The US Is Weaker Today Than It Was Under Obama

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JR: Welcome to RiskHedge Radio. I am your host Jonathan Roth coming to you from Vancouver. There is so much news coming out of Washington, DC. I don't even know where to start. The Trump administration is changing the political and economic landscape like never before. They are threatening Mexico with a 20% tax on all imports to the US. They have declared they are leaving the TPP trade deal, and they are negotiating with Canada on all sorts of trade issues even as we speak. The Keystone XL Pipeline was just approved. As so many things are going, it's crazy how much has happened here in just the first few days.

At the same time, the Federal Reserve seems to be indicating that they are going to continue to slowly raise interest rates. So the question is, what is the world going to look like once all of these changes go into effect?

Joining me to discuss this is Sam Rines, the senior economist and portfolio strategist with Avalon Advisors in Houston, Texas. Welcome to the show, Sam.

> **SR:** Hey, thank you for having me, Jonathan.

JR: Now, Sam, I want to start with the Trump administration's relationship with Mexico. It seems to be going completely off the rails. Mexico's president just canceled his upcoming trip to DC. This 20% tax that's being talked about, where is all of this going?

> **SR:** Thank you, Jonathan. The interesting thing about this 20% tax… canceling the meeting with Trump… this whole thing with Mexico is it all comes back to how does Trump deliver on his campaign promises for manufacturing jobs and getting better deals, right? He sold himself as a dealmaker; he sold himself as "I'll be the greatest jobs president ever." He has got to deliver there.
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> He sees Mexico as kind of the easy soft target, and I say the easy soft target because in a lot of ways what he is throwing out at Mexico is really directed at China. It is, "China, play ball with us or this will be you next." Right? So you float the idea of a 20% tariff. Those monies are going to be used to build a wall that I have promised to build. That way, I can say, "Mexico, you paid for the wall." These things are rhetoric that's floated at a state that, one, is one of our closest allies… always been fairly close. We've cooperated. We caught El Chapo by sharing intelligence… you know, we are very close allies. These are things that the Trump administration feels, we can say, we are going to get a better deal with Mexico. Then we're going to apply that to China, and so I think China is really taking this as a red flag of "Wait a minute. The Trump administration really is going to renegotiate these things. We need to pay attention here." So I think it's a little bit about Mexico. It's more about China.

JR: Fascinating. Okay, I want to jump to China on this. But before we do, what do you think the feeling is in Mexico over the long term about these renegotiations of deals like NAFTA?

It seems to me just looking at it from the outside that this is going to breed a tremendous amount of at least political resentment towards the United States that could manifest in all sorts of negative ways for America over the long term.

> **SR:** It was interesting. I was in San Antonio at a dinner that included a significant number of wealthier Mexican families, and the way that they described it was, it's both sides, right? It's the way the Mexican president Pena Nieto handled it… that's sort of a problem, and it's also a problem of Trump not trusting Mexico. So they see it as kind of a two-sided conundrum, right?
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> So Pena Nieto has an incredibly low approval rating—it's in the teens. So they see him as kind of a weak link who sacrificed an awful lot of his political credibility to have the meeting with Trump earlier… before Trump was elected. That took a lot of political capital away. That hurt him domestically, and now he's being disrespected by Trump. So they see it as a disrespect more than anything from what I've gathered from the people I've talked to.

JR: Okay, so you mentioned just a moment ago that this campaign against Mexico, China really sees this as… you know, that China is really the target in what's happening there. So the Trans-Pacific Partnership is seen to be at least… you know, as I said, from the outside looking in, it seems to be an arrangement designed to at least keep China in check because China was not going to be included in the TPP deal. Now that Trump has scrapped it, what does that mean for China's role (a) in the world and (b) this interplay between the US, Trump, and China on trade?

> **SR:** Yeah, it's interesting because it does leave China a window. It leaves China a window of opportunity to kind of fill the vacuum of global trade that the US is leaving. Granted, the Trump administration has said that they will negotiate bilateral agreements. It's these multilateral agreements that they don't care for. That's a different story though.
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> The problem that China will face is that China doesn't necessarily want to have the same type of trade agreement that TPP was. TPP protected intellectual property rights. It tried to have some things with workers and the working conditions. China is much more on the "how do we get tariffs down?"… not on redoing your state-owned enterprises, opening up economies, and really making some of those free market changes that TPP was all about. So it is a much different type of trade agreement. It's a much different negotiation.
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> But that being said, right now China is negotiating the RCEP which was a competitor to the TPP… but included in there is Japan, India, Australia, the ASEAN countries, the center of global growth, right? There is more population there than the rest of the world combined. These are just incredibly vibrant Asian Nations.
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> So China in a way has the opportunity now to fill that void and write the rules of trade the way it wants to write the rules of trade, not the way the US wanted trade to be done. That is really the gap that TPP left. TPP was never going to be a big boon for US growth.

