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Markets in High Resolution

China: What's the Plan?

China's meta-strategy has several critical components:

- Stimulate the economy. But not really
- Depreciate the currency. But not really.
- Negotiate with the U.S. But not really.
- Fight with the U.S. But not really.
- Crack down in Hong Kong. But not really.
- Capitulate in Hong Kong. But not really.

It's a grand strategy predicated on the hope that if they can just hold things together for a while longer, perhaps they'll wake up one day and all of these problems will have magically resolved themselves.

As the saying goes, "hope is not a strategy." But it's all they've got.

"Stimulus" Remains a Mirage

Wire stories this morning suggest and imminent RRR cut is in the works and that "special bond" issuance is likely to be expanded into year-end. Neither of these news items alters the long-held view here that China's stimulus cupboard has run bare. **Remain steadfastly short the Chinese growth outlook**.

BN 09/04 11:24 *CHINA CABINET CALLS FOR 'TIMELY' RRR CUT TO SUPPORT ECONOMY: TV

A handy rule of thumb for China-watching: ***ignore RRR cuts***. RRR cuts are the banking system's equivalent of breathing. It has to happen every so often or the system will die. The math is simple:

- RRR constrains growth in bank credit, which must grow at 10%+ or credit markets will collapse
- Expansion of bank credit requires either commensurate growth in bank reserves or a reduced Reserve Requirement
- "Organic" growth in base money via PBoC accumulation of FX is ancient history
- Growth in base money via PBoC lending to banks is constrained by collateral availability
- With growth in base money constrained, the RRR must be systematically reduced to accommodate the required expansion of bank credit
- Such reduction **do not generally indicate any "easing" of monetary policy**.

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BN 09/04 11:15 *CHINA TO SPEED UP LOCAL GOVT SPECIAL BOND USE

Special bonds are project-specific bonds issued by local governments to fund infrastructure development. But they're small in the scheme of things.

It's important to appreciate the scale at which Chinese credit growth must run merely to "stand still." The Chinese economy is circling the bowl amidst 12% credit growth.

To maintain that bare minimum growth rate throughout calendar 2019, **China must issue RMB 27.5T in new credit**. That entails a further RMB 10.5T over the last five months of the year, compared to RMB 9T in the same period a year ago.

Special Bond issuance has totaled RMB 1.625T YTD vs RMB 1.785T for all of 2018. An increased quota for calendar 2019 is less a "policy easing" than an act of economic survival. Perhaps they push total issuance for 2019 to RMB 2.5T. Meh.

"Stimulus" policies remain constrained by Xi's political and reputational commitment to deleveraging, the societal costs of further real estate appreciation, and a tenuous capital account situation.

The RMB: "When in Doubt, Do Nothing"

China's strategy on the RMB is indecipherable. The break of 7.0 seemed timed as a shot across the bow on trade. I It seems as if "the frog jumped the pot," in that the Chinese, realizing that escalating tariffs are inevitable, were shifting to a strategy of causing global economic havoc. If there is any truth to the narrative that "China plays the long game," shouldn't they be pressing Trump's economic disadvantage at this point?

