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MACROCOSM

Did China Just Run Up the White Flag in the Trade War?

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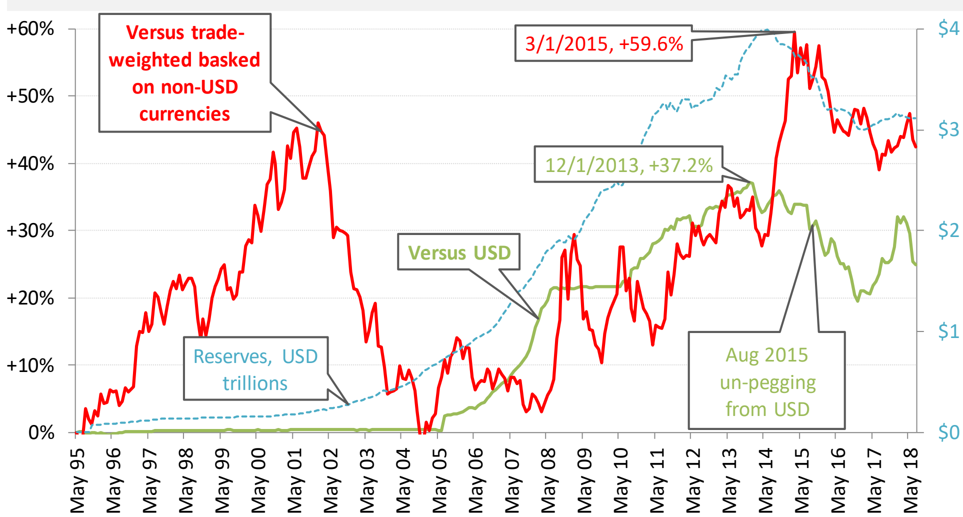
The PBOC rules out devaluation, fearing capital flight. China is too fragile to play this game.

Why are stocks rallying as the US and China finally actually begin to impose tit-for-tat tariffs in what had been, until now, only a tariff war of words? Maybe because, if you know where to look, you can see that China is already running up the white flag after only a few shots have been fired.

After the worst single month in history for China's renminbi (please see the chart below), People's Bank of China Governor Yi Gang said in a statement that the RMB's sharp weakening did not reflect a change in policy, but only "the strength of US dollar and external uncertainties." *Getting straight to the point the same day, Sun Guofeng, head of the PBOC's financial research institute, told Bloomberg that "China…will not make the yuan's exchange rate a tool to cope with trade conflicts."*

- Before we congratulate China on this noble laying down of weapons, consider that China *will* not cheapen its currency – a very standard tactic in trade wars – because it *can't*. *At least not without risking capital-flight that might expose untested systemic fragilities of unknown dimension.*
- *The sharp weakening of RMB shows some degree of capital flight is already underway, likely a pricing-in of anticipated fragilities as*

