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The Madman Theory

Trade war morphing into tech war; brinkmanship appears unavoidable

JIMMY C. CHANG, CFA

Chief Investment Strategist
Senior Portfolio Manager

Rockefeller Capital Management

(212) 549-5218 | jchang@rockco.com

May 2019 may turn out to be a pivotal month for the Trump Presidency. According to National Economic Council Director Larry Kudlow's football analogy, the trade deal with China had advanced to the 5 or the 7-yard line in early May. However, the trade deal fell apart after China returned the draft agreement with extensive edits that, according to U.S. officials, undermined the core architecture of the deal. After each side meted out more tariffs, President Trump significantly ratcheted up the tension by initiating steps to block Chinese telecom equipment national champion Huawei from accessing American technology. The U.S. has essentially expanded the *Trade War* into a *Tech War* with the specter of the *Cold War* waiting in the wings. It was a triumph of the hawks over the doves on both sides of the Pacific Ocean. Trump then closed out the month with the unprecedented move of threatening tariffs on Mexican imports unless the country manages to stem the flow of north-bound migrants.

These developments sparked risk-off reactions, with equities, emerging markets in particular, declining and sovereign bonds rallying. The bond market priced in a near certain Fed funds rate cut by year end, with the 3-month/10 year U.S. Treasury yield curve inverting further. Concerns over global economic slowdown drove commodity prices lower. Crude oil prices weakened despite rising tension in the Middle East, including: Iranian saber-rattling; Libya's simmering civil war; Yemen rebels' drone attacks on Saudi oil facilities; and Turkey's incursion into Northern Iraq to pursue Kurdistan militants. Gold and the yen rallied as investors sought out safe havens, while the U.S. Dollar Index was about flat. Sterling got pounded as Theresa May's resignation created more Brexit anxiety. China let the renminbi drop 2.5% against the greenback.

Recent data shows that leaders in both China and the U.S. run the risk of overestimating their own economic strength. Of late, Chinese economic data was decidedly on the weaker side. Some economists have downgraded 2Q19 U.S. GDP growth estimates to below 1%. Ironically, it may take some economic setbacks to motivate China and the U.S. to iron out a trade deal. That said, it will be a tug of war between political considerations and rational economic decisions.

EQUITY MARKETS INDICES[1]	4/30/19 Price	5/31/19 Price	MTD Change	YTD Change
MSCI All Country World	525	492	-6.2%	8.0%
S&P 500	2946	2752	-6.6%	9.8%
MSCI EAFE	1921	1817	-5.4%	5.7%
Russell 2000®[2]	1591	1465	-7.9%	8.7%
NASDAQ	8095	7453	-7.9%	12.3%
TOPIX	1618	1512	-6.5%	1.2%
KOSPI	2204	2042	-7.3%	0.0%
Emerging Markets	1079	998	-7.5%	3.3%
FIXED INCOME				
2-Year US Treasury Note	2.27%	1.92%	-34	-57
10-Year US Treasury Note	2.50%	2.13%	-38	-56
BarCap US Agg Corp Sprd	1.11%	1.28%	17	-25
BarCap US Corp HY Sprd	3.58%	4.33%	75	-93
CURRENCIES				
Australian *(AUD/$)*	1.42	1.44	1.6%	1.6%
Brazilian Real *(Real)*	3.92	3.92	0.1%	1.1%
British Pound *($/GBP)*	1.30	1.26	3.2%	1.0%
Euro *($/Euro)*	1.12	1.12	0.4%	2.7%
Japanese Yen *(Yen/$)*	111.42	108.29	-2.8%	-1.3%
Korean Won *(KRW/$)*	1168.15	1190.91	1.9%	7.2%
U.S. Dollar Index *(DXY)*	97.48	97.75	0.3%	1.6%
COMMODITIES				
Gold	1284	1305	1.7%	1.8%
Oil	63.9	53.5	-16.3%	17.8%
Natural Gas, Henry Hub	2.58	2.45	-4.7%	-16.5%
Copper *(cents/lb)*	290	264	-9.0%	0.3%
CRB Index	184	175	-4.8%	3.3%
Baltic Dry Index	1011	1096	8.4%	-13.8%

Source: Bloomberg.

Trump may calculate that there is more to gain politically by positioning himself as the defender of American interests against China's economic aggression.

THE STRATEGY OF IRRATIONALITY

In a 1985 interview with *Time Magazine*, former President Richard Nixon lauded the late Soviet leader Nikita Khrushchev as "the most brilliant world leader I have ever met." It was probably the highest form of praise for the crusty, shoe-banging former communist leader, as Nixon was known to be self-absorbed and staunchly anti-communist. It turned out that Nixon was most impressed that Khrushchev had fostered an image of boorishness and unpredictability that "scared the hell out of people." In fact, Nixon had even emulated Khrushchev's modus operandi with what he termed the "madman theory."

According to H.R. (Bob) Haldeman, Nixon's one-time loyal Chief of Staff, Nixon confided in him in 1968 that the secret strategy to end the Vietnam War was to convince the North Vietnamese that the President had become so crazy that he might do anything, namely use the nuclear bomb, to end the war. Nixon believed that this madman strategy would drive the North Vietnamese and the Soviets to the negotiating table.

