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Markets in High Resolution

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Trading Trade

I've persistently viewed the market as too complacent towards the risks to the brewing trade deal. The view was premised on the beliefs that:

- China will never offer meaningful and enforceable changes in behavior. It's weak deal or no deal.

- Lighthizer put up a steep hurdle by laying out his vision of a one-way enforcement mechanism in February. This would be very difficult for Xi to accept and, once it had been made public, equally difficult for Trump to forego.

- A weak deal would be extremely difficult for Trump to sell politically and would create a vulnerability in critical "rust-belt" states

- Trump needed to follow through on a tariff threat somewhere or risk being exposed as a blowhard. Making a weak deal with China and placing tariffs on European autos would have been a stupid place to end up.

- The media narrative of global economic meltdown in the event of tariffs is wildly overblown.

Some quick observations:

- China seems to have genuinely been caught off-guard by this, displaying a shocking lack of preparedness. The news was virtually blacked out on local media and we have yet to get confirmation as to whether this week's mission to Washington is on or off.

- I continue to believe events in North Korea are connected. If China was using NK as a negotiating chip, they overplayed that hand with this weekend's missile launch.

- Sunday's tweet-storm confirms that this is all more than just theatre to the President. Political calculus may dominate, but a tough approach is where Trump, in his heart of hearts, wants to end up.

I am a seller of today's consensus narrative that "this is a negotiating ploy."

- They've been negotiating for over 5 months now. The U.S. has a very good sense of where China's red lines are by now understands that Chinas' red lines are indelible.

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- **A deal now would require China to accede with a political gun to its head**. Given China's previous responses to perceived slights (including those from Canada) this seems highly unlikely.

- It is *possible* that the political price being extracted from the Chinese, who are otherwise getting away with a weak deal, is that they must prostrate themselves by signing under visible duress. I discount this.

- The initial "deadline" for these negotiations is now 60+ days behind us. Another empty threat would be lethal to Trump's credibility. The President must be prepared to follow through this time.

Ergo, **I see very little likelihood that tariffs do not go up on Friday**.

Whether the Chinese delegation makes the trip to Washington is still important.

- **My base case would be that China does not come to DC (65%).**

- There are two possibilities if they do come to DC:

    - They allow Trump to dominate the political theatre by signing the deal "under duress" (15%)

    - Tariffs increase, but both sides make a point "continuing to talk" so as to avoid imminent escalation to DEFCON 1. (20%)

Clearly, a tariff increase amidst continuing talks is significantly less bad than a complete breakdown of relations.

I continue to see the potential economic fallout of a breakdown in trade negotiations as being wildly overblown in the financial press:

- I detailed this last November in Economic Disengagement from China: Macroeconomic Costs and Benefits

- 25% tariffs on all Chinese imports could raise PCE inflation by 0.4%. Given the Fed's firmly on-hold stance, that's unlikely to matter much.

- Reduced exports to China won't subtract more than 0.2%-0.3% from GDP even in a worst-case scenario.

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- Shifting demand for fungible commodities is a particularly ineffective means of retaliation.

- U.S. corporate revenue to China is estimated at ~$300bn per year, less than 2% of total business sales. While some single name equities will get hit, this is not macroeconomically significant.

- The Chinese will fight the appearance of domestic crisis tooth and nail in the near term. The "national team" will be active in equity markets and they will gradually close the FX markets in order to maintain control over the CNY rate. A break of their established redline at 7.0 would give the impression that authorities have lost control, an impression they will want to avoid at all costs.

- **While market participants equate upset in China with global asset market volatility, that impression rests on a spurious correlation**. The root cause of both stress in China and global volatility has been a series of deflationary upsets that were global in nature – interbank collapse in '08, threatened Eurozone collapse in 2011-12, the QE exit and the resultant Dollar rally / commodity bear in 2014-15 (Fed Memo: You Had One Job, 12/18/18).

  Idiosyncratic financial stress in China is unlikely to generate global fallout on a scale with previous episodes which were in actuality global phenomena.

Conclusions

- This is not a "negotiating ploy."

- Tariffs are highly likely to rise next Friday

- Tone of rhetoric remains important. "Continued talks" is a less unfavorable outcome than DEFCON 1.

Market Strategy

- I'm kicking myself for not shorting Chinese stocks last week on fading stimulus hopes, but am selling into this morning' opening bounce.

- An increase in tariffs will create a very buyable dip in U.S. equities

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- Watch FX and gold. Stable G3 FX and gold prices in the face of increased tariffs would bode well for a quick stabilization in risk assets. Its notable how stable they are this morning.