Trade Update: China 25, Blame Canada and on to FOMC

- Chinese flexibility on "Made in China 2025" is a big deal
- Skepticism is warranted but not market-relevant in the near-term
- Chinese capitulation is a double-edged sword for markets
- Hopes for "China stimulus" will once again hang on Fed policy

On December 6 I wrote:

> *The Chinese seem prepared to offer "fudgeable deliverables" sufficient to justify a more extended cease fire if Trump so chooses. Aside from the obvious sop of stepped-up commodity purchases, China can offer new rules on IP protection, a pledge to halt cyber intrusions, and some limited market-opening measures. Heck, they might even actually slow the torrent of Fentanyl pouring into the U.S. Any "deal" on these issues would have to include a verification period of some timeframe – another call option for the U.S.*

The WSJ now reports that the Chinese are dangling a most tasty morsel of "deliverable fudge" in the form of a dialing back of their "Made in China 2025" blueprint for technological dominance. While skepticism may be warranted regarding the practical ramifications of China's offer, the political optics of this are of tremendous significance.

While critics will insist, with justification, that an economic tiger doesn't change its stripes, President Trump can claim a significant achievement in simply getting China to acknowledge that some alteration of its behavior is required. This is not a small thing. Frankly, it's a considerably more aggressive "give" by China than I thought likely.

Of course skepticism is warranted. Given China's lack of credibility in maintaining its commitments any pledges will require verification over some timeframe. As Wilbur Ross told CNBC yesterday:

> *what you will see if we did get to a trade agreement with China is there will be verification procedures, there will be enforcement mechanisms*

March 1 will not produce a finalized "deal" so much as a set of commitments by China to change its behavior in ways that can be monitored and measured. Ultimately, China is unlikely to fundamentally alter its growth model, and it may not actually alter "China 25" any more than to simply stop talking about it. But these potential verification snafus are for many months down the road.

For now, in what feels like the second or third inning of this trade game, the scoreboard is shaping up something like this:

U.S. “wins”:

- Tariffs in place on $250bn of imports from China
- Reversal of most of China’s retaliatory measures against those tariffs
- A tacit agreement on RMB stability
- Widespread reassessment of supply chain vulnerability to China
- A tightening of CFIUS strictures on Chinese acquisition of sensitive U.S. technologies
- Heightened international awareness of the risks of using Chinese technology products
- Heightened awareness of illicit Chinese cyber activities
- Acknowledgement by China that IP protection must be improved and some vague pledges regarding same
- Acknowledgement by China that domestic market share goals in “China 2025” are unacceptable and some vague pledges regarding same

China’s “wins”:

- They nabbed two Canadians who were in the wrong place at the wrong time

Well, that last one is actually an “own goal” by Team Xi. Exactly the kind of behavior which highlights China’s unreliability as a partner, the costs could be more than symbolic in that a potential ally against U.S. attempts to isolate them is probably lost. Just a few short weeks ago Canada was playing footsie with the Chinese on a potential free trade agreement. Now they’re in a full-blown diplomatic crisis.

It’s just the latest in a string of head-scratching responses by President Xi to the sudden and apparently unexpected increase in pressure from abroad, no doubt compounded by domestic stresses resulting from the poorly-timed “deleveraging campaign.” In this case I can only surmise that detaining the two Canadians is a costly sop to nationalists in the Party who may be upset with the optics of capitulation to the U.S. on trade. Blame Canada.

And it gets worse. According to a Bloomberg News report:

> *Beijing may postpone some aspects of its ambitious industrial program by a decade to 2035, according to two people familiar with the matter*

It’s hard to imagine anything more damaging to Chinese economic sentiment than to acknowledge that China’s goals for technological and economic advancement may have been knocked off course by as much as a decade. There’s no Plan B? Not even a pretend one?

“Made in China 2025” has been derailed, an inherent ceiling on global expansion for “national champions” like Huawei has come into focus, and a gradual supply-chain exodus has been set in motion. But there’s always Mor Stimulus, right?

Checkmate. The tacit understanding on currency stability touted by Secretary Mnuchin precludes an aggressive credit stimulus. The history shows clearly that despite the presence of capital controls China remains subject to the impossible trinity. Since the global financial crisis China has experienced three waves of credit stimulus: in 2009 coincident with QE1, late 2012-early 2013 coincident with QE3, and late 2015-early 2016 which resulted first in a dislodging of the RMB against the Dollar and subsequently in the Fed's capitulation in early 2016.

While the Fed may provide some relief by slowing the pace of rate hikes into 2019, China is unlikely to enjoy the degree of accommodation that allowed them to kick the bad debt can down the road in 2016.

Instead, constrained in its recourse to credit stimulus, China will limp along hoping for a U.S. economic slowdown of sufficient magnitude to knock the Fed back into easing mode, or for the external pressures to somehow miraculously blow over. Hope of course, is not a strategy.

Conclusions:

- The risks of trade-related dislocations to the U.S. economy have dissipated for 2019
- Downside risks to Chinese growth are exacerbated by the deal as currently structured
- *A re-pegging of the RMB will amplify the effects of Fed policy* through the impact on China's ability to engage in credit stimulus