



Worried About Hong Kong – Part I: Intervention Risk

Events in Hong Kong are taking on an “irresistible force vs. immovable object” quality. Chinese intervention would be too damaging to China and to global markets to contemplate. On the other hand, the window for less dramatic outcomes appears to be closing, as both protest activities and the physical and rhetorical responses intensify.

Some thoughts follow in two parts:

In Part I today I’ll provide a framing of the impossible-to-handicap question of how this plays out.

In Part II I’ll assess the fallout from a Chinese intervention – a potentially cataclysmic market event.

What are the chances of Chinese Intervention?

There are three possible outcomes:

- 1) The Hong Kong government, with Beijing’s acquiescence, capitulates to the protesters by withdrawing the extradition bill, opening an inquiry into police conduct and committing to some discussion about the quality of democratic representation;
- 2) The protests, in the face of mounting physical resistance, an accelerated pace of arrest, and the specter of serious criminal charges, peter out in the next few weeks;
- 3) Beijing intervenes in some form, likely involving a stepped-up police presence, curfews and suspension of rights with the tinge of martial law. (Hopefully we can discount the uglier Tiananmen-like version).

The odds of capitulation by the government have receded to near-zero. The Chinese government might capitulate to a group of protesters who lost money in a Ponzi scheme. But they will not, and if they want to remain in power cannot, capitulate to a mob on political issues.

Furthermore, if there were a time to capitulate, it would have been before Chinese officials started referring to the protests as a “color revolution,” or “terrorism.” You can’t capitulate to “terrorism.”

Is Protest Momentum Cresting?

Might the protests lose momentum in the face of increasingly violent resistance from the police and the threat of serious criminal charges? **The next few days will be a critical test.**

The ugliness at the airport yesterday seems to have left the movement somewhat chastened. Things got very real all of a sudden:

Seven men age 17 to 28 were detained, five for unlawful assembly and two for assaulting police officers and possession of offensive weapons, said Mak Chin Ho, assistant police commissioner. Mak then read aloud from Hong Kong’s Aviation Security Ordinance, which provides for potential life sentences for those found guilty of breaking the ordinance.

Threats of such severe punishment fit with an approach by Beijing and its supporters in the Hong Kong government to dramatically raise the potential cost of taking part in demonstrations.

Earlier Wednesday, the largely leaderless protest movement distributed statements on social media appealing for forgiveness from international travelers, journalists and medical personnel at the scene. Some even apologized to the police force, whose alleged brutality and refusal to apologize for its use of force in quelling street demonstrations had fueled protesters’ anger in the first place.

Protest momentum may have crested with the PR blunder at the airport, though this China-watcher thinks not:

Be Water Balding
 @BaldingsWorld

Anyone thinking the airport issue putting everything behind Hong Kong not paying attention. MTR workers, educators, and medical personnel most recent groups to support protesters. Big protests planned for this weekend

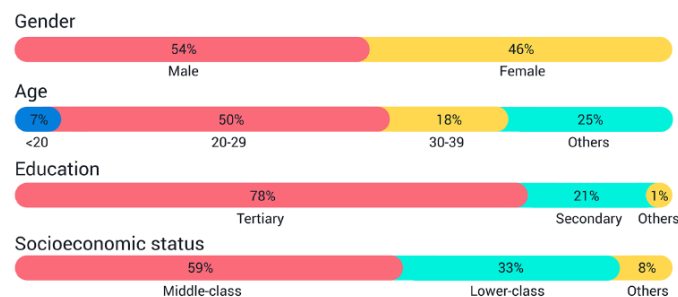
6:37 AM · Aug 14, 2019 · [Twitter for Android](#)

The severity of the upcoming weekend’s protests will provide a key data point as to whether things are subsiding or continuing to careen towards an ugly end game.

Who is Out in the Streets?

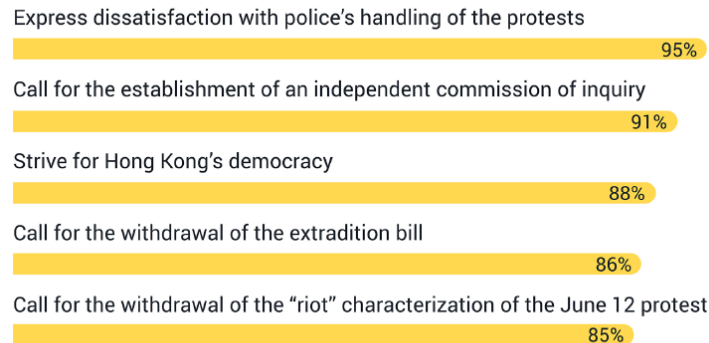
Protestors are well-educated, generally middle-class, and probably a bit older than you think. One would not characterize the tenor of the crowd as “having nothing to lose.” **It would be surprising if they pushed things to the point of martyrdom**, but emotions are clearly running high and a recent survey suggests most protestors remain in favor of continued escalation.

