half-measures, Trump chose the most aggressive line of attack under the Section 232 recommendations he received (item #1 in [Asia Cross Current: Don't Bring Higher Interest Rates to a Trade Fight](#), 12 January 2018), in what was for him not only about keeping campaign promises but preserving his political base. Trump officially faced 11 and 19 April deadlines for steel and aluminum, respectively, but there is a special US House of Representatives by-election on 13 March in Pennsylvania, once bedrock for the US steel industry (think Pittsburgh) and the "P" in our *FONP* states we said Trump must win if he was to win the 2016 elections (in the event, he won *all* four states: Florida, Ohio, North Carolina and Pennsylvania). The midterm US elections this year (6 November 2018) is widely seen as a general referendum on Trump and his controversial Presidency.

Buckle in, folks

At least 35 more months of protectionism

Perhaps what really drew our attention, though – more than mere fact of tariffs and which seemed less emphasized in reporting² - were Trump's promise to US steel and aluminum industry leaders that their new protections would last **"for a long period of time."** That seemed to suggest protectionism would be a defining feature of Trump's

¹ When we Googled what are considered the most aggressive chess opening attacks today, the list came back with names like King's Gambit and Fried Liver Attack; no Cheeseburger Attack in the list, however.

² We have drawn on, and use liberally, reporting from: *The Wall Street Journal*; Bloomberg; Reuters; the *South China Morning Post*; the *Washington Post*; and the *Financial Times*.

entire first term (another 35 months) with possibly a second term as well if he wins re-election (which he has intended since Day 1, when he registered his re-election organization as the *very first* act of his new Administration).

And We Still Have Section 301 to Go

And we haven't even discussed Section 301 yet

The Section 232 penalties are *product tariffs*, in this case on steel and aluminum. We have yet to reach a conclusion on the Section 301 investigation (item #3 in our earlier [ACC](#)). That's an investigation completely focused on China and China alone. It is the reason Liu He, Chinese President Xi Jinping's economic righthand man, is in Washington, DC right now to try to forestall what may be the inevitable (following an earlier visit by State Councillor Yang Jiechi, a longtime interlocutor for China with the United States, which seemed to have produced no results). The US threat in Section 301 is to produce a set of tariffs and other trade protective measures directed at China alone.

Market Reactions

Market reactions suggest maybe the news was leaked

At one point, the US Dow Jones Index dropped 500 points on Trump's pre-announcement and closed to once again show -ve YTD, but it's probably more instructive to look at a group of affected company stock prices.

HOW COMPANY STOCK PRICES REACTED TO THE TRUMP TARIFFS

Stock Price	1-Day Impact	From Week Peak
US Steel	5.7%	3.7%
Nucor	3.3%	-0.5%
AK Steel	9.5%	0.0%
Alcoa	0.2%	-3.4%
NSSM	-3.6%	-8.7%
JFE	1.1%	-4.7%
Posco	-2.6%	-7.0%
Baosteel	-3.3%	-8.6%
Hesteel	-2.5%	-4.0%
BlueScope	-0.2%	-0.2%
GM	-4.0%	-9.0%
Ford	-3.6%	-5.5%

Source: Bloomberg, MUFG Bank

There is a strong suggestion in these stock price movements that the Trump Administration, advertently or inadvertently, tipped its protectionist hand ahead of time; valuations were already sliding for some even before the pre-announcement. While US steelmakers (US Steel, Nucor – whose former Chairman was a part of Trump's trade advisory team during his campaign, AK Steel, etc.) largely reacted on Thursday, the day of the pre-announcement, in Asia except for Australia there were hints industry steelmakers (the targets of new steel tariffs) had a strong inkling what was coming down the pike, as the 1-day stock price decline trailed the decline from this week's peak (eg, see both NSSM in Japan and Baosteel in China). There is also the same hint in the performance of US automakers, comparing their 1-day move to the decline from this week's peak.