Some academics credit Daniel Ellsberg of the *Pentagon Papers* fame and Nobel economics laureate Thomas Schelling for coming up with the madman theory. The former lectured on the "political uses of madness" at Henry Kissinger's seminar at Harvard in 1959, while the latter wrote about the strategy of irrationality in his 1960 book *The Strategy of Conflict*. However, the madman strategy goes back much further in history. The 16th century Italian political philosopher Niccolò Machiavelli wrote in the *Discourses on Livy* that sometimes it is "a very wise thing to simulate madness" in the game of thrones. China's *Thirty-Six Stratagems*, which dates back as early as the third century, had "feign madness but keep one's balance" as the 27th strategy for military and political maneuvering.

Of course, not all irrational political behaviors are feigned madness. History is replete of truly mad kings and emperors. Rome's Caligula is known for his paranoia, debauchery, and brutality, while France's Charles VI, nicknamed Charles the Mad, suffered bouts of psychosis from his mid-twenties but still managed to remain on the throne for forty-two years. The late Ugandan strongman Idi Amin bestowed himself the title "*Lord of All the Beasts of the Earth and Fishes of the Seas and Conqueror of the British Empire in Africa in General and Uganda in Particular*." Oddly, according to Dr. Nassir Ghaemi, an academic psychiatrist at the Tufts University School of Medicine, mental illness may not always be a bad thing. His 2011 book *A First-Rate Madness* chronicled the supposed mental disorders of great leaders. He even went so far as to claim that, "*the best crisis leaders are either mentally ill or mentally abnormal; the worst crisis leaders are mentally healthy*." This observation should help many Trump detractors sleep soundly at night.

MADMAN THEORY REDUX?

Time and again, President Trump has shown that he is anything but conventional. He airs out his grievances and runs policies via Twitter. He makes a mockery of traditional media, diplomatic protocols, and the establishment. He trusts his instincts more than expert advice, and takes pride in being unpredictable. In short, he has achieved what Nixon found so admirable in Khrushchev – scaring the hell out of people.

Following the recent breakdown in the Sino-U.S. trade negotiation, the self-proclaimed Tariff Man tweeted that *"The unexpectedly good first quarter 3.2% GDP was greatly helped by Tariffs from China. Some people just don't get it!"* He kept on insisting that the tariffs were paid by China – *"Tariffs are NOW being paid to the United States by China of 25% on 250 Billion Dollars worth of goods & products."* He even proposed that *"with the over 100 Billion Dollars in Tariffs that we take in, we will buy agriculture products from our Great Farmers, in larger amounts than China ever did, and ship it to poor and starving countries in the form of humanitarian assistance."*

The fallacies in these tweets must have driven economists and the President's detractors crazy. Nike, Adidas AG, and 171 other companies jointly issued an open letter that stated, *"Your proposal to add tariffs on all imports from China is asking the American consumer to foot the bill. It is time to bring this trade war to an end."* So how can this self-proclaimed "very stable genius" express such misconceptions? The logical conclusion is that Trump is either a practitioner of the madman theory, or an unrepentant economic ignoramus who would fire his advisors for dissention. We choose to believe in the former, as the latter is simply too frightening. We suspect that Trump's irrational tweets on the benefits of tariffs were aimed at scaring China and others into making concessions, or risk the Tariff Man upending the global trade order. On June 10th, we will find out if Trump really does go ahead with the tariffs he threatened to impose on Mexico.

CHINA'S COUNTERMOVES

The problem with the madman theory is that, when pushed, the protagonist has to carry out the threat or risk being called out on one's bluff. China may have come to view President Trump as all bark and no bite, or as a Chinese proverb says, "loud thunder but tiny raindrops." To wit, Trump and Kim Jong Un's mutual-insults-turned-admiration has yet to drive North Korea to make any material concession. The contentious NAFTA renegotiation (remember Trump calling Trudeau *"very dishonest & weak"*?) did not result in much structural changes. More tellingly, following last December's Trump-Xi summit that set a 90-day truce to iron out a trade deal, Trump simply let the March 1st deadline go by without raising tariffs. The prolonged trade negotiation has given China time to steady its domestic economy with significant stimulus.

Chinese leaders probably believe that they are now in a stronger position to test Trump's resolve given that the White House needs a healthy economy heading into the 2020 election season. China has thus chosen to respond to Trump's tariff escalation with its own set of ultimatums. Chinese media has also started to stir up nationalist sentiment against alleged U.S. bullying by reminding people of the humiliation of the "unequal treaties" that were forced on China by Western imperialist powers in the 19th century.

