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He said, Xi said

U.S./China trade negotiations have gotten testy, but a resolution likely will be reached, calming market angst.

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BOTTOM LINE

After a powerful rally of nearly 26% from its Christmas Eve trough to its May Day record high of 2,954, the S&P 500 has corrected by more than 4% over the past 10 days, as the ongoing U.S./China trade negotiations hit a speed bump.

The two largest global economies had engaged in 10 rounds of bilateral trade negotiations over the past year to arrive at a tentative agreement. But a week ago Friday night, the U.S. received a diplomatic cable from Beijing, in which Chinese President Xi Jinping significantly reversed agreed-upon points in five key areas: the theft of U.S. intellectual property; forced technology transfers from U.S. companies to Chinese companies; a joint competition policy; Chinese access to financial services offered by U.S. companies; and Chinese currency manipulation.

In addition, because U.S. officials have been legitimately concerned about how to measure, verify and enforce Chinese compliance with the terms of their agreement, they had agreed to scale back the existing tariffs on Chinese goods over time as China demonstrated good-faith compliance with the terms of the deal. But the Chinese are now demanding the immediate rollback of all tariffs, which would eliminate the U.S. enforcement mechanism.

In the face of all of these reversals and demands, President Trump pushed back this morning, increasing tariffs from 10% to 25% on $200 billion of Chinese goods. Furthermore, the U.S. also has started the paperwork to impose 25% tariffs on an additional $325 billion of Chinese goods not currently taxed. Importantly, these higher tariffs would only hit products that leave China on or after May 10, not those that are already in transit. That leaves some wiggle room for ongoing last-second negotiation. In fact, Chinese Vice Premier Liu He arrived in Washington yesterday to continue the negotiations.

But the Chinese, who have already slapped tariffs on most U.S. exports (a particular hardship for important U.S. agricultural products), have threatened to respond with additional yet-unnamed "countermeasures."

The U.S. believes China has reneged on previously agreed-upon commitments to change its laws to reflect the negotiated trade deal. Americans believe that China engages in unfair trade practices, and that China needs to protect U.S. intellectual property and curb subsidies for state-owned businesses. On the other hand, China believes that the American demands impinge upon its sovereign rights.

While the situation is prickly and fluid, we still think a mutually agreeable resolution can be reached over time. But the near-term downside to this trade uncertainty is greater financial-market volatility, slower economic growth both here and abroad, rising inflation, declining bond yields as part of a flight-to-safety trade and stock prices that could decline 5-10% from this month's record highs.

Why is a China trade deal important for the U.S.? The overall U.S. trade deficit for both goods and services in March was $50 billion, with imports of $262 billion and exports of $212 billion. On an annualized basis, our deficit has been running at about $600 billion. So for a $21 trillion U.S. economy, the imbalance of imports to exports results in slower GDP growth of approximately 3%.

As the world's second-largest economy, China is by far the biggest contributor to this deficit. According to our research friends at Strategas, the U.S. runs a goods-only trade deficit with China of about $420 billion. We import $540 billion worth of goods from China and export $120 billion back to it. We believe that Trump's motivation is to cut that deficit in half and boost U.S. GDP growth by perhaps a percentage point annually.

First-quarter 2019 GDP blueprint The sharp improvement in net trade during the first quarter added a powerful 1.03 percentage points to the first quarter's stronger-than-expected 3.2% GDP growth rate. Exports rose 3.7% in the first quarter, adding 0.45 percentage points to growth, while imports plunged 3.7% in the first quarter, adding 0.58 percentage points.

Both sides motivated to consummate this deal With an eye toward the 2020 presidential election, Trump needs a strong economy and the GDP boost that a China trade deal likely would contribute, along with the foreign-policy success of achieving such a difficult deal that eluded his predecessor.

For Xi, the Shanghai composite index plunged nearly 32% last year, while China's GDP for 2018 was only 6.6%, the slowest rate in 28 years. Moreover, many economists speculate that the actual growth rate was perhaps only a third to a half its official reported level. So the elimination of the U.S. tariffs and the creation of open trade borders would likely boost GDP growth and the financial markets in China.

Trade piece already done? The hang-up here has been centered on the thornier side of the discussion: intellectual property theft. It's our belief they've already reached an agreement in principle on the easier part of the discussion, how to halve the U.S. balance of trade deficit. We believe that China will purchase approximately $1.2 trillion of additional goods from the U.S. over the next six years, in five key categories: agricultural commodities (largely soy beans and corn); energy products (mostly natural gas); automotive products; semiconductors; and aerospace products. If that proves accurate, and if the two countries can resolve their remaining differences by midyear, then the U.S. may begin to ship incremental exports tariff-free to China starting in this year's second half, which we believe will likely boost GDP growth, corporate profits and share prices.

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Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

Shanghai Stock Exchange Composite Index: A capitalization-weighted index that tracks the daily price performance of all A-shares and B-shares listed on the Shanghai stock exchange. Indexes are unmanaged and investments cannot be made in an index.

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