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Markets in High Resolution

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Osaka Deal Do-Over?

With myriad moving parts, there is scope for a temporary U.S.-China détente based on the fleeting "Osaka consensus" of Chinese Agriculture purchases and some limited relief for Huawei.

- Trump should jump at a limited deal if China offers it
- China may simply be desperate for some policymaking breathing room
- Alternatively, they may be misreading Trump's political calculus (again)
- Hong Kong remains a wildcard, but China's wrath appears in check until October
- **Imminent risk of "goodwill gesture tape bombs"** (Ag purchases, Oct 1 tariff delay)

Recall my description of the evolving Trump political strategy from June (Shake the Box, 6/6/19):

> *...pushing the Fed off the fence is only one aspect of the emerging Trump approach of throwing caution to the wind. More a "shake the box" strategy than a detailed blueprint, policy activism and high-risk gambits will keep markets on edge for the foreseeable future.*

Three months hence there remains no shortage of policy balls in the air. **It may be an opportune time to put the "China trade ball" down** for a bit.

From China's perspective, I have the grand strategy as one of indecision exacerbated by the need for stability through October's key political events (China: What's the Plan 9/4/19). **China needs some breathing room**.

A convergence of short-term needs and objectives opens a window for a limited and temporary cessation of U.S.-China trade hostilities based around the "Osaka consensus" (renewed Chinese Ag purchases in return for some limited relief for Huawei). Firm predictions are a mug's game in this environment, but let's unpack the known knowns and unknowns so we can at least interpret the news flow.

Recent Reportage

There have been two credible reports of China offering a return to the "Osaka consensus."

From Politico late on Friday:

> *China made a peace proposal in a phone call this week with top U.S. trade officials with an offer to buy a modest amount of U.S. agricultural goods, according to two people briefed on the call.*

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That offer, however, could be contingent on the United States easing up export restrictions on Chinese tech giant Huawei and delaying an Oct. 1 tariff escalation on roughly $250 billion in goods, the people said.

Depending on how negotiations proceed, President Donald Trump is also considering delaying another round of tariffs that will be imposed on Dec. 15 on almost all remaining imports from China, including laptops, smartphones and other consumer goods, the people said.

In a Tuesday update, the South China Morning Post tells us that:

As part of the discussions, China has offered to buy American products in exchange for a delay in a series of US tariffs and easing of a supply ban against Chinese telecommunications giant Huawei Technologies.

The piece also sheds light on China's negotiating position. It seems the bulk of their red lines through the April deal text remain:

A source familiar with the situation said working-level officials were discussing the text of a deal, which would be reviewed when Chinese Vice-Premier Liu He meets US Trade Representative Robert Lighthizer and Treasury Secretary Steven Mnuchin in Washington in October. The text is based on a draft the two sides negotiated in April, the source said on condition of anonymity.

The source said China could also offer more market access, better protection for intellectual property and to cut excess industrial capacity, but would be more reluctant to compromise on subsidies, industrial policy and reform of state-owned enterprises.

That take on China's negotiating stance confirms Monday's reporting from the SCMP:

China had already agreed to about 80% of US demands before the bilateral talks came to a halt in May, including "buying US goods, opening markets to US investors and making policy improvements in certain areas," Jin said.

According to Jin, who did not reveal the source of his information but is known to be well-connected in Beijing, the final 20% includes completely abandoning the "Made in China 2025" industrial policy program, a plan to cut the share of the state in the overall economy from 38% to 20%, as well as an implementing an enforcement check mechanism that would allow the US to dig into the books of different levels of the Chinese government.

"The Politburo would never agree to these terms," Jin said, referring to China's supreme decision-making body. "It would be forfeiting sovereignty and humiliating the nation."

Never mind the absurdity of referring to all the fundamentally meaningful demands as only "20%" of the deal. It's clear that **China doesn't intend to bring much of substance to the table.**

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China's Calculus

There are several possible motives for China's entreaty to restart talks:

- Stop the bleeding on trade while facing existential issues in Hong Kong and local pork markets
- To save as much of Huawei as they can
- A misreading (again) of Trump's political calculus

Between swine flu, Hong Kong, and the upcoming 70th birthday party on October 1st, China may simply be desperate for some political breathing room. This is the "Occam's Razor" conclusion.

Furthermore, if President Xi anticipates having to bring the hammer down in Hong Kong at some point in the Fall, shelving the trade fight makes sense. By making a short-term deal that has some political value to President Trump he may hope to dampen and forestall a U.S. response.

Also, China would like to forestall the full Huawei "death penalty" from the U.S. which President Trump alluded to last week.

We must also consider the possibility that China is yet again miscalculating based on a #fakenews notion that Trump is desperate to capitulate in order to save a stock market that is 2% off all-time highs.

It may in fact be the case that the U.S. is somewhat "worn out by the trade war," but it by no means follows that the Administration is willing to concede on key demands for Chinese structural change.

Another Chinese Miscalculation?