The Numbers

US IMPORTS OF STEEL AND ALUMINUM VS. BILATERAL TRADE BALANCE

USD million, 12-month sum	Iron and Steel Product Imports	Aluminum Imports	Trade Balance
United States	-\$38,824	-\$18,494	-\$796,149
Canada	-\$5,688	-\$7,092	-\$17,312
Japan	-\$1,918	-\$298	-\$68,848
South Korea	-\$3,205	-\$117	-\$22,887
China	-\$2,078	-\$1,906	-\$375,228
Vietnam	NA	NA	-\$38,320
Australia	NA	NA	\$14,550
Brazil	-\$3,172	-\$336	\$7,650

Source: CEIC, MUFG Bank

Steel/aluminum by themselves won't eliminate bilateral trade deficits

We now summarize the issues using US Census data (the only ones Trump will look at). One point should be immediately obvious from the table above. Steel/aluminum trade can hardly ameliorate the overall problem of the US trade deficit, which for goods last year was nearly USD800bn. This is most obvious in the case of China, which if *all* steel and aluminum imports were eliminated could make up only 1.06% of the total US-China bilateral deficit in 2017 (using US data).

Discussion

Though limited, the tariffs are bad for growth: Higher prices, lower volumes

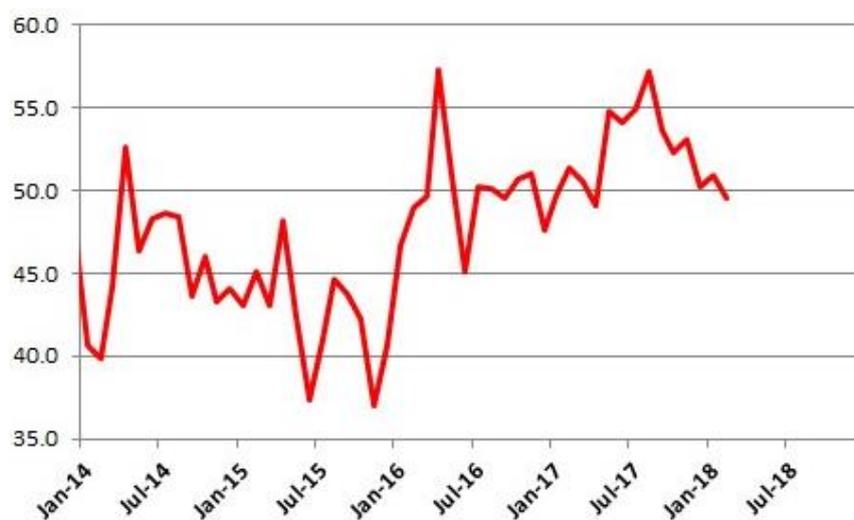
Bad for growth. With these tariffs, the United States under President Trump is now a more closed market for steel and aluminum (despite potential exceptions). For an economist, this seems to us one of those times to put up or shut up. Either we know something about the advantages of comparative advantage dating from Ricardo, or we don't. We don't believe in pulling punches here: **Even in two limited sectors, Trump's actions are bad for overall growth.** The natural expectation is *higher* steel/aluminum prices in the US but *lower* steel/aluminum volumes in the world. The latter should bother AUD and BRL.

In key sectors, China growth will be crimped; it may be more serious for Vietnam

China growth in key sectors will be crimped; Vietnam, too. As the world adjusts to these new US tariffs (a transition period that we guess could last up to two years), Chinese growth in key sectors will be crimped. China makes steel, and not only in China. Though China is now a small direct exporter of steel to the US (that's less true for the more expensive aluminum sector), that's only because of its shift of production to places like Vietnam.³ Production shifting was a very big issue in solar panel production, one of the two targets of the last Trump trade action, and we imagine it was part of the reason Trump elected to impose a general product tariff in steel rather than carve out exceptions for any country.

³ If China's growth is crimped, smaller economies like Vietnam where production has shifted may be affected even more.

CHINA STEEL PMI



Source: Bloomberg, MUFG Bank

Slower China growth will raise hurdles against de-leveraging, debt restructuring and may raise USD/CNY

An argument against de-leveraging, restructuring and maybe for higher USD/CNY. This is awkward for China because economic recovery there since later 2016 has importantly depended on smokestack industries reviving, which we have emphasized in our writings for a year. Eg, though there are expectations for China's steel production to revive from this month (after some pollution controls are lifted), if there are fewer open markets globally it will be that much harder for China to manage overcapacity. A growth hit, even of 0.1 or 0.2ppt, will increase the domestic voices arguing against de-leveraging, and also make it harder to restructure debt.⁴ It will be important, as we had stressed in the [March 2018 Foreign Exchange Outlook](#), to monitor China's trade flows as Trump protectionism kicks in. Growth concerns may lead FX traders to be more reluctant to keep pushing USD/CNY down. And as we said in the *FXO*, if a stronger bilateral currency failed to work for China as a pre-negotiation tactic, maybe there's no point for it to stay there.

