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Trade Showdown, Bank Runs & Weekend Links

By week's end **we have some welcome clarity** as to the dynamic in U.S. – China trade talks. We can confirm that China has moved the goal posts with a demand for some rollback of existing tariffs:

Hu Xijin 胡锡进 @HuXijin_GT · 1h

What President Trump said is not what the markets expect. But he said "the US hasn't agreed to a rollback of tariffs". It's not a flat denial. What's certain is that if there's no rollback of tariffs, there will be no phase 1deal.

The Wall Street Journal @WSJ · 2h

President Trump says the U.S. hasn't agreed to roll back tariffs, disputing a statement from China that tariff relief would be part of a phase-one trade accord on.wsj.com/2WX7yGI

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I detailed why tariff rollback is a terrible idea in Tuesday's note: China Overplays its Hand. Subsequent reporting from Reuters reinforces my view that Phase One is now **no better than a 30/70 proposition**:

Rollback of China tariffs faces fierce opposition in White House

> *The idea of a tariff rollback was not part of the original October "handshake" deal between Chinese Vice Premier Liu He and U.S. President Donald Trump, the sources said.*
>
> *The Chinese Communist Party is trying to "re-trade" the agreement, said Stephen Bannon, former White House adviser. He added that rolling back earlier tariffs "goes against the grain" of the original October agreement.*
>
> ***"There's nothing that Trump hates more" than someone backtracking on a deal**, he said.*
>
> *This is "very like" Beijing, said Christian Whiton, a former adviser in the Trump administration on East Asia issues. China's Communist Party is a using a "hyper-aggressive negotiation strategy of trying to redefine reality," he said.*
>
> *"At the end of the day, Trump is the original hawk" on China trade, said Whiton. "I would be very surprised" if he agreed to this.*

Here's was the President himself at this morning's chopper presser:

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> *"Well, they'd like to have a rollback. I haven't agreed to anything. China would like to get somewhat of a rollback, not a complete rollback because they know I won't do it. But we're getting along very well with China. They want to make a deal. Frankly, they want to make a deal a lot more than I do," Trump said. "I'm very happy right now. We're taking in billions of dollars."*

An optimist could characterize that as leaving the door open to a rollback. On the other hand we should probably take the self-described "tariff man" at his word when he says he's "very happy right now, taking in billions of Dollars."

And in a bit of pushback for China's attempt to re-trade him, the President also to laid down a demand that any signing take place in the U.S.:

> *Assuming we get it, and I don't like to talk about things until we have them, but it could be Iowa, or farm country, or someplace like that.* ***It will be in our country****, but it could be someplace like that.*

The initial "Ag purchases for December tariff deferral" deal construction seemed a viable middle ground, in which each side gave up little in return for a mutually-agreed temporary cease fire. The problem with China breaking that "handshake deal," and upping its ask, is that **a Phase One deal now requires a winner and a loser**.

Spin as he might, if Trump allows China to re-trade him for tariff rollbacks, he's the loser. If Xi accepts a deal without rollbacks now, he's the loser. It's not clear to me either leader is on a sound enough political footing to so overtly back down.

The winner / loser dynamic also ups the ante for financial markets. This is no longer about a mere cease fire. **This is now about capitulation vs. decoupling.** Fading risk assets here, given the market's extreme overconfidence in a Phase One deal, remains my stance into next week.

Meanwhile, the Chinese are deluding themselves if they think they have the upper hand in these talks. **The specter of a cascading panic in the banking sector** isn't conducive to bargaining leverage!

Mounting Signs of Bank Stress in China Prompt Government Action

> *On Thursday,* ***Guangdong Nanyue Bank made a rare decision to skip early redemption on its local tier-two bond*** *without giving a reason, sparking fresh concern about its financial strength.* ***Two other banks have faced runs*** *at some branches in recent days amid unsubstantiated rumors on social media that they might fail. Many other lenders are embarking on efforts to bolster capital.*

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> ***The drumbeat of news is heightening investor concerns about China's more-than 3,000 small banks****, many of which are coping with a mountain of bad loans and a government crackdown on risky funding practices. To prevent panic, authorities are considering a package of measures to shore up any cracks in the world's largest banking system -- a complex challenge.*
>
> *The plan under development by financial regulators would* ***encourage problematic banks with less than 100bn yuan ($14bn) of assets to merge*** *or restructure, people familiar with the matter said Thursday.* ***Local governments would be held responsible*** *for dealing with troubled lenders, with the central bank providing liquidity support if necessary, the people said, asking not to be identified discussing private information.*

Chinese local governments aren't exactly swimming in cash these days, so it's unclear how they're supposed to "take responsibility" for what could quickly become a rash of bank failures.

