



Coronavirus, Huawei and Weekend Links

More Coronavirus guesswork...

- **China is poorly positioned** to sustain widespread, extended economic disruption
- **Aggressive self-quarantine** would entail maximum disruption for minimum duration
- The **known unknowns** are significant

China is Vulnerable

- 11-12% credit growth in 2018-19 was merely sufficient to prevent a debt-default spiral
- There are presumably countless entities teetering on the edge of insolvency
- **“Deleveraging” is dead** – credit growth will have to accelerate to fill the cash-flow holes left by plant closures and lost business

Credit/GDP in China closed 2019 at 261% by my calculation. Nominal GDP growth in Q4 was 7.4% and credit growth on my metric came in at 11.6%.

This is not a forecast (yet), but for perspective, let's assume that credit growth is goosed to 20% in 2020, in order to prop up nominal GDP growth at 6%. That combination would **take China's credit-to-GDP ratio up 36ppts to 296%**, which looks like this (red):



Is that sustainable? Perhaps, if global liquidity conditions are benign and China can make a credible case that the credit blowout is merely a bridge to a more sustainable growth model. Neither of those conditions appear likely at this point (although if China can beat back tech decoupling it helps their case – more on Huawei below).



Nevertheless, **the RMB is a clear loser here**. It's inevitable we'll see some acceleration in credit creation into a very nervous market which is battling extreme uncertainty and a blow to the credibility of the country's leadership. The best case from here is a 7.00-7.20 type range for Q1, a considerable net negative for EM assets relative to Street forecasts that had been trending down towards the mid-6's after Phase One.

China's Approach: Maximum Disruption for Minimum Duration

It's not just Wuhan – reports indicate that an [eerie silence has befallen most major Chinese cities](#). This is positive in terms of containing the spread of the virus, but obviously terrible for economic activity, which has come to a virtual standstill.

At an extreme, there is some number of weeks for which China could mandate that no one leave their homes, after which everyone would either emerge virus-free, or not emerge. Economic activity would fall towards zero over that period and then recover towards normal levels fairly rapidly.

Obviously, this is not something anyone would recommend from a humanitarian perspective. Still, China seems to be tending towards this in its approach. (Check out this creepy [Global Times video](#) of drones barking at people to put on their mask and get back in the house).

In terms of the economic damage assessment, the key variable, so long as widespread self-quarantine remains tenable, is how many weeks for the virus to subside to the point where its sensible to allow people to crowd onto trains and buses and go back to work?

Known Unknowns

- Does China stick with the strategy of widespread self-quarantine?
- If so, how long before it's safe to go back to work?
- How much ink-money credit will be required to fill the resulting cash-flow hole?
- How far does the RMB fall while they're printing heavily in an environment where systemic confidence is shaken?
- Is the virus about to go global? (I've been assuming not, but that assumption seems likely to be tested next week).

I don't have much confidence in my ability to forecast any of this, but at least we have a framework in which to assess the news flow.



As of now, it looks like China Inc. is going to be largely shut down until Feb 10th. That's not an insurmountable problem, as activity generally ramps up only gradually after the New Year holiday anyway...

At Least Two-Thirds of China Economy to Stay Shut Next Week

*Fourteen provinces and cities have said businesses need not start operations until **at least the second week of February**. They accounted for almost 69% of China's gross domestic product in 2019, according to Bloomberg calculations.*

All the key eastern manufacturing provinces have extended the holiday. They include Guangdong, home to the tech city of Shenzhen across the border from Hong Kong; Shanghai, home to China's largest port and a newly-built Tesla Inc. plant; as well as Jiangsu, where Nike shoes are manufactured. Henan in central China, which has a large Foxconn plant making iPhones, also announced the extended break.

The extension come on top of other measures including quarantining whole cities that are set to disrupt supply chains and logistics, prompting economists to expect that this virus will deal a more severe blow to China's economy in the near term than the effect of the SARS outbreak in 2003.

China Metals, Energy Heartlands Hit as Virus Forces Slowdowns

Regions accounting for about 90% of copper smelting, 60% of steel production, 65% of oil refining and 40% of coal output have told companies to delay the restart of operations until at least Feb. 10.

