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It's the Trade War, Stupid

On a dry erase board in the so-called *War Room*, Bill Clinton's 1992 presidential campaign headquarters in Little Rock, Arkansas, well-known strategist and political firebrand James Carville famously wrote the words, "The economy, stupid."

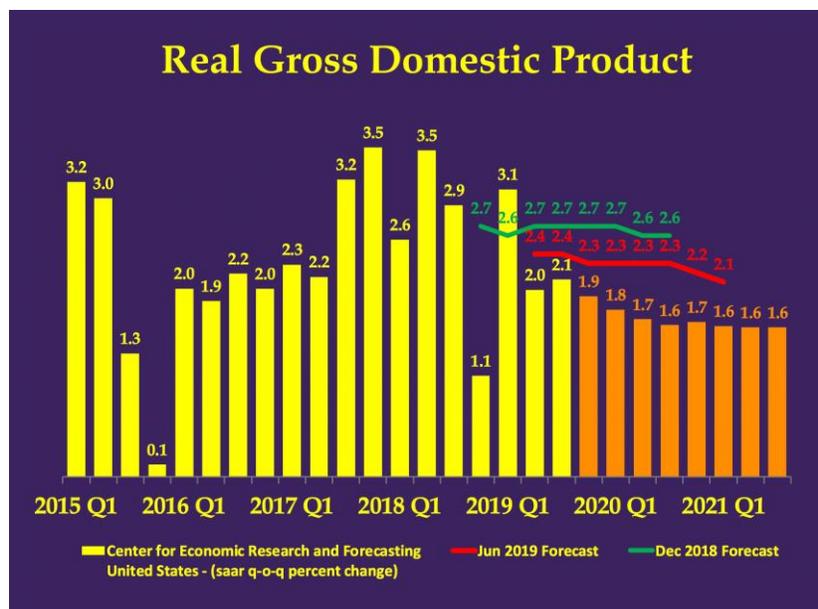
Meant to focus the attention of campaign staffers on an eroding economic outlook, the phrase quickly became the dominant campaign slogan as Clinton fought and defeated his incumbent rival.

Today, if you stop by the CERF offices in Westlake Village, California, you shouldn't be surprised to see a dry erase board with these words:

"The Trade War, stupid."

The economic outlook is once again eroding. In today's case, dramatically. Despite significant benefits still flowing from corporate tax reform, the economy is buckling under the weight of the most restrictive international trade policies in nearly 90 years. Looking at the trajectory of economic growth and the timeline of tariffs imposed on Chinese goods, it's obvious. It's the trade war.

The CERF forecast currently calls for quarter-on-quarter growth which ranges from a high of only 1.9 percent down to 1.6 percent across the entire forecast horizon. The average growth rate over this period is just 1.7 percent, 100 basis points lower than our December 2018 forecast average and 60 basis points lower than the June 2019 forecast average.



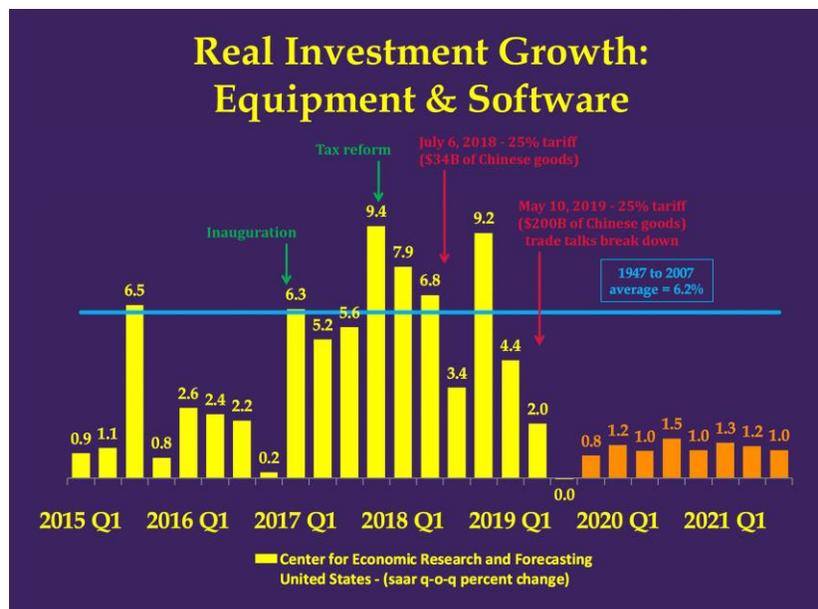
The current outlook is weak compared to almost any historical context. The current forecast anticipates growth that is only half of the Post World War II average growth rate of 3.5 percent. The current forecast is weak even compared to the anemic two percent average growth rate which marked the decade following the Great Recession.

