The Trade War that Isn't – Yet

When most of us hear talk about something described as a "war," we intuitively recognize that there could be very unpleasant outcomes on all sides. Wars have one thing in common: there is seldom a clear-cut "winner" amid the damage and destruction.

So when President Trump declares a "trade war" against the world's second-largest economy, it's natural that many people—including, apparently, a large number of investors—would feel spooked about what's to come in our collective future. This explains why every escalation of words, and new lists of things that will be taxed at U.S. and Chinese borders, has provoked sharp downturns followed by sharp upturns in the markets.

But what, exactly, is a "trade war?" Beyond that, what is a "trade deficit" and why are we trying to "cure" America's trade deficit with China?

To take the latter issue first, every bilateral trade deficit is simply a calculation, made monthly by government economists, that adds up the value of products manufactured in, say, China that are purchased in, say, the U.S. (Chinese exports or U.S. imports), and subtracts the value of products manufactured in the U.S. that are purchased by Chinese consumers (U.S. exports or Chinese imports). The first thing to understand is that this is not a very precise figure. To take a simple example, Apple manufactures its iPhones in southern China, ships them to the U.S. for sale, and the value of each of the millions of smart phones is counted as a Chinese export to the U.S. market. Apple reaps extraordinary profits, but this is considered a net negative in terms of U.S. trade.

Moreover, the full value of each iPhone is considered on the import ledger, without subtracting out the value of the "services" that Apple provides. The software and design were, after all, created in the U.S., and are a large part of the value of the phones that people become so addicted to. But these financially valuable aspects of the phone, made in America, are not reflected in the trade numbers.

Beyond that, many economists question whether a trade deficit is a bad thing in the first place. Chances are, you run a significant trade deficit with your local grocery store; that is, it brings to your neighborhood the food you put on the table, and you exchange money for it. You import food, but the grocery story doesn't import a comparable amount of things you make in your garage. Are you materially harmed by this economic opportunity that takes dollars out of your pocket and puts them in the hands of the grocery store? If you were, you might take your business to the grocery store further up the road, and run a trade deficit with a different establishment.

How does this relate to the U.S./China trade relations? Simple mathematics indicates that Chinese manufacturers are taking dollars from U.S. consumers, but they have to do something with those dollars to balance the ledger. That money finds its way into purchases of U.S. debt (Treasury bonds) or reinvestment in the U.S. economy, buying real estate or investing in domestic companies.

You fight trade wars with tariffs, which are simply a government tax on specific items when they cross the border. So when the Trump Administration announces the list of 1,300 different products that will become the targets of its tariff plan, that means that anyone buying those products will see their taxes go up—invisibly, in a higher cost of living.

The bigger potential damage comes when China retaliates in kind, and certain sectors of the U.S. economy have to pay the Chinese government a tariff for the privilege of selling their products to the Chinese market. China represents 15-20 percent of Boeing's commercial airline sales, so a proposed 25% tariff could sting. More directly impacted are U.S. farmers. Soybeans represent the largest agricultural export from the U.S. to China ($14.2 billion worth of shipments in 2016, about one-third of the U.S. crop), and the Chinese consume a lot of U.S. raised pork. When the tariffs were announced, pork futures dropped to a 16-month low, and soybean futures fell 5% overnight.

The larger concern is that China is preparing to shift its sourcing of agricultural products from the U.S. to Brazil and Argentina, and the retaliatory tariff makes this economically attractive for Chinese consumers. Will that business ever come back again?

If this has you worried, or searching China's latest list to see which stock might be impacted as the rhetorical trade war escalates, it might be helpful to take a step back. So far, none of these tariffs have been levied; no actual shots have been fired in the trade war, which means it is not yet a "war" at all. The U.S. and China are trading retaliatory lists of potential targets, and there is some escalation in the value and extent of those lists. But when it comes time to actually fire those shots, the most likely scenario is a generous compromise that leaves us with the status quo.

Remember how worried the markets were when the Trump Administration abruptly announced new levies against global steel and aluminum imports? It turned out to be mostly bluster. A full 50% of all U.S. steel imports from Brazil, South Korea, Mexico, Canada and others, were exempted from those tariffs. Larry Kudlow, the White House's new economic advisor, said several times last week that there would be, in fact, no new tariffs, and no trade war with China. It will be months before any of the proposed tariffs could be put into place, which is plenty of time for Kudlow's prediction to come true—and make all the panic sellers who drove down stock prices look a little bit silly.

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