It was estimated that it would be less than 1% cumulative growth for the US. What the TPP was all about was really being at the table when Asia's trade rules were being written. That was the entire point. Now the US has kind of stepped back. We are no longer providing that leadership. Now it's China's turn because China is the one country that can kind of fill that growth void for many of these smaller countries.

JR: So now, what about when you take a look at China? Charles Schumer, the senator from New York, the leader of the Democrats in the Senate, just a few days ago declared that China should be declared a currency manipulator… and I know that that's something that Trump seems to be, at least in broad strokes, in agreement with. What happens if the US declares China a currency manipulator?

SR: You know, nothing really happens if we just declare them a currency manipulator unless we enforce something, right? It gives us the ability to do some things on trade. That's the basic thing. So it opens up a realm of possibility there. But in many ways, it's just not worth it, right? China, at one point, three to five years ago, China moved to holding its currency higher. It is propping its currency up. So, it's kind of a… what? It's a misnomer, it's a popular misnomer. I mean, it really shouldn't have the type of effect that a lot of people think it will unless China reacts to it. That's the problem. If China reacts to it by saying, "Okay, you are calling us a currency manipulator. We're going to toss a 10% tariff on iPhones." It's something along those lines. It's more the tit-for-tat that really begins to trickle through the global economy.

JR: So what I really hear you saying is just that China in many ways holds up a pretty good deck of cards versus the US… and that anything that Trump seems to be doing as it pertains to the TPP and trade in general at least aimed against China is more likely to at least maybe… "backfire" is too strong of a word… but there is most definitely going to be blowback. And in many ways, Trump may be weakening America's strategic position in the world as it pertains to trade.

SR: Oh, there is no question in my mind that we are weaker today than we were a month ago… when it comes to both our standing globally in trade and our standing in terms of being the global leader of free enterprise and capitalism. The weakening that we've seen recently from the Trump administration on free trade, it has the effect of taking the western system and putting it in question. Right? If you spent the last four or five years spending your political capital at home negotiating a free trade agreement that may or may not have been popular. The TPP was popular in some parts of Asia. It wasn't popular in other parts of Asia and some leaders spent a lot of their political capital getting it passed and continuing to negotiate it.

All of a sudden, the US backs out of it at the 11th hour. You have to wonder to yourself if you're a politician in Asia, "Do I really trust the US to go through when it says it's going to go through it?" That's really the longer term problem. Does the US have the ability politically and domestically to go through with its promises? That's going to be the long term story here: Is the US trusted now or have we really lost kind of the faith of the rest of world?

JR: I have heard hints that there is the possibility that TPP may be essentially disassembled, and the US approaches each country that was a part of TPP and tries to basically do TPP as bilateral arrangements with each country... so with Japan, with Canada, with other countries, Australia, New Zealand, and such. What are the chances of that happening?

> **SR:** I mean, we can always try it. The question is, why don't we have a free trade agreement with Japan in the first place? The reason that we don't have a free trade agreement with Japan today is because Japan has a lot of things that it doesn't want to give up, right? It has strong lobbyists. It has an auto industry that does not like to have its home country touched. Those are the things we are going to have to negotiate individually... that when you negotiate as a whole, it's a lot easier. And so they think the idea of negotiating these trade agreements bilaterally, it sounds a lot easier. It sounds a lot better in some ways by being able to cancel them instantaneously if there is cheating or if it's not a good deal. You know that sounds good, but it's going to take a lot of energy and a lot of negotiators. Negotiating that many deals and getting them done in any sort of reasonable timeframe... that's going to take incredible amount of manpower, and I just don't think we have the capabilities to do that.

JR: Okay, why don't we pivot now to the Federal Reserve? Trump made it clear during the election that he did not like Chair Janet Yellen. I am not sure... Yellen has never really said publicly what she feels about Donald Trump, but I am sure the feeling is somewhat mutual. Yellen also seems to want to raise interest rates, but if rates rise, what is that going to do for growth in the US? What is happening with the Fed?

