

MACROCOSM

How Worried Should We Be About Hong Kong?

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Neither the US nor China will risk a vicious cycle of tit-for-tat in the post-pandemic world.

Late last week when China signaled its intention to unilaterally insert a security law into Hong Kong's constitution, one might have thought that it would trigger a dangerous reawakening of US/China tensions that had been put to bed with the conclusion of the Phase One trade deal (see "[Trump's Beautiful Monster](#)" January 16, 2020). Yet a week later, US equities have moved to new recovery highs, seemingly focused more on the first signs that the economy is coming back to life from the Covid-2019 lockdowns (see "[Data Insights: High-Frequency Post-Virus US Recovery Monitor](#)" May 28, 2020).

- *We would guess that Mr. Market is confident that the US will be unwilling to abort a nascent recovery by descending back into the mutually destructive economic tit-for-tat that characterized the trade war. Whatever the US does to punish China, it will mostly be just talk. Indeed, it stands to reason that General Secretary Xi Jinping chose this moment to act precisely for that reason.*
- *One reason why the US won't over-react here is that the outrage against China's action is, to an important extent, false.*
- *It's not accurate to say* this will "strip Hong Kong of the legal autonomy the territory was promised." In reality, in [Article 23](#) of [Hong Kong's Basic Law](#) – its constitution, agreed in 1997 in contemplation of the UK's handover of Hong Kong – it was Hong Kong that promised China it would:

"...enact laws on its own to prohibit any act of treason, secession, sedition, subversion against the Central People's Government, or theft of state secrets, to prohibit foreign political organizations or bodies from conducting political activities in the Region, and to prohibit political organizations or bodies of the Region from establishing ties with foreign political organizations or bodies."

- *Hong Kong attempted to pass such laws in 2003*, but the effort was shelved due to protests.
- *It's not accurate to say* China's insertion of the law into Hong Kong's constitution "would override Hong Kong's system of self-governance." [Article 18](#) of the Basic Law provides:

Update to strategic view

US MACRO, US STOCKS, ASIA MACRO:

China's imposition on Hong Kong of a new security law will trigger only economically insignificant responses from the US. In a presidential campaign year in which no candidate can seem to be "soft on China," there will be loud rhetoric, but only trivial sanctions and changes to the terms of trade. Neither nation will be willing to fall into a vicious cycle of tit-for-tat that could abort a nascent post-pandemic recovery. That is why China has acted now, even though Hong Kong's constitution has allowed it for over two decades. This won't derail the "risk-back-on" move from the March bottom. But it leaves China still having to successfully manage its brand in the post-pandemic global economy.

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“The Standing Committee of the National People’s Congress may add to or delete from the list of laws in Annex III ... those relating to defence and foreign affairs...”

- We don’t want to take sides with an authoritarian regime against a city-state that was [once a shining beacon of capitalism and freedom](#). But if we are to respect the rule of law, *the reality is that what China is doing is perfectly legal, and has been in the cards for over two decades. And it does nothing to overtly overturn the “one country, two systems” doctrine that has allowed Hong Kong to remain economically quite free.*
- China is already mounting an influence campaign designed to make the new security law seem reasonable, such as the assurances it [won’t interfere](#) with Hong Kong’s independent judiciary, and that any steps to maintain law-and-order would only [help business](#).
- Nevertheless, yesterday [Secretary of State Michael Pompeo announced](#) that he had certified to Congress under [the Hong Kong Policy Act](#) that Hong Kong was no longer deemed to be independent from China – and therefore, it “does not continue to warrant treatment under United States laws in the same manner as U.S. laws were applied to Hong Kong before July 1997.”
- *This opens the door to sanctions, and to possible loss of Hong Kong’s most favored nation status for US trade. In a presidential election year in which neither Donald J. Trump nor his presumptive opponent Joseph R. Biden can be seen as “soft on China,” sanctions and loss of trading status are, we think, a sure thing. To be useful in the presidential campaign, there will be a loud and belligerent bidding war about them. But at the end of the day they won’t be, in and of themselves, economically significant.*
- *The real risk is an escalating vicious cycle of tit-for-tat between the US and China, and we are quite confident that neither nation will be willing to go there in this fragile post-pandemic global economy.*
- It’s no coincidence that at the same Standing Committee meeting last week in which the Hong Kong security law was agreed, China also [abandoned its long-sacred numerical target](#) for economic growth, and [promised that it would stand by its commitment to the US](#) under the Phase One trade deal.
- Our thoughts here are aimed at understanding the immediate dynamics of the moment. In that sense, our judgment is that these new risks aren’t going to put a dent in the vibrant “risk-back-on” move from the late-March bottom (see [“On the Fed’s Massive Intervention”](#) March 23, 2020).
- But neither will these risks change the longer-term challenges facing China’s post-pandemic relationships with other large players in the global economy. The world will be looking to see that China has learned the right lessons from the pandemic (see [“After the Crisis, the Work Begins”](#) May 4, 2020). In that context, it is important that China manage well the [new wave of protests](#) triggered by the threat of the new law – and there’s a risk that it won’t.

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- But even if it handles the protests elegantly, and whether or not a new security law for Hong Kong is within the legal framework of its constitution, we can't see how anything that seems in any way like a power-grab would strengthen China's brand with its global partners.

Bottom line

China's imposition on Hong Kong of a new security law will trigger only economically insignificant responses from the US. In a presidential campaign year in which no candidate can seem to be "soft on China," there will be loud rhetoric, but only trivial sanctions and changes to the terms of trade. Neither nation will be willing to fall into a vicious cycle of tit-for-tat that could abort a nascent post-pandemic recovery. That is why China has acted now, even though Hong Kong's constitution has allowed it for over two decades. This won't derail the "risk-back-on" move from the March bottom. But it leaves China still having to successfully manage its brand in the post-pandemic global economy. ▶