Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

MACROCOSM

Death by China on the Way to Yes

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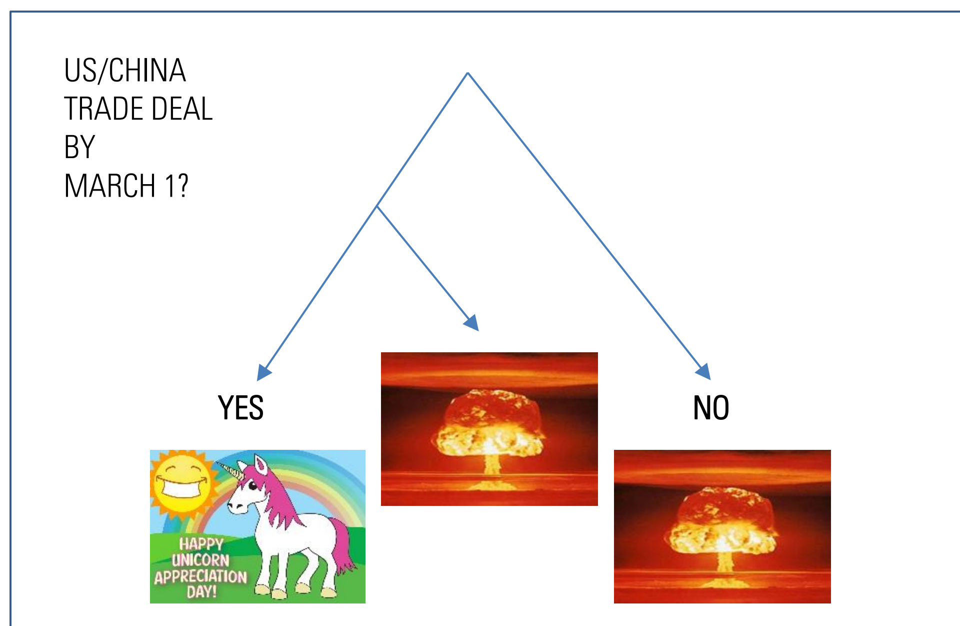
Donald Luskin

China is surrendering because it is under pressure. It can hold together until a deal is done.

We're surprised that markets haven't responded positively to the US/China trade breakthrough two weeks ago at the G20 summit in Buenos Aires (see "On the US/China Trade Breakthrough" December 2, 2018). We expected lingering volatility (see "On the Margin: Well, We Said 'Brace Yourself'" December 5, 2018), but after two weeks – and what has been, objectively, a flow of very good post-summit news-flow, *we shouldn't be seeing US equities testing the lows, with the S&P 500 equity risk premium back up to levels last seen at the 2016 presidential election*.

- We stand – more than ever – by our prediction that the US/China trade war will soon end, and we stand by our call that it will be a big positive for the US economy and even more so for China's.
- *Maybe what markets are telling us is that the risks of conducting this trade war, even if we do get to "yes," are still so great – or, indeed, so much damage has already been done – that a large risk premium is required. It would compensate for the chance – perhaps, it's too late already! – that US pressure will push China into a disorderly recession, which would spill over into the global economy* (please see the event-tree below, and "On the Margin: China's Scariest Fragility" August 6, 2018).



Update to strategic view

US MACRO, US STOCKS, ASIA MACRO, OIL: Markets have become over-focused on risks we've been talking about for months – that China might fall into a disorderly recession under the stress of Trump's tariffs, now amplified by the global revulsion at Huawei on security grounds. China's slowing has contributed to the collapse in oil prices, which in turn explain most of the small rollover in forward earnings and widening of credit spreads. Stocks are very cheap, with the S&P 500 equity risk premium back to where it was at the 2016 presidential election, and forward multiples in an almost 20% bear market from cycle highs a year ago. Several Chinese gestures of surrender indicate that a deal will be done by the February deadline. The probability that some eccentric catalyst will arise that throws China into recession before then is very small – and when we get to "yes," the restoration of confidence and a less-protectionist China should take all risks off the table.