More likely is that, as is usually the case, the risk will just be rolled up through larger institutions, towards the ultimate repository for all risk in China: the State.

China Considers a Wave of Bank Mergers to Bolster Stability

> *China has more than 3,000 small banks, many of which are struggling to cope with mounting bad loans and a government crackdown on risky funding practices. Authorities have so far taken piecemeal steps to stabilize the industry,* ***seizing control of one bank in May and orchestrating bailouts for two others****. President Xi Jinping's government is now laying the groundwork for a more comprehensive solution.*
>
> *The reform proposal, which has yet to be finalized, would also compel existing shareholders of troubled banks to buy perpetual bonds to shoulder potential losses, the people said. A UBS Group AG analysis of more than 250 Chinese lenders in July showed they face a* ***potential capital shortfall of 2.4tn yuan****.*
>
> *While a major industry consolidation might stabilize weaker institutions and make it easier for financial regulators to monitor risks, it's unclear whether the plan would do much to address China's moral hazard problem. If the nation's banks get larger through acquisitions, the government may feel even more compelled to rescue those that run into trouble.*

(Pro tip: it would reinforce the moral hazard problem)

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> *For the country's big publicly traded lenders, the proposals could prove a mixed blessing. Firms like Industrial & Commercial Bank of China Ltd. may benefit if the measures lead to increased financial stability and allow big banks to snap up smaller rivals on the cheap, but there's also a risk that they'll be compelled to absorb some of the industry's weakest players. ICBC's stock slumped to a two-year low in August after the bank injected capital into a troubled regional lender as part of a government-orchestrated rescue.*

Nonsense. Other than a small haircut that might be taken as current shareholders get swapped into perpetual bonds of the acquiring institution, **the vast majority of hidden losses in the target institution will simply get rolled on to the balance sheet of the larger, acquiring bank**. Shareholders of listed Chinese banks are at risk of being forced to "take one for the team" here.

Regulators absolutely cannot let this horse bolt the barn. If panic continues to spread it could rapidly necessitate a blanket state guarantee on bank liabilities. Like so many of China's pent-up economic problems – the capital account, the exchange rate – the moral hazard problem is all-or-nothing. There is no middle ground: either the State backs everything or everything will rapidly go bad.

When forced to guarantee everything, they will. But this will put even more extreme pressure on PBoC to maintain sufficient liquidity, and further pressure the RMB.

Sub-7.00 level on USDCNH are a gift to the medium-term investor. Leveraged specs might want to wait for the possibility of a move to to sub-6.90, should Phase One get done. Either way, the recent **rally in the RMB is big time fundamental fade**.

On to the links…

China Economy & Finance

Stable credit growth (~12%) is not so much a policy choice as an acknowledgment of the reality that credit stimulus has run out runway…

China's waning appetite for stimulus weighs on global economy

> *The dozens of abandoned, unfinished buildings in the central business district of Kaifeng, a city of 5m in central China, are a telling symbol of the country's stuttering efforts to stimulate its economy — and the dwindling effect it is having on global growth.*

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In Kaifeng, one landmark tower being constructed by the Henan Coal Chemical Group, a local state-owned company, has been halted for more than a year. The project has "run out of money for a long time"

Fears of unsustainable property investment, the viability of bank balance sheets, a trade war with Washington, rising fiscal deficits and exchange rate concerns all mean **Beijing is less able to ride to the rescue** *of the global economy than it used to be.*

The downside of front-loading is the back side…

China's local governments issue fewer bonds

China has seen its local government bond issuance fall for two months in a row in October, with 150bn yuan worth of bonds likely to be issued for the rest of the year, analysts said.