Who protestors are



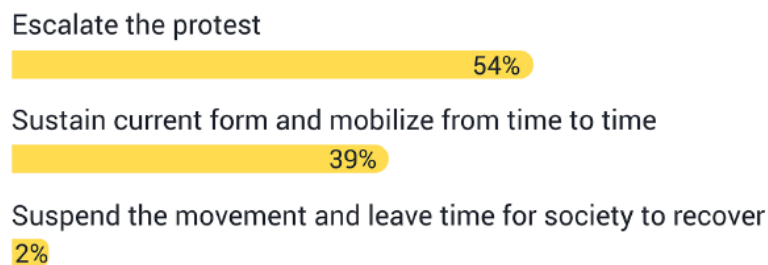
Survey conducted on August 4 during a protest on Hong Kong island.

What protesters want



Respondents who chose "most important." Survey conducted on August 4 during a protest on Hong Kong island.

What next



Source: <https://www.inkstonenews.com/politics/hong-kong-protests-who-what-and-what-next-4-charts/article/3022607>

China's Strategy

China's strategy to this point seems clear: to up the ante in the form of increased chances of physical harm or extended incarceration. The strategy is not without risk.

Increasingly violent engagement obviously increases the ever-present risk of things spiraling out of control, as this [widely-circulated clip](#) of a police officer pulling his weapon after being attacked by protestors highlights.

Also, it's unclear how long the Hong Kong police force can sustain the current level of activity without reinforcement, which **some speculate is already being provided by Beijing**.

[Here's a brief interview with Wily Lam](#), one of Hong Kong's preeminent political observers. For what it's worth, he sees no chance of direct intervention before October first, but also reveals this contention:

... there are many ways in which we can say that the machinery of the police state has already crossed the Shenzhen River into Hong Kong. The clearest example of that is the deployment of a large number of mainland police officers in Hong Kong, after Beijing decided the protests were a



colour revolution at the beginning of June. The ranks of the Hong Kong riot police now include anti-riot police from the north, who are wearing the uniforms of the Hong Kong police.

The suspicion of such infiltration served as a [flashpoint at the airport yesterday](#):

*An otherwise peaceful sit-in at Hong Kong International Airport on Tuesday turned ugly when protesters attacked and detained a man they suspected of being a security agent from the nearby mainland city of Shenzhen posing as a demonstrator. **Such a deployment, if true, could represent a violation of the charter** that guaranteed Hong Kong's autonomous criminal justice system before its return to Chinese rule in 1997.*

Should undercover activity by Chinese agents be exposed as widespread it **could greatly inflame tensions** by underscoring the degree to which "one country, two systems" has already being undermined.

China's domestic messaging strategy is equally problematic. Whether it's a deliberate strategy to inflame nationalism or a bow to the reality that international news can't be fully blacked out in the modern age, China's propagandists in recent weeks have [stepped up coverage of events](#), albeit with the expected slant.

The stepped up coverage domestically, in the conjunction with [increasingly inflammatory descriptions of events](#), **could box Chinese leadership into a corner.**

"These atrocities, which are lawless, trampling on human rights and inhumane, have completely gone beyond the bottom line of civil society, and is no different to terrorists," China's Liaison Office in Hong Kong said in a statement on Wednesday. In a separate statement, the State Council's Hong Kong and Macau Affairs Office strongly condemned the "almost-terrorism behavior" of the protesters and called on them to be severely punished.

How long can the leadership of the Chinese Communist Party continue to publicly describe the protests in this manner without acting. At some point they begin to appear feckless in the face of what, by their own description, is being labelled "terrorism?"

October First

If the protests do not subside, can China maintain both the heated rhetoric and its official composure through the all-important 70th anniversary of the founding of the PRC on October First?

And what backdrop will they choose?

The international opprobrium that would arise in the wake of an intervention in Hong Kong?

Or scenes of massive unrest in Hong Kong which would undoubtedly be staged as poke in the eye of the CCP?

I doubt the CCP cares much about international opinion at this point, with the budding realization that U.S. trade talks are a lost cause. The U.S. tariff wall is going up and Huawei sanction will usher in a “tech cold war” anyway.

What Comes Next?

I’ll detail in tomorrow’s note the incredibly high costs of Chinese intervention in Hong Kong, an event which could prove cataclysmic for global markets. It’s these costs which render Chinese intervention nearly unthinkable.

Unfortunately, a steady stream of geopolitical and economic miscalculations by Xi Jinping in recent years would suggest that we can’t fully discount the unthinkable.

China’s unnecessarily strident rhetoric can’t be ignored. It may well be a gambit to scare the protests into gradually disbursing. But if that gambit falls, the CCP will not be able to sanction having its bluff called in such a manner.

Market Ramifications

Until we can get through a weekend without a discernible increase in tensions, extant risks warrant some portfolio skew towards risk-protection.

This tactical roadmap published on 8/7 remains intact:

Positions & Roadmap

- *I am in a tactically bearish posture*
- *I have reduced gross in Long S&P / Short FXI by half in light of the heightened volatility and the speed of decline in FXI*
- *Long USDCNH until further notice*

If the protests haven’t lost discernible momentum by this time next week we will have to start marking up the odds of a Chinese intervention and considering more aggressive defensive market actions.