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Markets in High Resolution

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Phase One Shakedown & a Q1 Reflation Trade

- A new blueprint for U.S.-China Relations: The Shakedown
- Tensions return in Phase 2, but that's a Q2 story
- A 'Reflation trade' favors EM over DM
- China remains a laggard

"Structural" components of the Phase One deal – IP, forced tech transfer, financial services and currency - line up with **measures China has already taken**.

- China's new Foreign Investment Law taking effect on 1/1/20 has been derided by U.S. business interests as woefully inadequate.
- China announced access-easing measures on financial services earlier this year.
- Currency complaints have been irrelevant for a decade

Lighthizer folded on enforcement.

- Demand for a "unliteral enforcement" mechanism were dropped.
- Phase One allows "each party to take proportionate responsive actions that it deems appropriate."
- Any enforcement action risks blowing up the deal in a series of ratcheting counteractions.
- China will cheat in "salami slices" – none individually sufficient to risk blowing up the deal

Purchase commitments are enormous

- $200bn in *additional* imports over a 2017 base, of which $32bn in Ag
- "China's commitments cover a variety of U.S. manufactured goods, food, agricultural and seafood products, energy products, and services"

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- "China's increased imports of U.S. goods and services **are expected to continue on this same trajectory for several years** after 2021 and should contribute significantly to the **rebalancing of the U.S.-China trade** relationship."

<u>Phase One provides **a new blueprint for U.S.-China economic relations**</u>

- **Abandoning the push for structural change**, the Administration envisions forcing the trade account towards balance through **coerced Chinese purchases** of U.S. goods.

- WTO non-compliance is a feature, not a bug.

- While Congress loses its mind over the President's solicitation of an investigation, there is nary a peep while he **establishes a $100bn slush fund of CCP cash** for favored constituencies.

- $100bn is ~0.5% of GDP. Assuming some substitution effect (more beans to China, fewer to Europe), this **could goose election-year GDP by .2-.3%.**

<u>China gets:</u>

- Tariffs in reverse: **supply-chain exodus will slow** to a halt

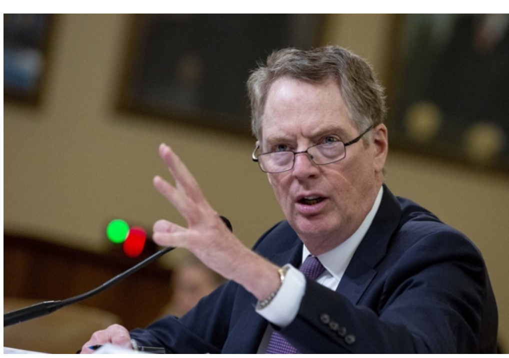
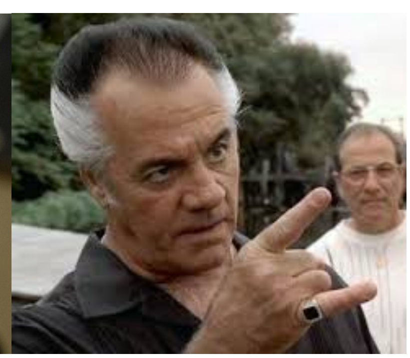
- No change to China's economic model

- Xi regains his political footing

<u>Phase One Shakedown</u>:

- As long as China pays the juice, they can run their business as they see fit.

- They come up short, you bust the joint. You light a match.

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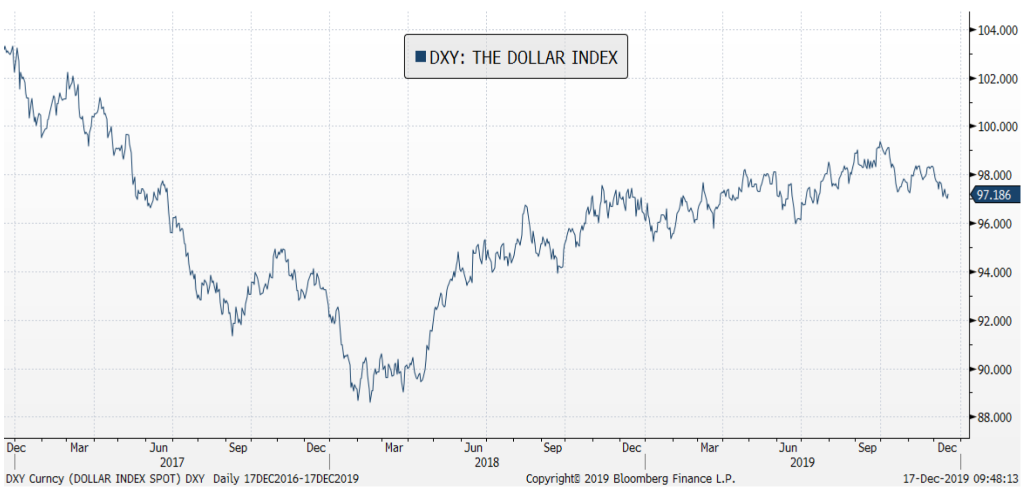
Phase Two is tricky