Retaliation is the Main Game

We never tire of saying this: Retaliation is what turns trade disputes into trade wars

We will repeat what we have said [repeatedly](#) since the prospect of Trump taking power arose: **Retaliation is what turns trade disputes into trade wars.** This morning the chyron on CNBC in Asia was labeled, "Trade War." This is the scenario of taking last night's events as the equivalent of Germany invading Poland.

Canada and Europe Will Retaliate Soon, Faster than China

On that front, expect Canada and Europe to retaliate soon, before China

It is very likely we will see both Canada and Europe retaliate soon, *before* China. In our December 2016 [note](#), we pointed out that European reaction might be even more important than China's.⁵ To quote European Commission President Juncker:

We strongly regret this step, which appears to represent a blatant intervention to protect US domestic industry and not to be based on any national security justification. The EU has been a close security ally of the US for decades. We will not sit idly while our industry is hit with unfair measures that put thousands of European jobs at risk.

⁴ In fact, if China was forward-looking, it may be even more urgent now to tackle debt restructuring. Whether that happens is uncertain.

⁵ Canadian retaliation will throw more question marks on the NAFTA re-negotiation. Destroying NAFTA, as we said in [December 2016](#), is the really big monkey wrench that could cause global growth prospects to tank (destroying stock markets in the process).

Not that Canada was any kinder [Foreign Minister Chrystia Freeland]:

It is entirely inappropriate to view any trade with Canada as a national security threat to the United States. Should restrictions be imposed on Canadian steel and aluminium products, Canada will take responsive measures to defend its trade interests and workers.

China's Initial Retaliation May Go Through Iowa

China's initial retaliation is likely to be in agriculture

For China, the most immediate path to retaliation is probably sorghum, an animal feed supplied by the US which China has already placed under trade investigation. It's about a USD1bn annual trade so (see table above) in the neighborhood of what the US has done so far. Next up could be soybeans, which is a USD14bn trade. Note the current US Ambassador to China was the former governor of the agricultural state of Iowa, not by coincidence. It's also not a coincidence President Xi Jinping spent a year of his youth in exchange in Iowa, and knows this former Governor; nor that this former Governor was Trump's campaign chairman in Iowa (which Trump won). If Liu He fails this week as Yang Jiechi was seen as doing, it's possible an even heavier hitter like Wang Qishan might be dispatched; Wang was the US point man for China during the Global Financial Crisis (when, eg, the US was keen to assure China the value of its US Treasury holdings were, uh, SAFE).

New Wine for New Wineskins

The US dog no longer responds to the same China dog whistles

Longtime US China scholar Nick Lardy of the Brookings Institutions listed some details in which China might be offering concessions – lower tariffs on consumer goods and higher foreign ownership caps on asset management companies and the like - but as discussed in our March *FXO* these old crumbs (including lower USD/CNY) don't seem to add up to a whole cake anymore.

If Trump launches China tariffs under Section 301, it is likely China *will* retaliate more seriously, perhaps in soybeans and against US corporates in China.

Make America Weaker Again

Trump moves may hinder US companies in Third Markets and new product areas

Just as Trump fires his first serious trade cannon, 11 other countries that had agreed to the Trans Pacific Partnership (TPP) till Trump scuttled TPP will sign next week a watered-down (but still large) alternative, without the US. In many ways, this is probably our greatest concern from the point of view of the US: That Trump Protectionism will hurt the competitiveness of US companies in Third Markets and new product areas, and in this way Make America Weaker Again.

Epilogue

Slouching towards Bethlehem Steel

Growing up we had a school chum whose father was an executive at the now-defunct Bethlehem Steel and who once lived in Bethlehem, Pennsylvania himself. 10 years after high school, we drove through Bethlehem on our way to Canada. The steel industry then was nearly dead, and thoughts of our old friend kept coming up. That was 30 years ago.

Trump told reporters yesterday, *"We're going to build our steel industry back and we're going to build our [aluminum] industry back."* We will see.

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