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Trump's trade bluff?

President Trump in March proposed tariffs on an estimated $50 billion in imports from China, weeks after slapping tariffs on aluminum and steel. In April, China retaliated by imposing tariffs on U.S. imports. While there is low probability the tariff dispute between the United States and China will erupt into a full-scale trade war, the markets are struggling to grasp the implications of the measures. We think the world's two largest economies will resolve differences through negotiations, but the process could drag on.

The Federal Reserve Bank of New York named John Williams, who has helmed the San Francisco Fed since 2011, as its next president. Assuming one of the top leadership positions at the U.S. central bank, Williams brings expertise and perhaps a dovish disposition. Meanwhile, in Germany, a coalition agreement between the Social Democrats and Angela Merkel's Christian Democrats could lead to an uncustomary relaxation of fiscal policy. In Asia, Japan's economy continues to struggle with slow growth and inflation remains below the central bank's target.

THIS MONTH

A real war or a *sitzkrieg*?

Fed's Williams signals continuity

Japan's economy weakens

Germany opens its wallet

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A real war or a *sitzkrieg*?

While there is low probability the tariff dispute between the United States and China will erupt into a full-scale trade war, the markets are struggling to price the risks.

President Trump proposed tariffs on an estimated $50 billion in imports from China, weeks after slapping tariffs on aluminum, steel, and washing machines. The tariffs follow an investigation by the administration into the theft of intellectual property from U.S companies. In April, China, the world's second-largest economy, retaliated by imposing tariffs on U.S. imports worth around $3 billion. China also launched a World Trade Organization complaint against the U.S. action, and while it could be withdrawn, this machinery is now in motion.

Is it all just bluster, or is there a real threat?

However, it should be remembered that the major tariffs on both sides remain proposals. The U.S. tariffs are going through a period of public comment and will probably not take effect until June. The Chinese tariffs are not constrained by a legal timeline, but they are likely to be imposed within hours of the U.S. tariffs. A full-scale trade war, which would produce significant negative economic effects and lead to a very bad outcome, has low probability, in my view. However, markets struggle to price events that have a low probability but a high impact. So how worried should we be about trade? Is it all just bluster, or is there a real threat? A *sitzkrieg* or a real trade war?

The Korea deal offers clues

We are noticing a clear pattern in Trump's trade policies. Tariffs on steel and aluminum were imposed but promptly relaxed for "allies." The trade agreement between South Korea and the United States (KORUS) was denounced by Trump as "disastrous" and then was renegotiated. Under the revised agreement, U.S. auto companies saw their annual quotas in the Korean market increased from 25,000 to 50,000 vehicles; lost in the headlines was the fact that no U.S. company currently sells more than 10,000. Korea agreed to restrict its steel exports to the U.S. to about 70% of the volume of recent years and agreed to accept United States testing standards on

auto parts. A prohibitive tariff on United States imports of Korean pickup trucks that had been set to expire in 2021 will now run for a further decade. That's it. Pretty impressive, no? It was enough to transform the deal into one Trump described as "great."

Trump wants headlines but lacks a grasp of details or even of how policy works, so he ends up accepting whatever deal his team can strike. There is obviously a good chance that this pattern will hold in the case of China. But there are two reasons for caution. First, his administration's makeup seems to be changing. The new foreign policy team is much more hawkish; John Bolton is a neo-conservative who has advocated military action against North Korea and Iran. Geopolitical risks, especially with North Korea, may re-emerge under a new foreign policy team.

The second reason is that the relationship with China is much more complex. China is bigger, a more serious player. It is run by nationalists, and its leaders understand the country's strategic interests in a way that the current U.S. administration does not. The stakes are a lot higher. Moreover, Trump and some of his recently empowered advisors, notably Peter Navarro, seem to focus a lot more on China than they do on other countries.