It's also not clear that China fully understands Trump's political constraints with regards to Huawei. The Japanese press reported yesterday that President Xi told Japanese PM Abe at the Osaka G20 in June that *"I can't believe what President Trump says"* because

> *Despite agreeing to Xi's proposal on the phone to deal with Chinese telecommunication giant Huawei Technologies Co. during the next working-level negotiations, "once the negotiations began, the U.S. side said that Huawei is not a trade issue but a security issue and did not deal with it," Xi told Abe*

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Unlike the ZTE case which was under the purview of the Commerce Dept., Huawei's legal issues are explicitly not under the purview of Lighthizer's negotiating team, and furthermore Congress is now deeply involved, limiting Trump's political maneuverability. Shouldn't the President of China be cognizant of these political intricacies?

Hopefully the Chinese negotiating team is aware that the **only the non-security related aspects of Huawei's business are up for negotiation**. Trump-whispering uber-hawk Tom Cotton (R. Ark) laid this out in a July CNBC interview: Congress is red-lining the 5G and security-related aspects of Huawei's business but doesn't much care about Huawei's sales of "second-rate handsets" throughout Asia (Market Narratives, 7/25/19). **The deal on offer is essentially "Ag for Android."**

Trump's Calculus

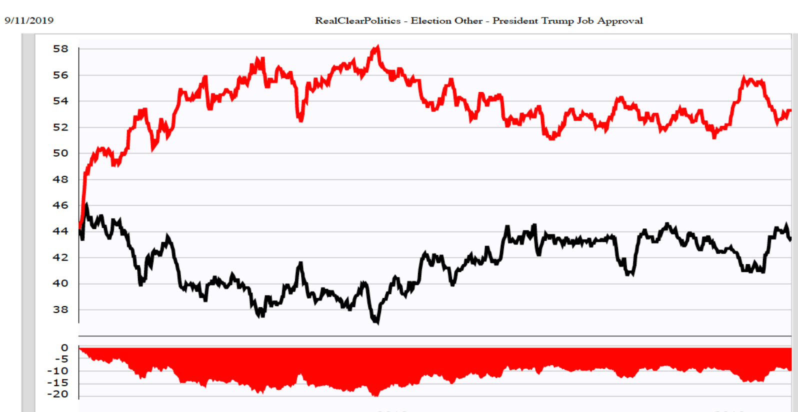
From a tactical perspective **Trump should do this deal** if it's available. There is no point in winning a battle while enduring such losses that you lose the political war.

A cessation of hostilities now would allow Trump to pocket significant tariff increases to date and two (maybe three) Fed rate cuts. Even a temporary cease fire would cause equity markets to rocket and undercut the ubiquitous recession narrative. A return to Chinese Ag purchase would be of obvious political benefit.

In terms of costs, Trump would surrender a hostage he has no use for (Huawei's handset business) and defer consumer-product tariffs that will probably do him more political harm than good anyway. (He's already signaled openness to punting on the December 15 batch of tariffs).

Meanwhile, Huawei's 5G business would remain impaired and China would remain under plenty of pressure from other sources – namely Hong Kong and debt-deflation.

The nattering nabobs will of course cry "Trump caved!" But he'll head into 2020 with reduced recession risk, a booming stock market, and well-established bona fides on the issue of countering the China threat. With his approval ratings at the low end of the established range, it's probably time for a break.



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Tactical Outlook

A Chinese team will be in Washington next week for deputy-level talks. **Signposts of an "Ag for Android" deal should be obvious**: goodwill Ag purchases on China's part followed by U.S. deferral of the October 1 round of tariff increases (25% to 30% on $250bn).

Alternatively, **if we don't see some goodwill gestures by the end of next week the odds increase that this latest round of talks is just another fizzle**. If China is looking not just for a ceasefire but for U.S. surrender on broader issues, then ministerial-level talks in October may not even take place.

While the best-case on trade is for a short-term cease-fire, that should be sufficient to generate a significant risk-asset rally, so long as Hong Kong remains contained. **These markets are all about extant tail risks**. Tail risks might not even be the right term. They're huge risks – of economic and financial calamity in China – and they're staring us right in the face.

Meanwhile, things didn't calm down in Hong Kong over the weekend, in fact they deteriorated significantly in terms of the level of instigation, with a stars & stripes-waving demonstration at the U.S. consulate in support of passage of the Hong Kong Human Rights and Democracy Act. China responded sternly through local media.

There's no way round the fact that Hong Kong remains an impossible-to-handicap wildcard.

Conclusions

- China's penchant for political and economic stability around major political events reduces near-term tail risks
- U.S. – China decoupling remains the ultimate destination, but a near-term cooling of tensions is in the interest of both sides
- Likelihood of bullish tape bombs in the form of "goodwill gestures"
- Reduce risk into weekends. Hong Kong could go pear-shaped with one itchy trigger finger

Tactical Update

- I've capitulated on my short-risk positioning
- Now running a moderately long-risk position (QQQ) hedged with December HSI puts that will perform in a Hong Kong tail scenario and retain some value in a near-term risk rally
- Flat risk into weekends