[Strategy dashboard]

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- We have said from the beginning that China would have to surrender in this trade war because its economy is too fragile to withstand US tariffs and other pressures (see "Did China Just Run Up the White Flag in the Trade War?" July 10, 2018).
- The pushback all along has been that China's economic model of "state capitalism" makes it effectively invulnerable, and *if anything did go wrong, president-for-life Xi Jinping would just tough it out and out-last Donald Trump. But the consensus has suddenly changed on all that*. Friday's reports of China's lowest-ever growth in retail sales and industrial production were surely the story-of-the-day that drove the S&P 500 to new closing lows. And now, "news analysis" pieces in the same mainstream media who were celebrating the effectiveness and resiliency of China's regime just weeks ago are saying that accelerating economic deterioration is a clear-and-present danger to it.
- No wonder China, in a press statement designed primarily to validate the Trump administration's claim that the two nations had agreed in Buenos Aires to a 90-day negotiating deadline, added "the sooner the better."
- We're not going to tell you there is no risk here. We're the ones who have been saying all along that if China wanted to change its trading practices to conform to Trump's wishes, it would already have done so. We've said from the beginning that only the threat of economic violence will make China comply – just as only the threat of physical violence causes a victim to hand over his wallet to a mugger. Indeed, China admits that Trump is holding "a knife at its throat." *Markets seem to suddenly be afraid that the knife has already hit an essential vein, or that it might do so by accident over the coming period of US/China negotiations – and let's not forget the unlikely but possible result that negotiations fail, in which case the knife will take off China's head entirely.*
- There's never been a nation like China – a command-and-control economy operating on such a vast scale, and with such wide engagement with other nations. And there's never been a recession in China. So no one knows what would happen when an unprecedented event takes place in an unprecedented environment. We do know that it's part of everyone's supply chain. We do know that, even though the developed world wishes China were a better export customer, given its vast size, it is still everyone's largest export customer. *Therefore, we do know that a recession in China is highly likely to cause a global recession. If it is a disorderly recession with social unrest of unknown dimension and consequences, it could be worse than an ordinary recession.*
- This isn't the first time the US equity market has undergone a significant correction thanks to risks that China would blow up. A 12.52% correction for the S&P 500 – a little deeper than the present 12.16% – came in mid-2015 when the Chinese stock market crashed and China devalued its currency and went off its decades-long dollar peg (see "On the RMB Devaluation" August 11, 2015). At that time, China was threatened by USD strength far greater than anything we have seen this year – so its change in foreign exchange policy was appropriate and effective.

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
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Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

[About us]

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Wall Street Journal
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Wall Street Journal
December 11, 2018

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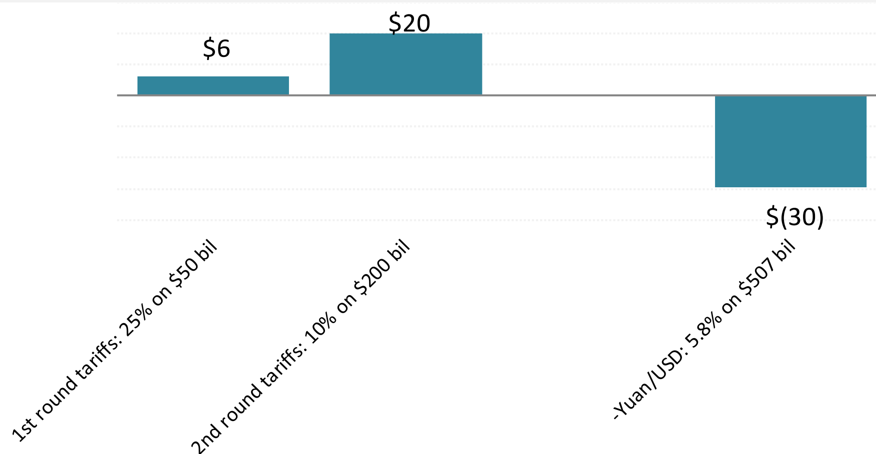
Alistair Gray
Financial Times
December 10, 2018

[Reading home]

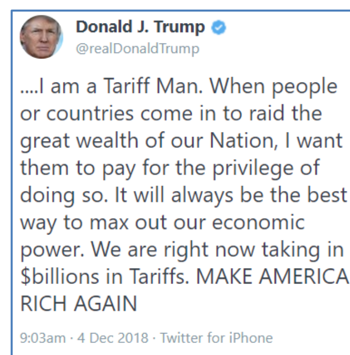
- This time around looks similar in many ways. The Chinese stock market has fallen to levels even lower than those of 2015. The yuan has weakened sharply – indeed, June and July this year were the two weakest months in its history. This time China claims it didn't devalue on purpose – which in its own way is quite worrisome (see "On the Margin: China Sees the Cliff" October 19, 2018).
- Thanks to the yuan devaluation this year, US importers of Chinese goods – in aggregate, at least – are more than held harmless against the tariffs that have been imposed so far. The *per annum* tariff cost is offset by the effective cost-discount provided by the weaker yuan (please see the chart below).

