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Markets in High Resolution

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

Slow Motion Train Wreck

For the past two weeks I've been looking for a sharp sell-off in risk assess – an opportunity to fade the overwrought media narrative that tariffs on Chinese imports will prove economically disastrous. Alas, market opportunities are never as clear-cut as we might hope. Instead of a reaching a crescendo of risk-reduction, markets are only gradually awakening to the risks of an irreparable break in U.S.-China relations. With events moving rapidly, and the ramifications so broad and uncertain, markets are naturally struggling to adjust. It's a slow-motion train wreck.

In this note I'll review the state of play, assess the degree to which risks are priced in, and sketch out what might come next.

China Gets Hit with the Kitchen Sink

It's as if both the U.S. Administration and Congress have been storing up rocks to throw at the Chinese in the event of a failure of trade negotiations. Aside from the Huawei bombshell, which threatens to destroy the company's business outside of China, and the accelerated threat of another $300bn in tariffs, this week saw the following:

- The U.S. is considering blacklisting five Chinese companies supplying video surveillance equipment in Xinjiang
- Commerce Dept. to tighten restrictions on the export of high-tech goods to China
- A bipartisan effort in Congress to sanction Chinese producers of Fentanyl
- A Commerce Dept. proposal to impose countervailing duties on countries that undervalue their currencies
- Legislation proposed in the Senate to seize assets of anyone involved in "actions or policies that threaten the peace, security or stability" of contested areas of the South China Sea
- Increased freedom-of-navigation activity in the Taiwan Strait and South China Sea

While it's possible that this show of overwhelming force is intended to cow Xi Jinping into unconditional surrender, I doubt the U.S. side is that naïve as to the political realities in China. Each ratchet of tensions simply raises the hurdles to a return to the negotiating table.

Backtracking from here to a "weak deal" would be political suicide for President Trump. Alternatively, submitting to an "unequal treaty" in the face of foreign pressure would be an

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insufferable embarrassment for President Xi - a lethal blow to his carefully crafted persona as an historical figure.

No, **the U.S. strategy is intended to signal to allies and multinational corporates that "it's on."** The message to allies in Europe and Asia is that – like it or not - it's time to pick a side. And to corporates with supply chain vulnerabilities in China – like it or not – it's time to move.

Doesn't Xi Have an Exit Plan?

The market's hopes for a resolution of trade tensions seem to have swung from "Trump will take a weak deal" to "Xi will find a way out of this mess."

But has he found a way out of the managed-currency mess? Of the housing-bubble-mess? Of the moral hazard mess? In the economic realm we've seen a steady stream of short-termism in recent years that has created an array of insoluble structural problems. What makes people so sure Xi has a plan for this sudden turn in the external environment?

If economic policy is any indication, President Xi is a true believer in the power of central command. Capital outflows? Order the capital account to be balanced and it shall be so. Debt ratio is looking scary? Order that it shall no longer rise and it won't. Equity market falling uncontrollably? Order that it shall stabilize and it does.

In the economic realm, when presented with the option of addressing imbalances via an adjustment to a market-based equilibrium Xi has instead opted to simply order the problem away by fiat, every single time. Why would trade and technology be any different?

Huawei cut off from U.S.-sourced semiconductors? Order then to make their own. Supply-chain exodus leaves factories empty? Order them filled. Reduced trade leaves a dent in the economy? Order it fixed.

Having watched Xi Jining's Communist Party pursue an economic policy path that to my mind is irrational, if not delusional, **I don't find it all that surprising that they seem to have maneuvered themselves into a box on trade policy**. I suppose that President Xi will now simply command that trade and access to foreign technology is of no consequence to the Chinese economy. Perhaps he'll find that it shall be so. I suspect not.

The Long March

Don't underestimate the symbolism intended by President Xi's Monday inspection of a Ganzhou rare earths facility followed by his visit to the monument marking the start of the "Long March" – the Red Army's epic year-long, 9,000km retreat after escaping encirclement and likely

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annihilation at Jaingxi in 1934.

A foundational myth of the Communist Party, involving escaping encirclement and enduring unimaginable hardship, **"the Long march" would be an unlikely image to invoke if Xi were looking for an economic easy way out** by surrendering to the demands of the Western capitalists.

Xi's signal is meant for both internal and external consumption. The message to the U.S. is "if you wanna do this, we can do this. But we can take more pain than you can." The visit to the rare earths facility is a thinly veiled threat to inflict some.

Dual-Track Tech

Globalization fosters interdependence. Interdependence creates vulnerabilities. Acceptance of vulnerability requires trust.

There is insufficient trust in U.S.-China relations for either side to allow itself to become subject to the kind of vulnerabilities inherent in globalized communication networks.

Here was U.S. Secretary of State Pompeo on CNBC: "the decision that was made to list Huawei had an enormous national security component to it. The company is tied deeply not only to China but to the Chinese Communist Party and that connectivity - the existence of those connections - puts American information that crosses those networks at risk."

