Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

MACROLENS
Markets in High Resolution

Trading Phase One

Here's a quick roadmap for trading the impending announcement on the fate of a Phase One trade deal with China. Let's start with some context gleaned from this week's news flow.

A Tuesday article in the WSJ suggesting that both sides were "planning for a delay," claimed that:

> *The biggest holdup in the U.S.-China negotiations is Washington's demand that China guarantee its pledge to buy more American soybeans, poultry and other agricultural products.*

This hardly makes sense. The only way for China to "guarantee" a level of purchases would be to pre-pay, which is a non-starter. As for enforcement, in an Ag-only deal that's straightforward: raise tariffs if China doesn't make the requisite level of purchases.

No, **the hold-up is the demand for rollbacks**. The WSJ continues:

> *Mr. Liu's team has also been trying hard to get the U.S. not just to eliminate the December levies but also to relax portions of the existing tariffs on the $360bn of Chinese imports. But Mr.* ***Lighthizer has so far held firm on not rolling back tariffs****—a point of leverage seen as key to keeping the Chinese side engaged in negotiations over knottier issues such as subsidies and forced technology transfers. Other senior officials have indicated they are willing to eliminate the last round of tariffs, on $110bn of Chinese goods.*

China want's rollbacks to halt the supply chain exodus. Trump can't offer rollbacks absent some "Phase Two grade" concessions from China (none are on offer) without looking like he's capitulating in way that would both dent his political brand and impair his future ability to use the tariff to gain leverage over China, the EU or any other large trading partner.

China is steadfast on this point. This from today's NY Times version of the "Signs Point to Tariff Delay" story:

> *… people familiar with China's trade policies said that* ***the Chinese government had discernibly hardened its negotiating positions*** *since Mr. Trump and Vice Premier Liu He reached their agreement in October.*
>
> *The Phase 1 agreement* ***attracted criticism from the more nationalistic wing*** *of the Chinese government because it called for Beijing to resume buying American farm goods in exchange for the United States not raising tariffs further, but without any American pledge to roll back some of the tariffs already imposed. Any tariff cuts were left for later phases, an arrangement that was assailed in China as too favorable to the United States.*

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

MACROLENS
Markets in High Resolution

> *Deferring rollbacks to a Phase 2 or subsequent agreement is being resisted by Chinese negotiators, Mr. Tu said, adding that, "they want every agreement to be equal."*
>
> *But China has been wary of offering further concessions to offset a tariff rollback. That* ***has stymied negotiators*** *at least temporarily.*
>
> *American officials say that they are still waiting for China to signal its willingness to make the necessary concessions to seal a deal.*

I don't see either China blinking on rollback or Trump allowing them to "re-trade" him on the October deal. **It's a stalemate**. Hence, the increasing chatter around a "tariff delay," predicated on the widespread assumption that the Dec 15th tariffs can't possibly go into effect, lest the planet immediately spin off its axis.

Market Reaction in Various Outcomes

There is a growing consensus that a Phase One deal could prove a "buy the rumor, sell the fact" event. This is an unhelpful oversimplification. There are shades of grey across all outcomes that need to be considered in assessing the likely market performance in the weeks that follow.

Let's consider the following scenarios:

- Trump capitulates on rollback
- China capitulates on rollback
- Delay for continued talks
- Delay for a "unilateral deal"
- Tariff increase on Dec 15th

Trump Capitulates on Rollback

This is a melt-up scenario.

A rollback deal is unambiguously bullish for equity assets (which is not the same as saying it's the optimal outcome for U.S. economic and national security in the medium term).

Trump's capitulation on rollback would be about more than tariffs. It would suggest that the **populist assault on globalism was cresting,** under the weight of relentless pressure from the vested elite. It's Trump siding with Gary Cohn over Lou Dobbs.

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

Rollback would also dramatically reduce "China tail risk," both economically and politically. The supply chain exodus would stop in its tracks, the decoupling threat would be defused, and President Xi's political standing would be greatly enhanced.

China Capitulates on Rollback

This is a **more likely a "buy the rumor, sell the fact"** scenario.

In October, halting further tariff increases in return for nothing more than Ag purchases would have shown weakness by the U.S. side, exposing itself as having no further stomach for the fight. But that same deal now, should China's back off its public demands for rollback, would look quite different – like the U.S. was still "calling the shots" in a long game of countering China.

A no-rollback deal will be tenuous, as **China walks away unhappy**, perhaps less likely to follow-through with its Ag commitments and perhaps looking for opportunities to roil markets, or otherwise stick a finger in Trump's political eye.

This is a much less stable equilibrium than a rollback-inclusive deal.

Delay to Keep Talking

The new market consensus - a punt of unspecified duration to "keep talking" - likely results in a **short-lived market rally**.

The imminent threat of tariffs will be removed, but that is largely "in the price" already. While most market participants will stick with the assumption that Trump will eventually "fold," in the absence of some indication that the rollback knot can be untied, the risk overhang will remain.

