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MACROCOSM

Our Knife at China's Throat

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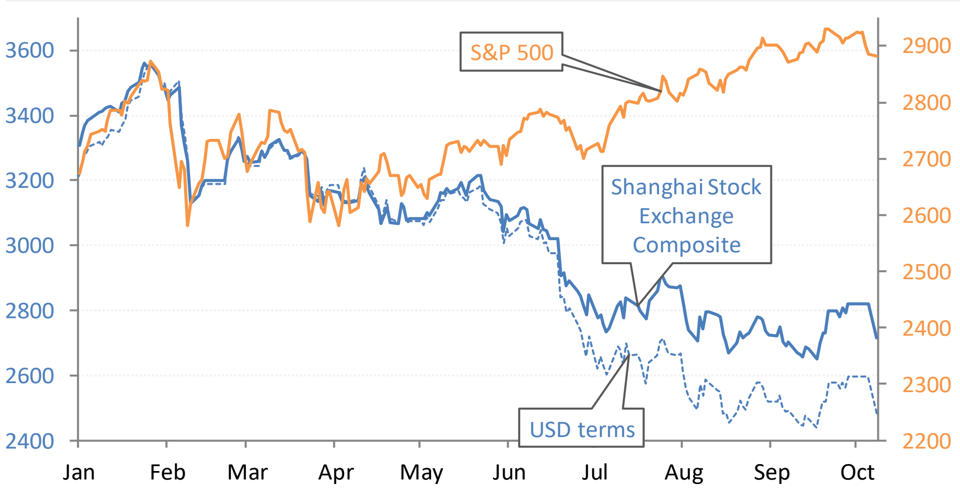
NAFTA 2.0 and a nascent EU deal leave China isolated. The bond market seems to agree.

US stocks took a beating last week as the US/China trade war became louder and scarier – but in a moment we'll look closely to see if there is really a cause-and-effect relationship.

It's been building up for a while. Two weeks ago President Donald J. Trump told the United Nations Security Council that "China has been attempting to interfere in our upcoming 2018 election." Last week Vice President Michael Pence repeated the same charges in a China-bashing speech at the Hudson Institute. The Defense Department released a 140-page report decrying the US's lack of "supply-chain resiliency" due to China's "economic aggression." Bloomberg published a story claiming the Chinese army implanted spy-microchips on circuit boards used by Amazon Web Services and Apple (all of whom deny it). There was a "confrontation" between US and Chinese vessels in the South China sea, following Beijing's cancellation of a visit by Defense Secretary James Mattis.

- *It's all part of Trump's campaign to maintain and increase economic pressure on China* to force president-for-life Xi Jinping to make sufficient concessions so that a trade deal can get done.
- China is saying it would discuss a deal, but according to vice-minister of commerce Wang Shouwen, it won't negotiate while

US and Chinese equities as the tariff war gets started



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US MACRO, US STOCKS, ASIA MACRO, ASIA STOCKS, FX, US BONDS, US FED, EMERGING MARKETS STOCKS: Chinese spy-chips are background to a sharp correction in equities, but are not necessarily the cause. The rhetoric is the same pressure that has gotten progress with North Korean denuclearization and trade deals with Mexico and Canada (virtually an anti-China pact), South Korea and the EU. Ahead of the mid-terms, it could earn Trump a China deal, and either way an unassailable rallying point. A renewed bear market in Chinese stocks and a drop in FX reserves add to non-tariff pressure on China. A pre-election deal could be an upside black swan, especially for China and the emerging markets. The global back-up in yields is not a "risk-off" reaction consistent with trade fears, nor is it the result of contractionary Fed policy expectations.

[Strategy dashboard]

Trump holds "a knife at its throat."

- If you think that's China talking tough – bravely saying "we don't negotiate with terrorists" – think again. *That's China admitting a knife is in fact at its throat, which is to say that the US holds China's life in its hands.*
- Markets appear to agree that the pressure remains quite real and quite dangerous (see "On the Margin: China's Scariest Fragility" August 6, 2018). Chinese equities traded almost back to their lows today, reversing a relief rally over the last couple weeks, and coming off a week-long market holiday for "National Day" (please see the chart on the first page, and "On the Margin: Eerie Calm in China and Italy" September 24, 2018). The yuan is working on its seventh month in a row of weakness against the US dollar, while foreign reserves have fallen to a 15-month low. China's manufacturing purchasing managers index fell to 50.8 in September, barely showing any growth at all (see "Data Insights: Global PMI" October 3, 2018).
- *We're actually glad to see market pressures on China return*, because the more work along these lines Mr. Market is willing to do, the less Trump will have to use tariffs to do all the heavy lifting. Tariffs are a costly weapon (see "Did China Just Run Up the White Flag in the Trade War?" July 10, 2018).
- China is acting increasingly desperate. Reversing its deleveraging strategy, it is jamming special-purpose bonds into the banking system and cutting reserve requirements for the fourth time this year. Prime Minister Li Keqiang has repeated the vow not to weaken the yuan competitively. Despite such assurances, to attract foreign investors in light of the weak yuan, China is issuing its first dollar bonds in four years.
- *Trump smells the weakness.* As though deliberately taunting China, he said last week, "They want to talk very badly…. "Frankly, it's too early to talk… Can't talk now, because they're not ready."
- *The pressure and the taunting is classic Trump – and he does it because it works.* It's moved North Korea toward denuclearization (see "Thoughts on North Korea, Fire And Fury Edition" August 11, 2017), it's moved Mexico, Canada and South Korea to trade deals, and it's moving Europe toward one, too (see "On the US/EU Trade Deal" July 26, 2018). Are you getting bored by all the winning?
- The new NAFTA – the US Mexico Canada Agreement – is in some ways an anti-China pact. Its increased quota for "regional content" in automobiles is, effectively, an exclusion of Chinese components. And the media has bestowed the name "the China clause" on a provision that would effectively give the US veto power over any bilateral deals Mexico or Canada may wish to make with any "non-market economy" – a blocker on the China deal that Canadian Prime Minister Justin Trudeau has been pursuing.
- When Trump's trade initiatives began in March, the conventional wisdom was that he was a foolish general fighting a war on too many fronts. *But in a matter of months, he's won or gotten into position to win on all fronts except China.*
- In some sense Trump was pushing on an open door. Despite the dominant narrative that Trump is a rogue protectionist violating

