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

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Markets in High Resolution

Phase One Leads to a Huawei Crossroad

Who said this on CNBC Wednesday morning?

"The central thing we want is basically to merge the industrial economies of the West with China's."

Was it:

a) Steve Mnuchin
b) Xi Jinping
c) Stephen Roach
d) Steve Bannon

The answer of course is d) – the very same Steve Bannon who was the driving force behind *The Committee on the Present Danger: China*. THAT Steve Bannon.

Along similar lines, this was President Trump at the Phase One signing ceremony:

> *As we move on to phase two, I look forward to continuing to forge a future of greater harmony, prosperity, and, really, commerce — commerce and — far beyond commerce, between the United States and China. This is something that — far beyond even this deal — it's going to lead to an even stronger world peace.*
>
> *We now have — we now have a big investment in each other and in getting along with each other.*

Peace on earth, good will towards men. Kumbaya.

A Confusing Dissonance: The Phase One Panda Hug & Techno-Decoupling

Then again, on Tuesday Reuters reported that:

> *The U.S. government is nearing publication of a rule that would vastly expand its powers to block shipments of foreign-made goods to China's Huawei, as it seeks to squeeze the blacklisted telecoms company*
>
> *Under current regulations, the United States can require a license or block the export of many high-tech products shipped to China from other countries if U.S.-made components make up more than 25% of the value.*

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> *According to two people familiar with the matter, Commerce has drafted a rule that would lower the threshold only on exports to Huawei to 10% and expand the purview to include non-technical goods like consumer electronics including non-sensitive chips.*

It is not possible to force a decoupling in tech standards while fostering integration in trade and manufacturing. The two are incompatible. So which is it – **are we decoupling or not?**

Whether the Administration follows through with tightening the noose on Huawei will provide an **important clue** as to whether Phase One is just a ploy by President Trump to turn down the heat on the increasingly jumpy frog in the decoupling pot, or whether the decoupling threat was a bluff all along.

One interesting aspect of the Phase One section on forced technology transfer suggests **the U.S. is still pushing hard against "Made in China 2025**," or whatever the Chinese are not calling it these days:

> *A Party shall not support or direct the outbound foreign direct investment activities of its persons aimed at acquiring foreign technology with respect to sectors and industries targeted by its industrial plans that create distortion.*

The U.S. assesses such investment into the U.S. through the CFIUS process (Committee on Foreign Investment into the U.S.). Phase One appears to arm the U.S. with **CFIUIS-like veto power over Chinese M&A anywhere in the world**! (The recent case of the U.S. pressuring the Dutch over the sale of sensitive chip technology shows the U.S. is already wielding such power in an ad hoc fashion).

Huawei is now the swing variable in U.S.-China relations, with decisions on the company's inclusion in 5G development due in coming weeks in both the U.K. and Germany (and it can't help Huawei's cause that the Germans just raided three alleged Chinese spies).

BoJo and Merkel Will Judge Phase One

Until the fate of Huawei is clarified, it is **premature to assess who "won" Phase One**.

If the U.K and Germany allow Huawei into their 5G networks it would indicate the U.S. lacks the international backing for techno-decoupling, which in turn undercuts the threat of trade decoupling. In this case, China can slow-walk its Phase One purchases, push hard for more tariff rollback and comfortably wait to see who wins in November.

If, on the other hand (and as I expect) Huawei is excluded from the UK and German networks, the U.S. will really have the whip hand in the bilateral relationship. In this case, geopolitical

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quiescence would require China to:

- Accept Huawei's impairment and the threat of techno-decoupling
- Obsequiously increase U.S. purchases as ordered
- Let Trump keep the bulk of his tariffs in place

I don't see Xi Jinping taking all that sitting down, China's economic vulnerability notwithstanding.

In this scenario I would expect **overt non-compliance** with Phase One and acquiescence to a "market-driven" **weakening of the RMB**. If Xi Jinping is going to be techno-decoupled AND slapped around like a misbehaving child on trade, what the heck does he need with Donald Trump's re-election?

