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Markets in High Resolution

A-Shares See Xi Playing Trump for an Easy Mark

China is a pig on LSD, you never know which way it's going to run.
— Bobby "Axe" Axelrod, "Billions,", Season 2

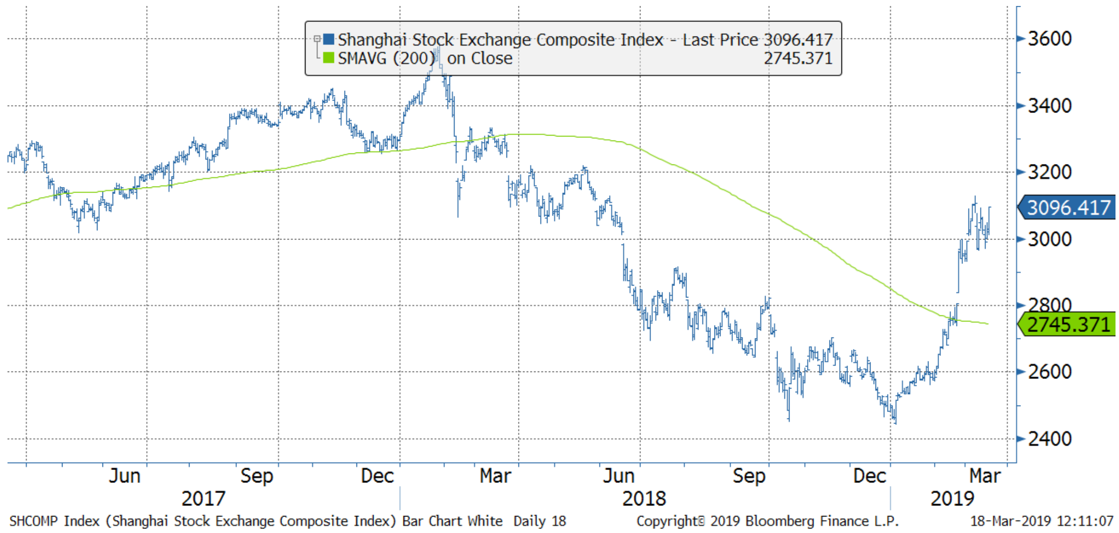
Noting the eye-catching overnight gains in onshore Chinese equities this morning, I scanned the newswires to see what the driver might be. The first story on my Bloomberg feed said this:

> *The Shanghai Composite gained 75 points, or 2.5% to 3,096 on Monday, after South China Morning Post reported on Saturday U.S. President Trump and China's Xi Jinping could meet to sign a trade deal in June.*

A trade deal which was initially supposed to be signed in late March is now a maybe for June and that's *bullish*? From the Chinese perspective, perhaps it is.

The SCMP piece in reference didn't provide much new insight, but paints negotiations about where we thought they were: Lighthizer sent Liu He home in late February with a proposal for a "one-way" enforcement mechanism and now **the two sides are in a Mexican standoff. China can't accept a deal with such onerous terms and the U.S. can't accept one without them**. The proposed Trump-Xi summit (which I'd give only a 1-in-3 chance of happening) awaits a painful capitulation from one party or the other.

While its foolhardy to ascribe rationality to a swine on an acid trip, the A-share market does seem to be having visions of a sort: it sees Xi Jinping playing Donald Trump for an easy mark. Any deal lacking in stringent enforcement strictures will amount to China having retained its highly advantageous status quo.



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So long as there is no news to undercut the "Xi plays Trump" narrative, there seems little to stop the A-share rally. That said, the news of late has NOT been supportive of the consensus view that a large stimulus is in the pipeline ,as February TSF data showed a significant payback from the booming January release, and officials at the NPC meetings steadfastly maintained the deleveraging narrative (specifically targeting that "TSF growth would be in line with nominal GDP growth").

China is in the throes of debt-deflation: if credit growth doesn't accelerate, "fiscal stimulus" is of little use. A March 15 Caixin article entitled "Local Governments Scrounge for Money in Face of Budget-Busting Tax Cuts" highlights the dilemma:

> *China's leadership has pledged to cut taxes and fees by nearly 2 trillion yuan ($298.2 billion) to boost the economy, in part by reducing tax and fee burdens on businesses.*
>
> *However, the pledge leaves China's local governments in something of a lurch as they have had to bear about half the cost of such cuts, according to Caixin calculations based on public data.*

While there is of course some marginal supply-side benefit derived from shifting the financing of economic activity from the State to the private sector, simply re-allocating credit does little to alleviate the overall debt servicing problem. For tax cuts to be additive to liquidity conditions they need to be debt-financed, not offset by other revenue measures or expenditure cuts:

> *Other local governments have decided that state-owned enterprises (SOEs) in their localities could do more to pitch in. For example, Guangdong province has required SOEs to turn in at least 30% of their profits to the province's finance department this year, compared with 25% in 2018.*
>
> *Last week, Frank Ning, the head of chemicals giant Sinochem Group Co. Ltd., said that the government will **offset lost revenue from tax cuts** with income from other sources — and specifically mentioned SOE profits.*
>
> *The central government has also asked all local authorities to reduce their general spending — the day-to-day expenditures of government agencies — by more than 5%. Beijing, for instance, said it would cut its general spending budget by more than 5%...*

Unless government entities are going to borrow more in 2019 than they did in 2018, the tax cuts will amount to little more than shuffling the debt-servicing deck chairs. And as I pointed out in the Macrolens China Credit Deep Dive deck, it will be extraordinarily difficult for the combined government – central and local – to provide additional impetus to credit growth as they were already issuing debt securities to the tune of 9% of GDP in 2018.

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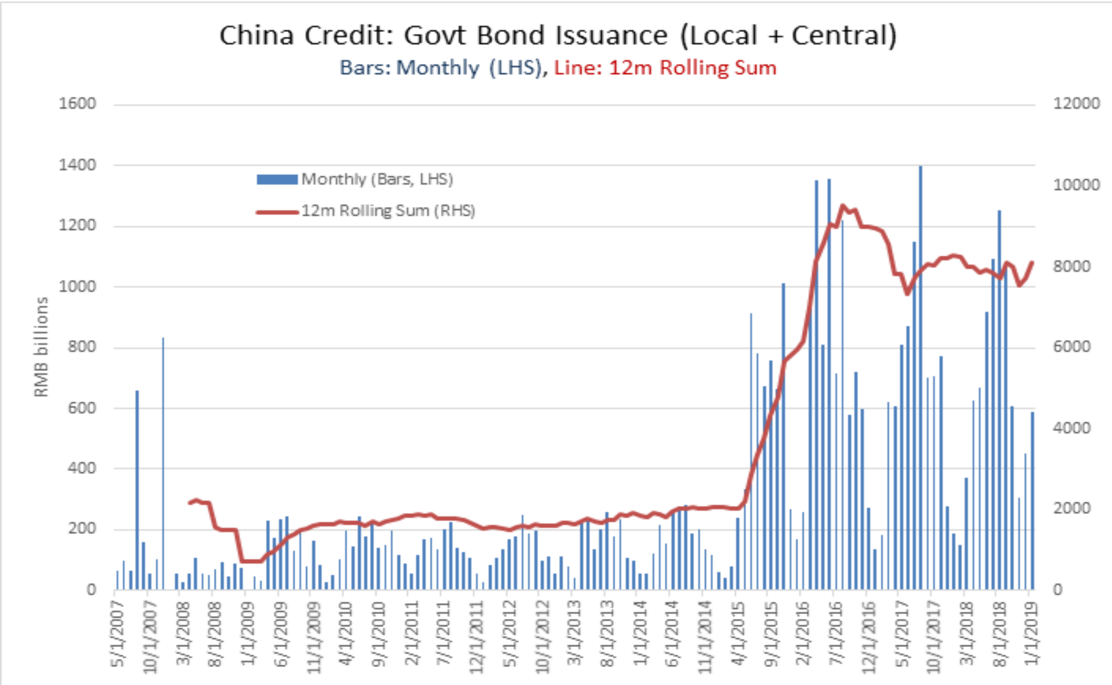

As the red line shows, the annual rate of government borrowing blew out in 2015 with the initiation of the muni-bond program and has sustained levels around 8T RMB since. With outstanding credit totaling some 240T RMB, for government borrowing to goose credit growth by an additional 3 ppts (say, from 10% to 13%) debt issuance would have to grow by 7T RMB *more than it did last year*. To be bullish on "tax cut stimulus" one needs to envision the red line above rocketing to 15T RMB.

The limited scope for stimulus is what makes a trade deal so critical – specifically one that removes tariffs as an ongoing threat and leaves Xi's plans for technological development intact. A deal favorable to China makes credit stimulus both more effective and less necessary.

China is trying mightily to fend off debt-deflation and can ill afford an external shock that could trigger a fear-based spike in liquidity demand and unleash the doom loop of asset price declines and policy impotency a la 2008.

A-shares seem priced for a big Xi win and the "fake deal" the Chinese credit bubble so desperately needs to sustain itself. Alas, I'm afraid it's an hallucination.