



DC in a Pickle on China and Weekend Links

I was honored to be invited to testify to the U.S.-China Economic and Security Review Commission this week on *“China’s Quest for Capital: Motivation, Methods, and Implications.”* Seems a bit dry, I know, but the topic in fact led to a wide-ranging, day-long discussion of the costs and benefits of deepening financial integration in the context of the broader U.S.-China relationship.

The Commission’s mission is “to monitor, investigate, and submit to congress an annual report on the national security implications of the bilateral trade and economic relationship between the United States and the People’s Republic of China, and to provide recommendations, where appropriate, to Congress for legislative and administrative action.”

The Commission is truly bipartisan, composed of 12 members – mostly ex-Congresspeople or high-level staffers – with 3 appointments accorded to the majority and minority leaders of each chamber of Congress.

And boy oh boy are they hawkish. By “hawkish,” I mean Bannon/Navarro-level hawkish. And by “they” I mean all of them.

That is not to say they all agree with the Bannon/Navarro prescriptions, or that there isn’t wide debate about the Trump Administration’s approach on trade and other issues. But they all share a deep concern for the challenges to our national and economic security posed by China’s deepening integration into the global economic system.

In short, it was my kind of audience!

Kidding aside, it is notable – having been doing China “bull-bear” debates for the better part of a decade – how dramatically the landscape has shifted. Defending the bear side used to feel like playing the heel at a WWF match. Now I’m getting tossed softballs, while the China bull is getting shot full of holes. It’s somewhat disorienting.

In an attempt to remain “outside the box,” I concluded my remarks with a recommendation to reduce our Phase Two trade demands to one “silver bullet” - to force the opening of China’s capital account - which one Commissioner remarked was “ingenious - but it’ll never happen.”

That summed up the day for me. The DC establishment has full appreciation of the pickle we’re in with China and there is no shortage of ideas for how we might rebalance the relationship so as to protect market capitalism. The problem is that we can’t actually execute on them.



For instance, there was widespread acknowledgement that the flow of hundreds of billions of dollars of index-driven portfolio capital to China is providing non-reciprocal benefit to an authoritarian system tottering for a lack of Dollars, and building a transmission channel for systemic risk to the U.S. in the event of a Chinese crisis. From the perspective of national and economic security, the Commission was in broad agreement that this is problematic.

As for what to do about it, not so much. On what basis is the federal government supposed to tell MSCI how to construct their indices? Is the government to outlaw the purchase of Dollar bond issuance from Chinese property companies because so-called experts like myself insist that on a timeframe relevant to national security they are assuredly destined to blow up?

More broadly, it's obvious that the Chinese have made political compliance from the NBA and others a requisite for doing business. How is a system based on the rule of law and free-market capitalism supposed to handle that? While it's good that we're finally engaging in the debate, our political establishment seems to be a very long way from devising adequate solutions to these questions.

And of course, each day we debate the cost of poker goes up. The rest of the world's financial exposure to China is growing rapidly. Increasingly, the question becomes "how on earth can we survive the economic fallout of a crisis in China?" Of course, on a time horizon relevant to national security policymakers the pertinent question is "how can we survive with China NOT having an economic crisis?"

I left DC pleased that these issues are at the forefront of the national debate. People are asking the right questions. But closing in the right answers will be no easy feat.

You can find the written testimony of all participants and the video of the hearing (3:39:00 for my remarks) [here](#)...

Huawei is of course at the epicenter of the debate...

[GOP rep introduces bill to block intelligence sharing with countries using Huawei for 5G](#)

Rep. Jim Banks (R-Ind.) introduced a bill Tuesday aimed at barring the United States from sharing intelligence with any countries that permit Huawei to operate their 5G networks.

"Huawei is a Trojan Horse for the Chinese Communist Party to spy on and infiltrate other nations. Our allies must choose: Adopt Huawei and lose access to U.S. intelligence, or remain our trusted partner," Banks said in a statement.



Proponents of the new bill — which include Rep. Liz Cheney (R-Wyo.) — argue that it's a necessary step to prevent the Chinese government from spying on the country, saying the company poses a risk to U.S. national security.

Cheney, a member of the House Armed Services Committee, also called on the United Kingdom to refrain from doing business with the telecommunications company, arguing it could strain relations between Washington and London.