The Lunar New Year period is disruptive even in normal years, with many factories and businesses shutting down for about a week to allow workers to travel home. There's usually an anticipation of a jump in manufacturing activity after the break, but that outlook is muddled amid the unprecedented extension, adding to uncertainty over the economic impact of the virus.

The extended holiday affects the following areas with a total population of more than 850 million.

Extending the holiday until Feb 10th is a no-brainer. After that the government will have to balance the cost of lost output with the risk of a renewed outbreak. A widespread return to



factory work on Feb 10th seems untenable at this point. If that's accurate, forecasts like this will prove wildly optimistic:

[Coronavirus May Drag China GDP Down to 4.5% in First Quarter](#)

I know economists like to move incrementally, and that any rate of GDP growth in China below 6% is almost incomprehensible, but as long as widespread self-quarantine remains in effect, it is not economic growth that will be tending towards zero, *its economic output*. In other words, in real time, growth isn't trending towards zero, **its trending towards -100%**.

For now, the bulk of the hit is in services, with the holiday season nearly wiped out. imagine the effect on the U.S. economy if Christmas was cancelled! While industrial output is far more relevant from a systemic risk perspective, services has increased in importance as a source of employment...

[Coronavirus stokes worry over job losses in China's thriving service sector](#)

The fear of job loss has been added to growing concern about contracting the deadly coronavirus for many mainland Chinese, as the outbreak has forced numerous small businesses in the thriving service sector to close indefinitely.

The closures have not only depressed consumer spending, but cast a shadow over the near-term outlook for China's growing service economy – and the millions of jobs that come with it.

*Beijing's restructuring of the economy to rely more on domestic consumption has resulted in strong growth in the service sector in recent years. **Services accounted for more than half of China's employment in 2019**, compared to 29% during the severe acute respiratory syndrome outbreak (Sars) in 2002-03.*

In 2003, during the height of the epidemic, about 8 million people lost their jobs, according to official Chinese data, although real job losses may have been much higher because government data did not cover most migrant workers.

Job losses could be more severe this time as the employment situation was fragile even before the virus outbreak

Concerns over a market-relevant disruption to global supply chains will grow if factory closures are extended. Interesting to note here that some plants have been operating normally throughout..



[Coronavirus wreaks havoc on tech supply chain](#)

Semiconductor manufacturing is heavily automated, whereas companies such as Foxconn and Pegatron rely heavily on labor-intensive assembly, which [is] more exposed," said Mr Cheung.

Analysts said the most immediate impact would be felt by those with operations in Wuhan, the Chinese city at the centre of the outbreak. These include flat panel display television fabrication plants owned by China Star, Tianma and BOE, which are estimated to account for up to 9% of global capacity.

*DSCC, a consultancy focused on the display industry supply chain, said **China Star was not expected to reopen until mid-March.** "Thus, their Q1 '20 shipments are most definitely at risk," the consultancy said in a research note.*

Because of the extended holiday in the six provinces, the technology supply chain could suffer beyond Hubei. Some 290 of about 800 plants named in Apple's global supplier list are located in regions that have delayed returning to work.

However, it remains unclear how strictly the Chinese government is enforcing the work restrictions. Semiconductor and LCD panel fabrication plants cannot easily stop production without huge losses and therefore usually continue running through the holidays.

LG Display and memory chipmaker SK Hynix, both of which have plants in the provinces where the government ordered a delayed return to work, said their factories there had been operating normally through the lunar new year holiday and continued to do so.

It's too soon to be handicapping the potential political fallout, but if things aren't under control shortly the questions about Xi's grip on leadership – already the source of an undercurrent of concern from global investors – will grow louder...

[New Paper Raises Fresh Doubts Over Authorities' Withholding of Coronavirus Details](#)

"I'm beyond furious," Wang Liming, a professor of neuroscience at Zhejiang University, said Wednesday in a post on Weibo, China's microblogging website, where he has about 500,000 followers. "This is the first time that I've found unmistakable evidence that human-to-human transmission of the new coronavirus has been intentionally hidden," he wrote in the post which has since been deleted.