Volatile global markets

You can see how this has been playing out in the early stages of the Sino-U.S. trade spat. In reaction to the steel and aluminum tariffs, China imposed tariffs on a range of U.S. exports, including pork and dried fruit (a possibility we noted in last month's edition). The Chinese tariffs were designed to match the U.S. move, but not escalate matters further, and were accompanied by official statements suggesting negotiations. With the latest round of U.S. tariffs, China responded with tariffs on soybeans. This came just as U.S. farmers were making their planting plans for the coming season, and farmers are reliable Republican voters. The Chinese were clearly signaling their willingness to raise the stakes and rely on the U.S. political system to isolate Trump.

Financial markets, especially equity markets, were quite volatile as this dance was proceeding. They fell as fears of a trade war rose and recovered on hopes these measures and countermeasures were just steps in an elaborate negotiation that would eventually result in a deal that, like KORUS and probably the North American Free Trade Agreement, would result in no major destructive changes to the trading regime and the economic outlook. But the dancing to and fro has been messy. Trump is currently in a difficult position. If he wants to be taken seriously by the Chinese, it doesn't help if U.S. markets treat his comments as empty rhetoric. He has to increase his bet, even if he knows he's going to fold eventually. This is the problem of making threats credible.

No power imbalance

Which way will this go? We are optimistic the world's two largest economies will resolve differences through negotiations. But this could drag on. The stakes and the conviction on both sides are high, and there is no obvious imbalance in negotiating strength. Some tariffs are likely to take effect this year. However, we may not get an actual trade deal until later. There are minor risks to the economy, and they are asymmetric. The chance that something bad happens to global trade flows is much greater than the chance China will open its markets to U.S. firms. If the drama goes on, even if there is eventually a benign outcome, it's hard to see how the recent stresses in the equity market will avoid spreading to financial markets more broadly. If Trump's threats don't disturb asset markets, why should the Chinese pay attention?

Fed’s Williams signals continuity

John Williams will assume a top position at the U.S. Federal Reserve, and brings with him policy expertise, and perhaps a dovish disposition on rates.

The Federal Reserve Bank of New York in early April named John Williams as its next president. Williams, currently the president of the San Francisco Fed, will oversee the operational functions of the New York Fed starting in mid-June and have a permanent vote on the Federal Open Market Committee (FOMC). Williams is a well-regarded monetary policy expert and something of a thought leader within the Fed’s system. While he has little experience of markets, his selection sends a strong message of policy continuity. In another nod to continuity, it is also being widely reported that the White House is likely to nominate Richard Clarida as Vice Chair of the FOMC. It’s also hard to see him as a radical, or as someone likely to try to lead the Fed in a different direction.

Williams is probably pretty much at the center of the FOMC in his near-term policy outlook. But, he may be a bit dovish over the medium term. He has done some important work on the neutral fed funds rate. The findings show the current neutral rate as quite low, and that the Fed has to be very cautious about raising rates above the neutral rate. Williams is also unhappy about the 2% inflation target.

The argument is that the 2% target is too low to allow the Fed enough policy flexibility, which risks creating reliance on unconventional monetary policy tools. An obvious alternative is price level targeting, which will require the Fed to run a higher rate of inflation in some years to offset periods of lower inflation. Both these factors suggest that, beyond the debate about the next few hikes, Williams is likely to be cautious.

