John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday June 19, 2019

President Trump's goals may be worthwhile, but his methods are scary. History tells us that no one wins a trade war. We also know that tariffs act like taxes, driving up prices for consumers. Fortunately there is a potential positive hiding in the trade tensions.

6/10/2019 Carpe Diem: The following is from James Freeman's article in the *Wall Street Journal* "Trump's Ruining Tariffs for Everybody":

"There are many negative consequences to President Donald Trump's tariffs, but one benefit is that they are finally teaching Democrats about tax incidence. Motivated by their hatred of our duly-elected President, a number of party leaders have lately discovered that even if an import tax is formally paid by a business, workers and consumers suffer, too. Perhaps the pols will now also consider the broad economic pain that results from high tax rates on corporate and personal income."

I hope James Freeman is right. But I worry that left leaning politicians won't make the connection. Meanwhile, President Trump is pressing his tariff threats against China in hopes of persuading China's leaders to change their ways and engage in free and fair trade. China keeps looking for leverage to use against President Trump. In March China sold $20 billion worth of long-term U.S. government bonds. Some U.S. pundits see that as a threat to U.S. financial market stability. China holds $1.1 trillion worth of U.S. government debt. Massive selling by China could drive up interest rates on U.S. government debt. That would make the current huge U.S. trillion-dollar annual deficits

worse. There are limits to how much any government can borrow. The last thing the U.S. government needs is higher interest rates. But are the pessimistic pundits right? Is China likely to unload huge amounts of U.S. government debt?

In the early 2000s China enjoyed rapid growth in exports. That put upward pressure on the yuan, China's currency. A rising yuan was a threat to export growth because it made Chinese goods more expensive. In response, China sold yuan and used the proceeds to buy U.S. government bonds. At the time China's buying spree was seen by the U.S. as welcome, low-cost financing. In 2002 China owned $100 billion worth of U.S. treasuries. By 2013 China's holdings had swollen to $1.3 trillion. At that point U.S. pundits began to worry about the consequences if China ever decided to sell and also worried that China might not continue to buy large amount of U.S. government debt. Pessimists had a field day creating financial horror stories based on China changing course. China did change course. China stopped pegging the yuan to the U.S. dollar and instead manages the yuan against a basket of currencies. As a result, China no longer buys very many U.S. treasury securities and the total holding has slipped to $1.1 trillion. However, the change did not follow the pessimists' forecast. The United States has had no trouble finding buyers for its increasing amount of government debt and interest rates have remained low.

The pessimists were wrong because they failed to see that massive sales of U.S. government debt would have consequences for China. What would China do with the proceeds? Converting dollars back to yuan would push up the value of the yuan and hurt China's exports. And there is no practical alternative. There is no other government bond market large enough, safe enough and liquid enough to absorb hundreds of billions of

dollars. German government bonds are safe enough but not anywhere near liquid enough. And if China was willing to take on more risk and started buying large amounts of government bonds in Japan or France there would be cries of foul as the yen and euro were pushed up, hurting their exports. Japan and France might follow Trump's lead and apply tariffs on Chinese goods. That would be a disaster for Beijing.

The final note on the China-U.S. government bond issue is that the $1.1 trillion worth of U.S. government debt is a valuable asset for Beijing. The dollar is the world's reserve currency. As such, it insulates Beijing against downward pressure on the yuan.

The bottom line is that the pessimists are wrong again. They were wrong about the consequences of China reducing the amount it buys of U.S. government bonds and they are wrong to scare investors with unfounded tales of Chinese sales of U.S. government bonds.

"America's place at the center of global finance is unassailable in the short term. Yet neither America nor China appears to understand just why its position is so commanding. China might like to discomfit America by becoming a credible alternative hegemon: if investors could flee American assets in response to bad behavior, America might behave better. But challenging America would require open markets, transparent financial institutions and the rule-of-law – all of which is difficult for an authoritarian regime.

America seems just as clueless. A protectionist bully is an unappealing steward of the world economy. In abusing its privilege, it undermines the shared trust that makes Treasuries an asset without equal. This trade war has been built on mistaking strengths for weakness – and weaknesses for strengths." (*The Economist*, June 1, 2019)

The Economist clears up quite a lot. Just a few weeks ago we thought a trade deal with China was almost complete. Then Beijing objected to terms that President Trump thought had been agreed. He felt betrayed and ramped up the tariff threat. Beijing responded with equally threatening rhetoric. Now it appears that both sides realize they do not have the upper hand, neither has the knockout advantage over the other. And, both sides are becoming acutely aware of the damage to their respective economies from the ongoing trade tensions. It may take another week or two, but a compromise trade deal between the U.S. and China is likely to be accomplished. It won't entirely satisfy either side, but it will likely benefit both.

An editorial in a communist Chinese paper recently said China was prepared for a long trade war with the U.S. That is likely political cover, so readers will celebrate when Beijing compromises and makes a deal.

Investors are ready for the news of a trade deal. Optimists may be disappointed. Stocks may not move much at all when the trade deal is announced. Everyone will simply breathe a sigh of relief that the trade war is over.

I will have the next market review and update for you one week from today on Wednesday, June 26, 2019.

All the best,

John Dessauer