*“My question is simple: Judging from the data in this paper, **the National Centers for Disease Control and Prevention already had clear evidence of human-to-human transmission as early as the first few days of January.** From then until Jan. 20, at what point was this information concealed,” Wang wrote on Weibo.*

The appointment of Li Keqiang as “coronavirus czar” raises obvious questions about the severity of the situation...

[China’s Xi Gives His No. 2 a Rare Chance to Shine in Coronavirus Fight, With Risks for Both](#)

The move turns a rare spotlight on Mr. Li, who was once seen as a potential force for liberalization until he was sidelined by Mr. Xi. The premier could now be remembered as the hero of the crisis, his legacy defined by images of his visit on Monday to Wuhan, the quarantined city where the epidemic first emerged.

If Beijing’s efforts to contain the virus fail, however, Mr. Xi could seek to insulate himself from public anger by making Mr. Li take the blame, tarnishing the premier’s reputation—even if Mr. Li is unlikely to face any formal penalty, political observers said.

[Huawei](#)

It was another in a string of bad weeks for the China hawks. The UK’s decision to allow Huawei into the “non-core” aspects of its 5G network is unfathomable from a security perspective, and highlights the degree to which China has established vectors of influence in western governments.

China hawks retain some hope that a parliamentary revolt might yet derail the Huawei plans, but it seems a stretch to expect Conservative backbenchers to deal the new government such a high-profile defeat...

[Why There’s Tory Trouble Afoot For Boris Johnson Over His Huawei Decision](#)

Tory backbenchers see a glimmer of hope in the fact that this decision is now subject to primary legislation (until a new law is passed, the policy operates through GCHQ guidance to the phone industry).

*“**This is not the end,**” one MP told me. “This was not a defeat, we will have legislation that can be amended. We are not having our tummy tickled. And we are regrouping.”*



Even with a majority of 80, potential rebels think there may be 40 Tory MPs ready to back an amendment that reduced that 35% to a lower figure. Labour and the SNP, who were both very down on the idea of cost-cutting coming before long-term security, could easily ally with Tory MPs. I know it sounds far-fetched now, but I also wouldn't rule out resignations from government.

Perhaps the U.S. is resisting bringing the hammer down on the U.K. so as not to upset the machinations of rebel MP's who hope to overturn the decision. Or perhaps the U.S. threats to halt intelligence sharing and hold up a free trade agreement were simply empty all along. I fear the latter...

[Pompeo Brushes Off Tensions to Hand Johnson a Brexit Trade Boost](#)

"We intend to put the United Kingdom at the front of the line" for a free trade deal, Pompeo said, speaking alongside British Foreign Secretary Dominic Raab at the Policy Exchange think tank in London. "We intend to continue to take the relationship, which we think is in a fantastic place today and put it in an even better place in the weeks, months and years ahead."

But relations between Washington and London have been dogged by friction in recent months on issues including how to manage Iran's nuclear ambitions, the involvement of a U.S. diplomat's wife in a fatal U.K. car crash, Johnson's plan to impose a digital tax on U.S. technology giants, and the use of technology from Chinese company Huawei Technologies Co. in telecommunications networks -- something Pompeo has regularly warned the British government not to allow.

Pompeo's friendly words will be seen as a welcome shift in tone in Downing Street.

"It's your best friends you call up and say 'what the heck are you doing?'" Pompeo said. "You can't have those conversations without a deep relationship, because if you have them with people you don't have that type of relationship with, you risk the relationship. This relationship is not at risk."

This was the U.S. National Security Advisor on Wednesday:

**O'BRIEN SAYS 'VERY BAD IDEA' FOR UK TO ALLOW HUAWEI IN 5G*



- *U.S. HAS 'VERY GOOD RELATIONSHIP' WITH U.K., O'BRIEN SAYS*
- *U.S. MAY HAVE TO ADJUST HOW IT COMMUNICATES WITH U.K.: O'BRIEN*
- *U.S. WILL 'SEND COURIERS WITH PAPER' TO U.K. IF NEEDED: O'BRIEN*

Right, so if the 5G network is insecure, there's always carrier pigeons, I guess. All of this bodes poorly for those Germans hoping to defend the security of their network...