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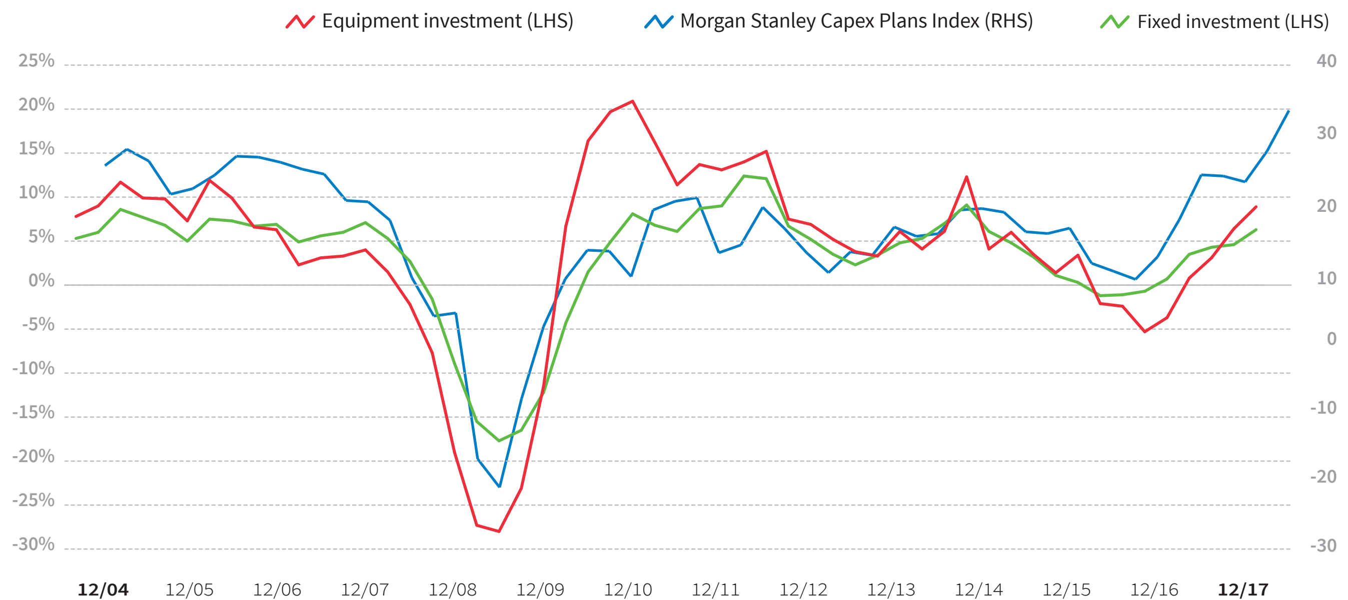
We still think the Fed will raise rates three more times this year. This pace, once a quarter, is higher than discounted in markets and puts us among the somewhat more hawkish group of Fed watchers.

U.S. capital expenditure (Capex) on the rise

Capex (year-over-year)



Sources: Putnam, Bloomberg. Data as of March 2018. The Morgan Stanley Capex Plans Index is a 3-month moving average of a population-weighted composite compiled from various monthly Federal Reserve Bank surveys of manufacturers measuring 6-month capex plans.

Underlying growth story positive

The data flow continues to be mixed. First-quarter gross domestic product is likely to be weak compared with growth in the fourth quarter, partly because of winter weather and because the fourth quarter was boosted by hurricane-related recovery spending. Still, the underlying growth story hasn't changed, and capital expenditure indicators point to a modest boost to growth in the second half of 2018. The labor market report is the best indicator of this broadly steady outlook.

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While the headline jobs creation number in the latest report was lower than expectations, a lot of the weakness is from the weather effect, including the series of storms that hit the East Coast in March. We don't expect any key changes in labor market trends. The latest data isn't going to change any minds on the FOMC. The economy will pick up some speed in 2018 given the encouraging outlook for capex. Of course, how the trade conflict with China develops will have an important influence on the outlook, and there are clear downside risks. There may already be an impact on business confidence. However, the Fed's confidence in the economy remains high, and if fears of widespread protectionism dissipate, the Fed will continue on its path of moderate policy tightening.

Japan's economy weakens

Economic indicators deteriorate as industrial production and the labor market slows; inflation seems likely to fall back.

Japan's economy has a high beta to the global cycle, and so it's not surprising the economy has decelerated along with the deceleration in the global economy. However, even though the economy is a bit weaker, we don't believe this is an early sign of a sharp downturn. Japanese industrial production fell at a faster rate than forecast in January; output dropped 6.8% month over month. While it rebounded to 4.1% in February, the data was below that of the Ministry of Economy, Trade and Industry (METI). METI's survey-based forecast for March is 0.5%. If this output gain is realized, it would leave the first quarter 2.0% lower than the fourth quarter of 2017. Capital goods shipments fell 1.3% in February after declining 5.2% in January.