The U.S. can't use China's telecommunications gear. China can't be dependent on the U.S. for semiconductors any longer. The U.S. can't be dependent on China for rate earth minerals any longer. (China however has one critical dependency it can't kick unless it wants to exit and isolate itself from the global economy: China needs hard currency.)

Dual-track development of technology is globally sub-optimal. But it will prove far more costly to China, which is likely to end up as the isolated party. Made in China 2025 is indefinitely postponed.

China's Response

China is likely to refrain from globally destabilizing actions – like a high-profile consumer boycott or an export ban on rare earths – through the G-20 meetings in order to see which way the geopolitical winds are blowing.

Whether by accident or design, Trump's threat to tariff European autos may deter China from an all-out retaliatory response until they have clarity on whether Trump may actually push the

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Europeans towards an anti-tariff alliance with China. My guess is the auto tariffs are a bluff designed to elicit Europe's cooperation in the China-decoupling effort. But who knows?

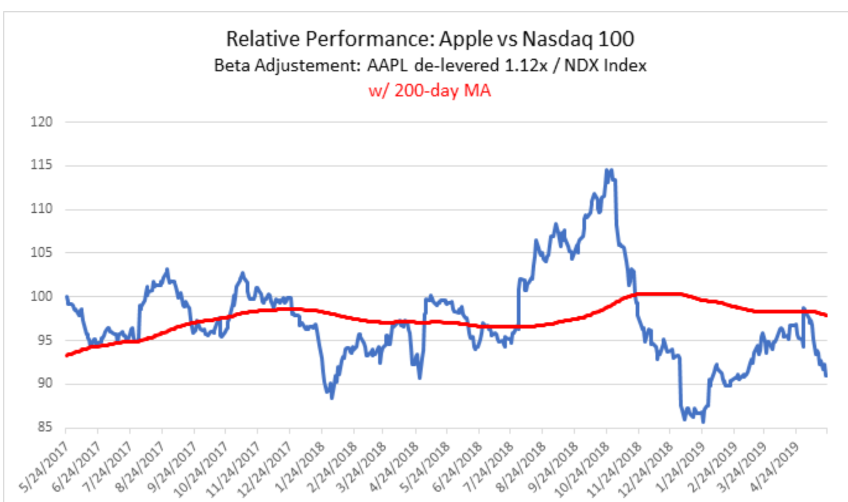
Expect China to remain restrained through the G-20 meetings (including by capping USDCNY at 7.0). As it becomes clearer that Western democracies don't really have any choice but to remain on the "U.S. track" in trade and tech, a fuller retaliatory response is likely to evolve throughout a long, hot summer for multinationals with operations in China.

(To highlight China's angst at becoming diplomatically isolated, the Chinese charge d'affairs in London has publicly threatened retribution should the UK ban Huawei from Britain's 5G network.)

What's Priced in?

Let's look at some metrics of the degree to which an economic decoupling has been priced in. Below we have:

- AAPL vs the Nasdaq 100 (beta adjusted). (Goldman Sachs made headlines this week with a forecasted 29% hit to earnings if trade relations really go pear-shaped).
- The Philly Semiconductor Index vs the Nasdaq 100 (beta adjusted). (CNBC: Chip Stocks Ground Zero in the Trade War)
- MSCI China vs. MSCI World (beta adjusted)
- 1-year 25-delta USDCNH call option implied volatility (currently a 7.28 strike)



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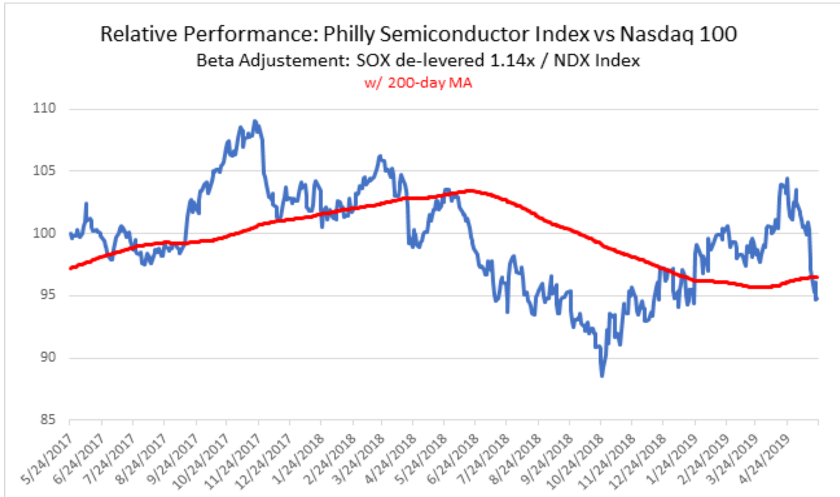