Per annum tariff costs, versus YTD yuan depreciation



Source: Bloomberg, TrendMacro calculations

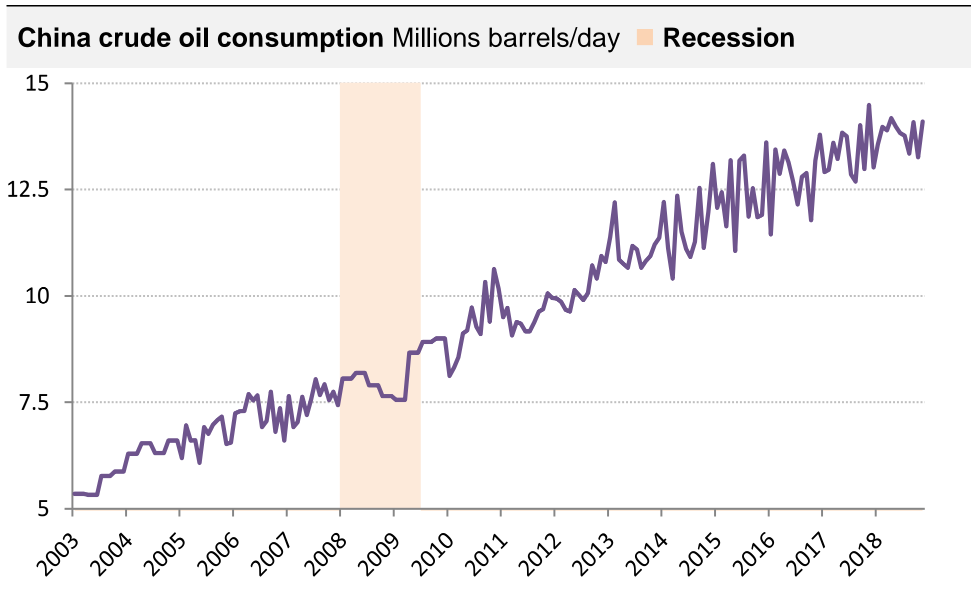
- *The result is US importers come out a little ahead on an after-tariff basis. Yet the US Treasury still collects the entire tariff amount. US importers write the check, but, effectively, China pays it. That is to say, the "tax incidence" of the tariffs falls entirely on China.*
- This may be what Trump was talking about in his infamous "Tariff Man" tweet, in which he talked about making China "pay for the privilege" and bragged "We are right now taking in $billions in Tariffs."



- By the way, non-US importers, who import in non-dollar currencies that have also strengthened versus the yuan, get a free ride (let it never be said that Trump is surrendering America's global leadership role).
- *The arrest in Canada at the US's behest of Huawei chief financial officer Meng Wanzhou puts a doubly dangerous spin on these issues.* We think markets were initially spooked when they learned about the arrest probably due to fears that this bold "capture the queen" move would lead to escalating reciprocity in executive kidnappings, possibly leading to risky military threats or interventions, or at least to costly travel bans. But it seems that, two

weeks later, China has responded only by capturing a couple pawns, in the form of detaining two Canadians. Perhaps China would rather not take too many actions that draw even more attention to the stench of Huawei's criminality – actions that seem to validate the harshest views of China's harshest critics in the Trump administration.

- *Indeed, the greatest effect of the Meng arrest, we think, has been to elicit an outpouring of global support for the move and condemnation of China, and a catalyzing of what is developing into a global boycott of Huawei and ZTE products. With the US's global allies having been conspicuously silent on trade issues, it would seem that there is nevertheless a great willingness to stand up and be counted on security issues.*
- Since the Buenos Aires summit – falsely called in the media a mere "truce" – the US has continued to exert every form of pressure that was in place before (indeed, added pressure through the Meng arrest), while China has laid down its arms: it has resumed buying US agricultural products, dropped retaliatory tariffs on US autos, and announced it will re-engineer its provocative – and seemingly sacrosanct – Made In China 2025 doctrine.
- *So make no mistake about it – we are getting to "yes" with a very high probability.*
- *But the pressure on China that will drive it to "yes" is already starting to show up in costly and dangerous ways that are spilling over into the global economy.*
- Most tangibly, Chinese oil consumption peaked in November 2017 at 14.49 million barrels per day. *Off 0.39 million barrels per day since then, that's one of the worst 12-month periods in the history of the data* (please see the chart below).