[As Britain decides, Europe grapples with Huawei conundrum](#)

In Germany, Chancellor Angela Merkel's preference for applying the same rules to all equipment vendors faces growing resistance from lawmakers in her own party, who back U.S. calls to ban Huawei outright.

...lawmakers across party lines are challenging Merkel's pragmatism. They agree with the Donald Trump administration's arguments that Huawei can't be trusted because it is beholden to the Chinese government. Huawei denies this.

Merkel has called for a time-out on the domestic debate ahead of a March EU summit...

Concerns expressed by Germany's powerful car industry that a Huawei ban could provoke trade retaliation from China - its largest export market - have influenced the thinking of Merkel and senior aides.

Operators Deutsche Telekom, Vodafone and Telefonica are all Huawei clients. They warn that replacing its kit could cost billions of euros, on top of heavy outlays for German 5G spectrum at auction last year.

More broadly, Europe has emerged as a battleground in the technology 'Cold War' playing out between China and Washington. Huawei's European competitors, Ericsson and Nokia, would become a supplier duopoly should the Chinese company be shut out.

It's amazing that the EU is passing up an opportunity to set up Ericsson and Nokia as a Western duopoly supplier of next-gen communication equipment, but such is the power and reach of China's influence.

But no worries, the EU has a "toolbox"...

[No pan-EU Huawei ban as Commission endorses 5G risk mitigation plan](#)

The European Commission has endorsed a risk mitigation approach to managing 5G rollouts across the bloc — meaning there will be no pan-EU ban on Huawei. Rather it's



calling for Member States to coordinate and implement a package of “mitigating measures” in a 5G toolbox it announced last October and has endorsed today.

“Through the toolbox, the Member States are committing to move forward in a joint manner based on an objective assessment of identified risks and proportionate mitigating measures,” it writes in a press release.

It adds that Member States have agreed to “strengthen security requirements, to assess the risk profiles of suppliers, to apply relevant restrictions for suppliers considered to be high risk including necessary exclusions for key assets considered as critical and sensitive (such as the core network functions), and to have strategies in place to ensure the diversification of vendors”.

“Strengthen requirements,” “assess the risk,” “have strategies in place” – the verbiage is so vapid it’s as if the CCP wrote it itself.

Apparently it didn’t matter that the U.S. presented the U.K. and Germany with evidence of Huawei’s connection to China’s security apparatus that Handelsblatt called a “smoking gun.”

[5G-Debatte: „Smoking gun“: Streit um Beweise gegen Huawei](#)

*The Federal Government apparently knows far more about Huawei's intelligence contacts than it communicates publicly. "At the end of 2019, **we received U.S. intelligence that Huawei has been proven to work with China's security agencies,**" it said.*

The State Department picks up on the Americans' wording that the evidence is a smoking gun, which is clear evidence. In terms of content, the "intelligence information" is no longer carried out. However, the Federal Foreign Office comes to the clear conclusion: "The trustworthiness of Chinese companies is not given in connection with the security requirements when building 5G networks."

This is the best piece I’ve read that describes, in layman’s terms, why keeping Huawei out of 5G infrastructure is so important. It’s not just the scope for capturing data. One day the Chinese are going to do something in Hong Kong, Taiwan or elsewhere that raises the ire of the U.K. government, and the Chinese will simply tell London “shut the hell up or we’ll turn out the lights over there.”

[5G choices: a pivotal moment in world affairs](#)



5G decisions reflect one of those quietly pivotal moments that crystallise a change in world affairs.

This is partly because the technology itself promises to be revolutionary, connecting not just humans but every device with a chip in it with super-fast, high-bandwidth and low-latency communications.

*That means if you have the keys to 5G networks, **you will be trusted with the nervous system running down the backbone of every country** which uses your gear and contracts you to service it. That includes critical infrastructure and safety-critical systems on which the lives and livelihoods of our citizens depend—traffic, power, water, food supply and hospitals.*

I was part of the team in the Australian Signals Directorate that tried to design a suite of cybersecurity controls that would give the government confidence that hostile intelligence services could not leverage their national vendors to gain access to our 5G networks.