The value of local government bonds issued in October totaled 96.46bn yuan (about 13.78bn U.S. dollars), much lower than 219.6bn yuan in September and 569.5bn yuan in August, according to the Ministry of Finance.

In the first 10 months, local governments issued nearly 4.28 trillion yuan in bonds, including 2.53 trillion yuan in special-purpose local government bonds aimed at providing financial support for public-interest projects.

Amazingly enough, the Chinese financial system is circling the bowl, and we haven't even seen a discernible break in sentiment toward real estate assets yet! In fact, even a government plan for a massive supply of subsidized, price-capped housing **can't seem to break the fever** in Shenzhen's housing market…

Shenzhen's buyers defy flood of cheap homes by leaping into market

Shenzhen's government plans to build 1 million homes during the 18 years through 2035 *for young professionals, first-home buyers and low-income residents, which means close to* ***60,000 new homes being added to the housing supply every year. That's triple the annual additions in 2016 and 2017****, and more than 30-fold the completion every year prior to 2010.*

The ambitious plan is still fraught with unanswered questions, including the qualifications of housing applicants, the quality of the housing and whether the supply target is reachable.

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> *"Until homebuyers get the exact answers for their questions,* ***the new plan cannot really put a brake on sales, or halt the price increases****," said Midland's chief analyst Fion He. "The best scenario is that it can lower a buyer's expectation and help moderate the price increases. For most people who have an immediate need for housing, they will just have to get whatever they can get right now."*

That said, the real estate markets in smaller cities must be much **worse than the data shows** if they are offering hukou permits, which commit the locality to providing costly public services…

Across China, Buying an Apartment Just Became a Whole Lot Easier

> *At least 30 cities in China have made it easier for workers to obtain highly sought-after residency permits since September in a sign authorities are keen not to let the nation's real estate sector slow further.*

This kind of thing has actually been happening sporadically for years…

China's Housing Market Is Finally Cooling. Some Homeowners Are Furious.

> *Some of those who have pooled their life savings to become homeowners are now finding it wasn't the sure-bet investment they thought.*
>
> *At the sales center at Sunac China Holdings Ltd.in Tianjin, over the sound of upbeat electronic pop music, buyers crowded around a customer service representative demanding to know why the company had substantially lowered sales prices.*
>
> *"You promised me the house price wouldn't drop," one woman yelled. "I am bankrupt because of this home." Yu Xi, the customer-service representative, remained impassive, telling home buyers there was little he could do.*

U.S. – China Relations

Chinese finance is nowhere close to being "marketized." NPL ratios are a centrally planned variable. Moral hazard is widespread. The only area in which foreign firms have a natural competitive advantage is in the management of non-Chinese assets, which is being increasingly restricted. **China's plan here is clear: write checks (via allocation of market share) to JPM, GS and others in exchange for lobbying support** for accommodative trade practices.

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Trade War Hasn't Stopped Wall Street's $9 Billion China Rush

> *Executives from the biggest U.S. financial firms, including JPMorgan Chase & Co. and Goldman Sachs Group Inc., met with top regulators in Beijing in a sign that the trade war with the U.S. has done little to derail China's opening of its $43 trillion financial system.*
>
> *"China is very determined to reform its financial markets and knows that without the major American players, it is very hard to talk about having a truly internationalized market," he said. "It also makes sense for China to accommodate a very important source of lobbying support, especially as there's so little in the U.S. right now."*

China's steps to improve market access are yet another smokescreen…

Business groups' complaints show how Trump's China deal falls short on foreign investment

> ***"If you thought the foreign investment law was going to allow multinational companies to compete with state-owned enterprises, you're a fool***," *said Derek Scissors, a senior fellow at the American Enterprise Institute who is critical of China's policies.*
>
> *"What the Chinese are saying is, 'We will treat you better subject to the condition that with any sector the state thinks is important we will take your technology and give you nothing.'"*

