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Markets in High Resolution

Grim Tidings from China's NPC

The headlines from Premier Li's speech last night to China's National People's Congress made the 2019 economic outlook sound like the Bataan Death March:

*CHINA SETS 2019 GDP GROWTH TARGET AT 6%-6.5%
*CHINA FACES MORE CHALLENGES, RISKS IN ECONOMY THIS YEAR
*CHINA SAYS NEEDS TO BRACE FOR `TOUGH' ECONOMIC BATTLE
*CHINA TO REDUCE FUNDING DIFFICULTIES FOR MANUFACTURERS
*CHINA TO FOCUS ON STABILIZING FOREIGN TRADE
*CHINA TO STABILIZE JOBS IN COS AFFECTED BY U.S. TRADE TENSIONS
*CHINA: ENHANCE SUPERVISION OF CAPITAL FLOWS, RISKS IN FIN. MKTS
*CHINA: STABILIZE LAND, HOME PRICES, PROPERTY MKT EXPECTATIONS
*CHINA TO DECISIVELY PREVENT, RESOLVE PROPERTY MARKET RISKS
*CHINA TO KEEP STOCK, BOND AND FX MARKETS STEADY
*CHINA TO TACKLE ABNORMAL FIN. MARKET FLUCTUATIONS IN TIMELY WAY
*CHINA FISCAL POLICY TO BE PROACTIVE, STRONGER, MORE EFFECTIVE
*CHINA PLANS 2T YUAN CUTS IN TAX, SOCIAL SECURITY FEES IN 2019
*CHINA SAYS 2019 MONETARY POLICY TO BE PRUDENT
*CHINA TO KEEP ECONOMY'S LEVERAGE `BASICALLY' STABLE IN 2019
*CHINA OUTSTANDING AGGREGATE FINANCING GROWTH IN LINE WITH 2018
*CHINA TO STICK TO STRUCTURAL DELEVERAGING
*CHINA TO PAY ATTENTION TO DELEVERAGING PACE, STRENGTH

As noted in my recent "China Credit Deep Dive," fiscal stimulus is largely a smokescreen. RMB ~800bn is coming in the form of the announced VAT cuts, with the rest to come via small personal income tax cuts (to lower brackets) and around half of the announced RMB 2T via lower social security contributions. (Note, we still don't know what's happening on the ground given announced plans to strengthen collection enforcement of social security charges).

Stimulating via tax cuts is certainly preferable to funding more bridges to nowhere, given some potential for dynamic effects from the VAT cut (from 16% to 13% for manufacturers). But the crux of China's problem is high debt against a backdrop of decelerating cash flows (nGDP).

Continued adherence to the deleveraging campaign – i.e. a "basically stable" credit-to-GDP ratio – dictates that any debt-funded fiscal stimulus comes in lieu of – not additive to – the usual credit stimulus. Yes, its marginally more effective, but not nearly of a scope to prevent a continued deceleration in nominal GDP growth from 2018's 9.1% level to the 7-8% range.

China's obsession with stability in every vector is a Minksyite nightmare. The best case for 2019 is that they can continue to dance ever closer to the edge of disaster. "No deal" on trade and/or significant Dollar strength would heighten the risks of a significant vol event.

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Enforcement, Enforcement, Enforcement

Reportage that the U.S. and China are "closing in on a trade deal" seems accurate as far as it goes. By all accounts they are in fact "close" to a deal – with little left to agree on *but the one thing that actually matters*. Recall Lighthizer's admonition in the first oval office conclave with Liu He: "enforcement, enforcement, enforcement."

The enforcement mechanism as Lighthizer describes it – including regular reviews at which the U.S. has the ability to respond "unilaterally and proportionally" to deemed breaches with China forgoing the right to retaliation – leaves the interpretation of China's commitments up to the U.S. A lack of specificity in the agreement is actually to the U.S advantage in this framework.

The approach also, quite brilliantly, throws the salami-slicing problem into China's lap. Instead of an all-or-nothing enforcement option against which China could continually engage in breaches that were each individually insufficient to elicit the "nuclear" response of termination, the U.S. would now get to do the salami slicing – applying "proportional" penalties to push changes in Chinese behavior while China is left with the decision to break the pact.

The problem of course – as I pointed out last week – is that this is going to be a difficult political pill for President Xi to swallow. This from Politico yesterday:

> *China is now being pressured to accept a deal in which they would not retaliate to any tariff punishment by the U.S., which experts say could be a tall order. "It clearly veers into a loss of sovereignty for the Chinese and could be rejected on this ground," said Mary Lovely, a professor of economics and China expert at Syracuse University.*

We're left with two paths to a deal:

- Xi agrees to the U.S-unilateral enforcement mechanism
- Xi rejects the enforcement mechanism but Trump agrees to a deal anyway

Each of these outcomes would be surprising - but we only need one to get to a deal. Nonetheless I maintain, perhaps stubbornly, that the market is still far too optimistic on the odds of a Mara Lago signing ceremony.

Market strategy:

- Preferred hedge as we await the outcome: long VIX
- Xi caves on enforcement: Sell the rally in Chinese equities
- Trump caves on enforcement: Sell the rally in U.S. equities
- No deal: Look to buy U.S. equities into the turmoil