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Myths and other sea monsters on the slow boat to China

If one does the math, it′s difficult to see how U.S. consumers will be hurt by new tariffs on China. It′s easier to see how China, with its response, may end up hurting itself.

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We finally have gotten the long overdue and healthy market correction we've needed, on the back of trade war news that we worried we'd get last week and were hoping we wouldn't. So, now what? At Federated, we are evaluating cautiously where to reload on stocks, but think it still a tad too soon to do so. In the meantime, we are digesting all the hysterical market commentary about the mere 5% correction we've had so far. Our conclusion is that much of it is sourced in fundamental myths that underscore the bearish viewpoint. As the media scrambles for an explanation of the market tumble, these myths are presented so assuredly by the market pundits that the average mortal is left assuming they are correct. By way of antidote, here's my list of sea monsters to ignore.

1. **"U.S. consumers will pay for the latest tariff round."** Really? This myth is sourced from someone's basic Economics 101 textbook, where economists assume competitive equilibrium across the global economy and that therefore any tariff applied is simply and smoothly passed through to the end consumer. This overly simplistic assumption utterly ignores the various forces at work in today's

Amazon-dominated world that will surely work to offset, at least partially, the pass-through. First, the Chinese companies, mostly producing commodity and/or easily imitated products, will be asked by their U.S. customers to cut their prices to offset the tariff. If they don't, they risk losing the business to Vietnam or Indonesia, either immediately or eventually. Second, the U.S. buyers, facing their own set of ruthless competitors such as Amazon, will themselves either raise productivity and/or lower their own margins to absorb part of the tariff. Taken together, these two forces are likely to offset most if not all of the price increase that otherwise would flow through to the U.S. consumer.

2. **"China's currency devaluation is a disaster for the U.S."** Wow! Let's work through this whopper. Within 48 hours of President Trump's 10% tariff announcement on \$300 billion of Chinese goods, China's central bank delivered, through its non-freely-floating currency, a 3.5% devaluation of its currency (the yuan or renminbi). This was effectively an across-the-board price cut on all Chinese goods of 3.5%, affecting not just the \$300 billion the president targeted but the entire \$500 billion China exports to the U.S. So this effect alone cut the prices to U.S. companies and consumers by close to \$20 billion, about two-thirds of the \$30 billion in announced new tariffs. So at a minimum, the renminbi devaluation largely offset the impact on the U.S. consumer, even before individual Chinese companies almost certainly will be forced by their U.S. customers to eat some of the tariff increase themselves. So let's sort this out. By virtue of its recent currency devaluation, China receives roughly \$20 billion fewer U.S. dollars for its exports to the U.S. than it did before. China's export industry absorbs this plus another \$10-20 billion in price cuts demanded by U.S. customers to "offset the tariff." U.S. consumers pay virtually not a dime more than they did last week. And the U.S. Treasury is enriched by the \$30 billion in tariffs collected. Disaster, yes. But for whom?

3. **"President Xi just needs to play the long game and outlast Trump."** Goodness. Just because someone declares himself "President for Life" doesn't make him so. The road to hell is paved with many that so declared. Right now, President Xi is in trouble. His export-driven economy is slowing dramatically, the equivalent of a

recession in China terms. Hong Kong is in chaos, and rolling tanks through the Central District of one of the world's most affluent cities is not likely to prove as easy as it was to do so in the darkened streets of then relatively poor Beijing in 1989. He is caught in a trade war he cannot win and his economy, for all the propaganda to the contrary, remains extremely trade dependent. President Trump has his own domestic political challenges to be sure, but if he loses next November, he'll be the first U.S. incumbent president in history to do so in the face of a powerful economic and stock market expansion and a historically low unemployment rate. Let me make the call now: President Trump will be in power long after President Xi is forced to retire.

At Federated, we are sticking with our game plan, and intend to add back the cash profits we've taken in the run-up to 3,000 on the S&P 500 at some point in the next several weeks, dependent either on level or time. We don't see a V-shaped recovery out of this sell-off as we had in December, as the uncertainties that now overhang us cannot be resolved with a single Jay Powell press conference. But they will resolve over the course of the next few months, and so we wait. In the words of poet John Milton, "They also serve who only stand and wait." Sometimes, doing nothing is the best advice.

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