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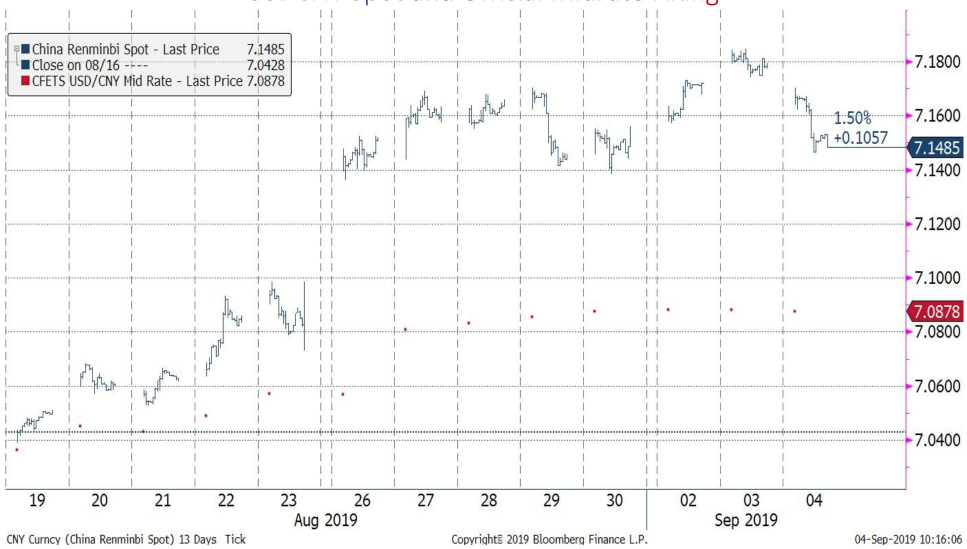
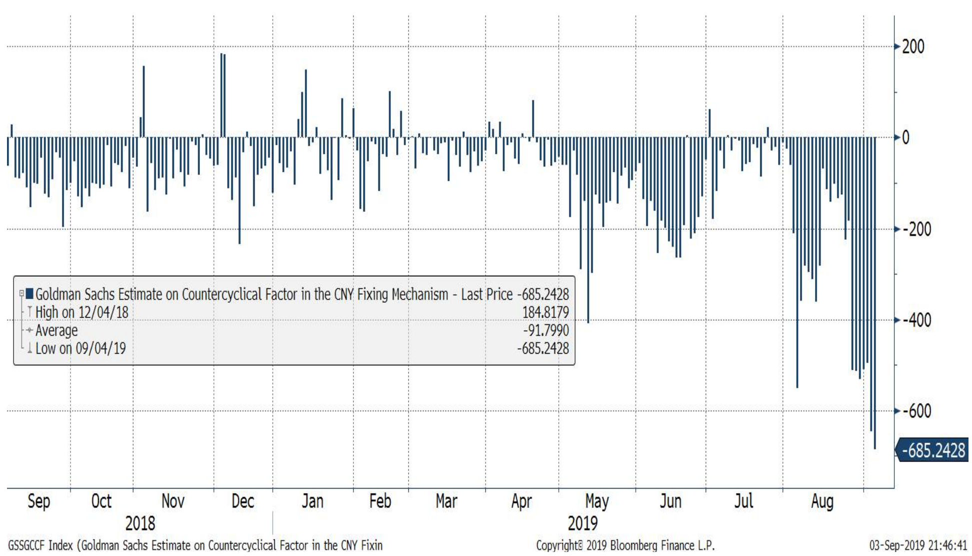
Alas, China's own weakness reveals itself in its recent handling of the RMB. Whatever the initial strategy might have been in allowing USDCNY to breach 7.0, the subsequent retreat from any flexibility has been remarkable. The fixing has been inexplicably "fixed" for 8 sessions now.

USDCNY Spot and Official Midrate Fixing



Here is Goldman's estimate of the "countercyclical factor" (i.e. fudge factor) in the PBoC fixings. Two years of trying to establish a partially "market-based" fixing mechanism have gone out the window with a run of 500-pip+ "adjustments." The fixing is once again essentially arbitrary.



Does stability in the fixings portend a return to fixity? The short answer is: yes, for now.