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established global norms, other countries have started to re-evaluate their relationships with China, too. For example, Germany has slammed the brakes on any Chinese acquisitions of German technology companies – while as recently as 2016, China was acquiring them at the rate of one-a-week.

- *That leaves China isolated in the community of nations* – alienated from its customers who make possible its debt-driven, CAPEX-driven, export-driven "state capitalism" model.
- *And all the histrionic pressure on China is a classic Trump persuasion tactic heading into the mid-terms, giving him two different ways to win.* A trade victory would be a trophy for the GOP (so China should probably act now while a deal with Trump is effectively "on sale"). But in the meantime, if China isn't smart enough to do that, Trump wins at rallies for GOP congressional candidates by demonizing a foreign threat, one that Democrats have typically been unwilling to defend, even against Trump.
- *We think the possibility of the US and China making a deal before the mid-terms should be regarded as an upside "black swan" possibility – not heavily likely by any means, but far more likely than the consensus expects. After the mid-terms, Trump will insist on a tougher deal, and that would delay things. But be that as it may, the rising tariff and market pressures on China will drive a deal, just as it has with all the others – and the virtual consensus to the contrary only underscores the upside opportunity when it happens, especially for China itself and the emerging economies in its orbit* (again, see "On the US/EU Trade Deal").
- *Remember – China doesn't want to change voluntarily. It takes pressure. China will only negotiate for peace when it looks like war is inevitable.*

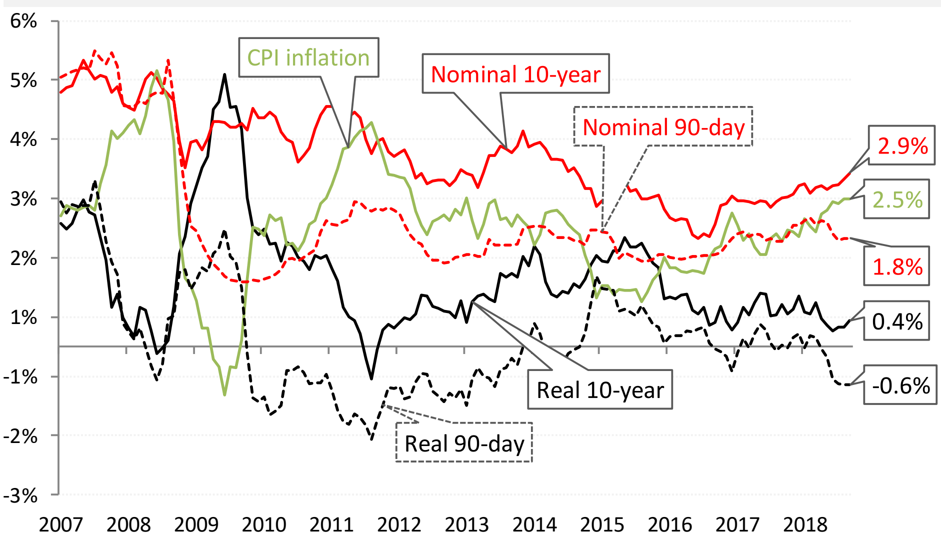
We started by casually assuming that the weakness in equities last week is due to China trade risks. *To be sure, it's a worrisome prospect to consider the full force of all the tariffs Trump is threatening – which amount to corporate tax hikes at a scale sufficient to pretty much reverse the corporate tax cuts of last year* (again, see "On the Margin: Eerie Calm in China and Italy"). But it's not clear that US equities were really focusing primarily on China trade last week.