What seems unlikely in any scenario is China's enthusiastic fulfillment of its Phase One commitments. The absence of both the President and Prime Minister at today's signing event is a clear sign that **China is not a willing partner** to this deal. They'll comply only to the extent that circumstances dictate that compliance is their least bad option.

Phase-One is Well-Designed to Get Us Through November

That said, the Phase One agreement is a well-designed punt. That a **firm assessment of China's compliance is next to impossible prior to November** is a feature, not a bug.

Take, for instance the purchase commitments that conveniently "ramp up" to $200bn over two years with a total of only $76.7bn in year one.

- **$18.5bn in energy and $12.5bn in Ag** are easy. They can divert demand from elsewhere and if need be they can over-purchase and store or re-sell non-perishables.

- **$12.8bn in services** includes incremental financial services business *in China* which is purely a function of China allocating requisite market share.

- **$32.9bn in manufactured goods** might be a stretch, but it includes a fudge factor - both **orders** and deliveries of aircraft will count.

Not to say China can or will reach these benchmarks, but it will be **easy for them to show sufficient progress** between now and November to avoid any accusations of non-compliance.

China's soybean purchases, for which there is timely, high-frequency data, provide a simple barometer by which to measure China's enthusiasm for meeting its purchase commitments. If China is serious about compliance, **this metric should ramp up hard in coming weeks**.

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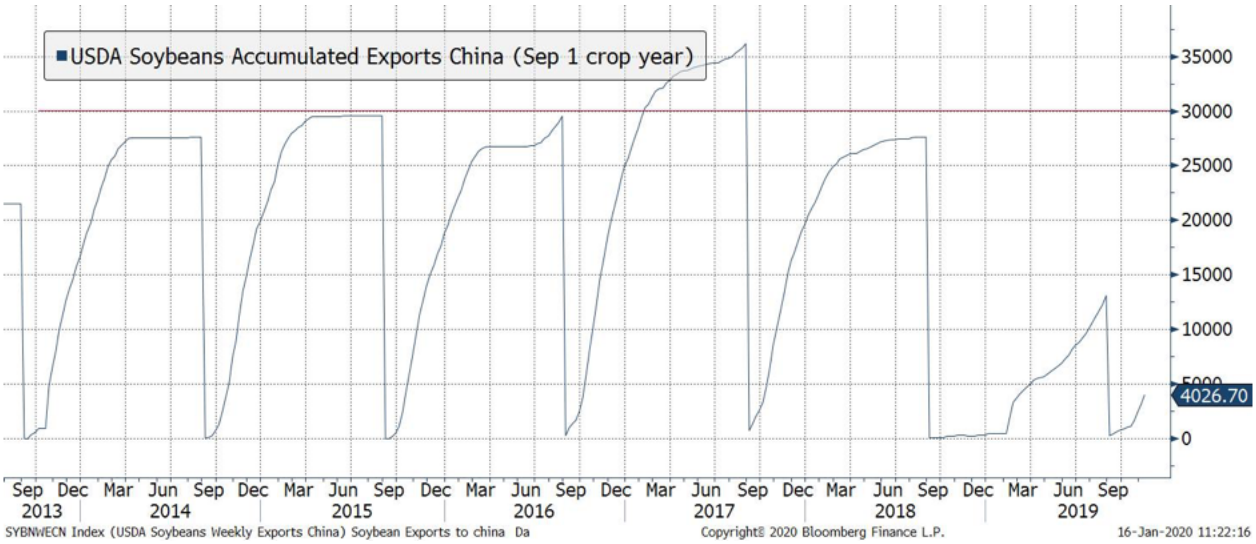

<u>IP Theft and Tech Transfer – It Doesn't Really Matter</u>

While skepticism is justified given China's compliance history, the **agreements on IP protection and tech transfer are not insignificant**. There are certainly aspects of the deal that, if enforced, would benefit U.S. companies doing business in China. However, while IP theft and forced tech transfer are real problems, **they pale in importance** relative to the endemic features of central planning – subsidy, implicit guarantee, non-tariff barriers – that are left for Phase Two.

