

## Phase One: A Cease Fire Agreement is not so Easy

- “Phase One” – a cease fire based on empty gestures
- Intractable hurdles remain: deal-signing no better than 50:50
- Both sides want to turn down the heat

### Phase One Deal – Thin Gruel

The term “skinny deal” overstates the magnitude of what’s been accomplished - nothing more than a deferral of the October tariffs in exchange for some limited soybean purchases thus far. Deferral of the more important December tranche is being dangled as the prize for signing the broader Ag deal, but **serious hurdles remain**.

Agreements on “intellectual property rights” and “financial services,” are warmed-over half measures announced months ago. The “currency pact” is toothless.

What seems clear is that:

- a) Phase one accomplishes nothing of substance
- b) There is no phase two
- c) This is not a sustainable equilibrium for the relationship

So, we’re in a timeout, which is bullish in terms of tail risk reduction for as long as its lasts. I don’t think it will last long, but let’s look at some of the variables...

### Enforcement, Enforcement, Enforcement

**The glaring hole in the phase one deal is enforcement.** Here was Lighthizer on Friday:

*WE ARE GOING TO HAVE A CONSULTATION PROCESS. WE HAVE AN ESCALATION IN VARIOUS AREAS OF IT, SO THAT DIFFICULTIES CAN BE RESOLVED. BOTH PARTIES HAVE ASSIGNED VARIOUS PEOPLE AND CREATED A STRUCTURE UNDER IT. AND **WE ARE DOWN TO THE FINAL DETAILS OF WHAT WILL HAPPEN IF THERE IS NOT A RESOLUTION, AND THAT IS THE FINAL ISSUE WE ARE PUTTING TOGETHER.** BUT BOTH SIDES AGREED IT ABSOLUTELY HAS TO HAVE A WORKABLE DISPUTE SETTLEMENT MECHANISM, AND WE ARE CLOSE TO THAT.*

Ok, so **they’re down to the only thing that matters**: what happens when a dispute cannot be settled. As we know, USTR Lighthizer is insistent on a “unilateral enforcement mechanism” that would allow for the U.S., in the event of an unresolved dispute, to impose targeted tariffs which *could not be countered by Chinese retaliation*.

There is no indication that either Lighthizer or the Chinese have moved their red lines on this issue. Here was the in-the-know [Taoran Notes blog on Sunday](#), with the Chinese perspective:

*“An agreement should be signed on an equal basis with mutual benefit, [so] how can one side accept an enforcement mechanism imposed by the other side? Now the wording has changed to dispute resolution, and it is an interesting adjustment that reflects a substantial change in mindset”*

“Dispute resolution” is one thing. Enforcement in the event no resolution can be found is quite another. It seems **wishful thinking on the part of the Chinese that the U.S has conceded the point** on unilateral enforcement. From Lighthizer’s perspective the **unilateral enforcement mechanism is a *sina qua non***. I suspect he’d resign before conceding the point. From the Chinese perspective, unilateral enforcement is seen as an unacceptable loss of sovereignty.

**Enforcement is the key issue to watch** in terms of assessing the viability of the deal. While they could perhaps punting enforcement to phase two given that the deal to this point has nothing in it to enforce, it’s more likely this issue never gets resolved. One side still has to blink, *hard*.

## Huawei

Of the issues being glossed over in phase one, Huawei is perhaps the most notable.

While [Huawei seems to be doing just fine so far](#), they have been operating under the reprieve granted via “temporary general license” extended through November 18<sup>th</sup>. ([Huawei’s phones are still using Android OS for instance](#)).

Coincidentally, the APEC meetings in Chile – touted as a potential phase one signing venue – is November 16-17. President Trump may have some wiggle room to provide limited relief to Huawei’s non-security sensitive business lines, but it seems completely lost on the public (and most of Congress) that Huawei is more than just a diabolical plan to hijack the global 5G network. It will be very difficult to spin any meaningful relief for Huawei as anything other than “sacrificing national security.”

I’d be shocked if the Chinese are prepared to fold on Huawei, but USTR Lighthizer made clear in the Oval Office meeting that “**we are not dealing specifically with Huawei** – that is not part of this agreement. That is a separate process.” This is a sticking point that cannot easily be punted to “phase two.”

## Human Rights

There are two emerging issues on this front. First, is last week’s addition of 28 names to the U.S.



“entity list” as sanction for activities in Xinjiang. China should view this as a dangerously slippery slope.

Once human rights are used as a rationale for economic penalties, where should one stop? What is the economic penalty that is proportional to what many describe as a program of “ethnic cleansing?” Is it not fair to ask why we’re trading with China at all if that’s what’s really going on?

**The Administration has brandished a potentially lethal political weapon** here. China is obviously not happy with it, but there is little they can do.

The more pressing human rights issue is the imminent passage (and signing into law) of the Hong Kong Human Rights and Democracy Act.

A People’s Daily editorial [suggested passage could imperil the trade truce:](#)

*“In a crucial period in which China and the US are meeting each other halfway [on trade], some American politicians are effectively putting the car in reverse by pushing this bill and flagrantly meddling in China’s internal affairs,” it said.*

While the [foreign ministry suggested unspecified countermeasures:](#)

*“Regarding the wrong decision of the US, China will surely take effective countermeasures to firmly safeguard its sovereignty, security, and development interests,” the foreign ministry said.*

Is China willing to swallow two highly significant diplomatic slaps to make an empty deal?

## Rollback

And has China also capitulated on their previous redline that any agreement had to include some rollback of current tariffs? Beyond that, haven’t even definitively secured deferral of the December tariffs yet!

Of course, according to Bloomberg [the Chinese have already begun to move the goal posts](#) on phase one by suggesting that getting to the touted \$40-\$50bn in Ag purchases would require some degree of tariff rollback by the U.S.

Trump is not going to start dismantling his big, beautiful tariff wall for Ag purchases. Given that, if Bloomberg is accurate, then the Chinese have already signaled that “\$40-\$50bn” doesn’t actually mean they’ll buy \$40-\$50bn. The renege has already begun.

## Needles to Thread

It's a testament to the state of U.S.-China relations that even getting to a substance-free cease-fire deal is like threading a needle:

- China needs to swallow the Xinjiang sanctions pill
- China needs to swallow the Hong Kong Human Rights and Democracy Act pill
- Someone needs to swallow the Huawei pill
- Someone needs to swallow the enforcement pill
- Someone needs to swallow the tariffs rollback pill

All these pills to swallow – none of which will actually prevent eventual onset of the decoupling disease. Why are both sides willing to go through all that trouble just for a temporary cease fire?

## The Frog In the Pot and a Faulty Control Knob

I've been using the [Frog in the Pot](#) (7/22/19) analogy to describe the U.S. strategy of gradually decoupling without declaring a decoupling. The strategy entails two risks: the Frog might jump the pot and try to bite you (its venomous) or the Frog might die before the soup is ready. In other words, China can upset financial markets either actively, by taking aggressive countermeasures, or passively, by having its economy and/or the RMB fall apart.

The situation in Hong Kong, now amplified throughout U.S. popular culture as a result of one innocuous tweet by an NBA general manager, has turned up the heat dramatically and in unexpected and potentially uncontrollable ways. Congress is becoming more involved (taking some decision-making out of the President's hands), and the nationalist beast has been unleashed on both sides. (Its notable how quickly [China pulled the plug on the nationalistic attacks on the NBA.](#))

Trump no longer has control of heat modulation on the pot. I suspect he's decided its safest just to turn off the stove for a moment, less the decoupling soup get ruined.