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Trade Deal Optionality and Weekend Links

I still see tariffs going up on Dec 15th. Here's my closing market:

Phase One Deal incl. tariff rollback:	20%
Phase One Deal without rollback:	5%
Delay / punt:	20%
Tariff increase:	55%

With its renewed public demands for tariff rollback, China has greatly diminished the degree of mutually-acceptable negotiating room for a deal.

Putting the tariff process into reverse, absent significant credible and enforceable changes in China's economic behavior, would mark a clear capitulation by President Trump. China wants this for obvious reasons, not the least of which is to halt the supply chain exodus.

I won't belabor the point (having covered it here last week), but **capitulation would prove far more damaging to Trump's political brand** than any short-term market upset resulting from completing construction of the "tariff wall" to China.

What makes predicting this event so fascinating is that it seems like **even the folks with inside information don't actually have inside information**. Bloomberg news posted this today under the heading "*Larry Kudlow's Rah-Rah Attitude on Trade Deal Goes Missing*:"

> *The Trump administration's happy-talk about a China trade deal went missing when economic adviser Larry Kudlow was interviewed on Bloomberg television. The White House economic adviser* ***was emphatic that he couldn't predict whether tariffs would rise on Dec. 15*** *or which way Trump was leaning on the outlines of a deal. If anything, he warned markets to tread carefully.*
>
> ** There can be no doubt that Trump is a "tough, canny, wily negotiator."*
>
> ** "I don't want to predict what his decision will be."*
>
> ** "I don't want to mislead anybody."*
>
> ** "We've all learned that if he's not satisfied with these talks" as Trump wasn't satisfied in earlier rounds, he "won't hesitate to raise tariffs."*

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My impression of the process is that the principals are working to solicit the best deal they can from the Chinese, and ahead of Dec. 15th will present it to the President for a thumbs up, down or sideways.

It's quite **possible the President himself does not yet know** for sure what he's going to do. While he undoubtedly knows his "lean," and has a broad sense of where he wants U.S.-China policy to go, perhaps this "mystery-until-the-last-moment" process is about creating optionality.

And with just over a week to go to the December 15th deadline, there are still variables in play generating uncertainty as to the political costs and benefits of a Phase One deal. Most notable in this regard is **USMCA, which is on a knife-edge**.

Tougher North American steel definition in USMCA holds up talks

> *...the latest point of contention is a U.S. request to tighten the definition of North American steel and aluminum to ensure that it is melted and poured within the three countries — and not simply finished here — to fulfill a USMCA requirement.*
>
> *The demand, which these people said Mexico considers new but the U.S. does not, comes amid a* ***flurry of disagreements this week that have complicated reaching a compromise*** *deal Congress can vote on this year.*
>
> *Rep. Henry Cuellar (D-Texas) appeared to be referring to this steel demand when he told reporters on Thursday: "There was a new issue that got brought up and the Mexicans said, 'We're not going to touch this issue.'"*
>
> ***"They're like this close,"*** *Cuellar said, "but this new thing came up and the Mexicans said no."*

USMCA would be a legit "big win" for Trump, showing that he can, in fact, "make deals." USMCA would also provide a slave to the farm belt in the event that the $40-$50bn in touted Chinese purchases proves a chimera. Furthermore, it seems dissonant to couple a hard fought USMCA deal, in which our Mexican neighbors have swallowed compromise upon compromise, with a sweetheart deal for the fentanyl-peddling, muslin-interning, democracy-quashing CCP.

That **USMCA will get done** is an important assumption embedded in my Phase One assessment. Admittedly, news in the last 24 hours is not good, but this may just be the last "walkaway moment" before a deal is consummated next week. **Odds of a Phase One deal would rise if USMCA goes off the rails**.

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If USMCA remains on track, but simply runs out of Congressional calendar runway, (note that House Democrats recently extended the session by one week to Dec 20th), then Phase One delay comes into play. The Administration likely wants to pair the China tariff medicine with a spoonful of USMCA sugar for the markets to swallow.