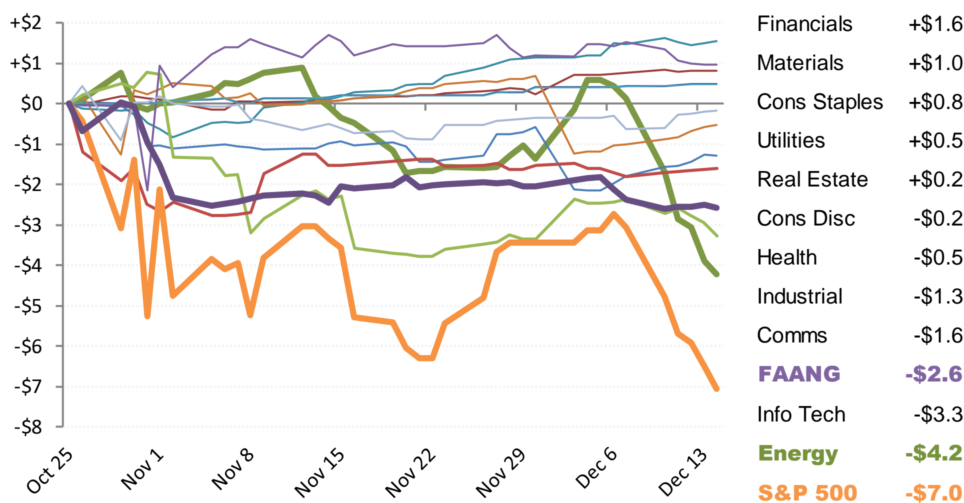
Source: Dept of Energy, Energy Information Administration, TrendMacro calculations

- With China the only large nation where oil consumption has reliably been growing over the last few years, this disappointment has factored significantly among a set of geopolitical factors that have

collapsed the oil price from its peak in early October (see "OPEC's Gifts to Trump" November 14, 2018).

- One result has been what may be the beginning of a rollover in S&P 500 forward earnings (see "Recession Risk at Last?" November 20, 2018). Since the peak almost two months ago on October 25, aggregate forward earnings are off $7.0 billion. Of that, 60%, or $4.2 billion, is due to the energy sector (please see the chart below). The rollover began with the FAANG stocks, but with the storm of downgrades in the energy sector over the last week, they now explain only 37% of the earnings decline (still a remarkable contribution from just five companies, with most of *that* coming just from Facebook).

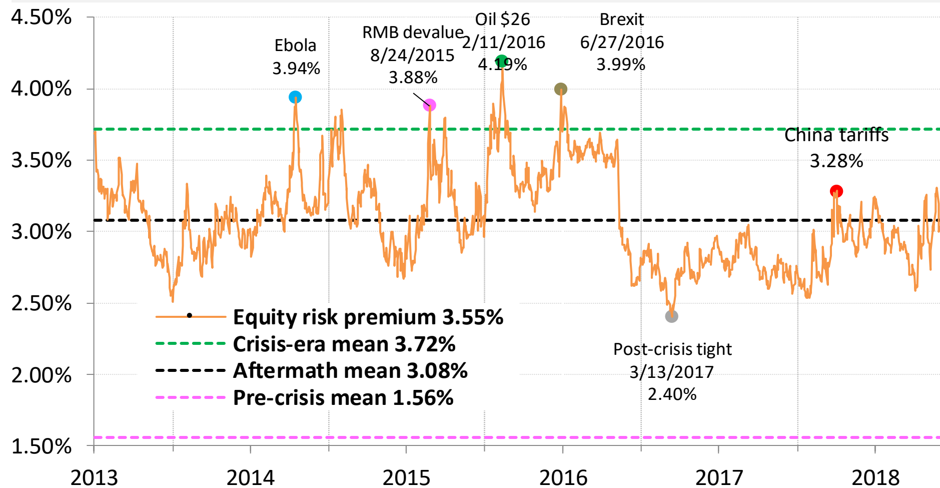
S&P 500 consensus forward earnings, change from October 25
365-days blended forward, bottom-up, USD $billions



