Building a Remedy, for Tariff Man and Mr. Xi…

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… and for Wall Man and Pelosi.

After a powerful rally to start 2019, markets largely pulled a sideways shuffle this week, with stocks aiming for modest net gains, yields dipping, and currencies mostly flat. In a week dominated by the deep thinkers in Davos, a U.S. data void, and few shocks from Q4 earnings, **the focus fell on global growth** and **any new developments in the big three market irritants**. As we outlined last week, that Hall of Shame is occupied by **the U.S. government shutdown**, **Brexit**, and **the U.S./China trade battle.** On each front, this week brought a lot of heat, and only a little light. **The shutdown is seemingly ending until February 15 on a stop-gap funding bill**. But the battle on border security will rumble on, with both camps locked in position, seemingly unable to back down. The Brexit morass prompted some Royal intervention, while the pound rose more than 2% on rising hopes that a hard exit can be averted.

We continue to assert that, by far, the most important of the three market irritants is the U.S./China trade tiff. It is the one flashpoint that can rise to the level of causing some serious damage to the global economy if the talks founder. **In turn, even semi-success on this front could provide a meaningful boost to sentiment and the broader outlook.** The news flow was back and forth this week, ahead of the next set of meetings in Washington on January 30/31. While Treasury Secretary Mnuchin played good cop (*"a lot of progress"),* Commerce Secretary Ross was the bad cop ("*miles and miles"* from a resolution). In fact, both could be quite correct; trade deals can be extraordinarily complex, and perhaps there has been some real progress in recent weeks. Call us skeptical—no, highly skeptical—that a broad agreement can be reached anytime soon. But the generally positive tone does suggest that there might be just enough headway to extend negotiations well beyond the March 1 deadline.

While U.S. economic data—and trade figures specifically—have gone AWOL amid the shutdown, such was not the case in China. This week started with the entirely unsurprising **news that Q4 GDP in China cooled to 6.4% y/y, holding full-year growth to "just" 6.6%.** That's the slowest annual gain since 1990, and we're calling for 6.0% this year, even with some stimulus support. That calmer pace, along with a more modest U.S. advance, is a big reason why the global growth outlook is fading. Markets stumbled early this week on the IMF's downgraded forecast for world GDP, which they clipped to 3.5% for this year and next. **Spoiler alert:** That's not the last downgrade for 2019, as we are already pegging this year at 3¼%.

Besides the high-profile GDP figures, **China also quietly released the details of its 2018 trade flows. And the results amply reveal the law of unintended consequences.** For all of last year, China's trade surplus narrowed to US$367 billion (from $438 bln in 2017), as imports jumped 15.8%, while exports remained strong at up 9.7%. However, the bilateral gap with the U.S. actually widened to $325 bln (from

$278 bln), as exports to the U.S. remained strong at +10.8%, while imports almost stagnated at up just 0.1% on the year. (Somewhat ironically, China's imports from Canada surged 39.4% last year, cutting the bilateral surplus to just $7 billion.) So, in a year when China was ramping up imports aggressively, thus cutting into its towering surplus, the U.S. was left out of the buying spree. In other words, stage one of the trade war completely backfired.

This is not to suggest U.S. policy is misguided on this issue; it's more that such a crucial file may require a defter touch and a bit more patience. After all, a strong case can be made that the biggest current threats to the cycle are all policy-driven and self-inflicted. At this stage, the goal should be to aim for small short-term wins in the trade talks, and keep the dialogue going. That's actually a more likely scenario than we may have guessed just a month ago.

Today is Robbie Burns Day *('Scots Wha Hae!');* besides being a poet and a connoisseur of fine Scotch and haggis, Burns also had a few great quotes on forecasting.

> *"There is no such uncertainty as a sure thing."*
>
> *"The best-laid plans of mice and men often go awry."*

Which naturally brings us to next week's FOMC meeting, as well as the Fed's reversal of QE, or quantitative tightening (QT). The process of gradually reducing the Fed's balance sheet, which was supposed to be a non-event for the market, has suddenly become a hot topic, especially for stocks (the best-laid plans, and all that). This week's Economist chimes in that the process is causing unexpected market volatility, while today's Wall Street Journal suggests that **the Fed may halt the QT program sooner than expected**. As a reminder, the Fed's balance sheet now stands at just over $4 trillion, down nearly 10% (or $420 billion) since QT began in 2017Q4, but still well up from pre-crisis levels of under $1 trillion.

So, is the possibility of an earlier end to QT bullish or bearish for Treasuries? Well, theory would suggest that since QE supposedly served to reduce long-term yields by up to 100 bps below where they otherwise would have been, then QT should have pushed up yields. Thus, halting QT early should be bullish (i.e., push yields down). But, since stocks have ostensibly been roiled by QT, then halting QT should be stock-supportive, so risk-on and, thus, bearish for Treasuries (i.e., push yields up). And, meantime, this is all complicated by the fact that yields are also being swayed by QE decisions at other central banks. On balance, we would land on the first line of reasoning—that, ultimately, bigger Fed holdings of Treasuries than initially expected will tend to keep a mild damper on yields. For the U.S. dollar, the impact of a less forceful QT seems unambiguous—it would be negative for the greenback.

As Burns may have also said, forecasting is hard, especially when it's about the future. (Actually, that was Niels Bohr, but who's counting?)

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