DAWN OF THE TECH WAR

In our April report, *Only the Paranoid Survive*, we wrote about the U.S. government's effort to stifle Huawei's rise, and surmised that the U.S. may eventually resort to the so-called nuclear option by prohibiting companies from selling critical components to Huawei. That eventuality arrived on May 15th, with the U.S. Commerce Department placing Huawei on its Entity List for export and technology transfer control. This move prompted many firms – Intel, Qualcomm, Google, Microsoft, and U.K.'s Arm Holdings – to suspend their dealing with Huawei. While Huawei has allegedly stockpiled 12 months' worth of inventory, the lack of continued access to components and software made by Western firms could seriously disrupt Huawei's product development. The Commerce Department later granted a Temporary General License that allowed existing businesses with Huawei to continue for 90 days.

It remains to be seen if the Trump Administration is using Huawei as a bargaining chip in the trade negotiation, or if it really intends to put the company out of business. We find the latter unlikely as it will open up the proverbial Pandora's box. Huawei, a behemoth with annual sales twice that of Cisco's, operates in 170 countries and controls 15% of the 5G, the new state-of-the-art mobile communications technology patents. China has amassed more than a third of all 5G standard-essential patents and could use them to extract an ounce of flesh from Western firms if the tech war escalates. We suspect the administration may wind up requiring Huawei's U.S. suppliers to renew their export licenses every 90 days. Such a move would leverage the FUD Factor (fear, uncertainty, and doubt) to induce U.S. allies to exclude Huawei equipment from their 5G network buildout. Indeed, several European and Japanese telecom operators have suspended the sales of new Huawei smartphones as the company's continued access to Google's Android ecosystem was put in doubt.

Following the U.S. moves against Huawei, Chinese President Xi Jinping and Vice Premier Liu He, the top trade negotiator, toured a Chinese rare earth mining and processing facility. It was viewed as a veiled message that China could inflict material damage to the global economy by withholding its rare earth metal exports, which account for 90% of the global supply. Following the tour, President Xi spoke at a wreath laying ceremony at a Long March monument to commemorate the Red Army's 5,600 mile trek through difficult terrain during the civil war of the 1930. President Xi then told a cheering crowd that *"there is a new Long March, and we should make a new start."* It was a signal to the U.S. that he was ready for a protracted trade battle. As the trade war escalates, we expect the Chinese government to inject additional stimulus to fuel domestic demand. Huawei's vulnerability will likely prompt China to invest even more in technology in an effort to become self-sufficient, which would ultimately drive the U.S. to further stiffen control over technology exports to China.

POLITICS TRUMPS ALL

At the time of this writing, the 12th round of the Sino-U.S. trade talk has yet to be scheduled. However, we suspect the two sides will likely resume the dialogue shortly in preparation for the meeting between Presidents Trump and Xi at the G20 Osaka Summit in late June. The best outcome from the meeting may be an agreement to de-escalate the tension and resume constructive dialogue. On the other hand, the two leaders may choose to forgo trade talks if the gap remains too wide. The tension could escalate further by autumn. The administration will be in a position to start levying 25% tariffs on an additional $300 billion worth of Chinese imports, while China will likely find other ways to retaliate. Anti-American sentiment in China could become more widespread as the flame of nationalism will burn brighter heading into the 70th anniversary of the founding of the People's Republic of China on October 1st. This backdrop could make it harder for President Xi to agree to a deal unless he can extract some concessions from the U.S.

Should China refuse to yield to the administration's demands, Trump will have to decide between making a lesser trade deal, and escalating the trade war. Contrary to the conventional wisdom that he would accept a lessor deal to avoid hurting the economy during the 2020 election season, Trump may calculate that there is more to gain politically by positioning himself as the defender of American interests against China's economic aggression. He could lessen the negative economic impact of tariffs by gradually phasing in the 25% tariffs on $300 billion worth of Chinese imports over many months. Such a move would not only keep his tough-on-China credentials in the headlines, but also give U.S. businesses more time to divert their production from China. Trump could also try to work out an infrastructure deal with the Democrats to offset the negative impact of tariffs. Should the fallout from the trade war start to seriously weigh on the economy, financial markets, and consequently his re-election prospects, Trump can always pivot to make a compromise with China and then spin it as a total victory.

In the final analysis, we are dealing with a fluid situation where the rational avoidance of a bruising trade war may be trumped by domestic politics and longer-term geopolitical considerations. In the near term, we suspect the risk in equities outweighs the potential upside. The question is how much of a market pullback is needed for Trump to blink.

For more information on Rockefeller Capital Management:

rockco.com

New York, NY
45 Rockefeller Plaza, Floor 5
New York, NY 10111
212.549.5100

Rockefeller Trust Company, N.A.
45 Rockefeller Plaza, Floor 5
New York, NY 10111
212.549.5100

The Rockefeller Trust Company (Delaware)
1201 N. Market Street, Suite 1401
Wilmington, DE 19801
212.498.6000

Atlanta, GA
3560 Lenox Road, Suite 3000
Atlanta, GA, 30326
404.443.2700

Boston, MA
99 High Street, Floor 17
Boston, MA 02110
617.375.3300

Saratoga Springs, NY
18 Division Street, Suite 308
Saratoga Springs, NY 12866

Salt Lake City, UT
2603 East Parleys Way
Salt Lake City, UT 84109
801.736.9950

Washington, DC
900 17th Street NW, Suite 603
Washington, DC 20006
202.890.8080

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