"Huawei is controlled by the Chinese Communist Party and its efforts to infiltrate 5G are nefarious at their core. Allowing Huawei into the U.K.'s 5G networks would pose a national security threat that could not be mitigated or contained. Such a decision would necessarily have negative consequences for the U.S./U.K. relationship in many areas, including trade and intelligence cooperation," she said in a statement in support of the measure.

"I hope that the U.K. unites with the U.S. and other allies against the threat from Huawei," she added. "However, the U.S. must always be prepared to protect its national security interests."

The United Kingdom is expected to announce whether it will use Huawei in its 5G networks in coming weeks.

Sen. Tom Cotton (R-Ark.) recently introduced companion legislation in the Senate.

But the Executive Branch is sending mixed messages all of a sudden. Wilbur Ross says tightened restrictions are still in the hopper...

[New U.S. Limits on Huawei Suppliers Coming Soon, Ross Says](#)

Commerce Secretary Wilbur Ross said new rules are coming soon that will put more limits on U.S. companies supplying China's telecommunications leader Huawei Technologies Co.

"They are works in progress that will come out near-term," Ross said of the new restrictions, during an interview at the World Economic Forum in Davos, Switzerland. A Commerce Department spokesman said the department will make an announcement when it is ready.

But the WSJ is reporting the new rules have been "withdrawn." It's unclear if that means killed or simply pulled back in light of interagency haggling.



This particular objection stinks to high heaven. Is it really the place of the Defense Department to be concerned with the revenue of semiconductor companies? I would question their ability to determine that a 12% drop in Micron Tech revenues would have a negative effect on our national defense capacity.

(Also – slight non-sequitur – but Mnuchin is a globalist narc who has outlived his usefulness after getting the tax cut passed).

[Pentagon Blocks Clampdown on Huawei Sales](#)

The Commerce Department's efforts to tighten the noose on Huawei Technologies Co. is facing a formidable obstacle: the Pentagon.

Commerce officials have withdrawn proposed regulations making it harder for U.S. companies to sell to Huawei from their overseas facilities following objections from the Defense Department as well as the Treasury Department, people familiar with the matter said.

The Pentagon is concerned that if U.S. companies can't continue to ship to Huawei, they will lose a key source of revenue—depriving them of money for research and development needed to maintain a technological edge, the people said. The semiconductor industry has pressed that argument in talks with government officials.

Defense Secretary Mark Esper was asked about The Wall Street Journal's report in an appearance Friday at the Center for Strategic and International Studies in Washington.

"We have to be conscious of sustaining those [technology] companies' supply chains and those innovators," Mr. Esper said. "That's the balance we have to strike."

This derailment of these regs is really curious. I was told just yesterday by a contact in DC who is plugged in on this that the tightening strictures were a "done deal." Huawei seemed to be of a similar mind.

[Exclusive: Huawei stockpiles supplies, fearing new US tech ban](#)

*Huawei, the Chinese telecoms giant that Washington views as a global security threat, is scrambling to stockpile up to a year's worth of foreign supplies for its core telecoms equipment business ahead of a **widely-expected toughening of U.S. technology sanctions** that may come as soon as next month, multiple sources told the Nikkei Asian Review.*



*The new U.S. measures, which Huawei and its suppliers fear **could amount to a U.S. technology quarantine** of the world's largest telecoms equipment maker, underlines how the two countries' battle for global technological and military supremacy continues unabated even though Washington and Beijing signed a phase one trade deal last week.*

In a sign of how seriously Huawei is taking the risk of an outright U.S. ban, sources said the company, which has a roughly \$70 billion global procurement budget, was prioritizing inventory for its more strategic 4G and 5G routers, switches and base stations businesses over its smartphone operation.

It's a particularly bad time (or propitious if you're a semiconductor lobbyist) for the U.S. to be going wobbly on Huawei. The debate in Germany is really heating up...

[Merkel ally sees growing German support for tough Huawei stance](#)

*The groundswell of support in the CDU/CSU bloc for a tough line on Huawei means **a softer stance could struggle to find a majority in parliament**. Roettgen believed the government would come around to supporting a credibility test too.*

Take-up of 5G technology is expected to be on the agenda at the March EU summit. Roettgen wants the CDU/CSU parliamentary group to take a stance on Feb. 11 once the European Commission has issued its view at the end of this month.

