— Analysis

Release the doves: Trump's inevitable escalation

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For how popular "Trump-bashing" seems to be among the middle classes, has anyone noticed that he's been winning? It has been more than a year since the first tariffs were imposed on Chinese imports into the US. The trade cycle has weakened, many parts of the world are in manufacturing recession, and nobody seems to want semiconductors anymore.

But the US economy is currently performing better than most of its rivals, and crucially China's economy is still slowing, with its state media having to prepare the nation for tough times ahead akin to "The Long March".

Trump has also "won" with regards to US monetary policy. The global uncertainties that have been kicked up as a result of multiple rounds of trade war escalation have been sufficient not only to one-eighty the Fed into the first easing cycle in a decade, but also for bond markets to behave like another 200 basis points of rate cuts have already happened.

This easing cycle is coming just in time because it's clear that the Fed overtightened rates and that a US recession is very close if not already upon us.

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But despite starting the easing cycle with a cut in July, worryingly the Fed seem destined to get themselves further behind the curve. These fears are highlighted by the long-awaited inversion this month in the US yield curve which has rightly sparked broad-based media panic that the countdown to the next recession has begun.

However, you don’t have to join me in the “recession camp” to buy into the trends of lower bond yields and flatter yield curves. After all, what is at work here is not a US phenomenon but a global one.

Europe is at the heart of this trend, having tried so hard and for so long to avoid “Japanification”, only to accelerate well beyond that into its own brand of “Eurofication”.

The ECB are talking tough and promising they are up to the task and I eagerly look forward to the ECB meeting next month to see what they can pull out of the hat. But the task is very difficult for them, as the more they ease, to help the currency, the more pressure they put on the domestic banking system which further curtails growth.

A truly terrible situation to be in.

So with every bond that dips into negative yielding territory, demand grows for the next bond along the curve. And with every yield curve that sinks below zero, the hunt intensifies for the next alternative that provides a positive level of income. Within this context, the fact that “only” 30 per cent of global bonds yield below zero should feel more like a boon than a bane.

By virtue of its high-yielding status the US has become by far the most attractive of the core global bond markets, and will continue to be so, as with every trade war escalation, Trump is lending more weight to the FOMC doves.

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However, the line between winning and losing from this point on for Trump will be a fine one. By keeping the trade war limbo in play, interspersing periods of tariff escalation with upbeat and friendly tweets, he slowly but surely kills corporate sentiment and therefore capex.

It would be much better for the US and global economy were he to escalate the trade war beyond the point of no return giving policy makers the green light to go hard on all available stimulus measures.

Perversely, a further escalation of the trade war would directly benefit China. It would provide the perfect cover for China’s higher-ups to turn their backs on reform and deleveraging without losing face. They could pump credit growth like it's 2016 and blame the build-up of financial fragility on Trump.

They could slash interest rates and let their currency weaken regardless of being labelled a "manipulator". In essence, they would recoup sufficient policy flexibility so as to navigate the consequences of the ongoing trade war.

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In short the world is in a pretty rough place right now, and the global manufacturing recession we are in is slowly leeching into the consumer sector. Central banks have woken up to some of the risks but will panic when the recession in the US finally arrives, at that point the Fed will throw everything they have at it.

But there is no certainty that their all will be enough by then.

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