We developed pages of cybersecurity mitigation measures to see if it was possible to prevent a sophisticated state actor from accessing our networks through a vendor. But we failed.

*The tools and language of traditional cybersecurity are ill-equipped to describe and manage a world in which the Chinese state entwines China's tech giants. Old-style cybersecurity evolved to deal with threats from outside the network. The ecosystem itself was trusted, and cybersecurity's job was limited to protecting that ecosystem from external bad actors. But none of this works if the threat is inside your network. In this new world, **no number of impressive-sounding mitigation measures or cybersecurity standards can provide confidence that your networks are fully protected.***

I find myself battling lately with a number of China hawks who retain faith in the Trump Administration to maintain its resolve in standing up to the CCP in the face of inevitably mounting costs. It looks to me like the Administration has gone wobbly. David Goldman expressed a similar sentiment in the Asia Times...

[Asia Times | Did the US just concede defeat in China tech war? | Article](#)

The Wall Street Journal this morning reported that the Defense Department blocked a long-signal change in export rules that would forbid US companies from selling components to Huawei from foreign subsidiaries if 10% of the content is derived from US technology. The Treasury Department reportedly backed the Pentagon's objections.



In related news, the United States has backed off from earlier threats to abandon a trade deal with Great Britain if Boris Johnson's government allowed Huawei to build part of its 5G network,

In an apparent break from the previous US position, Treasury Secretary Steven Mnuchin told an audience at Britain's Royal Institute of International Affairs on January 25 that the US might not oppose Huawei's participation in some parts of Britain's 5G network. Mnuchin said, "Which parts of the network it [Huawei 5G] goes into matters," according to a tweet by the RIAA's director Robin Niblett. "Is the Trump administration giving a sliver of manoeuvre to B Johnson?," Niblett added.

US technology companies, especially chip designers, sell the great majority of their products in Asia. China's chip design and manufacturing capacity is expanding rapidly with a blank check from Beijing, and US companies fear that Huawei and other Chinese companies will retaliate against US export controls with a price war for the high-end chips that power smartphones and servers. The Pentagon and Treasury objections to the proposed export controls indicate that the balance of power in the global chip industry has shifted towards China.

*This appears to be **an admission of defeat in the US-Chinese tech war**, which in the long term is far more important than the trade war. China seeks to dominate what it calls the Fourth Industrial Revolution centered on 5G and artificial intelligence. China is investing massively in its "Made in China 2025" plan to leapfrog the West in high technology, while US support for basic R&D is barely half of its Reagan-era level in proportion to GDP.*

Another data point suggesting that the Administration is standing down...

[U.S. lifts Iran sanctions on one unit of Chinese shipping giant COSCO](#)

The United States on Friday lifted sanctions on one of two units of the giant Chinese tanker company COSCO, the Treasury said, partially reversing its punishment to the company for transporting Iranian oil after China raised the issue in trade talks with Washington.

President Donald Trump's administration on Sept. 25 blacklisted two units of COSCO, named after the northeastern Chinese port of Dalian. The move sent worldwide freight costs to record highs and disrupted the global shipping market.



The U.S. Treasury Department said on Friday it deleted from its sanctions list COSCO Shipping Tanker (Dalian) Co, but continues to blacklist the second unit – COSCO Shipping Tanker (Dalian) Seaman & Ship Management Co Ltd.of COSCO.

A U.S. official said lifting sanctions on only one of the COSCO subsidiaries would allow the Trump administration to retain leverage on China and push COSCO to stop taking Iranian oil.

A top Chinese official had raised the COSCO issue in the U.S. trade talks, said one source who advises COSCO and is familiar with the Chinese government's position.

I was actually presenting to a China discussion group at the Harvard Club of New York the evening this news hit. The shock and horror was palpable. Just kidding – no one was surprised in the least actually...

[Harvard Chemistry Chairman Charged on Alleged Undisclosed Ties to China](#)

The chairman of Harvard University's chemistry department was arrested on charges of lying about receiving millions of dollars in Chinese funding, in an escalation of U.S. efforts to counter what officials said is a plot by Beijing to mine U.S. universities to catapult China to the forefront of scientific development.