On to the links…

U.S. – China relations

I think China is going to be even more upset about this one than the Hong Kong Bill. The Senate version passed unanimously in September, but because the House made some changes, the Senate will look to take up the House version for a vote, perhaps **as soon as next week**…

US House passes Uyghur Act calling for tough sanctions on Beijing over Xinjiang camps

> *The Uyghur Human Rights Policy Act, which still needs to gain approval from the US Senate, calls for concrete measures to be taken against Beijing over allegations that up to two million Muslim-majority Uyghurs have been detained in "re-education" camps in the far western region.*
>
> *The Chinese government reacted with fury to the proposed legislation, which Foreign Ministry spokesman Hua Chunying said "wantonly smeared China's counter-terrorism and de-radicalization efforts."*
>
> *"The issue that Xinjiang faces is not about ethnicity, religion or human rights. Rather, it is about fighting violence, terrorism and separatism," Hua said in a statement Wednesday. At her daily press conference, Hua added that the US would have to pay "the due price" for any wrong actions.*
>
> ***"It's impossible that it will not affect China-US relations or cooperation in important areas,*** *" she said.*

If you're managing funds for public institutions, this issue is not going away…

Opinion | Stop Investing in China's Brutality

> *American financial heavyweights and pension funds have in recent years shunned fossil fuels, guns and other investments on ethical grounds. Yet when it comes to providing*

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> *capital to Chinese companies — including those directly engaged in surveillance or supporting the People's Liberation Army — many haven't resisted investment.*

My prediction for the hot new China-bashing issue in Congress next year:

Opinion: The U.S. should boycott Beijing's 2022 Winter Olympics

> *The International Olympic Committee should revisit its decision to award the Games to Beijing in light of the overwhelming evidence of Chinese crimes against the people in Xinjiang.*
>
> *Unfortunately, the IOC has shown that it's incapable of standing up for human rights. That means that the United States and other concerned countries must act.*
>
> *The Trump administration, with congressional support, should begin working now to build an international coalition that will call on the IOC to move or cancel the Games unless China closes the camps and ends abuses in Xinjiang.*
>
> *If the IOC refuses to play ball, which is likely, the coalition should be prepared to threaten a boycott of the 2022 Olympics and to hold parallel "Freedom Games" if Beijing does not rapidly alter course.*

Fentanyl: it sounds like a mixed bag. They've cut down on exports but the suppliers are still there. Would it surprise anyone if the Chinese government opened the floodgates again in the wake of a breakdown in trade talks?

China Cracks Down on Fentanyl. But Is It Enough to End the U.S. Epidemic?

> *The large, freewheeling and mostly unregulated fentanyl industry that had operated in a gray area of Chinese law appears to have stopped selling the drug for export — or at least as openly as hundreds of suppliers once did.*
>
> *Some of the distributors, who still can be easily found in online searches, claimed to be complying with the new rules banning the overseas sale of synthetic opioids.*
>
> *Others appeared to have shut down their operations, disconnecting numbers which had previously reached salespeople offering to mail the drugs to the United States — no questions asked.*

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> *China's new focus on shutting down the trade has meant shipments of fentanyl to the United States have declined significantly in the last year, according to Chinese officials, citing figures from the United States Customs and Border Protection agency. The American agency did not dispute that drop.*
>
> *"China's control over fentanyl substances is becoming stricter and stricter," said Yu Haibin, the deputy director of the country's National Narcotics Control Commission.*

Huawei

This leak seems like a warning to China: "don't do anything rash when we walk away from Phase One. We can make always make it worse." Secretary Ross issued a "non-denial denial" on this story on CNBC…

Exclusive: White House considered kicking Huawei out of U.S. banking system - sources

> *The Trump administration considered banning China's Huawei from the U.S. financial system earlier this year as part of a host of policy options to thwart the blacklisted telecoms equipment giant, according to three people familiar with the matter.*
>
> *The plan, which was ultimately shelved, called for placing Huawei Technologies Co Ltd [HWT.UL], the world's second largest smartphone producer, on the Treasury Department's Specially Designated Nationals (SDN) list.*
>
> *One of the people familiar with the matter, who favors the move, said it could be revived in the coming months depending on how things go with Huawei.*

Exclusive: U.S. weighs new regulations to further restrict Huawei suppliers - sources

> *The U.S. government may expand its power to stop more foreign shipments of products with U.S. technology to China's Huawei, amid frustration the company's blacklisting has failed to cut off supplies to the world's largest telecoms equipment maker, two sources said.*
>
> *Key foreign supply chains remain beyond the reach of U.S. authorities, prompting inter-agency discussions within the administration of President Donald Trump about possible changes to two key rules that could expand U.S. authority to block more foreign shipments to the company, giving more teeth to Huawei's blacklisting*

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U.S. to Tap $60 Billion War Chest in Boon for Huawei Rivals

