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On the Margin: China Trade Talks at the Edge of Chaos

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

Don't worry. In trade talks, chaos is a good thing.

We have said repeatedly that the US/China trade negotiations would go down to the wire, and maybe a little beyond – all the way to the "edge of chaos" (see, most recently, "On the Margin: True Fake News on China Trade" January 18, 2019). That's where any information system experiences its highest potential, but it's also where everything can blow up (see "Death by China on the Way to Yes" December 17, 2018). The chaos is evident in the news, where just on Friday last week, a single outlet, Bloomberg, issued the following headlines – recorded here in two pairs of *hilariously contradictory on-line headlines leading to exactly the same story!*

- U.S.-China Trade Talks Set to Wrap Up With Few Signs of Progress
- Mnuchin Calls U.S.-China Talks 'Productive' as Deadline Nears

- Xi Hails Progress in Trade Talks While U.S. Sees 'Much Work' Ahead
- Trump, Xi Hail Progress in Trade Talks as Tariff Deadline Nears

Blame the media for writing click-bait headlines to get your attention. Or blame the anonymous "sources" the media always quotes, most of whom are low-level staffers honestly representing a view, but a view which is necessarily idiosyncratic to an ill-informed individual. The rarer well-informed high-level sources, to the extent they will talk to the media in the first place, aren't giving their views, as such, at all – they are leaking information and disinformation to the other side in order to influence further negotiations. Either way, it's not very reliable – but *it means productive talks are underway. This is what the edge of chaos is supposed to look like*.

Consider even President Donald J. Trump's statements during a press conference on Friday. Knowing that his counterpart Chinese President Xi Jinping will surely be parsing every word, Trump said on the one hand,

> "The tariffs are hurting China very badly. They don't want them. And

Update to strategic view

US MACRO, ASIA MACRO, US STOCKS ASIA STOCKS, EMERGING MARKETS STOCKS, FX: The March 1 deadline for the US/China trade talks, before increased US tariffs are imposed, is driving negotiations to their most productive and dangerous phase. Headlines within a single day are starkly contradictory, as are Trump's remarks within a single press conference. We doubt the negotiations are snagged on enforcement mechanisms, because the existing tariffs that drove China to the table in the first place are self-evidently effective enough. More likely, because China has shown weakness by rushing, and by offering many concessions in advance, Trump is pushing for new non-economic terms involving China's cooperation with North Korea, Iran and Venezuela.

[Strategy dashboard]

> frankly, if we can make the deal, it'd be my honor to remove them."

And then, a few minutes later,

> "…I happen to like tariffs, okay? I mean, we're taking in billions and billions of dollars in tariffs from China."

That's the one-man good cop-bad cop routine we've come to expect from Trump' negotiations playbook. We were more intrigued by his reply to a question about whether he would extend the March 1 deadline for imposition of additional tariffs. Trump said,

> "There are many, many points that we're bringing up that nobody ever brought up or thought to bring up, but they're very important, because we were on the wrong side of every one of them. There is a possibility that I will extend the date…if I see that we're close to a deal or the deal is going in the right direction…"

Don't assume an extension is a sign of Trump's weakness. He let the deadline slip with Canada at the end-game of the US/Mexico/Canada Agreement, and he ended up getting his deal a month later. In this case, with Xi now submissively engaging in classic "mirroring behavior" by holding a photo-op with the negotiating team on their last day in Beijing – as Trump had done two weeks prior after meetings in Washington – we think Trump would extend the deadline primarily because he sees an opportunity to pursue those "many points we're bringing up that nobody…thought to bring up."

What might those "points" be? Hard to imagine the Trump team has come up with an economic demand that wasn't already included in the seemingly exhaustive list of 142 demands that have been active in the negotiations for months already.