A federal criminal complaint alleges that Charles Lieber, a pioneer in nanotechnology, misled the Defense Department and the National Institutes of Health about his participation in China's Thousand Talents Plan while the U.S. agencies were spending more than \$15 million to fund his research group in the U.S.

This op-ed from the Global Times was a real WTF...

[Tariff war risk may go beyond economic loss](#)

While the US' intention to continue hardball tactics might not be so surprising to many, the risk of carrying on the tariff war might have been underestimated. Many around the world have been focused primarily on the economic losses stemming from the trade wars, but the consequences could be far more dangerous than hundreds of billions of dollars lost for businesses and slower GDP for China, the US and the world.

If the US continues the tariff war, a trade decoupling, as many radical elements in the US are wishing for, could become reality. If the Chinese and US economies will no longer be



intertwined as they are now, things could easily get out of control for what is widely believed to be the world's most consequential bilateral relationship.

U.S. Policy & Politics

I'm not a huge Neel Kashkari fan, but he nails it here...



I'm not a huge Bill Dudley fan, but he nails it here...

Fed's Repo Response Isn't Fueling the Stock Market

But couldn't it be that the rise in bank reserves is increasing liquidity, fueling the equity market? The problem with this argument is that when the Fed buys T-bills and increases the amount of reserves in the banking system, that liquidity can't go elsewhere. It can move from bank to bank as households and businesses shift where they hold their bank balances. The only exception is if bank customers decide to increase their holdings of currency. But if they do that, that reduces the amount of excess reserves in the banking system.

The Fed's T-bill purchases substitute a bank reserve (essentially equivalent to a one-day T-bill) for a slightly longer risk-free asset (a T-bill) that the Fed now holds in its portfolio. But that's it. There are no funds created to purchase equities.

Yield Curve Control is a horrendous idea. Its popular to say "its' working OK in Japan," but it's quite likely that the neutral l/term rate in Japan is around current levels, in which case BoJ isn't actually manipulating the market much at all.

YCC at a non-neutral rate level however could be wildly destabilizing. If it "works" (raises inflation expectations) yields will see upward pressure and the Fed will have to buy more bonds, adding yet more liquidity. If the policy fails to eliminate deflationary pressure, yields



will want to fall and the Fed will have to sell bonds, withdrawing liquidity. I'm guessing the BoJ just got lucky in targeting a rate that has happened to be close to market-neutral...

[Fed Officials Weigh New Recession-Fighting Tool: Capping Treasury Yields](#)

At their October meeting, officials said they thought capping yields on short-to-intermediate-term securities could be an effective way to augment their other tools.

"Short-term yield-curve control is something that is worth looking at," said Fed Chairman Jerome Powell at a moderated discussion shortly before that meeting.

As the Bernie surge continues, it's helpful to keep in mind how quickly these campaigns can flame out once momentum starts to fade...

[How Iowa Could Decide Joe Biden's Fund-Raising Future](#)

DES MOINES — Joseph R. Biden Jr.'s campaign has quietly rolled back hundreds of thousands of dollars of television ad reservations in New Hampshire and South Carolina in recent weeks and redirected the funds to buy more ads in Iowa instead.

Mr. Biden's campaign and a super PAC supporting him are on pace to churn through nearly \$9 million on television ads in Iowa ahead of the caucuses on Monday, while spending virtually nothing so far in the other three states that vote in February.

The movement of money and energy into Iowa is a sign of not only the opportunity that Mr. Biden's campaign now sees here — he sits in second or first place in most polls — but also the acute risk for him, according to interviews with Democratic strategists, Biden fund-raisers and allies.

In Iowa, Mr. Biden is not just chasing votes and delegates. He's chasing cash.

***A disappointing finish in the state**, where there are four candidates bunched in the top tier in polls, **could dampen his fund-raising at a crucial juncture**. Candidates need resources to build up their operations in delegate-rich Super Tuesday states like California, where campaigning and ad rates can be prohibitively expensive and early voting begins next week.*