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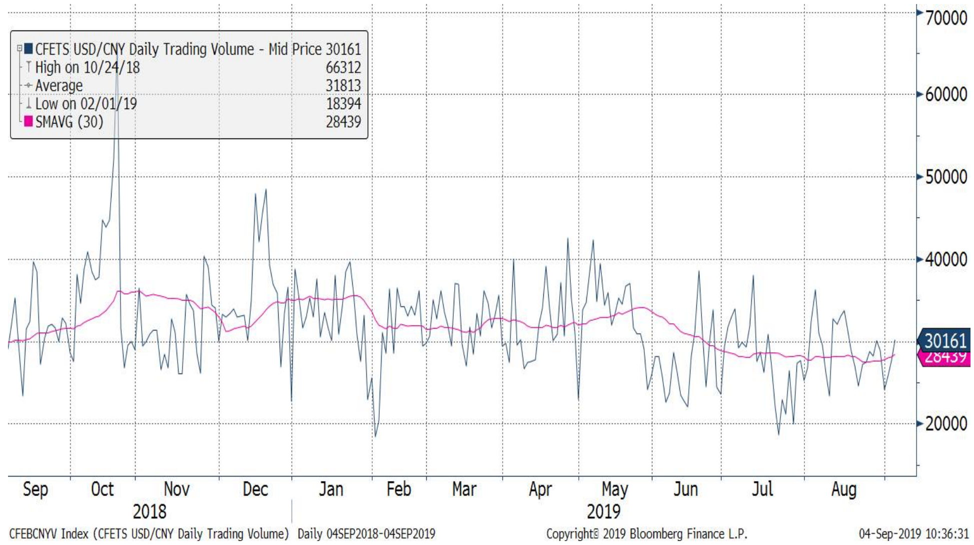
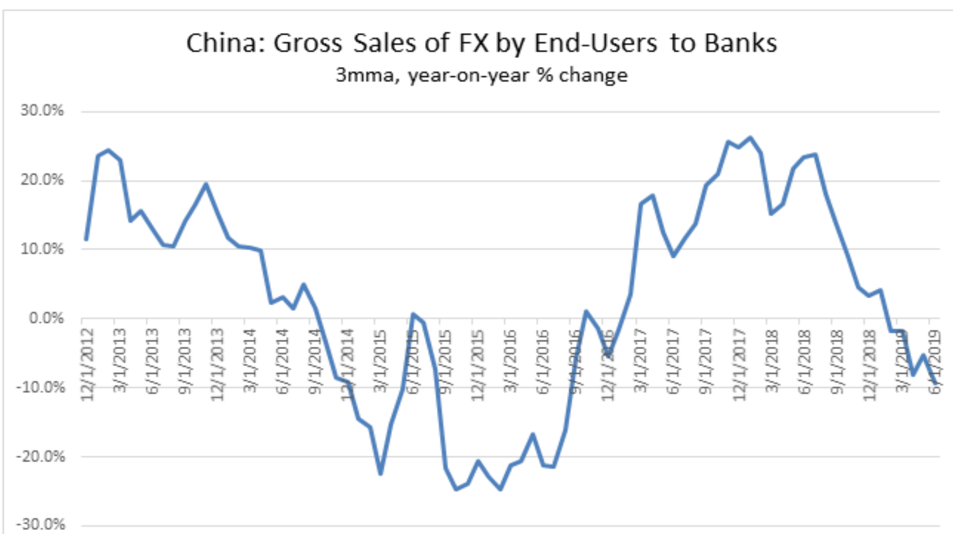
Remember, the PBoC controls both volumes and prices in China's FX market (The Renminbi Regime, 6/25/19). We won't get the August data for client sales of FX until later this month (I would expect a deterioration in FX supply), but interbank volumes have been unnaturally subdued given the news and price action.



And the flow of FX liquidity into China had already begun to roll over in July…



With price and volume controls in effect, **exchange rate pressures are revealed in the form of a "buyer's strike"** (or sellers strike from the FX perspective). Any monetary easing in conjunction with a policy of RMB fixity will lead to a further deterioration in already tight FX liquidity. China crawling back into its shell on exchange rate policy is **not a viable policy option at the current (off-market) exchange rate**.

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Trade" "Fighting While Talking"

On U.S.-China trade, the stated approach of "fighting while talking" doesn't look much like either.

As for talking, China's reluctance to revisit the status quo pre-"reneging" renders any discussions moot.

As for fighting, outside of the boycott of U.S. agricultural products, China's pushback has been minimal. Besides agricultural products, China's imports from the U.S. are dominated by semiconductors, of which they continue to buy all they can get their hands on. Tariffs on remaining imports are of minimal significance.