- *The technology sector is realistically threatened by the possibility that the Bloomberg story about spy-chips might be true* – but that's not exactly about trade. Setting aside what it says about tech companies' supply chains, it opens up possibilities of unbounded product recall and consumer liability costs. And it focuses investors in this faddish sector – which has provided market leadership for a long time – on what has been, all along, its great Achilles Heel: the critical vulnerability to security and privacy breaches (see "DeFANGed" March 28, 2018, and George Gilder's provocative new book, *Life After Google: The Fall of Big Data and the Rise of the Blockchain Economy*).
- *But if equities, overall, were really worried about that or, more broadly, a catastrophic trade war, then we would have seen a more generalized "risk-off" environment in which long-term Treasury*

yields had fallen while investors sought safe-havens. But instead yields backed up sharply – on a global basis. That's "risk-on."

- *We're inclined to blame the yield back-up itself for the dip in stocks, because it is typically – though wrongly – associated with central bank tightening fears.*
- To be sure, since the September FOMC press conference two weeks ago at which Fed Chair Jerome Powell spoke perhaps too casually about the funds rate rising gradually to a level above what is now considered "neutral" (see "On the September FOMC" September 26, 2018), the money market curve has built in an additional rate hike (now looking for three 25 bp hikes over three years, front-loaded).
- *But if that new expected hike were really something to be feared as a contractionary tightening, then the 10-year yield would have fallen, as growth and inflation expectations fell. Instead, the back-up in the 10-year yield effectively ratified and gave permission for that extra hike, implying it is justified by rising growth and inflation expectations.* Powell specifically thinks in these terms, having stated that he sees the 10-year as a market-based proxy for the equilibrium neutral rate of interest (see "The Fault is in R-Star" September 17, 2018).
- *Had long-term yields not ratified higher short-term rate expectations, then the shift in the front end of the yield curve would have inverted it – but that didn't happen.* If it had, we think markets would have no trouble seeing the contractionary implications, yet they can't seem to see the expansionary implications of it not happening (see "On the September Jobs Report" October 5, 2018).
- Another way to look at this is to observe that real rates and yields have drifted lower this year, on a global basis, as inflation has gradually revived to more normal levels (please see the chart below, and "Data Insights: Global Real Rates and Yields" October 8 2018). In that context, the global back-up in nominal yields still

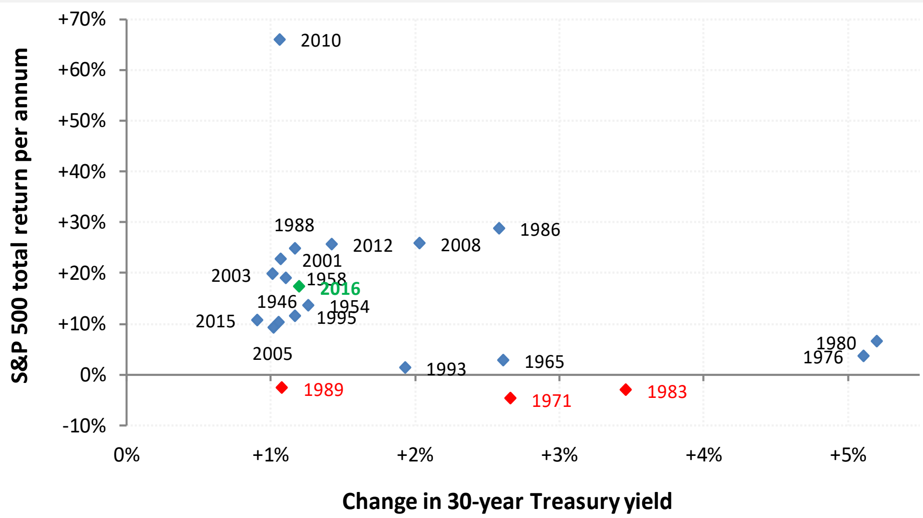
Global inflation, real 90-day interbank rates and 10-year sovereign yields
GDP-weighted US, EU, UK, JP, CH, IN, BR



Source: Bloomberg, TrendMacro calculations leaves real rates quite low, with plenty of room on the upside before they become restrictive.

- This is textbook example of how rising rates and yields ought to be entirely consistent with higher equity prices – which also feed on improving growth and inflation expectations. Yet for some reason it always seems that equities initially get spooked whenever yields back up. We don't understand why stocks just can't quite keep in mind that, over the entire post-war period, in the 21 instances in which there were large long-term yield back-ups, equities rallied in 18 of them (please see the chart below).

Stock market performance during yield back-ups By year back-up begins



Source: Bloomberg, TrendMacro calculations

Bottom line

A crescendo of Trump administration China-bashing and reports of Chinese spy-chips are background to a sharp correction in equities, but are not necessarily the cause. The rhetoric is the same pressure that has gotten progress with North Korean denuclearization and trade deals with Mexico and Canada (virtually an anti-China pact), South Korea and the EU. Ahead of the mid-terms, it could earn Trump a China deal, and either way an unassailable rallying point. A renewed bear market in Chinese stocks and a drop in FX reserves add to non-tariff pressure on China. A pre-election deal could be an upside black swan, especially for China and the emerging markets. The global back-up in yields is not a "risk-off" reaction consistent with trade fears, nor is it the result of contractionary Fed policy expectations.