[Minister: Germany needs China's Huawei to build 5G network](#)

Interior Minister Horst Seehofer, Germany's top security official, was quoted Saturday as saying he is "against taking a product off the market just because there is a possibility that something might happen."

Seehofer said Germany must be protected against espionage and sabotage, but estimated that shutting out Chinese providers could delay building the new network by five to 10 years, the daily Frankfurter Allgemeine Zeitung reported.

"I don't see that we can set up a 5G network in Germany in the short term without participation by Huawei," Seehofer told the newspaper.

The EU's recommendation is not binding, but clearly provides political support for appeasement...



[EU won't recommend banning Huawei in upcoming 5G risk rules](#)

The European Union will not explicitly ban Huawei Technologies or other 5G network equipment vendors when the bloc unveils guidelines for member states to mitigate security risks.

The EU will unveil a set of recommended measures that are “naturally strict and vigilant” at the end of January, European Digital Commissioner Thierry Breton said at a news conference in Paris on Monday. No companies will be explicitly excluded in the EU’s recommendations, he said.

The EU is limited in what it can tell its member states to do, however. Any decisions to ban companies for national security reasons rest with member states, and many operators in various European countries have already struck deals with Huawei on 5G.

[Blocking Huawei will harm China-UK relations: ambassador](#)

Refusing Huawei will severely harm China-UK relations and undermine Chinese companies' confidence in the British investment environment, Chinese Ambassador to the UK Liu Xiaoming told the Global Times on Monday

The Canadians are towing the line thus far....

[Rogers begins roll out of 5G network in major Canadian cities](#)

TORONTO (Reuters) - Rogers Communications Inc said on Wednesday it has started rolling out the fifth-generation (5G) telecoms network in some Canadian cities, becoming the country's first cellphone provider to offer the super-fast telecom services.

Rogers, one of Canada's largest wireless carriers, will launch first in downtown Vancouver, Toronto, Ottawa, and Montreal, before expanding into over 20 more markets by the end of the year, in advance of 5G-enabled devices becoming available this year, the statement added.

“5G is the biggest technological evolution since the launch of wireless in Canada. We are making the right investments, building the right partnerships and deploying the right technology to bring Canadians the very best of 5G,” said Joe Natale, chief executive of Rogers Communications.



Rogers has partnered with Sweden's Ericsson to provide the technology needed to build the network.

Canada is reviewing the security implications of 5G networks, including whether to allow China's Huawei Technologies to supply 5G network equipment.

On balance, **the Huawei news has tipped in a significantly bullish direction for China this week**, albeit lost in the bearish haze of the coronavirus....

Coronavirus

I know nothing about infectious disease. What I do know is how to tell is a Chinese Government official is lying: his lips are moving...

This from Bill Bishop's Sinocism newsletter on Thursday"

The disconnect in the People's Daily and CCTV Evening News continued Thursday. There was nothing on the front page of the Thursday People's Daily, and it was only the fifth story on the Thursday CCTV Evening News, after a report on Xi's speech at the State Council New Year's Banquet, a report on New Year cultural activities around the country, a happy report on new year's travel at the Beijing West train station, and a report on the rehearsals for the CCTV Spring Festival. Other CCTV News programs are reporting a lot on the outbreak.

*A CCTV Online paean to Xi's Yunnan trip used "people's leader" in what is really an unfortunate use of words given the situation: "The amiable image of the people's leader moved through the crowd and through the screen, **infecting everyone.**"*

This propaganda department disconnect is remarkable if predictable, but other Chinese media have been unleashed. How far they can push with accurate reporting before the censors pull them back is unclear, but the Party is trying to show there is transparency, though its credibility gap is so great that it is going to be hard to convince most people they are being told the true picture.

[China heads into Lunar New Year on shutdown as virus toll hits 26](#)

it was a "bit too early" to consider the outbreak a "Public Health Emergency of International Concern," WHO Emergency Committee panel chair Didier Houssin said after



the body met in Geneva. Such a designation would have required countries to step up the international response.

*"Make no mistake, though, **this is an emergency in China**," said WHO chief Tedros Adhanom Ghebreyesus.*

WTH are the odds of this being a coincidence? Confirmation of a link here could have market consequences beyond those related to the lost economic activity. It would be like the biohazard equivalent of Iran shooting down the Ukrainian jet...