> *A new agency, called the U.S. International Development Finance Corporation, plans to tap some of its $60 billion budget to help developing countries and businesses purchase equipment from other companies.*
>
> *"The U.S. is very focused on ensuring there's a viable alternative to Huawei and ZTE. We don't want to be out there saying no. We want to be out there saying yes," Adam Boehler, the first chief executive officer of the DFC, said in a recent interview.*
>
> *He declined to discuss specific company talks or how the money would be spent. However, the plans would be a welcome boost for Sweden's Ericsson AB and Finland's Nokia Oyj*

Mike Pompeo Op-Ed: Europe must put security first with 5G

> *"The United States respects each nation's right to set technology policy, and decide how it will protect its people. But our friendships and alliances with EU states — ones ultimately built on a common love of freedom — demand that we raise our concerns when we see threats to our shared security."*
>
> *"I am confident that European states will keep making good decisions on behalf of their citizens. The United States looks forward to working with Brussels to build a strong, secure and prosperous digital future for all."*

EU – China Relations

This is about more than Sweden, obviously. China is making it increasingly clear that kowtowing on geopolitical issues is a prerequisite for trading with them…

China's ambassador: Trade with Sweden should be limited

> ***China will restrict trade with Sweden*** *following the government's handling of the Gui Minhai case. This is announced by China's ambassador Gui Congyou to the Gothenburg Post. - No one can expect to damage China's interests on the one hand and make big profits in the country on the other.*

Hong Kong

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Bad Vibes: HK Police have recently begun to instigate confrontation at permitted marches, of which a large one is planned for Sunday.

Public security minister meets new HK police commissioner

> *State Councilor and Minister of Public Security Zhao Kezhi said on Friday that ending violence and restoring order is still the most urgent task for Hong Kong at the moment, and he hoped that Hong Kong police could be firm and confident in safeguarding the rule of law in the special administrative region.*
>
> *He said the central government and the ministry will stand firmly behind the police team in Hong Kong, and* ***expressed hope that mainland police and Hong Kong police could strengthen cooperation*** *to jointly safeguard national security and protect Hong Kong's social stability.*
>
> *Zhao made the remarks in Beijing while meeting with Tang Ping-keung, Hong Kong's newly appointed police commissioner, according to a ministry release.*
>
> ***Zhao said that President Xi Jinping****, in his speech made on Nov 14, revealed the serious harm and nature of radical violent crimes in Hong Kong, and* ***made clear the basic position*** *and attitude of the central government on the situation in Hong Kong.*

China Economy & Finance

By “avoid systemic risk” they mean “roll just about everything, by hook or by crook.”

China’s Leadership Vows to Avoid Systemic Financial Risk in 2020

> *China’s leaders vowed to avoid systemic financial risks next year and keep growth in a “reasonable range,” state-run Xinhua News Agency reported, citing a Poliburo meeting in Beijing on Friday, as the economy stutters with its slowest growth in decades.*
>
> *The monthly gathering of the 25-member Politburo, chaired by President Xi Jinping, came ahead of a key planning meeting known as the Central Economic Work Conference, which will decide targets for 2020, including how much the government should spend and what the growth rate should be.*
>
> *“****Risks and challenges at home and abroad have risen significantly****,” Xinhua reported, citing a statement from the meeting.*

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No change in messaging here…

PBOC Signals Policy to Stay Cautious Amid Uncertain Data

> *Policy should be prepared for a "mid- and long-distance race" and stick to a conventional approach as long as possible, according to the article by Governor Yi Gang*

Anatomy of a centrally-planned credit crisis: Strong Dollar / Weak commodities = negative CHINA PPI = slowing nominal GDP = reduced debt-service capacity. So long as credit growth remains contained, the authorities will be tasked with deciding which entities live or die. **Rollover credit is in increasingly short supply**.

Two China Firms Miss $526 Million Bond Payments as Woes Grow

> *Two Chinese companies failed to repay bonds worth a combined half a billion dollars on Monday, underscoring rising debt risks in the highly leveraged nation as the economy slows.*
>
> *Peking University Founder Group was unable to secure sufficient funding to repay a 270-day, 2 billion yuan ($285 million) bond, according to a company filing to the National Interbank Funding Center. Tunghsu Optoelectronic Technology Co. failed to deliver repayment on both interest and principal on a 1.7 billion yuan bond, according to Shanghai Clearing House.*
>
> *The quickening speed of bond defaults in China, especially among ailing private firms, highlights the growing financial strain triggered by the country's worst economic slowdown in three decades and unabated trade tensions with the U.S. Last week, industrial firm Xiwang Group failed to pay a 1 billion yuan bond, missing a fresh repayment deadline on an already defaulted bond.*
>
> ***"It's getting harder for companies to get funding help when facing a debt crisis, unless they're centrally-controlled companies and local SOEs** that have great importance to the local economy," said Yang Hao, fixed income analyst from Nanjing Securities Co.*

AMC's are no magic bullet: instead of a market-based workouts, loss-given default will be determined by cash-strapped local governments. Most of these defaulting entities, "restructured"

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via debt write-down, will then be released back into the wilds of Chinese credit markets to start borrowing and "investing" again...