Renminbi, cumulative change from May 2015, and PBOC foreign reserves



Source: Bloomberg, TrendMacro calculations

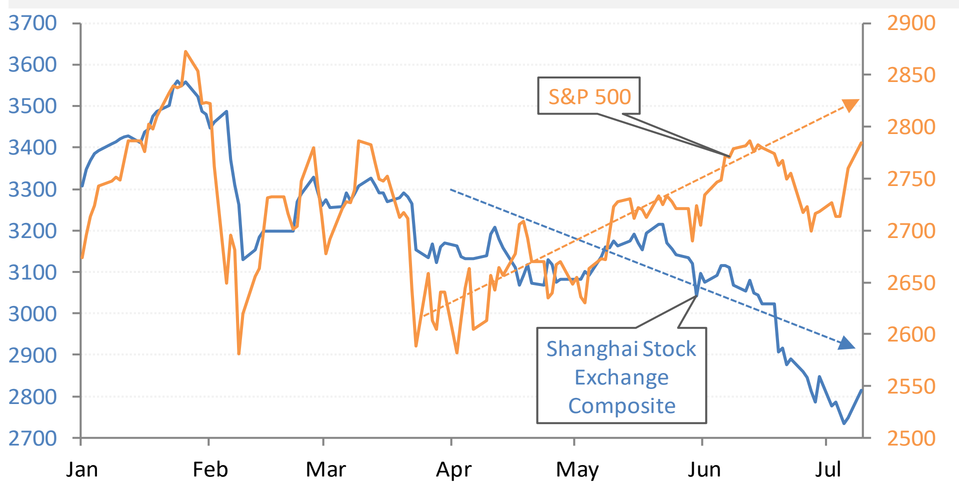
Update to strategic view

US MACRO, ASIA MACRO, EM MACRO, FX, US STOCKS, ASIA STOCKS, EM STOCKS: After the worst month in history for China's currency, the PBOC has had to declare it won't use RMB as a trade weapon. Otherwise it would have risked capital flight like China experienced from 2014 to 2017, when it lost $1 trillion in reserves. This highlights, along with the bear market in Chinese equities and the record number of downgrades and defaults, that China is too fragile to take the pain of a sustained trade war, and won't dare to employ regulatory interventions that could cost Chinese jobs at foreign-owned factories such as Foxconn. It explains weakness in the emerging market complex, of which China is the hub. Despite some tough talk, China is already negotiating against itself. Trump keeps raising the stakes and may not take yes for an answer until closer to the mid-terms. The risk here is not from a trade war itself, but the chance that China will fall into instability. When this ends, the biggest winner will be China – short-term with a major relief rally and long-term with a second wave of massive growth.

China enters a trade war with its largest counterparty – but capital flight is, itself, a major fragility. And not just to China, but to the entire emerging market complex of which China is the hub. We think this potential fragility in China – not "dollar strength" – is the real culprit behind the difficult quarter just experienced by all the EM's (see "USD, Euro and the Risk of Italeave" May 25, 2018).

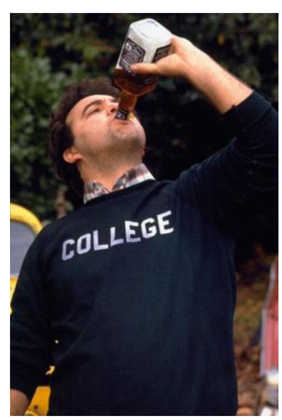
- The last time China let RMB weaken, starting in December 2013 – and punctuated in August 2015 by an overt devaluation and the abandonment of its USD-peg in favor of a basket of currencies (see "On the RMB Devaluation" August 11, 2015) – it ended up losing almost $1 trillion in foreign reserves before things stabilized in early 2017 (please see again the chart on the previous page). Reserves have only stabilized – not grown – since then, even as RMB considerably strengthened through late March.
- Meanwhile, as RMB has sharply weakened starting in April – as the US/China trade dispute emerged – Chinese equities are in an outright bear market. As we pointed out two weeks ago, comparing resilient US equities to sagging Chinese ones, *it's clear who Mr. Market thinks is winning this trade war* (see the chart below, and "Is Trump Really Bluffing on Tariffs?" June 22, 2018).

US and Chinese equities as the tariff war gets started Local currency



Source: Bloomberg, TrendMacro calculations

- At the same time, China is suddenly experiencing record levels of debt downgrades and defaults.
- No wonder that despite reports of some tough talk, the PBOC voluntarily disarmed itself, in order to avoid capital flight. No wonder China is already negotiating against itself by announcing unilateral easing of foreign ownership restrictions in some industries. No wonder it is already offering to reimburse local firms for tariffs on US goods.



There are many metaphors through which we can try to think about the dynamics of trade wars ("trade war" is itself only a metaphor). For today's purposes, *we'll liken it to a drinking contest in a college frat-house.* Like tit-for-tat tariffs – which, after

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all, are a tax upon one's self – that's a game of turn-by-turn self-destruction, in which the winner is the least-poisoned one, the last man standing.