The aforementioned data is used to estimate capital investment in the national income accounts and suggests this component of GDP will be weaker in the first quarter compared with the fourth quarter. In the labor market, the unemployment rate rose to 2.5%, and the jobs-applicant ratio ticked down for the first time since 2012. The April Tankan (quarterly survey of business sentiment released by the Bank of Japan [BoJ]) edged up a little. The improvement was in smaller non-manufacturers; the indexes for large manufacturers and planned capex dropped. This was partially offset by planned capex increases by smaller firms. The data is consistent with a gentle turn in the cycle, not a sudden deceleration. The latest inflation data also disappointed, at least for the BoJ. The Tokyo core rate ticked down to 0.8% year over year in March from 0.9% in February. The recent appreciation of the yen has played a role.

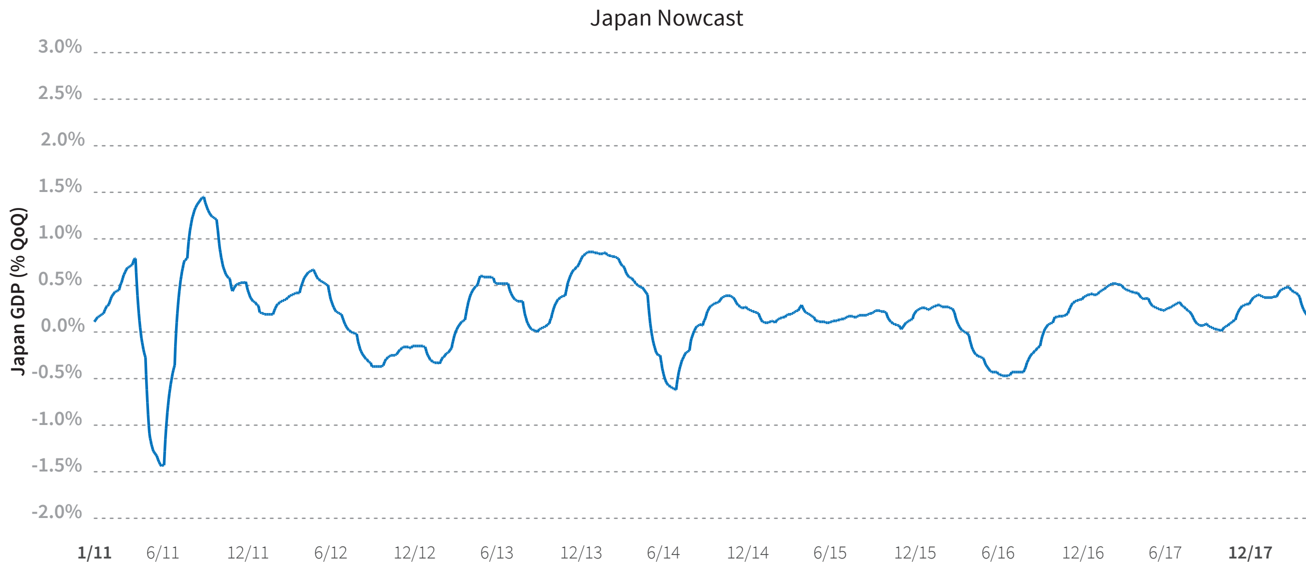
Waiting on wages

The BoJ is less confident about the outlook than a couple of months ago. The inflation data was low, and the shunto (spring wage negotiations) in the labor market was disappointing. The typical wage increase at large firms was 0.64% this spring, the highest since 1998 and up from 0.48% in 2017. It was insufficient to change household income expectations. Companies may raise prices, and that will add a little bit of headline inflation into the pipeline.

There is still a possibility that there will be a policy adjustment later this year. However, we think this is quite unlikely. For the BoJ to change policy, the yen has to be significantly weaker or something dramatic has to happen in the labor market. While we can't rule out a significant weakening in the yen, it doesn't seem very likely.

