Return of the tariffs

No not China, at least not yet anyway, but Brazil, Argentina, and possibly France, Austria, Italy and Turkey. Markets are behaving in text-book fashion. Bond yields down, equities down, USD-Asia (in particular KRW) moving higher.

Source: Shutterstock

Trade, trade, trade

It took about 5 seconds this morning, maybe ten, to register that today's note was basically going to write itself. The home page of my go-to newspaper, the Financial Times, runs with:

- Trump to hit Brazil and Argentina with metals tariffs
- US threatens EU with new tariffs in Airbus-Boeing battle
- Beijing retaliated against Trump's signing off of Hong Kong act
- US manufacturing contraction worsens in November
- And Fed considers letting inflation run above target.

The first four are clearly part of the same overarching story - the Trade war. And it's not just the US and China. President Trump is taking the controversial decision to sanction Argentina and Brazil, two countries whose currency weakness stems from economic weakness, possibly a fair bit of mismanagement, with tariffs. Bloomberg adds a story that France and a handful of other

European countries plus Turkey may get tariffed for imposing a digital services tax. This tax would predominantly hit US companies in the FAANG group. And then there are threats of new US tariffs on Europe's Airbus.

The third bulleted story talks about the Human rights groups that China will sanction in retaliation for President Trump signing the HK bill. In my view, this was a very, very restrained retaliation, and while it may anger the US, and complicate any phase one deal, it does not totally rule it out. In tennis, this would be "15-all", and all to play for still.

But in total, the US' show of force on tariffs is as much a message to China as it is to the countries which are affected. It says, "tariffs are still a weapon we can use if you don't sign a deal".

However, the fourth story about manufacturing contraction stems of course from the effects of the trade war, and ties in possibly with why we still have not yet seen an agreement on the phase one deal. China knows that the additional tariffs scheduled for imposition on December 15 will do proportionately more harm to the US than to China. They may also believe, as a result, that the US would like, if it could, to find a way to avoid or defer them. China also has had some better economic news of its own: See this FT story for more: (I even get a small quote in that one). That gives it a stronger hand to play, and of course, data corroborating a US manufacturing slowdown (not backed up by the MarkIt PMI numbers I should add for balance), lends that view further weight.

And the verdict is....

In a late-night chat with my colleagues last night, we discussed these various developments, some of which were already hitting newswires. Our considered opinion was that the chances of a December trade deal were diminishing. In fact, you could probably re-write that statement omitting the word: "December".

Failure to get a deal, will, we are told by the US President, result in much worse tariffs on China. Though I'm not sure this seems as credible a threat now that the damage to the US economy is looking more obvious. Moreover, President Trump is right, the PBoC can turn on looser policy to offset the tariff damage in a way that the US Fed would find hard to emulate. And this takes me onto the last bulleted story. Can the Fed indeed let the economy run a little hot?

In your dreams!

I laid into this "a little hot" proposition last week when it was being touted by Lael Brainard. The latest version of it has Eric Rosengren mulling whether the Fed ought to target 2% inflation "on average" and not as a spot target.

The right answer is, of course, they should. Monetary policy, if based on an inflation target, should be symmetrical. So a prolonged undershooting of the target is no better than prolonged overshooting.

But this idea of letting the economy and inflation run a little hot is, in my opinion, utter nonsense, maybe worse.

The only time in which the Fed has overachieved its 2% PCE target (I'm going to focus on core PCE, as it is a more reliable gauge of underlying inflation, though the Fed's target is, of course, the headline rate), was in 2004-2008. It is probably no coincidence that this immediately preceded the global financial crisis. M2 money supply growth picked up during this period, but it is M3 that we really would want to look at - though this stopped being compiled in 2006 - funny that!

Right now, probably only the US President would argue that the Fed was running policy too tight and that this was the cause of the lack of inflation. The labour market is exceptionally tight, yet still, wages will not grow faster. Would still looser monetary policy achieve faster growth and push up prices and wages? The overwhelming evidence suggests, no, it would not. So even if they wanted to, I doubt the Fed, or the ECB, or the BoJ, or any of the central banks that have practised unorthodox monetary policy, could manage to consistently push inflation above 2%. If they could, they would have done it by now, with all the trillions of dollars, euros. yen, pounds and kronor printed and pumped into the financial system. Attempting such a feat would only push up financial and real asset prices further, raising the odds of the next financial crisis. Such ideas not only lack credibility and would utterly fail to achieve their objectives but in my opinion, could be very damaging to the economy.

RBA - easy now

One central bank that is so far resisting the lure of unorthodox monetary policy (UMP), is the Reserve Bank of Australia. They meet today at 1130 Singapore/HK time, and we tend to agree with the consensus that they will resist the temptation to cut rates. However, their ability to keep holding off will need the run of data to improve.

This week, we get 3Q19 GDP data. Though even if that exceeds the consensus 0.5%QoQ/1.6%YoY outcome, will still probably leave annual growth sub-2%, and in that insipid - "B+ could do better" range that will have market pundits crying out for more easing. The RBA's calls for some supporting fiscal policy seem to be falling on deaf ears, with the government apparently intent on returning the budget to surplus.

I think the market view could change on one single labour market number, and these are fickle figures, so a big win after the last big miss is not to be ruled out. But a further downside miss would probably tip the balance in favour of a February 2020 cut. If so, we probably wouldn't stop at one cut. But two would take policy rates to only 0.25%, and the next stop for the RBA would indeed be QE. I don't think they want to go there, but the data may provide them with little choice.

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