But the details are not terribly relevant anyway, as the deal is **not meant to be publicly assessed prior to the U.S. Presidential election**. It would be absolutely shocking if we were to hear about any kind of enforcement action between now and November.

After the election we're either going to get a historical Phase Two agreement that breaks down the vestiges of China's centrally planned system and pushes the country towards true marketization, or we're not. (Pro tip: we're not). In neither case is the substance of the Phase One agreement of particular relevance.

<u>What Comes Next: Looking for Bigfoot</u>

As noted, the UK and German decisions on Huawei set up as watershed events in U.S.-China relations. And the market will be watching China's purchase of soybeans and other commodities to assess the degree to which Phase One is a sustainable.

But behind the scenes **a more critical monitoring process** will be taking place. Phase One will

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serve as a test for the so-called reformers in Beijing. As USTR Lighthizer puts it, Phase One "will work if the reformers in China want it to work."

I liken economic reformers in China to Bigfoot. While there here have been numerous reported sightings, I have personally yet to see any firm evidence they exist.

With Phase One, the China doves are in the ascendency. Peter Navarro was supposedly seated in the back row at yesterday's signing ceremony. Secretary Mnuchin, on the other hand, is already talking about slicing Phase Two into bite-sized pieces – 2a, 2b, 2c – so as to facilitate capitulation via sequenced tariff rollbacks (though I've yet to hear this formulation echoed by other officials).

Whether President Trump is simply acting out of political expediency, or genuinely believes in Bigfoot, I couldn't guess. But China's adherence to its Phase One commitments will be critical in determining whether Phase Two negotiations are undertaken in earnest or prove just a pro forma step before proceeding to the next round of decoupling.

The Big Picture

To provide some perspective on the daunting challenge a Phase Two deal presents, the U.S., EU and Japan this week reached agreement on a proposal to dramatically stiffen the WTO rules on subsidies. The agreement reads:

1. *The current list of prohibited subsidies provided for in Article 3.1 of the Agreement on Subsidies and Countervailing Measures (ASCM) is insufficient to tackle market and trade distorting subsidization existing in certain jurisdictions. Therefore, new types of unconditionally prohibited subsidies need to be added to the ASCM. These are:*

    1. *unlimited guarantees;*
    2. *subsidies to an insolvent or ailing enterprise in the absence of a credible restructuring plan;*
    3. *subsidies to enterprises unable to obtain long-term financing or investment from independent commercial sources operating in sectors or industries in overcapacity;*
    4. *certain direct forgiveness of debt.*

Bigfoot is one thing. But this is a full-on Santa Claus list right here. Never mind that removing guarantees and halting the facilitation of zombie debt rollover would result in an immediate financial meltdown. But the State-directed allocation of credit to favored industries is at the core of China's system of economic management. Central planning is what Communists do.

While it's conventional wisdom that there will be no Phase Two, I'm not sure that's correct.

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There will be no *credible* Phase Two. But we can't discount the possibility that if decoupling is rejected out of hand, the U.S. might fall back into yet another multiyear, multilateral exercise in futility under the rubric of "Phase Two." (This is the base case in a Biden or Bloomberg Administration).

Market Tactics

- **China tail risk is removed for now**, but could easily return if China loses the Huawei battle in Europe and/or China's purchases are noticeably lacking in coming months
- The **"Q1 Reflation Trade" has unfolded** largely as expected, although the bout of **Dollar weakness** I anticipated as a driver of EM outperformances has **yet to materialize**.
- 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.
- USDCNH trades nicely offered, although with the Dollar remaining broadly strong I fear I am getting greedy in remaining long of a currency I structurally hate. I am **reducing my core USDCNH short** and looking to trade it more tactically - though still with a short bias – from here.