Japan's growth is slowing

The Putnam Japan GDP Nowcast Index (quarter-over-quarter)



Source: Putnam. Data as of March 2018.

We base our individual country GDP Nowcasts on a tailored methodology that captures daily data releases for the most essential growth characteristics for the specified country — including purchasing managers' index data, industrial production, retail sales data, labor market metrics, real estate price indexes, sentiment indicators, and numerous other factors. The mix of factors used for each market may change over time as new indicators become available from data sources or if certain factors become more, or less, predictive of economic growth.

Abe dodges a scandal bullet, but opponents are watching

Prime Minister Shinzo Abe is in the midst of a scandal involving a land deal where the government allegedly sold land at a below-market price to a school foundation. Abe's wife was a director at the foundation. While Abe's approval ratings have fallen, he is not under any immediate threat, or at least the immediate threat has passed. However, he will face a party leadership election in September. And, since the party leader is the prime minister, the election is central to Abe's ambition to become Japan's longest serving post-war leader. His party rivals will be eyeing opportunities to unseat him.

This is important because his opponents, and his successor if he loses the September vote, are less enthusiastic about Abenomics. A new leader may stir the BoJ on a less accommodative policy path. While the BoJ is legally independent, it would be naive to imagine the government has no ability to influence central BoJ policy. Abe is a committed reflationist, and he's given support to BoJ governor Haruhiko Kuroda. The broader political support for this policy mix is eroding. If Abe loses power because of a scandal or some other development, his successor is not going to follow the same policy mix.

Germany opens its wallet

The program by the new coalition government is likely to result in fiscal expansion, and is expected to support economic growth.

In Germany, the largest eurozone economy, a grand coalition is finally in place. The coalition agreement between the center-left Social Democrats and Angela Merkel's center-right Christian Democrats provides for a material relaxation in the country's fiscal policy. Chancellor Merkel's governing coalition plans to invest nearly 50 billion euros in additional expenditure, according to media reports. Germany has to respect the eurozone's fiscal rules, as well as its own more restrictive, internal rule on the federal fiscal position. However, both of these permit quite a large change in the fiscal stance.

The German fiscal surplus is about 1.4% of gross domestic product. While the new finance minister, Olaf Scholz, has said he will respect the "schwarze null" — the zero-deficit rule — the relaxation of the fiscal stance is going to start soon. Clearly there is a risk that the relaxation will overshoot. Germany's Federal Audit Office has already warned of this possibility. This policy relaxation will be supportive of growth in Germany at a time when the domestic real interest rate remains extraordinarily low.

Fiscal policy will be supportive of growth in Germany, at a time when the domestic real interest rate remains extraordinarily low.

A looser fiscal policy will allow domestic demand growth to offset the negative impulse that comes from the external sector, including global trade uncertainties and the euro's appreciation. Germany's domestic consumption growth has a tendency to disappoint. But something is changing in the country, and the outlook for domestic spending is improving.

The Putnam Global Risk Appetite (RA) Index is a proprietary quantitative model that aims to measure investors' willingness to invest in risky assets, including equities, commodities, high-yield bonds, and other spread sectors. With a composite view of risk-appetite signals across a broad mix of asset types, Putnam's RA provides a framework for discussing investor preferences and can signal trend changes in broad market sentiment.