[China was warned in 2017 that a deadly virus could escape its level 4 safety lab in Wuhan](#)

*As the Wuhan coronavirus outbreak escalates, **the only lab in China which is equipped to study and deal with such deadly and emerging infectious diseases is located in Wuhan -- the city where the virus first appeared.***

*The lab -- the Wuhan National Biosafety Laboratory (Level 4) of the Chinese Academy of Sciences -- works with and studies the world's most dangerous pathogens such as Severe Acute Respiratory Syndrome (SARS), and Ebola. However, **scientists had warned in 2017 that a dangerous virus could escape the lab.** According to Nature, some scientists outside China were worried about pathogens escaping, and the addition of a "biological dimension to geopolitical tensions" between China and other nations.*

"Tim Trevan, the founder of CHROME Biosafety and Biosecurity Consulting in Damascus, Maryland, says that an open culture is important to keeping BSL-4 labs safe, and he questions how easy this will be in China, where society emphasizes hierarchy," said the 2017 Nature article.

"Diversity of viewpoint, flat structures where everyone feels free to speak up and openness of information are important," he had told Nature.

In fact, the SARS virus had escaped from high-level containment facilities in Beijing multiple times, according to Richard Ebright, a molecular biologist at Rutgers University in Piscataway, New Jersey.

Currently, however, it is not suspected that the Wuhan lab has any connection with the new coronavirus outbreak.

The timing of the outbreak is terrible from a public health perspective, but of course also from



an economic one...

China's Economy May Suffer Knock as Deadly Virus Spreads

The [outbreak](#) of viral pneumonia that's spreading across China has raised concerns that the world's second-largest economy could take a hit as consumer confidence slumps, hurting retail sales and spending on travel, leisure and entertainment.

Share prices of Chinese airlines, travel and restaurant companies [dropped sharply](#) this week after the government confirmed that the disease, thought to be caused by a previously unknown type of [coronavirus](#), can be transmitted between humans and significantly raised the number of known cases and deaths. Now, economists are warning that consumption could suffer and dent economic growth in the first and second quarters of the year and prompt further policy easing by the government.

"If the pneumonia couldn't be contained in the short term, we expect China's retail sales, tourism, hotel and catering, travel activities likely to be hit, especially in Q1 and early Q2," UBS AG economists Zhang Ning and Wang Tao wrote in a Wednesday report. "Our forecast of a sequential growth rebound in Q1 and Q2 2020 would face some downside risk.

Q&A: WHO representative addresses China's new virus outbreak

Q: TO CONTAIN AN OUTBREAK, IS THIS KIND OF TRAVEL BAN USUALLY EFFECTIVE? WHAT ARE THE BENEFITS AND SOME OF THE PITFALLS?

A: To my knowledge, *trying to contain a city of 11 million people is new to science.* It has not been tried before as a public health measure, so we cannot at this stage say it will or will not work. If this is happening we will note carefully to what extent it is maintained and how long it can take. There are pros and cons to such a decision. Such a decision obviously has social and economic impacts that are considerable. On the other hand, it demonstrates a very strong public health commitment and a willingness to take dramatic action. It sends a message to Wuhan, to China and to the rest of the countries. It remains to be seen what its effect will be.

Q: WE'VE SEEN MODELING AND EXPERTS SAYING THAT THERE WILL EVENTUALLY BE THOUSANDS OF CASES. HOW SERIOUS IS THIS GOING TO GET?

A: *The numbers of cases are not in themselves a measure of seriousness.* ... One of the patterns that we have seen is that as milder cases are detected, there has been a



reduction in the percentage of the rate of people dying but it is too early to reach a full conclusion. We are now daily hearing of massive increases in the numbers. Part of that increase is coming from the processing of specimens earlier. Another part is a broadening of the case definition. So numbers are going to increase. Even if they are in the thousands, this would not surprise us. That is not an indicator of seriousness. Indeed it is very, very good to get and identify as many cases as possible.

Q1 Reflation Trade Update

On January 16th I wrote"

Last week's The Q1 Reflation Trade lays out the liquidity indicators I'm watching like the proverbial cyclops with a monocle. They don't yet provide great assurance that the Fed has gotten itself into a sufficiently accommodative position to avoid a further deceleration in growth. I am reducing my long equity exposure somewhat, given the lack of confirmation of improved liquidity conditions. It's still a bull market, of course.