US government urged TSMC to stop selling chips to Huawei

> *TSMC has received a boost from Washington's blacklisting of Huawei, which limits some US companies from selling to the Chinese company. China accounted for about 20% of TSMC's revenue in the third quarter, and Huawei constitutes almost half of that, estimates Randy Abrams, head of regional semiconductor research at Credit Suisse.*
>
> *Industry experts remain sceptical that Washington can force Taiwan's hand. The Trump administration's campaign to convince other countries to ban Huawei from their 5G networks has had patchy success.*
>
> ***"Given Washington's focus on competition with China and the role of semiconductors in things like 5G and advanced military capabilities, I expect the administration and Congress to increase their scrutiny of the export of advanced chips to China from Taiwan and other***

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> ***countries** like Japan and South Korea," said Eric Sayers, vice-president at Beacon Global Strategies, a security advisory firm in Washington.*

Interior Department Grounds Aerial Drone Fleet, Citing Risk From Chinese Manufacturers

> *WASHINGTON—The Interior Department is grounding its entire fleet of aerial drones, one of the largest in the federal government, citing increasing concerns about the national security risk from Chinese manufacturers.*
>
> *Under an order from Interior Secretary David Bernhardt on Wednesday, the drones will be grounded until the department completes a review of potential security risks of Chinese drones, said department spokesman Nick Goodwin.*
>
> *Officials worry that U.S. reliance on Chinese drones might be putting critical infrastructure at risk. They are concerned the drones may be sending information back to the Chinese government or hackers elsewhere to use for cyberattacks or other offenses.*

Didn't see any news coverage of this, but interesting nonetheless…

SEC.gov | SEC Chairman Clayton, PCAOB Chairman Duhnke, and Members of SEC Staff Meet With Auditing Firm Representatives to Discuss Audit Quality in Emerging Economies and Markets

> *The Securities and Exchange Commission today announced that SEC Chairman Jay Clayton, Public Company Accounting Oversight Board (PCAOB) Chairman William Duhnke, and members of the SEC staff **met last week with senior representatives of the four largest global network auditing firms to discuss the audit quality and certain of the challenges faced in auditing public company operations in emerging markets, including China***

Tariff rollback would likely put a halt to the supply chain exodus. Better to just get on with it…

US-China trade war spurs apparel factories' exit from China

> *Since the start of Trump's presidency, household names such as Uniqlo, Levi's, Crocs, Calvin Klein and Tommy Hilfiger have moved their entire manufacturing base out of China.*
>
> ***The more entrenched the trade conflict with China becomes, the more appealing it is for companies to divert supply chains**, despite the risk involved, and move…*

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> *Vietnam **has long been the logical first choice – particularly when it comes to footwear**. This comes down to a number of factors: Vietnam has free trade with end-market countries including the 28 nations of the EU, Australia, Canada, Japan, Mexico, New Zealand and Singapore.*
>
> *Workers are skilled, and while wages are relatively high for the region (at US$216 a month), they are less than half that of China. Infrastructure is good and, unlike in some countries in the region, electricity remains reasonably cheap thanks to government subsidies.*
>
> *"I would say at the moment that **Bangladesh has the advantage in terms of apparel** and Vietnam has the advantage in footwear;*
>
> *"We're noticing a lot of brands migrating to Bangladesh," says Coxall. "They are training the workforce and importing new, expensive machinery. It's the one place you could do everything: denim, jumpers, shoes, you name it. They have even developed the laser technology you need to create high-quality jeans."*
>
> *And then there is **Cambodia, where apparel manufacturing accounts for 80% of national export earnings and employs more people than any other industry** – so it is no surprise that the government is putting policies in place to tempt even more international brands to their shores.*
>
> *There is also Indonesia**. Jakarta is rolling out an ambitious plan** to digitalise its clothing and textile industry – a key policy devised to meet the government's goal of turning Indonesia into one of the world's top five textile and apparel producers by 2030.*

Hong Kong

I can only presume Senate Majority Leader McConnell has this bill on ice until the trade negotiations reach a conclusion. I don't see any way can avoid bringing it to the floor eventually…

Effort in U.S. Congress to rein in China on Hong Kong protests faces obstacles

> *"Your guess is as good as mine as to why something that enjoys that broad, bipartisan support - and on an issue that's acute and happening now - has not reached the floor of the U.S. Senate," Republican Senator Marco Rubio, a leading China hawk and the bill's chief co-sponsor, told Reuters.*