> **SR:** The Fed is moving toward a more normal hiking arrangement, right? So it looks like we are going to get two to three rate hikes this year, probably back-half loaded. Back-half loaded always means back-half delayed. But back-half loaded, two to three rate hikes? All of a sudden we're beginning to hear murmurs about the possibility of the Fed beginning to roll the balance sheet. That's the balance sheet off from almost 4.1 to 4.2 trillion. Let that roll off a little bit. That would be a significant tightening move. So you're beginning to hear some of these rumblings around tightening a little bit quicker.
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> But the problem is, that I think we are hearing these rumblings because there is the anticipation of growth and inflation coming from the Trump administration lowering taxes, getting rid of some regulations, doing some things that should be kind of growth positive. That's phenomenal, but that is just hope. None of that has materialized yet. So if we don't see that materialize, the discussion will kind of be for naught. We will not be able to raise rates more than two or three times. We won't be able to roll the balance sheet unless we do see an acceleration in everything from growth to wages to inflation. First comes growth, then comes wages, then comes inflation. If we don't see that pattern, it's going to be very difficult for the Fed to make those moves.
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> And if the Fed does make those moves in anticipation of Trump policies, that will be very bad. The Fed could go very quickly from being kind of right on top of the curve—not stomping on inflation too hard but not pushing inflation too high—to killing inflation before it could ever really get moving.

I think that's one of the biggest risks we really have during the Trump administration, is this risk that there is too much hope and too much anticipation of growth and inflation, and too little in the way of actual before the Fed begins to move.

JR: I know the Fed is supposed to be politically independent… and to what degree they are, that's up for debate for sure. But to what extent is the personal relationship between Trump and Yellen important moving forward, especially as Trump moves on some of these ideas that are really the antithesis of what we've seen in terms of economic thought in the US over the last 20 years?

SR: To be honest, I think having no relationship would probably be best. And by no relationship I mean not being close and just having a zero relationship would be good. Because the Fed is going to have to maintain a significant amount of independence in order to be able to do the right thing. Because if inflation picks up significantly and growth begins to accelerate, it is not entirely clear whether or not the Trump administration is going to like the Fed slowing the economy. You have a Trump administration official who came out and said that 7% GDP wasn't out of the question. The Fed is probably going to make sure that it is out of the question. So it's going to raise rates at a pace that would tamp that down significantly. Right? 7% growth would probably have some significant inflation consequences. So the Fed would begin to move rather quickly with those types of numbers or even if we got anywhere near that. So I think there could be some conflict there, and the more independence the Fed has to make the moves that are in its view (and hopefully rightfully so) the best moves for the economy, it's going to have to be a relationship that is fairly distant… if not nonexistent.

JR: So let's take everything that you have just talked about, that we've discussed into account. What are you advising your clients? What should investors out there that are listening to this, what should people be doing with their money to hedge against all these risks that seem to be out there right now?

SR: It's a really difficult question to answer because you don't know which way it's going to go. Right now, it looks like there's a lot of hope. There's been a tremendous run in certain sectors of the US economy or in the US stock market based on pure hope—without any sort of idea what's actually going to happen. So you have injected a significant amount of risk into certain sectors.

So we are being pretty tactical in the way that we move around equities. We think growth expectations and inflation expectations have moved well ahead of themselves. So we think the longer end of the yield curve, interest rates - longer-term interest rates - are looking somewhat interesting here… strictly from a "2017 doesn't look like it's going to be much different than 2016" point of view. But the market has priced in some significant acceleration in GDP growth and inflation, so we think that interest rates should come down a little bit once the lack of growth acceleration is accepted.

And we are looking a little bit at your dividend and buyback driven equities. We think those can be somewhat interesting. And it sounds like one of those old stories, interest rates fall and even though you want to buy those, blah, blah, blah.

But one, the most popular tax reform that's been tossed around is repatriation… and if you look at the 2004 Bush repatriation tax plan, it mostly went to buybacks and dividends. And so those companies that benefited most from bringing back cash, buying their own stock and returning capital to share holders, those stocks did very, very well. So we are kind of playing it as if we are going to have this type of radical change, let's get in front of the portions that make the most sense for investors and kind of avoid those sectors that have already run.

JR: Well, excellent advice for our listeners, Sam. Really appreciate you joining me today.

SR: Excellent, thank you very much, Jonathan.

JR: Be sure to visit riskhedge.com for the latest on how to manage risks to your portfolio. For RiskHedge Radio, I am Jonathan Roth.

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