- **China will be pushing for more rollback** within months.
- China's leverage increases as the election approaches.
- China should want no part of a Trump second term – they could play nice in 2020 and he might still blow them up in 2021.
- Another round of confrontation is likely, but that's **probably a Q2 story.**

Q1 Reflation Trade

- Disappointment over the slight degree of tariff rollback is misplaced.
- Key for markets is the **removal of China tails risk.**
- Risk that China tries to re-trade the deal and derails things is slight (15%).
- Reduction of tail risk should foster **easier liquidity conditions** as precautionary demand for liquidity subsides.
- Improving U.S. data is not necessarily USD-bullish with the Fed in cement shoes.
- I lean USD-Bearish here.



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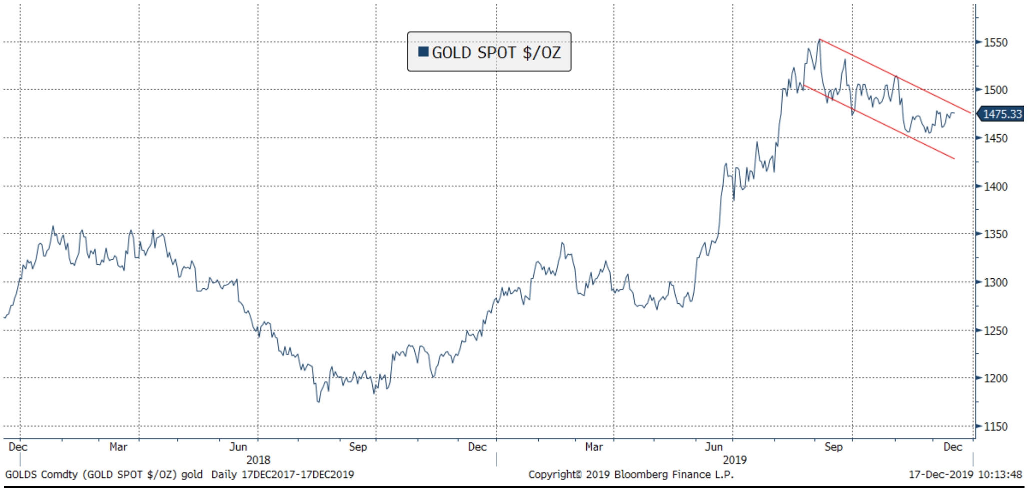
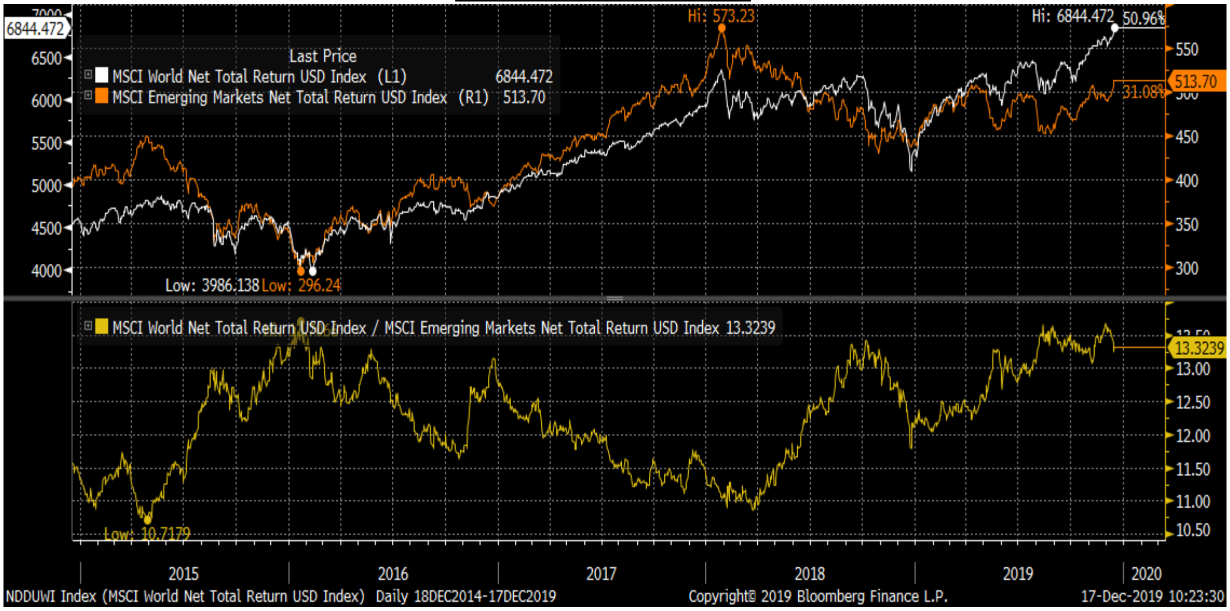
- Gold looks bullish too (although it has already run considerably ahead of FX).