Source: Bloomberg, TrendMacro calculations

- An energy-led forward earnings rollover began in October 2014, and climaxed in the first quarter of 2016, a point that we regard to be the trough of an undocumented recession (see, among many at the time, "The Recession Caused by Low Oil Prices" January 8, 2016). Then, one of the most dangerous consequences was the sharp widening of spreads in the US high yield market – which today has an even larger share of its face value attributable to the energy sector than it did then. In 2016-Q1 the trauma in the energy sector infected the whole high yield market, which became dysfunctional for much of that quarter. It spilled over into investment grade and bank loan markets as well, and was part of a deep correction in US stocks – immediately following on, and going deeper than, the correction we mentioned earlier associated with China's currency devaluation and stock market crash.
- *No wonder markets are building in a big risk premium. Again, as we calculate it, we haven't seen a risk premium like this in the S&P 500 since the 2016 presidential election. We're closer to the crisis-era mean than we are to the post-crisis mean – and we are definitely not in a crisis, at least not yet* (see the chart on the following page).

S&P 500 equity risk premium Fwd earnings yield minus 30-year Treasury



Source: Bloomberg, TrendMacro calculations

- It doesn't have that much to do with Treasury yields having fallen so much over the last two months. The 30-year yield today is about the same as it was then. It's all about multiples, which are back to where they were two years ago, having undergone in just a year an almost 20% bear market from cycle highs. *Stocks are as cheap today as they've been in two years. If you don't think China is actually going to catch fire, fall off a cliff and explode, and take the whole world down with it, then stocks are a buy.*
- By the way, we can't help but be encouraged by anecdotal contrarian evidence. Capping a week of catastrophism in the meantime media and from Wall Street strategists, The *New York Times* Sunday Style section – yes, the *Style* section – featured yesterday a front-page story headlined "Assume Crash Position," offering "five ways things could get bad for everyone."
- We respect the *possibility* of something going terribly wrong in China, and the negative *intensity* of it. Indeed, it's only the threat of it that keeps China at the negotiating table, as we ourselves have been arguing since the beginning of the trade war. Maybe the fact that we've been talking about China's economic weakening for months – the recent evidence that has convinced everyone else is just what we've been expecting all along – means we can dispassionately separate an increasingly *obvious outside possibility* from an *outcome that only seems inevitable*.
- *We expect the outcome is that we will get to "yes" on a trade deal, and we think the chance of a disorderly recession in China during the 90 days or so till we get there is smaller than markets seem to be pricing.*
- *The real risk in China is some form of extreme social instability. Such things can be catalyzed by seemingly minor events – as when the Arab Spring swept through the Middle East, seemingly out of nowhere, following the burning-suicide of a protestor in Tunisia*. It's not out of the realm of possibility that some elderly Chinese saver, whose life savings were wiped out by some "wealth

management" scam, could set himself on fire in Tiananmen Square. But the catalyzing image would be difficult to spread on tightly controlled social media in China. For that matter, China just jailed a businessman who had run a 100 billion yuan pyramid scheme – perhaps less for the crime of having run it, than that of organizing a street protest about his treatment by the police.

- *Absent some eccentric and unpredictable catalyst, the US/China negotiating period that runs through February is a very narrow window of time during which nothing serious is likely to go wrong. In the meantime, while it's not a smart long-term solution, China is throwing the kitchen sink at re-leveraging to try to stimulate growth, which should hold things together until a deal can be done. After that, the relief from uncertainty – coupled with the reforms China will have agreed to, which by making it less protectionist should be very growth-positive – will take all the present risks off the table.*

Bottom line

Markets have become over-focused on risks we've been talking about for months – that China might fall into a disorderly recession under the stress of Trump's tariffs, now amplified by the global revulsion at Huawei on security grounds. China's slowing has contributed to the collapse in oil prices, which in turn explain most of the small rollover in forward earnings and widening of credit spreads. Stocks are very cheap, with the S&P 500 equity risk premium back to where it was at the 2016 presidential election, and forward multiples in an almost 20% bear market from cycle highs a year ago. Several Chinese gestures of surrender indicate that a deal will be done by the February deadline. The probability that some eccentric catalyst will arise that throws China into recession before then is very small – and when we get to "yes," the restoration of confidence and a less-protectionist China should take all risks off the table.