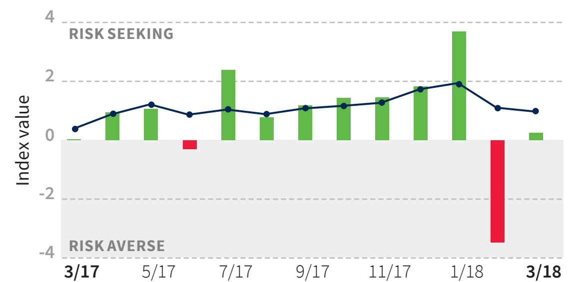
Risk appetite turns flat

SHORT-TERM TREND

March was flat in terms of appetite for riskier assets

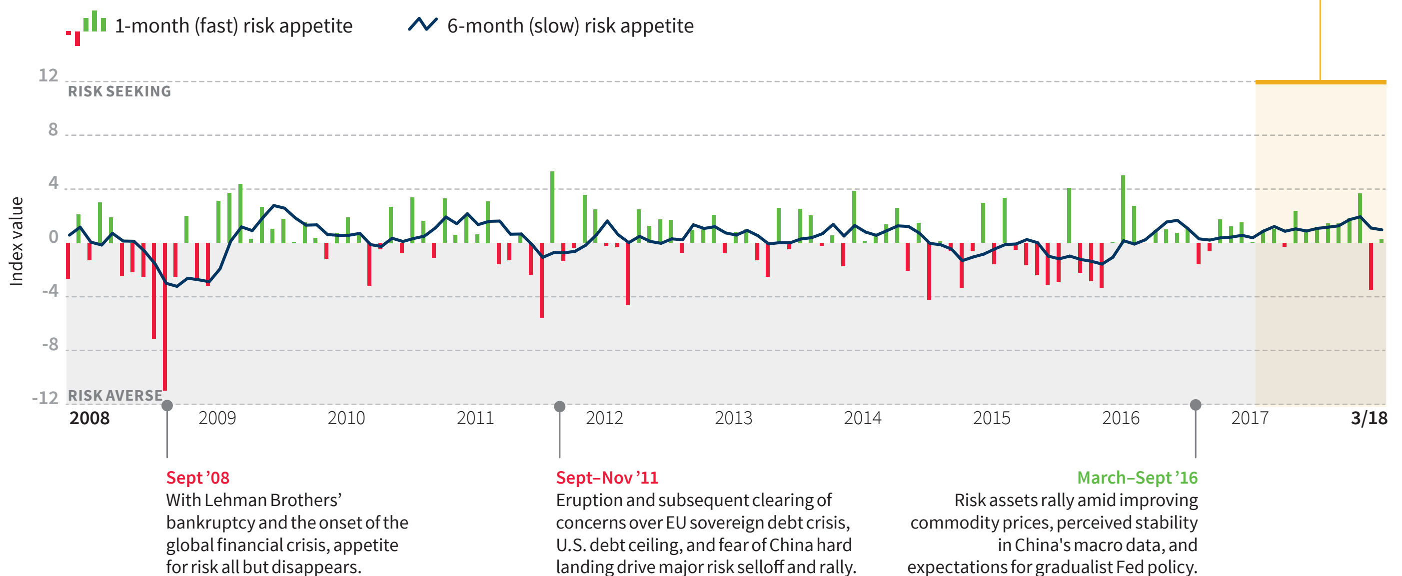
Risk ON OFF

- Almost all equity indexes, except U.S. small cap, were in the red
- Fixed-income assets had positive returns. The front end of the Treasury curve rallied a bit after the Fed raised rates in March, while the long end outperformed
- Agricultural commodities were mixed, industrial metals were down, and energy rose



LONG-TERM CYCLE

This 10-year illustration captures the cyclicality of investors' appetite for risk.



Sept '08
With Lehman Brothers' bankruptcy and the onset of the global financial crisis, appetite for risk all but disappears.

Sept–Nov '11
Eruption and subsequent clearing of concerns over EU sovereign debt crisis, U.S. debt ceiling, and fear of China hard landing drive major risk selloff and rally.

March–Sept '16
Risk assets rally amid improving commodity prices, perceived stability in China's macro data, and expectations for gradualist Fed policy.

Source: Putnam. Data as of March 31, 2018. To create the Global Risk Appetite Index, we weigh the monthly excess returns of 30 different asset classes over 3-month T-bills relative to the trailing 2-year volatility of each asset class. The higher the excess return and the lower the volatility, the greater the risk appetite; conversely, the lower the excess return and the higher the volatility, the stronger the risk aversion.