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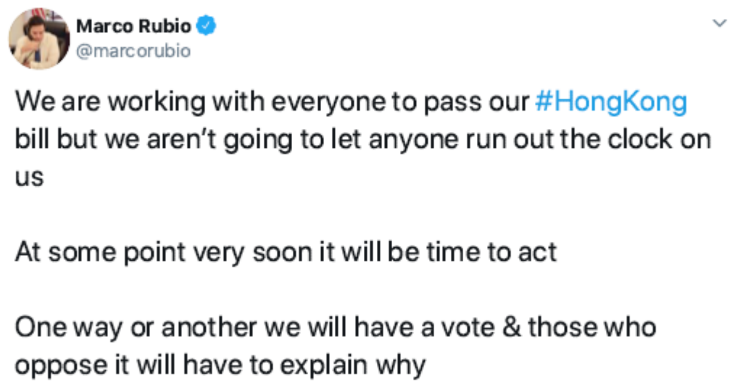
Marco Rubio
@marcorubio

We are working with everyone to pass our #HongKong bill but we aren't going to let anyone run out the clock on us

At some point very soon it will be time to act

One way or another we will have a vote & those who oppose it will have to explain why

Admittedly, this is not the first time I've gone to this well, but 3-6m puts on the Hang Seng are fantastic hedge to "phase one risk" from current levels. Even if phase one gets done, there is little indication of improvement on the ground in Hong Kong…

Hong Kong Slows Further With Business Outlook Worst Since 2008

> *"The ongoing political unrest and impact of trade tensions* ***saw business activity fall at the sharpest pace since the survey started over 21 years ago****. Anecdotal evidence revealed that the retail and tourism sectors remained particularly affected," Bernard Aw, principal economist at IHS, said in the release. "As new orders continued to fall sharply, led by a record decline in demand from mainland China, firms were becoming increasingly pessimistic about the outlook."*

Taiwan

Interesting insights on Taiwan from Richard McGregor…

China Is Sabotaging Itself in Taiwan

> *Over the past year,* ***Beijing has single-handedly revived the electoral prospects of its political adversary, incumbent President Tsai Ing-wen of the independence-leaning Democratic Progressive Party****. At the turn of the year, Tsai's approval rating was a miserable 24%. Now polls show her with more than 53% support versus about 31% for Han, whose Kuomintang is the natural ally of Beijing.*
>
> ***China's increasingly hardball tactics have helped to drive Tsai's resurgence****, along with its call for Taiwan to return to the fold on the same terms as Hong Kong. In January, Chinese President Xi Jinping urged unification talks on a "one country, two systems" model, saying*

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> *the political impasse could not be passed from generation to generation and reiterating that Beijing wouldn't promise to refrain from using force if Taiwan refused to discuss terms. Tsai's support leaped after she rejected the overture. This year's unrest in Hong Kong has further boosted the popularity of Tsai, a vocal supporter of the protesters, who have complained of China's encroachment on the former British colony's autonomy and called for greater democracy.*
>
> *Why has Beijing resorted to such a self-defeating strategy? China is a vastly richer and more powerful country than in the past, with a military that towers over Taiwan. It is also governed by a leader in Xi who has amassed more personal power than any leader since Mao Zedong. In this more confident and muscular era, the Communist Party seems determined to set its own path toward unification, taking little account of the views of naysayers.*
>
> ***The logic of Chinese politics in the Xi era makes a softer, more accommodating line from anywhere in the system untenable, unless it comes from the top. In turn, Xi himself is determined not to display any weakness on either issue, lest he should give his critics ammunition that can be used against him****.*

ECB Tiering

It looks like 'tiering' is working pretty well, which suggests that the ECB does in fact have more "room to cut rates" if it chooses to use it. Having a deeply negative rate on a smaller pool of "marginal" reserves would likely prove more effective than a slightly negative rate on a large pool…

Tiering Isn't Tightening as Money Markets Show ECB 'Nails It'

> *"ECB must be pleased for now as it apparently managed to calibrate the multiplier correctly, with depo continuing to set the price for overnight cash," said Michael Leister, Commerzbank AG's head of rates strategy. "This also implies that more rate cuts are feasible as pass-through works"*