As of now, **consider me OUT**. I am off the "reflation trade" until further notice in light of the putrescence emanating from DXY and the Treasury market. Even when all the news was coming up roses around the Phase One signing, **Treasury yields refused to confirm market expectations of an acceleration in growth.**

Now the curve is re-flattening, 10y break-evens are back below 1.70%, and EURUSD is threatening to break 1.10. **Equity markets are seriously stretched relative to the message emanating from reliable indicators of a deterioration on liquidity conditions.** I've cut all tactical long-equity risk and USDCNH is to be traded from the long side from here.

And NO, the Fed is NOT doing QE!

Far more people are getting this wrong than right. Therein lies an opportunity perhaps...

[QE or not QE? Why the Fed is struggling with its message](#)

Wrong:

Many investors were dubious then, and are still dubious now. "I think it is QE," said Koon Chow, a strategist at Union Bancaire Privée. "It might not be explicitly recognised as QE — but it is QE."

Wrong, and he really should know better:



Dallas Fed president Robert Kaplan admits there may be some unintended consequences to the central bank's repo fix. "On the one hand this is not QE, but I think it is having some QE-like effects," he told the Financial Times last week.

Bingo:

"They are not doing QE but the market doesn't believe them," said Priya Misra, an interest rate strategist at TD Securities. "[Investors] are saying it looks like QE, smells like QE, so therefore why is it not QE? It's a tough one for the Fed to push back on."

Wrong in the most elemental fashion. This is exactly the issue I was harping on in [last week's IOER rant](#) – the Fed is NOT “adding cash”...

It could simply be that the Fed is removing Treasuries from the market at the same time as adding cash, said Matt King, a strategist at Citigroup. Investors have to put this cash somewhere...

If I'm right about a deterioration in liquidity conditions, this window for EM easing could shut more quickly and forcefully than many expect ...

[Emerging market rate cuts prompt rethink on outlook](#)

Unexpected interest rate cuts in Malaysia and South Africa have raised the prospect of further monetary policy easing across emerging markets, as policymakers aim to shore up faltering economic growth.

I offer no particular insights into Russia, but that this is the kind of situation that seems particularly vulnerable to correction if the recent trend towards Dollar strength and US yield curve flattening extends materially...

[Russia's rally puts it back on the radar for global fund managers](#)

Luis Costa, head of European emerging markets strategy at Citi, describes a "special cocktail" to attract investors: positive growth, inflation under 4%, a current account surplus and \$542bn in foreign exchange reserves.

Other analysts continue to tread cautiously. "There are limits on the potential growth Russia can generate," said Magdalena Polan, senior economist at Legal & General Investment Management. "Despite a lot of talk and plans drafted in the past, there hasn't



been much investment in shifting the economy away from commodities.”

“The ship is safe and secure but not moving forward,” Russia’s deputy finance minister Alexei Moiseev said in October. “That is the problem”.

“We’re looking for corporate governance, which is really important for protecting minority shareholders — that’s why we really struggle in Russia,” said Rob Marshall-Lee, an emerging-markets portfolio manager at Newton Investment Management. “There’s every prospect of the rally continuing for a little while, but with growth not very strong and governance poor it’s unlikely it will last.”

I know Hong Kong has gotten plenty of attention, but I feel there is still insufficient appreciation for how vulnerable that economy is....

[Hong Kong protests sink retail property transactions to record low](#)

Hong Kong’s commercial and industrial property transaction volumes fell to the lowest level last year since record-keeping started in 1996, sinking nearly 50% year on year, as investor sentiment took a beating since the anti-government protests started last June.

Good chance for a brief, irrational freakout in Italian bonds at some point...

[Italy Prepares Itself for Prime Minister Matteo Salvini](#)

The Emilia-Romagna region has supported the left since World War Two — even as the rest of Italy backed a succession of Christian Democrat leaders or Silvio Berlusconi. “Red Emilia,” Italy’s sixth-largest region by population and one of its wealthiest, has also been one of the left’s most reliable financial coffers. Traditionally, it would have been less of a surprise for Boston in the U.S. to vote Republican than for Emilia to pick a conservative regional governor.