- Even slight Dollar weakness could produce a **significant retracement in EM vs DM equity** performance:

MSCI World / MSCI EM



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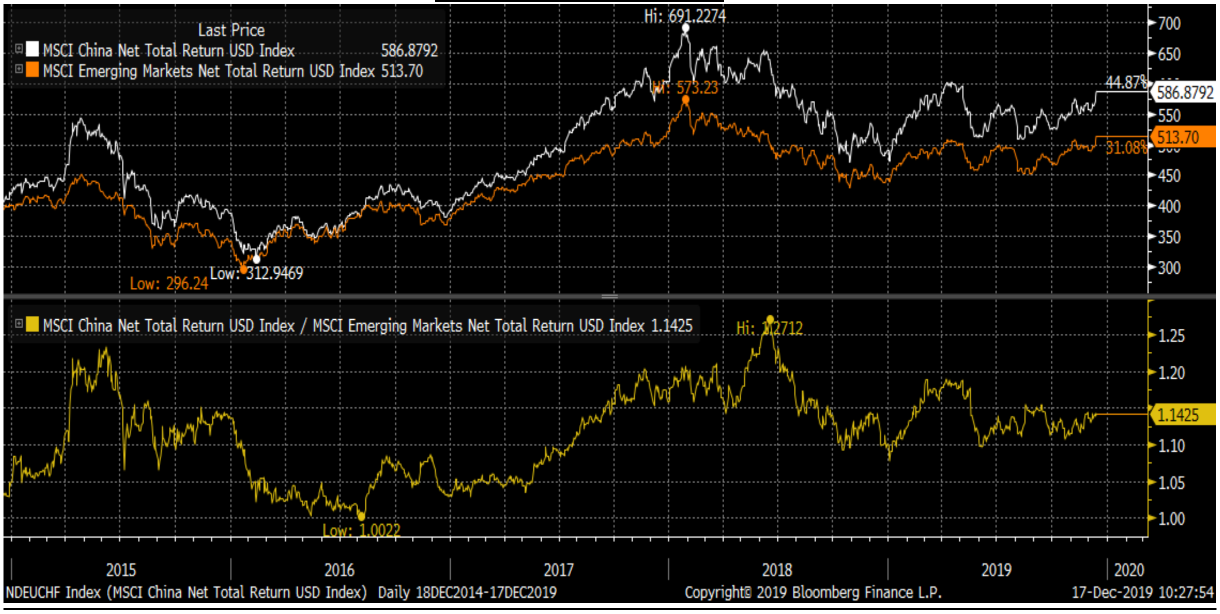
- Despite China's centrality to the story, **China remains an underperformer** <u>unless the Dollar weakens substantially</u> (as in 2017).

- Moderate Dollar weakness will leave China mired in debt-deflation

<u>MSCI China / MSCI EM</u>



- I'm tactically short USDCNH but expecting pent-up demand to put in floor around 6.85.

- P.S. – Where exactly is China supposed to come up with an extra $100bn a year?