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# Post-G20 Trade War Dynamics

Risk assets remain buffeted by the risk of Fed error, U.S.-China trade tensions, the economic swoon in China (which sits at the intersection of the Fed error and the trade war), an OPEC breakdown and a disorderly Brexit. While teasing out causality can be more art than science, *as far as U.S.-China trade goes, the situation is in unambiguously less bearish* than it was a week ago, the Huawei news notwithstanding. *The Fed can, should, and likely will "fix all this" at the December FOMC meeting.*

I make two key assumptions in handicapping U.S.-China trade outcomes:

- The Chinese government has no intention of fundamentally altering China's State-centric economic model (i.e. the U.S. can't actually "win").
- President Trump will not (nor can he politically) accept a "fake deal" that leaves China's fundamental practices unchallenged (i.e. China can't actually "win").

It seems logical that if neither side can win, both must lose. Hence the pervasive sense of bearishness on this issue. But that lose / lose logic is too clever by half.

The Trump Administration's goal is to disengage economically from China so as to immunize the U.S. and its market-oriented trading partners from the social and economic costs of China's market-distorting behaviors - a problem that grows in intensity with China's GDP and degree of global integration.

I make two further assumptions:

- Disengagement is essential to the continued functioning of an open, market-oriented global economy
- Disengagement is achievable with an acceptable degree of economic dislocation (more on that here) *with a properly executed strategy*

Of course, economic disengagement is fraught with risk. No strategy can be road-mapped with any degree of precision. The goal is simply to keep the process moving forward over time without being derailed by an economic dislocation or a lack of sufficient political capital.

More succinctly, *the President is not going to pursue a strategy that hammers the economy* and dooms his chances for re-election.

Furthermore, disengagement *requires obfuscation*. You can't just come out and declare "we want to cut China out of global trade and finance." The only hope of success is to engage in an *ongoing game of cat and mouse* with both the financial markets and the Chinese.

Recent events, which were eminently predictable, are just more "cat and mouse." The President called

timeout in a nod to the economic and political realities, but the broad heading of the Administration remains unchanged. The only "new news" that came out of Buenos Aires was confirmation that nurturing the economic recovery maintains precedence over skirmishing with the Chinese. That's not bearish.

The disengagement strategy will continue to be pursued subject to the ebbs and flows of economic sentiment and the President's political capital. Given the inherent volatility in those variables, the 90-day optionality that Trump acquired in Buenos Aires came very cheaply, indicative of a significant leverage advantage held by the U.S.

Presidential tweets have already alluded to a possible extension of the 90-day negotiation period and framed the outcome as a win-win for the U.S. in the form of either a "REAL deal" or the triumphant return of "Tariff Man™." The President's options 90 days hence are deal, no deal, or punt.

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.

So long as the U.S. retains control of the process, markets should take comfort that the President is not going to take rash actions that would put the economic recovery at risk. If we get more tariffs in 3 months it will be because the economy and markets can reasonably handle it. More likely (particularly if the Fed hasn't corrected its impending error), we'll get another fudge or punt that will push China trade risks towards the back end of 2019.

Things get tricky heading into 2020 as the Chinese may grow impatient with the cat and mouse game and Trump will become attuned to the risk of letting a Democrat get to his right on China trade policy. But this is hardly relevant to near-term price action.

Perhaps more problematic for risk assets is the creeping realization that *China has no easy way out of its debt-deflation predicament* this time. The 90-day respite comes at a steep cost: the constraint of an RMB-stability pledge on domestic monetary policy. By precluding aggressive credit stimulus China consigns itself to a continued deterioration in economic sentiment. The risk of a non-linearity in Chinese credit or real estate markets remains ever-present.

This places even more importance on Fed policy. While it's unlikely the Fed can provide China the kind of extended respite they enjoyed from the mythical "Shanghai Accord" of early 2016, a Fed pause could certainly loosen the monetary noose enough to keep the Chinese financial system limping along for the next 6-9 months.

Alternatively, any Fed error in over-tightening will be rapidly transmitted to the teetering Chinese economy, and thereby amplified dramatically.

## Postscript: Huawei Bullets

While it's unclear how the news on Huawei might affect the 90-day trade talks it appears unlikely to derail the process.

- Like ZTE, Huawei has been accused of breaching licensing agreements barring the re-sale of U.S. products and components to sanctioned entities, although the specific charges against Huawei CFO Meng Wanzhou are not yet clear.

- The threatened component ban on ZTE was *not* in response to their alleged breach of sanctions, which resulted only in a fine and an agreement to punish those involved, but to ZTE's brazen flouting of that agreement. If that precedent holds, *Huawei should not be facing any kind of U.S. "death penalty"* for the sanctions breach itself.

- That said, things could be more serious for the individual involved who is facing a criminal matter handled by the U.S. Dept. of Justice. ZTE in contrast was administratively sanctioned by the U.S. Commerce Dept. This *could limit the President's flexibility* in using this case as a trade bargaining chip.

- China's response has been encouragingly muted thus far:

    - Chinese authorities have presumably been aware of the Dec. 1 arrest since the dinner in Buenos Aires or shortly thereafter.
    - A Chinese Commerce Ministry spoke positively about the impending trade talks and *declined to comment on the Huawei arrest*.
    - Even the ever-incendiary *Global Times*, while criticizing the "rogue's approach" of the U.S., said that "Huawei should try to defeat the accusers under the U.S. legal framework."

- This brazen action by the U.S. and China's response to it suggest that evidence of illegality may be of the "smoking gun" variety.

This event is only as important to trade talks as the Chinese government cares to make it. While information is limited to this point, China's reaction suggests the story is of only marginal relevance to the market outlook.