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On the Margin: Eerie Calm in China and Italy

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Developing items of interest and deeper color on themes from our regular reports.

All Complacent on the Eastern Front

10% tariffs on US imports from China of $200 billion per annum – including items ranging from glass in balls (unworked) to edible meat offal of rabbits and hares (fresh or frozen) – take effect today. After their announcement last week, and promises of Chinese retaliation, both US and Chinese equities rallied sharply. There are many theories for why. We are inclined to credit the fact that President Donald J. Trump chose to start at a 10% tariff rate – while building in a "doomsday machine" threat of an automatic move to 25% after year-end – to create an environment of modulated aggression and artificial deadlines in which negotiations can take place.

There was a bullish rumor that Treasury Secretary Steven Mnuchin had reached out to Chinese counterparties to restart talks. Now a rumor that China has backed out of those rumored talks – which had never actually been scheduled in the first place. *This is the way high-stakes negotiations always go. Threats. Walking away. Coming back.* It was less than three months ago that North Korean officials were calling US Secretary of State Michael Pompeo a "gangster," and less than one month ago that Trump ordered Pompeo to cancel scheduled talks in Pyongyang. Now Supreme Leader Kim Jong-un has told his own people that his "fixed stand" is to turn the Korean peninsula into "the cradle of peace without nuclear weapons." He then hosted South Korean president Moon Jae-in in Pyongyang, and conditionally agreed to dismantle some nuclear facilities and allow unfettered UN inspections.

In the meantime, China continues to pursue – with some degree of desperation in our view – policies to stimulate its economy and protect it from capital flight, in order to fortify itself as much as possible and as long as possible from the effects of a trade-war with the US in which time is not on China's side (see "Did China Just Run Up the White Flag in the Trade War?" July 10, 2018).

Update to strategic view

ASIA MACRO, ASIA STOCKS, FX, US STOCKS, EUROPE MACRO, EUROPE BONDS: US and Chinese stocks rallied last week as new US tariffs were imposed and Chinese retaliation was announced, possibly because Trump created a period for negotiation until year-end when they automatically more than double. China is desperately debt-stimulating its CAPEX-driven growth model, and trying to jawbone yuan stability after six back-to-back months of weakness. Li articulated the deep sticking point, China's existential commitment to state control and subsidy of key industries. That won't lend itself to either/or bargaining outcomes, but offers a broad field for compromise, still potentially before the US mid-terms. Italy's coalition has fallen into timidity and confusion, lowering the risks of a budget confrontation with the EU that would threaten Italeave, at least temporarily relieving sovereign yields. Still a possible "October surprise."

[Strategy dashboard]

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We don't see how China can do much to stimulate consumer demand by cutting already low taxes on low-income workers. *It is left having to double down on its CAPEX-driven debt-funded growth model*, with the issuance of $200 billion of so-called "special-purpose bonds" – a rather embarrassing reversal from policies put in place last year to rein in leverage, policies which the government claims are *still* in place, as China experiences record corporate downgrades and defaults. From a *Financial Times* story on it:

- "China's parliament in March approved a quota of Rmb1.35tn ($197bn) for issuance of 'special-purpose' bonds for 2018, more than the combined quotas for the previous two years. But until recently, actual issuance was sluggish as local governments were under pressure to cut borrowing.
- "… the bonds, which are low-yielding and do not trade actively, are not especially attractive to investors. As a result, local governments have exerted political pressure and other inducements to ensure robust demand from banks.
- "…'When these bonds are getting promoted, they mostly get apportioned to banks, which have no choice but to buy them. Non-bank investors prefer other bonds with higher yields and better liquidity,' said a Shanghai-based bond analyst at a mid-sized Chinese investment bank.
- "…China's central bank has also injected liquidity into the financial system to ensure that the market can absorb the wave of bond sales."

At the same time as the People's Bank of China prints money so that commercial banks can buy these bonds – which, therefore, amounts to a form of quantitative easing – Chinese Premier Li Keqiang repeated for the third time since July that China does not intend to use its foreign exchange rate as a weapon in the US/China trade war. From his keynote address last week at a World Economic Forum event in Tianjin, China:

- "The recent fluctuations in the RMB exchange rate have been seen by some as an intentional measure on the part of China. This is simply not true. Persistent depreciation of the RMB will only do more harm than good to our country.
- "…We will not engage in competitive devaluation; we will work to create conditions for keeping the value of the yuan stable."

Li has always been something of a "good cop" in US/China trade rhetoric. But he is in a difficult position. Devaluation is a standard weapon in the

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armamentarium of combatants in trade wars, and it speaks volumes about China's self-perceived vulnerability to capital flight that it must forswear it, and instead reassure foreign holders of yuan that China is not deliberately destroying their investment. At the same time, that assurance is a confession that China isn't in control of events. After all, if those "recent fluctuations" weren't "intentional," that means six back-to-back months of CNY/USD weakness – including June and July, which were the two worst months in history – were "unintentional." Which is scarier to investors?

And just how is the PBOC supposed to support the yuan on foreign exchange markets while printing the money the banks will need to buy those special-purpose bonds on the domestic market?

Li's keynote address also shows China caught in the difficult stance of not being able to push back against US demands because they are unreasonable in principle, but rather by pretending that China already complies.