I discount the odds of delay relative to the consensus, as delay, while imposing limited cost, has limited benefit, unless China is going to continue taking down the soybean harvest. I can't imagine the Chinese will let themselves be suckered into that.

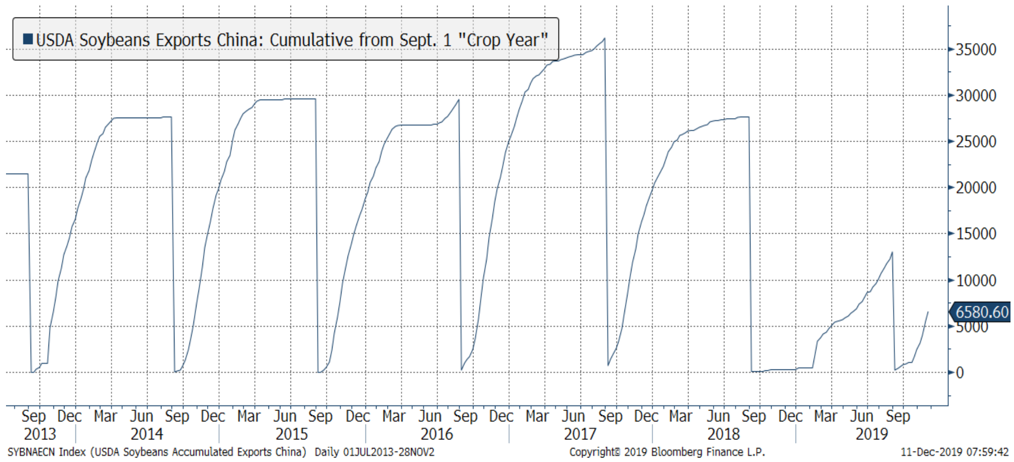
A Quick Sidebar on Beans

Soybean exports are highly seasonal, with the bulk of sales occurring in the 5-6 months from the September 1 opening of the "crop year" into mid-March.

Through end-November, Chinese soybean purchases are running at 35-40% of the run-rate seen

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

in previous years.



There is some potential benefit to the U.S. in delaying the tariffs – even in the absence of hope for an eventual deal - if China will continue to support the drawdown of U.S. soybean inventories.

The rate of **Chinese soybean purchases will be a key indicator** of the robustness of any "truce" resulting from a scenario of "delay with no path to a deal."

<u>Delay for a "Unilateral Deal"</u>

This is an outlier scenario, but seems logical if the U.S. side really does not want to have to raise tariffs further.

The U.S. could **unilaterally declare a Phase One deal on the basis of the initial October agreement** by pledging to delay tariffs so long as China showed continued "good will" in the form of Ag purchases deemed sufficient by the U.S.

This would put the ball back in China's court, allowing them to retrace their steps to the early October deal formulation without losing face by overtly folding on the rollback demand. As long as they are persistent buyers of US Ag product, they could avoid further tariffs.

So long as China maintained purchases at near "normal" levels, the U.S. would retain the optionality as to whether to re-engage with tariffs in 2020, or try to stretch out the truce through the elections.

Stated or not, **any delay will require some element of continued "good will"** Ag purchases to be sustained. So again, **watch those soybean export numbers**.

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

No Deal – Tariffs Increase on Dec 15th

This **remains my base case**. Obviously, it is **heavily bearish** for risk assets in the near-term. **China's response** to a breakdown in talks **is the key variable** to the depth and duration of any market selloff.

The tariffs themselves aren't the problem. An incremental 15% on $110bn is not going to be the straw that breaks the economy's back. And despite all the media hand-wringing, we won't see mobs in the street over a 7% increase in iPhone prices.

The problem with the last increment of tariff increase on Chinese imports is that it will seem **a demarcation point,** beyond which the establishment dream of a return to the status quo ante is dashed. This **brings all manner of Chinese tail risk into view**, including RMB devaluation, boycott of U.S. products, lashing out in Hong Kong, or the emergence of a more overt backlash to Xi's rule.

However, **strong countermeasures are not without costs for China**. With a U.S. election upcoming, China might be reluctant to take actions that would endanger their chances of re-setting relations in the event of a transfer of power. The more hopeful they are of a Trump loss, the more restrained they are likely to be.

Lastly, China's economic fragility is such that it could unwittingly become a global financial tail risk, should dashed hopes for a trade truce dent economic confidence significantly.

In a no-deal scenario, 2020 equity returns will suffer from a continued overhang of China-related tail risk, the degree of which will **depend on China's response** to being threatened with decoupling.

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

Conclusions

- **A Phase One deal is a melt-up**, more sustainably so if Trump capitulates on rollback. Consider "selling the fact" on a no-rollback deal.

- A delay scenario brings a short-term rally followed by a range-trade and potentially an interim top in risk assets. **Watch soybean exports**.

- A tariff increase is an obvious risk-off event. **Watch China's retaliatory actions and management of the RMB** to gauge its depth and duration.