Yet no rare earths embargo, and no overt attacks on U.S. multinationals in China. China has yet to release its version of the "entity list." China seemingly does not want to take measures that would push relations past a point of no return. Don't they realize we're already there?

The indecision may belie a rift in Chinese policymaking, or may simply be a product of the array of intractable issues that leadership faces. Either way, **China's trade policy is adrift.**

Hong Kong: Capitulation or Precursor?

Carrie Lam's capitulation on the extradition bill underscores the high costs to China of any form of intrusion into Hong Kong. Apparently, Chinese leadership decided that even a high-profile capitulation, albeit a symbolic one, was a preferable cost to bear. However, it's unlikely they will get off that cheaply.

Withdrawal of the bill may have been sufficient to quell the protests in June. Unfortunately, China has since taken numerous actions - dictating terms to Hong Kong corporates, summarily rounding up protestors – that have crystalized the fears initially triggered by the extradition bill. Namely, that "one country, two systems" remains in name only.

To review, here are the five demands of protestors:

- The complete withdrawal of the proposed extradition bill
- The government to withdraw the use of the word "riot" in relation to protests
- The unconditional release of arrested protesters and charges against them dropped
- An independent inquiry into police behavior
- Implementation of genuine universal suffrage

Official withdrawal of the extradition bill could be an opening offer in a negotiation that ultimately yields to some further demands. Its' conceivable that Lam could find some middle ground by relenting on the independent inquiry into police behavior and showing some leniency to arrested protestors.

While this would be the smart move for the Chinese to extricate themselves, I'm not convinced they're prepared to make it. Today's capitulation came with some very stern warnings, and could just as well prove a precursor to a crack-down as to a negotiation.

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This thinly veiled warning (albeit from the ultra-nationalist Global Times) suggests the possibility that today's gesture is of the "take it or leave it" variety.

Perhaps more disconcerting were comments Carrie Lam made towards the end of her remarks today (7:00, emphasis mine).

> *Fellow citizens, lingering violence is damaging the very foundations of our society, especially the rule of law. Some people, though not many, attacked the Central Government's office in Hong Kong and vandalized the national flag and national emblem. This is a direct challenge to "one country, two systems." **Both have put Hong Kong in a highly vulnerable and dangerous situation**.*

Xi Jinping sounded a similar note in a speech on Tuesday calling for cadres to "maintain a fighting spirit and strengthen their ability to struggle" in pursuit of the "Chinese dream of national rejuvenation." The speech singled out for prioritization "risks and challenges" in Hong Kong, Taiwan, and Macau:

> *"[We must] focus on the main contradictions … and choose the methods of struggle in reasonable ways," Xi said. "[We should] have a good grasp on [how to carry out] the struggles and that means we cannot give even an inch on issues of principles but must be flexible on strategic issues."*

The ball is in the protestors' court now. They can pocket some symbolic concessions and retreat while "one country, two systems" continues to whither, or they can start burning Chinese flags and trigger a conflagration which leads to China's global condemnation and isolation. **I'm not sure today's official withdrawal of the extradition bill changes the calculus all that much**.

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Conclusions and Market tactics

- Stay short Chinese growth in any form, and long USDCNH

- China-U.S. trade is a mess, China's economy is a mess, yet **risky assets clearly "want" to rally** in response to the easier Fed policy

- **This makes sense** – the effects of both tariffs and a Chinese economic downturn on the U.S. are dramatically overstated

- **I continue to run net short-risk out of concern for the situation in Hong Kong**, viewing the risks of a Chinese intervention as uncomfortably high and such an outcome as an existential market risk. (Worried About Hong Kong Part I and Part II, 8/15/19)

- If Hong Kong risk fades I'll regret this defensive stance. But long exposure in a choppy market with a non-negligible risk of a 5% down-gap at any moment is unattractive

- **Reassessment will be in order if Hong Kong is relatively calm this weekend** (not my base case)