- We aren't advocating self-destruction, but some self-sacrificial acts can be framed as costs, or investments, toward achieving some goal deemed worthwhile. For example, President Ronald Reagan's arms race against the Soviet Union in the 1980s could be seen as a costly self-imposed tax – one which it turned out we could bear better than the USSR could – and we eventually out-drank them, winning the Cold War.
- *We think that with the PBOC's announcement, China is already revealing that it has internalized the message of its own equity, credit and FX markets – it doesn't dare take too many more drinks. It's just too fragile for it.*
- The "China fragility" bear-case has been made for almost a decade by the hedge fund community, led by the famous PowerPoint decks of short-seller James Chanos. We've all seen the evocative pictures of the empty "ghost cities" that supposedly symbolize a massive debt-crazed malinvestment of capital. The bears have gotten it right only to the extent that Chinese equities have significantly underperformed their large-economy peers (and most emerging economy peers) over the last decade. But China's economy has resolutely refused to experience even a recession. Most of those "ghost cities" have gone on to be occupied, while most of the hedge funds devoted to that theme have had to close up or move on to other things.
- We haven't previously bought into the "China fragility" bear-case. But until now China hasn't been faced with an exogenous shock like an American president determined to force it, whatever it takes, into a more open trade regime befitting a mature nation now tied with the US as the world's largest economy. And now, China has had most of a decade to compound the fragilities Chanos started talking about in 2009, and move further down the diminishing-returns curve of state-subsidized debt-fueled growth.
- *We have always thought that China's most dangerous fragility is social cohesion*, in a society in which economic liberalization has far outpaced political liberalization. After all, it is still functionally a police state – yet citizens numbering in the hundreds of millions have experienced upward-mobility at a scale and pace unprecedented in human history. What if that mobility runs in reverse? *We really don't know what would happen if China experienced a recession with significant unemployment – or even without a recession, what would happen if China punished foreign businesses operating in China who would then have to lay off significant numbers of Chinese workers.*
- China's ability to create "stranded capital" by punishing foreign firms with non-tariff penalties – usually over-the-top punitive regulatory interventions, such as those that drove the South Korean firm Lotte out of the China market – is often touted as China's greatest weapon in a trade war. But would China dare to use it, if it resulted in large-scale unemployment, with all the risk of social

instability that might imply?

- Consider the Foxconn factory in Shenzhen, a 1.16 square mile walled complex employing as many as 450,000 workers making iPads and iPhones for Apple. *Apple's stock would have a very bad day if Chinese authorities were to announce that this factory had to close until further notice because of fire code violations* (which is basically what it did to Lotte). *But the real question is: what would the 450,000 workers do? General Secretary Xi Jinping would have to consider carefully, before authorizing such a move, just how many riot police he's really got and what he's willing to let them do to keep order.*
- Europe, for its part in President Donald J. Trump's trade reform conflicts, is not so different: it has its own fragility issues. No wonder the EU is considering taking up the German auto-makers' idea for a reciprocal zero-tariff deal on cars between the US and Europe.
- *Meanwhile, Trump just keeps up the pressure.* Last week it was reported that he is considering pulling the US out of the World Trade Organization. Maybe (indeed probably) the sensationalistic media just made that up (and Trump has denied it), but it serves Trump's negotiating style either way, as a shot across the bow.
- Same news cycle – leak then denial – on Trump pushing for tighter restrictions on Chinese investments in US companies.
- And Trump has now gone all the way – declaring "all in" in this game of poker – by threating, if need be, to apply tariffs to essentially all $505 billion of US imports from China. That's a bet that China can't match, having only $130 billion of imports from the US to tariff – even if it dared. Within that small opportunity set, China is already finding that it faces little choice but to buy US products, tariffs or no tariffs – such as soybeans, or commercial jet-liners, of which there is not that much elasticity of global supply.
- And with having foresworn the currency weapon, that leaves China with little choice but to use non-tariff barriers – such as a regulatory attack like the one used against Lotte – which we think implies the greatest risks to China's economic and social stability.
- It doesn't matter what metaphor we use – drinking game or poker or war. We just don't see how China has a move here, other than to sue for peace.
- It could still take a while for China to fully realize it and act. And it may be too soon for Trump to take yes for an answer, when a win here would come too soon ahead of the November mid-terms.
- *Strategically, we see the greatest risk not arising from a trade conflict as such, but rather if this drags on too long, China could slide over a difficult-to-observe cliff-edge into instability that would spill over into the global economy. When this ends, even if the US is the "winner" of the trade war, the winner in securities markets will be China – that's where most of the risk is, and where the relief-rally will predominantly be.*
- *Besides, no one has more to gain from this trade war than China. Losing it would be the best thing that could possibly happen for it, opening up a still-developing economy to a massive second wave of growth in personal liberty and economic well-being.*

Bottom line

After the worst month in history for China's currency, the PBOC has had to declare it won't use RMB as a trade weapon. Otherwise it would have risked capital flight like China experienced from 2014 to 2017, when it lost $1 trillion in reserves. This highlights, along with the bear market in Chinese equities and the record number of downgrades and defaults, that China is too fragile to take the pain of a sustained trade war, and won't dare to employ regulatory interventions that could cost Chinese jobs at foreign-owned factories such as Foxconn. It explains weakness in the emerging market complex, of which China is the hub. Despite some tough talk, China is already negotiating against itself. Trump keeps raising the stakes and may not take yes for an answer until closer to the mid-terms. The risk here is not from a trade war itself, but the chance that China will fall into instability. When this ends, the biggest winner will be China – short-term with a major relief rally and long-term with a second wave of massive growth.

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