The Putnam Global GDP Nowcast index is a proprietary GDP-weighted quantitative model that tracks key growth factors across 25 economies. This index and individual country indexes are used as key signals in Putnam's interest-rate and foreign-exchange strategies.

Global growth slows

SHORT-TERM TREND

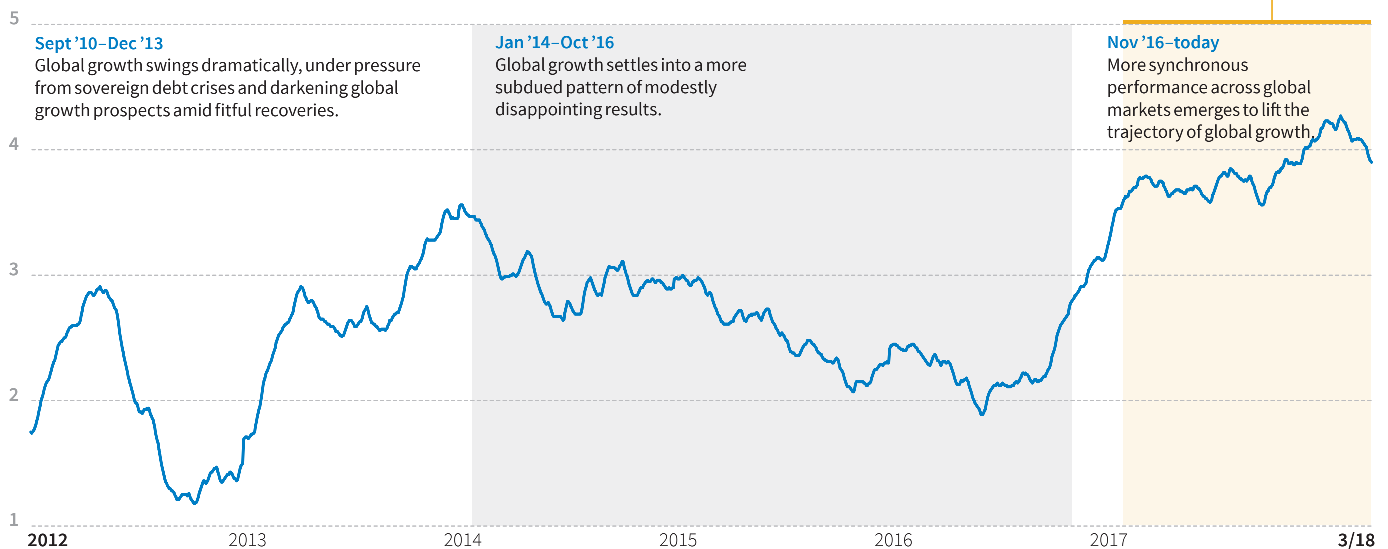
Global growth downshifts in March

▲ 3.90%

Among G10 countries, growth in the eurozone and Japan lost momentum. Industrial production slowed among eurozone economies, while Japan's industrial production and business indicators disappointed. Turkey's economy also slowed, and growth in Latin America moderated. China's growth held steady, while the economies of Taiwan and Singapore slackened.

LONG-TERM CYCLE

This six-year illustration captures GDP gyrations since the financial crisis.



Source: Putnam. Data as of March 31, 2018. We base our Global GDP Nowcast on a tailored methodology that captures daily data releases for the most essential growth characteristics for each of 25 countries — including purchasing managers' index data, industrial production, retail sales data, labor market metrics, real estate price indexes, sentiment indicators, and numerous other factors. The mix of factors used for each market may change over time as new indicators become available from data sources or if certain factors become more, or less, predictive of economic growth.

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The Macro Report is written by members of Putnam's Fixed Income team. With backgrounds in applied economics, currency and interest-rate analysis, and sovereign and local bond market dynamics, this group conducts macroeconomic research in support of Putnam's global fixed-income strategies.

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