



Lighthizer Follow-Up

Between the Lighthizer testimony and an extensive interview of Larry Kudlow on CNBC we now have a lot of clarity on the state of play:

- There's less light btw Lighthizer and Trump than the markets have been assuming
- Lighthizer's impassioned and enthusiastic support for the robust version of the deal he laid out closes the window on the "weak deal" scenario
- The deal as described will be immensely difficult for President Xi to swallow. The ball is in his court
- Markets have priced to a median outcome of a "weak deal" when in fact the bimodal tails – a real deal or no deal – now appear to be in play

Lighthizer laid down some clear markers against which Congress and the public will judge the ultimate deal. This narrows the window for a "weak deal" considerably:

What the President wants is an agreement that #1 is enforceable but that changes the pattern of practice of forced technology transfer, intellectual property protection, large industrial policy subsidies and then a whole variety of specific impediments to trade and unfair practices in the area of agriculture, the area of services. What we want is fair trade that requires structural change and it has to be enforceable.

Lighthizer's used the term "turn the corner" in his prepared remarks and expounded on the phrasing in Q&A. It's key to understanding his approach:

I'm not foolish enough to think that there's going to be one negotiation that's gonna change all of the practices of China out our relationship with them. I don't believe that. I think that we have to take on the major issues and we have to specifically preclude anti-market practices and practices that are unfair to our ranchers and farmers and workers, and there are lots of 'em. At the end of this negotiation if we're successful there will be signing and a then there's going to be a long process of me working with [congress] to ensure that we actually live up to this and I believe other problems are going to arise and they'll have to be dealt with. I view this as a process but this the – I use the term turning the corner - the first time I believe that it's been approached in this way and it's really the result of the creation of an enormous amount of leverage by the President.

Lighthizer is not portraying the deal as a be-all, end-all solution. He views it as a start to what he anticipates will be a long and grueling process of trying to alter China's behavior. With a



decades-long addiction to playing by its own rules, the first step for China will be admitting there's a problem. It's not yet clear they're willing to take that step. What Lighthizer presents them with is a hard, painful and seemingly endless slog of rehab and withdrawal.

As for what China might decide, Lighthizer expresses his hope that Chinese reformers will carry the day:

We have to approach this with the view that there are reformers in China who want to change these practices and we're working together with them – that has to be our approach – and if that's the case our hope is to have specific language on specific issues that is enforceable through a very clear process.

This is a flashing red light for those of us who have been following China closely in recent years. **Betting on Chinese reformers to carry the day has persistently been a bad bet.**

In an [interview with CNBC](#) yesterday Larry Kudlow provided some remarkable color on how this all went down:

I think Bob Lighthizer has just done a tremendous job. You know, when we had the Chinese over last week, the first day of the deputies' meetings went very poorly. And the second day was cancelled because of that. And then the principles met at the plenary session. I was there. Led by -- Lighthizer read them the riot act. And Vice Premier Liu He was the leader of the Chinese side responded. And all of a sudden everything picked up. And so we had line-by-line discussions on Thursday and Friday, and then it was extended to Saturday and Sunday. So I have to tell you, the progress has been terrific. We have to hear from the Chinese side. We have to hear from President Xi and his Politburo, of course. But I think we're heading towards a remarkable historic deal. That's what it looks like to me. We still have to get their sign off, you know, that's important. But I think we're heading for a historic deal.

Clearly the reporting that China was proving intransigent on the structural issues has been accurate. The picture we're left with is that Lighthizer finally said "enough is enough. Here's what we need – we'll write this down, call it an MOU (or not), and you take it back to President Xi and then let us know if he wants to come to Mar-a-Lago for a big signing party."

[Politico confirms this state of play:](#)

[Morning Money] is told by a senior administration official that there isn't much tension between Lighthizer and Trump, who speak nearly every day. This person described the China deal as largely complete, currently running to around 140 pages and including significant enforcement mechanisms. If the Chinese are found to be in violation of the deal, the U.S. would be able to re-impose tariffs. The Chinese would not be allowed to retaliate.



Waiting on Xi — The enforcement structures would be a big leap for the Chinese. And it's still unclear whether Chinese President Xi Jinping will ultimately agree to them. So a deal could still fail. But the senior administration official told MM that if Xi accedes to what his negotiators have put on paper then there will likely be a signing event at Mar-a-Lago at the end of March.

This is where we stand - and wait, apparently. If there is an announcement of a Mar-a-Lago summit then we have a deal. **The tone and direction of [next week's "Two Sessions"](#) of key annual political activity will provide important clues as to China's thinking.**

The one area in which we have specificity on U.S. demands is enforcement. The mechanism would involve monthly meetings at the office director level, quarterly meetings at the vice-ministerial level and semi-annual meetings at the ministerial level — consisting of Lighthizer and Liu He apparently. Said Lighthizer:

"If we have an agreement there will be a process that has been agreed to. Individual companies will come to us with problems. In addition to that there will be systemic problems, hopefully in most cases they'll be resolved at the first or second level, if not then at my level and if they're not resolved the US can respond unilaterally and proportionally

Given China's poor record of keeping its commitment, a system of ongoing "report cards" like this is really the only type of enforcement mechanism that would be credible. But it will be highly problematic for China to accept.

From a practical standpoint, this structure leaves China vulnerable to ongoing "targeted actions" upon a unilateral U.S. judgement of misbehavior to which China could not respond. It's a brilliant technique from the U.S. perspective in that "unilateral and proportionate" responses rather than an all-or-nothing decision to break the accord will prevent China from cheating in "salami slice" fashion where no individual transgression seems big enough to break the pact. Now the U.S. can respond salami slice for salami slice. The risk overhanging China-vulnerable supply chains remains.

But the symbolic problems for China here are even bigger than the practical. "Report cards" put U.S.-China relations in a teacher-student or parent-child relationship. This is simply not the thing of co-equal world powers. It is wildly inconsistent with the view of China's role in the world that Xi Jinping has laid out for the Chinese people.

When push comes to shove, **I simply can't see Xi Jinping accepting this.** The Chinese may surprise me – it wouldn't be the first time, of course. **But I see the odds of a deal being consummated as less than 50%.**

Markets will naturally struggle to price a bimodal distribution consisting of a really bad outcome and a really good outcome of uncertain probabilities. But after the run we've had the immediate downside of the bad outcome probably exceeds the immediate upside of the good outcome. While placing a probability of the good outcome at less than 50% I'm trading lightly in global equity risk at the moment. Long vol exposure presents an attractive risk / reward.