Looming China Default Shines Light on New State Asset Managers

> *Trading firm Tewoo Group Corp., a onetime Fortune Global 500 company that seemed like a good bet for a full official bailout thanks to its state ownership, is struggling to make payments on its $2.05 billion of offshore debt.*
>
> *Tianjin State-owned Capital Investment and Management Co., the mastermind behind Tewoo's debt revamp, is one of more than 100 asset managers set up across China in recent years. The firms, with four in Tianjin alone, have become a key plank of Beijing's overhaul of the nation's cumbersome and inefficient state sector.*
>
> *As China battles against a slowing economy and mounting debt, these relatively obscure entities are now emerging as a key force in policy makers' efforts to allow more ailing SOEs to fail while avoiding a full-blown financial crisis. The thinking is that oversight by a dedicated financial-asset manager could encourage market discipline without the sort of corporate destruction wrought by unbridled U.S.-style capitalism.*
>
> *For investors, there's substantial pain in store. Tianjin State-owned Capital said last month it will offer Tewoo bondholders either **a haircut of as much as 63%** on $1.25 billion of notes, or replacement securities in its own name with significantly lower coupon payments.*

Preferential access to capital + implicit guarantee + mandate to generate investment at all costs + minimal oversight = Chinese LGFV's. What could possibly go wrong?

This $1.2 Trillion China Bond Market Is Studded With 'Fakes'

> *LGFV bonds are now seen as one of the most desirable assets in China. Strong demand from foreign fund managers has pushed LGFV dollar-bond sales to an all-time high this year. Along with their attractive yields, the bonds' appeal stems from investors' view that they're low-risk.*
>
> *The reasoning here, while a little convoluted, goes something like this: Local governments' fiscal revenue is growing at the slowest pace in at least a decade, thanks to corporate tax cuts and an economic slowdown. Yet spending on infrastructure is still needed in many parts of China, giving Beijing an incentive to keep this financing channel open—which means preventing LGFV defaults.*

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> *But there's a major problem:* ***Many LGFVs are no longer sticking to their construction mandates****. Investors call them fakes.*
>
> *As early as 2010, Beijing asked municipalities to refrain from borrowing funds for construction projects that would rely on repayment from the central government. As a result, many LGFVs pushed into new businesses to generate cash. Some have gone rogue, ditching underappreciated public services altogether.*
>
> *One example is Changde Economic Construction Investment Group Co., whose original focus was funding urban construction projects in Changde city in central Hunan province. Now it's set up businesses in five sectors, including tourism and financial services. In local parlance, these types of LGFVs that don't finance infrastructure or social welfare projects are referred to as fakes.*

A key facet of China's push to "support private enterprise": stop tossing entrepreneurs in jail willy-nilly…

Courts should be more lenient with private businessmen, prosecutor says

> *Under China's legal system, a suspect can still be held in detention for lengthy periods even if no formal arrest warrant or charges are issued.*
>
> ***Private business owners face a higher risk of being targeted by the legal system*** *compared with those working in the state sector.*
>
> *A 2018 study by Beijing Normal University showed that between 2013 and 2017, 85 per cent of the businesspeople involved in criminal cases worked for private companies.*
>
> *This situation has caused alarm among policymakers as the country's economic growth starts to slow, prompting a renewed focus on the importance of the private sector.*
>
> *The three most frequent charges private-sector workers faced were illegal fundraising, embezzlement and paying bribes, according to the study.*
>
> *Hu Xingdou, an economist, said* ***many cases showed that the law was being applied arbitrarily****.*

U.S. Economy

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A pleasant factiod…

Trump's Tax Cuts Push U.S. Burden Lower in World

> *Measured as a share of the U.S. economy,* ***taxes are now 10 percentage points below the 2018 OECD*** *average of 34.3%. Among 34 countries with preliminary 2018 data, the U.S. tax burden is lower than everywhere except Chile, Ireland and Mexico. The tax cut drove U.S. taxes below Turkey's, and taxes in France and Denmark are now nearly twice what they are in the U.S.*