White House

Trump’s high-wire act on trade risks a rough fall

The president is counting on a strong economy to cushion the U.S. during his tariff fight. But economists say conditions are already fragile — raising recession risks just before h

By Ben White | 06/07/2019 05:04 AM EDT | Updated

Donald Trump is trying to pull off the riskiest high-wire act of his presidency, threatening to escalate trade battles with Mexico and China even as warnings signals flash about a possible recession arriving just as his re-election campaign begins.

Trump is edging to the brink of a two-front trade war in a very different environment than he enjoyed last year, when the GOP tax cut pumped billions of dollars of stimulus into the U.S. economy.
“If you combine the effects of Mexico and China tariffs, the drag on the economy is close to 1.5 percent and that is quite significant when you consider that growth is already slowing quite a lot,” said Gregory Daco, chief U.S. economist at Oxford Economics. “And who knows about the confidence shock from tariffs or the stock-market shock. The risk here would clearly be recession if we are talking about these blanket tariffs.”

Signals on the direction of the U.S. economy remain mixed. A reading on private payrolls in May showed the smallest gain since 2010. And the official government employment gauge out Friday morning showed an increase of just 75,000 jobs in May, a slowdown well below expectations. The unemployment rate remained at 3.6 percent, near a 50-year low.

And the stock market tanked in May as investors worried about the impact of Trump’s tariffs. Shares jumped Thursday afternoon on reports that the Mexico tariffs could be delayed and that a deal could still be reached before the first levies of 5 percent go into effect on Monday.

Global Translations

In the bond market, investors now receive less interest on long-term than short-term bonds, a wonky but critical phenomenon known as an “inverted yield curve” that often precedes recessions. Oil prices officially entered bear market territory this week — a drop of 20 percent from a recent high — on fears that a slowdown in global growth will slice into demand. Low oil prices are good for consumer spending in a strong economy but can also signal an impending contraction due to weak demand.

Virtually every major economic forecasting firm now has growth downshifting to just below 2 percent in the second quarter of the year as the impact of the tax cut fades and a build up of inventories that boosted first-quarter GDP over 3 percent gets unwound.

The shock of tariffs as high as 25 percent on $350 billion in Mexican imports and over $500 billion in Chinese imports — coupled with negative reaction in markets — could push that number close to or below zero, analysts warn.

And the mere fact that Trump threatened the Mexican tariffs over an unrelated immigration matter and after negotiating a sweeping free-trade deal with Mexico could undermine the confidence of corporate executives to make investments and consumers to trust that the economy will remain strong.

“We are already fragile on sentiment,” said Diane Swonk, chief economist at Grant Thornton. Consumer confidence is still high but expectations for the future are now below a gauge of current conditions, she noted. That means consumers still feel good now but are getting worried about the outlook, suggesting potential for a spending pullback.

Swonk sees a recession coming in 2020 unless the trade fights come to a rapid end. ”We literally scared ourselves into a sharp market
Recession fears are showing up most sharply in the bond market, where an inverted yield curve presaged every recent recession. Ordinarily, investors demand more interest to lock up their money in longer-term Treasury bonds. But when investors get nervous that markets and the economy could be vulnerable, they tend to gravitate to long-term bonds, sending prices higher and yields lower.

“This is not normal and it tells us something is wrong,” said Campbell Harvey, a professor at Duke University’s business school who wrote his thesis on yield curve inversions and has tracked them for three decades. “What we’ve observed in the data is that if you’ve got an inversion of the 10-year bond against the 3-month bill for one full quarter, that has predicted each of the last seven recessions and provided no false signals.” This part of the yield curve has been inverted for nearly a full quarter.

The inverted yield curve, jittery markets and the threat of further destabilizing trade actions have clearly caught the attention of the Federal Reserve. Fed Chair Jerome Powell, speaking Tuesday in Chicago, sent stocks sharply higher when he indicated the central bank would be “closely monitoring” the trade disputes and would “act as appropriate to sustain the expansion.”

Wall Street traders now expect the Fed to cut rates as many as three times this year to battle the inverted yield curve and cushion the blow from trade wars. The problem here is the Fed has a fairly long tradition of cutting rates too late. Economists note that the Fed cut rates too late in 2008 when the housing market collapsed and in 2000 when the dot-com bubble burst. Rate cuts also take time to have an impact, meaning by the time the central banks get around to acting this summer or fall, the next downturn could already be gathering pace.

“Sometimes the Fed should worry that overly easy policy will lead to complacency in financial markets,” former Treasury secretary Larry Summers wrote in an op-ed this week. “In light of recent volatility in the markets and with the possibility of more adverse surprises on the trade front, this is not such a time.”

Trump, meanwhile, continues to argue that the economy is doing extraordinarily well and that tariffs are a net positive. “The higher the tariffs go, the higher the number of companies that will move back to the USA!,” the president tweeted Wednesday.

Inside the administration, aides including Treasury Secretary Steven Mnuchin and U.S. Trade Representative Robert Lighthizer have largely given up on the idea that they can talk Trump out of the Mexico tariffs.
White House press secretary Sarah Huckabee Sanders on Thursday rejected early reports that the president might hold off. “Position has not changed, and we are still moving forward with tariffs at this time,” she said.

Economists take a very different view of the likely impact of Trump’s proposed tariffs on Mexico, particularly on the auto industry, which relies on an integrated North American supply chain and often sends parts and completed vehicles across the border several times before they reach the market, leading to the potential for compounding tariffs.

Deutsche Bank estimates that tariffs of 25 percent could increase the cost of vehicles in the U.S. by an average of $1,300 and reduce demand by 3 million units, or 18 percent.

Economists also warn that Trump going to 25 percent on everything China exports to the U.S. will quickly lead to higher prices for consumers.

Trump has repeatedly claimed that foreign countries pay the tariffs he levies, leading to more revenue for the Treasury. But academic research thus far shows nearly all the cost has been borne by U.S. importers and consumers.

That’s what leads economists to warn that if Trump can’t pull off deals with China and Mexico, his high-wire act could lead to disaster.

“It’s one thing to impose tariffs when the economy is on the way up and we are doing fine,” said Daco. “But once you’ve reached the inflection point, and we’ve passed that point, then any push you give with tariffs is just going to make the slowdown more rampant and throw fuel on the fire.”