We doubt the answer is the obvious one – the subject of many skeptical media accounts – that the US is insisting on enforcement mechanisms to which China cannot agree. Despite head negotiator Robert Lighthizer's public statements last month signaling to China – twice – the importance of "enforcement, enforcement, enforcement," why does the US need it? Perhaps mostly to silence Trump's critics. But the US already has a very robust power to lay on tariffs at will, and indeed it is that power that has forced China to the negotiating table in the first place. Remember when China's finance minister Wang Shouwen said China would never negotiate with the US while tariffs were a "knife at its throat"? We said it was just the

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Recommended Reading

Gary Greenberg on the Placebo Effect
Russ Roberts
Econtalk
February 5, 2019

What if the Placebo Effect Isn't a Trick?
Gary Greenberg
New York Times Magazine
November 11, 2018

New AI fake text generator may be too dangerous to release, say creators
Alex Hern
The Guardian
February 14, 2019

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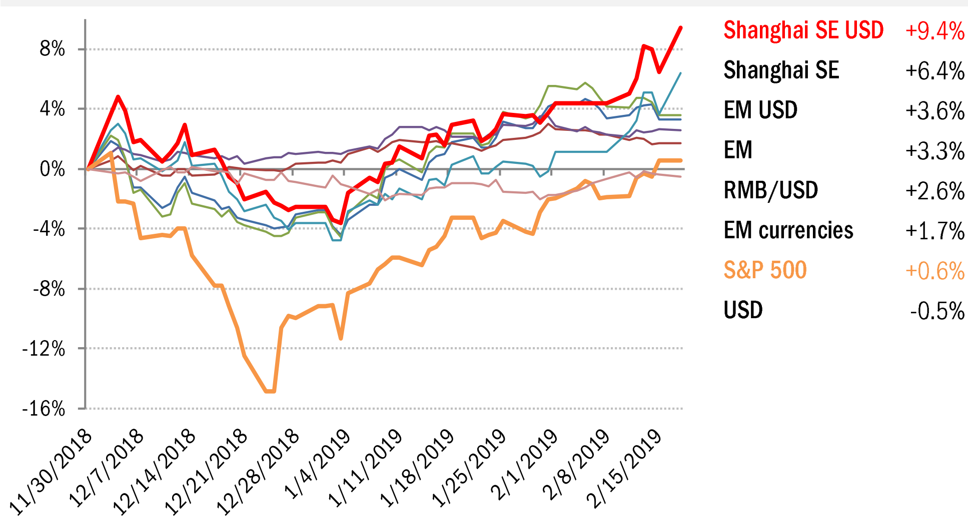
opposite – that the knife is precisely what would make China negotiate (see "Our Knife at China's Throat" October 8, 2018). Now here they are, negotiating. *That's* enforcement.

We think that probably most of the economic issues that can ever be agreed have already been agreed. After all, even before the first negotiating session, China had *already* removed its retaliatory tariffs on US autos, resumed buying US soybeans, promulgated a law eliminating forced technology transfers, walked back its inflammatory Made In China 2025 program – and even began buying rice from the US. To be sure, there are other issues the US team *could* raise – the grand-daddy of them all being China's agreement to privatize the state-owned banks that are the conduits for anticompetitive subsidies. Some media accounts persist in speculating that it is on the table, but we think that one is understood to be a bridge too far at this point. We say that because there was no hint of it in either nation's post-summit statements, which seemed to function to define the economic negotiating space (see "On the US/China Trade Breakthrough" December 2, 2018).

So we think when the deal comes down the surprises will be in the non-economic domain – and if privatization is being discussed at all, it is to build up its value as a sacrifice to be given up to earn other concessions. We think China will agree, officially or otherwise, to all or some combination of: aid in the denuclearization of North Korea; curtailing massive purchases of liquid condensates from Iran; and switching patronage of Venezuela away from the illegitimate Maduro regime.

Markets don't seem to disagree with our generally optimistic outlook for a

Cumulative performance from before Trump-Xi Buenos Aires summit



Source: Bloomberg, TrendMacro calculations deal. The recovery from the late-December lows could potentially be credited with another deal – the one cut between Trump and Fed Chair Jerome Powell (see "Did Powell Just Cut a Deal?" December 23, 2018).

That said, the distribution of relative returns from the time of the Buenos Aires summit points precisely to the what we have said all along will come with a deal – the outperformance of Chinese equities, the RMB, and other emerging markets equities and their respective currencies (see the chart on the previous page, and "Did China Just Run Up the White Flag in the Trade War?" July 10, 2018).