That period of poor economic growth was the result of policies implemented during the financial crisis and its aftermath, policies which constrained economic activity and stifled the recovery. In other words, the decade of anemic growth which followed the Great Recession was the fault of policy makers, including those in labor, healthcare and monetary policy. The current slow down again bears policy makers' fingerprints, but this time, it's the fault of those leading the extraordinary assault on trade partners around the globe.

To be clear, the CERF team does not believe that the current slow down in economic growth is the result of a global economic slow-down or some other external force impacting the United States. It's also not the result of the Federal Reserve failing to lower interest rates sooner and more aggressively. (As a matter of fact, if the Fed is implicated, it's because it didn't move more swiftly to *normalize* monetary policy.)

No. It's the Trade War.

As CERF has claimed again and again over the years, policy matters. The primary channel through which trade policy is impacting total economic output in the United States is businesses investment—decisions whether to increase intellectual property, invest in new capacity, expand operations, build new facilities, etc. An examination of the data reveals that business investment is highly responsive to recent changes in trade policy.



Consider that during the final 8 quarters of the previous Presidential Administration, business investment was extremely slow. Investment in equipment and software by U.S. businesses grew at an average rate of only 2.1 percent, well below the post-World War II average of 6.2 percent. We believe that this period of slow growth was driven by an unfriendly business environment fostered by an administration that seemed to want to regulate every corner of private economic activity.

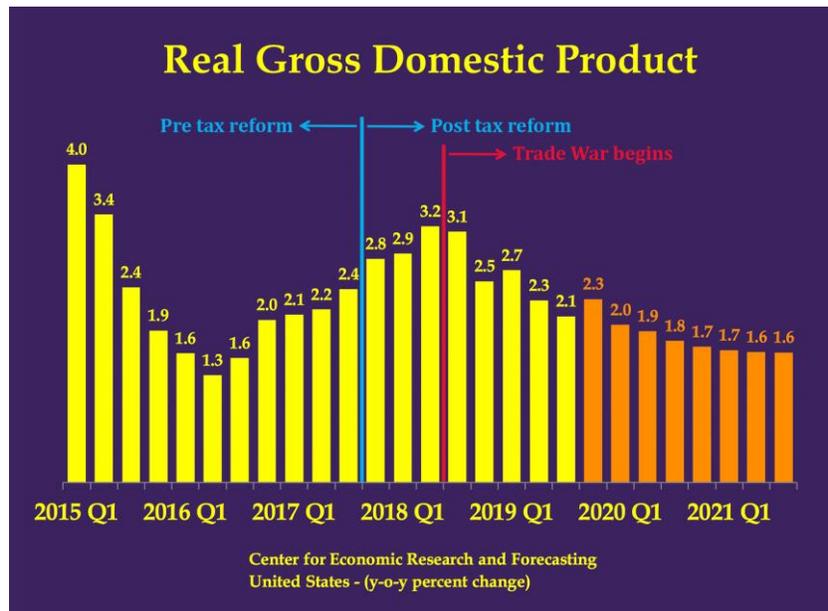
From 2017 Q1, when the new administration took office, through 2018 Q2, prior to the start of the trade war, investment in equipment and software grew at an average rate of 6.9 percent. The new Administration's promise of wide spread deregulation of the private economy seems to have had an immediate impact on business investment decisions.

Even more dramatically, from 2017 Q4 through 2018 Q2, the first three quarters impacted by corporate tax reform, business investment surged. Investment in equipment and software grew at an average rate of 8.1 percent during these three quarters.

Not surprisingly, tariffs implemented by the Trump Administration on July 6, 2018 and again on May 10, 2019 have been truly stifling. Average growth in real investment since the first \$34 billion of tariffs on Chinese goods were implemented, has averaged only 3.8 percent. Investment in equipment and software has grown at an average of only 1.0 percent since an additional \$200 billion in tariffs were imposed beginning in early May.

Investment in equipment and software represents only a portion of total business investment. Yet, had this one category of business investment continued to grow at the 8.1 rate which prevailed after tax reform, GDP growth would be more than 20% higher than it is today. The implied GDP growth rate is 2.7 percent as opposed to 2.2 percent. Considering the impact on business investment more broadly, we believe that without the trade war, GDP growth could be even higher still.

And we fear that we may soon pine for the good old days of 2.2 percent growth. Even with a substantial de-escalation of the trade war, we anticipate that restrictionist policies will continue to stifle growth across the entire forecast horizon.



Looking at year-on-year growth rates, GDP growth is forecasted to continue a sustained slowdown which began with the onset of the trade war at the end of 2018 Q2. If the forecast holds, the economic growth rate will have been cut in half.

We realize that it's a very different political era than 1992 when the phrase "It's the Economy, stupid" served to refocus the attention of elected officials and the citizens which they represent. The Clinton Administration went on to work with a Republican led House on bipartisan reforms, including welfare reform and a reduction in capital gains taxes, which fueled robust economic growth.

It's a different era and it will take more than a slogan to change the outlook. But we'll say it nonetheless. "It's the Trade War, stupid."