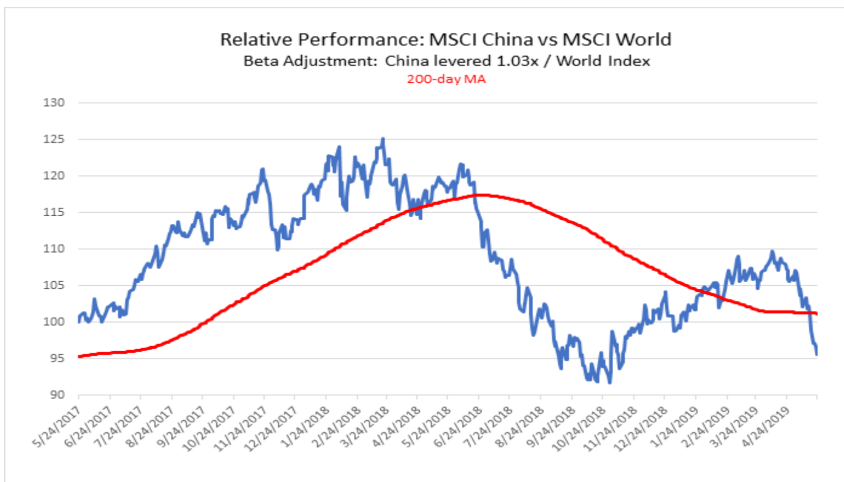

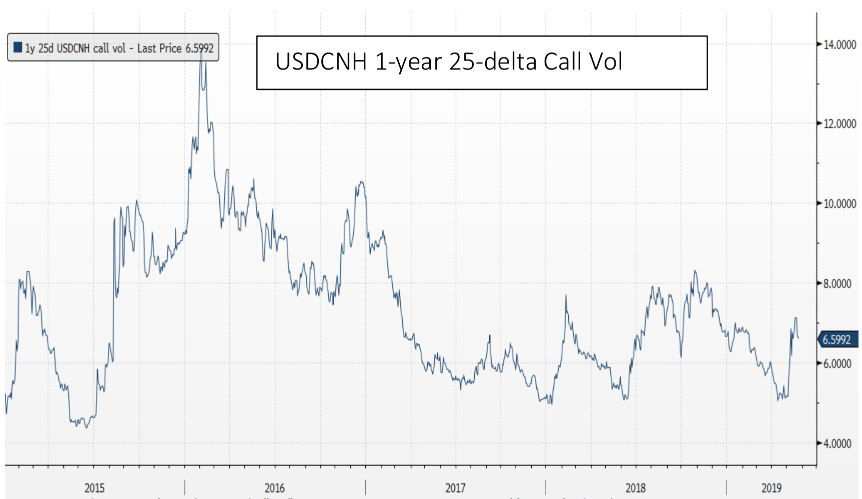

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It does not appear that we're "there yet" in terms of pricing in the risks. The SOX move, while severe, does not yet seem to reflect the likelihood that some of the biggest players in the industry could lose 40-60% of their revenue base. And while Chinese equities may be somewhat supported by the dream of endless credit stimulus, what of USDCNH option volatilities remaining at subdued levels? Surely the trade war will force China into a choice of either economic retrenchment or RMB devaluation.

China's response is likely to remain measured in the near-term and it's in the U.S. interest to keep hope for a deal alive for as long as possible. So while we perhaps lack a catalyst for a further deterioration in relations between now and G-20, the overhang of medium-term risk is unlikely to dissipate and is not yet adequately reflected in market pricing.

This geopolitical train-wreck is likely to continue to unfold in slow-motion.

A Systemic Market Event?

While global equity markets will need to further adjust to the existential risk to China-sourced revenues, the expense of supply-chain reorientation, and a sub-optimal structure for global technology and telecommunications development along a "dual track," **this should not prove to be a systemic event for U.S. asset markets**.

Systemic dislocations stem from the specter of debt-deflation, ever-present given the confluence of elevated debt levels and a Fed which perpetually undershoots its inflation target (see The Liquidity Landscape and the Risk Asset Outlook, 2/18/19). But debt-deflation is a process over which the Federal reserve has ultimate control *regardless of what happens in China.*

As a thought experiment, if I told you that China was going to descend into financial crisis in 2019 and devalue the RMB to 8.0 against the Dollar, but the Fed was going to cut the Fed Funds rate by 200bps in response, would you want to be long or short U.S. credit markets? (Answer: long).

A systemic market event would require crisis in China and a globally deflationary RMB devaluation *accompanied by the Fed's utter mishandling of the monetary response*. The latter is unlikely given the existential political threat the Fed would face in the aftermath of such an error.

Conclusion

Anticipate heightened choppiness in risk assets with a continued downward bias. Long-term investors might consider writing covered calls or reducing equity exposure in favor of non-China exposed U.S. credits. Chinese equities remain a strong relative short. RMB put options provide great value as a longer-term hedge, but may not perform until post-G20.