- "…China cannot realize innovation-driven development without respect for and protection of IPR [intellectual property rights]. Therefore, we have put in place a complete legal framework for IPR protection and set up special tribunals to handle IPR cases. Since China's accession to the WTO, intellectual property royalties paid by Chinese companies to overseas proprietors have increased by 14 times. Going forward, we will further strengthen law enforcement and introduce a more rigorous mechanism of punitive compensation for IPR infringements to deter violations and better protect innovators from all sectors."

Or perhaps we should interpret this as somewhere between a confession and a concession. If China admits the importance of IPR protection like this, and makes representations of its own good behavior because it intends to exhibit good behavior, then this should be an easy issue in any negotiations.

But Li's address also reveals the deepest sticking point in negotiations: the role of the state in China's economic model, a state that can funnel the coerced savings of its citizens into low interest debt to subsidize favored local industries and firms.

- "Governments need to support businesses in collaborating on innovation in line with market principles and commercial rules, while fully protecting their intellectual property rights. Greater government-business synergy will facilitate the new industrial revolution."

No self-serving representations about compliance here. It's all out in front. *Li wants more, not less, state control and subsidization of the flow of capital. This is the true sticking point – it cuts straight to China's existential needs under its "state capitalism" regime.*

We continue to think that there is a deal to be done. It is useful that much of China's rhetoric actually concedes many of Trump's points. And while the sticking point of state control and subsidies is indeed existential, its very imperviousness to complete solution makes it amendable to compromise, especially one that would involve gradual commitments that both save face and allow for political and market adaptations.

After the last week of seeming market optimism on trade, markets are probably vulnerable to correction as hopes inevitably get tempered in the normal diplomatic give-and-take. And if this goes on long enough, we're going to have to look hard at the impacts in the US. Tariffs are corporate taxes – and if all US imports from China were taxed at 25%, that would pretty much take back the entire 2017 corporate tax cut (or at least the demand-side components of it).

But we continue to think that a deal, or at least an outline of one, could happen in October before the mid-term elections. The need to deliver a victory for the US means Trump will grant relatively generous terms to get one. From China's perspective, that means deals are on sale right now – and won't be again for another two years, just ahead of the 2020 presidential election. China would be very stupid, we think, to imagine that it is better to wait because Trump will be weakened in his resolve by the likely GOP loss of the House in the mid-terms. And China is *not* stupid.

Government of Confusion

We have been tracking the evolution of Italy's 2019 budget, which we have warned could trigger a fight about deficits with fiscal authorities of the European Union in Brussels – leading to a confrontation in which Italy would threaten to leave the EU and the euro currency bloc (see "USD, Euro and the Risk of Italeave" May 25, 2018). We have said this could be an "October surprise" that could destabilize global markets.

When we last checked in on it, the new "populist" government of Italy – an unusual coalition of pro-growth forces in the north and socialist forces in the south, united mostly by their shared opposition to immigration – was styling itself a "government of courage," and rushing headlong toward big tax cuts

favored by the north and social spending programs favored by the south (see "On the Margin: Powell the Non-Independent, Pro-Growth Italeave" July 16, 2018).

But we also warned all along that the coalition would have to be able to agree internally on a budget, and a unified front with which to confront Brussels. Historically, Italian governments have not been able to agree on very much, nor present a unified front.

Six weeks ago, Vice-Premier Luigi Di Maio (of the south's Five Star Movement) was claiming that fears of an adverse bond market reaction to a large pro-growth budget deficit were "more a wish of the opposition" and that EU deficit limits of 3% of GDP "can't be a way to say that we can't do it…If we behave like that, we're the same as all the others and Italians will tell us to go to hell." At the same time, his counterpart Vice-Premier Matteo Salvini (of the north's League), was saying that the EU's 3% cap is not "the Bible."

Then something changed. Maybe it was the August 14 collapse of a bridge in Genoa, leaving 47 dead, that broke the new government's courage. Perhaps it was the embarrassment two weeks later of Di Maio having to deny stories that Italy had asked the European Central Bank for additional quantitative easing to sop up new bond issuance. Perhaps it was the downgrade by Fitch of the outlook for Italy's debt from stable to negative the next day.

Just days after that, Salvini was saying that Italy will "respect all the hurdles Europe imposes," and that the budget would rise to do no more than "touch" the 3% debt-to-GDP limit. Days later, Finance Minister Giovanni Tria was promising to actually *reduce* Italy's debt-to-GDP ratio. But these concessions are just as much confusions, as rumors swirl that Tria is being forced out, and even that Prime Minister Giuseppe Conte is looking for a job in the private sector. Now, over the weekend, Salvini is saying, "We'll do a courageous budget, the deficit isn't a problem."

While all this is going on, Italian sovereign yields have relaxed from their worst levels a couple months ago. It's not exactly an all-clear signal, but confidence is rising as resolve in the Italian coalition deteriorates. Well, it wouldn't be an "October surprise" if it weren't a surprise. Keep watching. We still see this as 2018's biggest "black swan" – that is, a risk that probably won't go terribly wrong, but would have a great deal of impact if it did, in part because it is so unexpected.