Yet Salvini’s League and its right-wing partners are neck-and-neck with the Democratic Party ahead of a crucial regional vote on Sunday. A win would be Salvini’s most symbolically important electoral triumph to date, and cement his role as Italy’s prime-minister-in-waiting. It would also make it much harder for his opponents to keep him out of office.

The governing coalition will try desperately to stick together to prevent new national elections, but the pieces are already falling. Luigi Di Maio is quitting as Five Star’s leader



after a string of electoral disappointments, and ahead of the Emilia-Romagna result.

Speaking of irrational freakouts...

[A thousand EU financial firms plan to open UK offices after Brexit](#)

More than a thousand banks, asset managers, payments companies and insurers in the European Union plan to open offices in post-Brexit Britain so they can continue serving UK clients, regulatory consultancy Bovill said on Monday.

The new offices and staff will help mitigate the loss of business going the other way as the current unfettered two-way direct access between Britain and the EU comes to an end in December following a Brexit transition period.

As a first step, the companies, who until now have been able to serve UK customers directly from their home base, have applied for temporary permission to operate in Britain after Jan. 31 when the UK leaves the bloc, Bovill said, using figures obtained from Britain's Financial Conduct Authority.

"These figures clearly show that many firms see the UK as Europe's premier financial services hub," said Michael Johnson, a consultant at Bovill.

U.S. Politics

I noted a few weeks back in this space that people seemed to be sleeping on Bernie. Well, they're starting to wake up and they're not in a good mood. A full "anybody but Bernie" movement by the Dem establishment is increasing in likelihood...

[What Polling Tells Us About Bernie Sanders's Chances](#)

At this point in 2016, Bernie Sanders was competitive in Iowa but had no clear path to the nomination. Four years later, he finds himself in an enviable position: rising in the polls, enjoying the most resources, and facing relatively few attacks from his campaign rivals.

A CNN/SSRS poll on Wednesday found him leading Joe Biden nationwide, 27% to 24%. In an average of polls, Mr. Biden still leads by about six percentage points, but his advantage over Mr. Sanders has been cut in half over the last three months.

Mr. Sanders's position may be even better in the early states. The Selzer poll, Iowa's most



highly awaited survey, shows him with a narrow lead in Iowa. Other polls show him gaining, though split on exactly where he stands in a divided field. He also remains well positioned in New Hampshire, giving him a chance to sweep the two early states.

Large elements of the Democratic establishment strongly oppose Mr. Sanders, who is not a Democrat, raising the possibility of a vigorous campaign to stop him if he emerges as a front-runner. But it is clear that if he wins the early states, he will not face the obstacles that made it all but impossible for him to win the nomination in 2016.

Mr. Sanders faces fewer obstacles than he did in 2016. Hillary Clinton was a juggernaut who consistently held around 50 percent support in national polls throughout the race and an overwhelming lead among black voters.

This time, it's conceivable that Mr. Sanders will face a split field after Iowa and New Hampshire, with as many as four rivals positioned to claim a strong showing in the two early states and with Mr. Bloomberg spending hundreds of millions of dollars on his own behalf.

Mr. Sanders's position among nonwhite voters is also better today than it was in 2016. Polls suggest he [is leading](#) among Hispanic voters, who will play a meaningful role in Texas and California on Super Tuesday.

He still trails Mr. Biden among black voters, but he is far more competitive among them than he was four years ago. A recent Washington Post/Ipsos poll gave Mr. Biden a lead of 48% to 20% lead among black voters, less than Mrs. Clinton's commanding 80-20 advantage.

A staunch Republican friend of mine is freaking out about Mini Mike buying the nomination and then presenting a formidable challenge to Trump (which he would). His path seems obvious: Biden falters and Bloomberg becomes the "anybody but Bernie." Could the Trump camp be having second thoughts about torching Biden too early?

[Rival Campaigns Are Starting to Take Bloomberg Very Seriously](#)

the Bloomberg path still remains predicated on a series of unlikely events: that no actual candidate emerges from the first four primary states and that former Vice President Joe Biden ends up dramatically weakened by a poor showing in those contests. Should that be the case—the theory goes—Bloomberg's ad spending in other states would propel him in the polls, turn him into the moderate alternative that Biden was supposed to be, and help him eke it out in a contested convention.

