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Markets in High Resolution

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Virus & Various

“The Virus is Temporary”

Well, of course the disruption is “temporary.” Humankind is going to outlast the Coronavirus.

That does not mean this episode can’t have lasting economic effects. Leverage increases not only potential return on capital, but also the “risk of ruin.” For any entity that is highly-levered, **a “temporary” disruption can become permanent if it results in bankruptcy**.

Clearly, Covid-19 has jumped the firewall and is spreading outside of China. I’ll leave the guesswork on that to others, but the obvious takeaway is that the wider the spread, the more pernicious the potential supply-chain disruptions and the greater the risk of reflexively amplifying the economic effects, through suppressed global trade and the decreasing benefit of supply chain diversification. **The economic damage will grow non-linearly with the spread** of the virus.

Systemic Risk in China

From the leverage perspective, China is particularly poorly placed to weather a significant unforeseen disruption (although Europe isn’t in great shape either from an economic perspective).

With the Chinese government seen as standing behind all systemic liabilities (albeit increasingly selectively), we can **think of the Chinese financial system as one big State bank**. While PBoC can provide unlimited RMB liquidity support, the **FX reserves serves as the “equity capital base”** – the store of hard currency providing credibility that the State can in fact stand by its liability guarantees *in real terms* (pro tip: it can’t).

The August 2015 peg break was taken as a sign of an impending haircut (via devaluation) on RMB liabilities, which generated a “run on the bank” – i.e. capital flight - as economic actors scrambled for a piece of that “equity.” China survived that near-death experience with the Fed’s help in 2016, and has held things together since with increasingly draconian restrictions on FX market access. However, since that 2015 episode, **credit outstanding has increased by over 100T RMB** while FX reserves have flatlined.

“Bank CCP” is far more heavily levered than it was five years ago and is now faced with the prospect of its own “subprime crisis” if the economy isn’t kicked into gear, pronto.

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Quick Virus Update

No, I don't believe the Chinese data. In recent days, we've learned of five Chinese prisons suffering outbreaks totaling over 500 cases; we've had a hospital epidemic in central Beijing shut down a district with 500k residents; we've had reports of two companies being shut down for infections, quarantining 100s of employees; and Harbin, in Northern China, has put four entire districts under lockdown. It defies credulity that there are now less than 10 new cases a day emerging outside of Hubei province.

Nonetheless, victory must be declared. Continued widespread lockdown presents an existential risk for the CCP. Here's the strategy as I discern it: claim that Xi has defeated the virus, push everyone back to work, hope that any outbreaks can be cordoned off and covered up, and pray like hell than an early spring knocks the thing down (as seems likely but by no means certain).

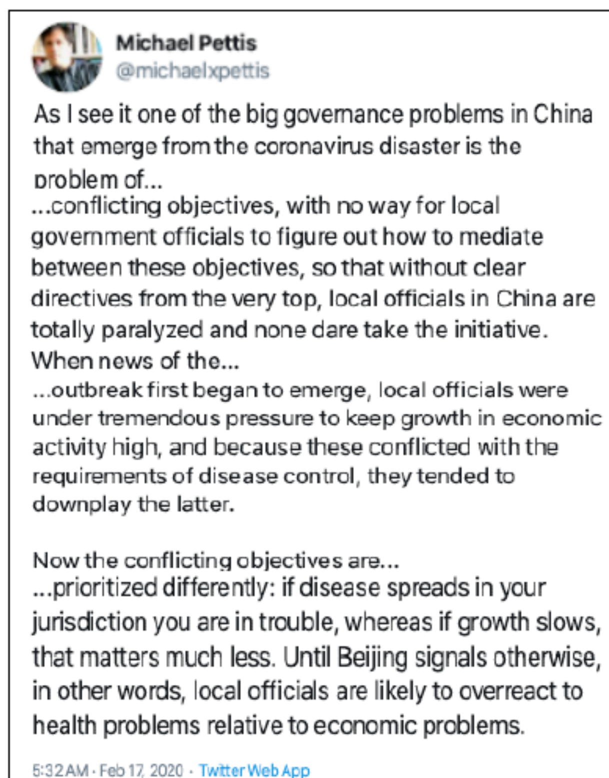
Governance Problems

"Declaring victory" entails two problems:

- Credibility: why should anyone believe them?
- The motivations of local officials have shifted

Xi Jinping is the master of incompatible objectives: control debt and hit the GDP target; liberalize the currency and balance the FX flows; get the economy running but don't let the virus break out.

That directive requires judgement as to the proper balance. After the purge of leadership in Hubei Province, local officials are likely to err on the side of caution. There will be safety in numbers for the economic underperformers. But a viral outbreak will put a target on your forehead.



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China Stimulus

Another tweet-thread from Pettis (highlights mine) encapsulates the **irrational stimulus enthusiasm** that has gripped Chinese asset markets. The virus is actually seen as *good for GDP growth*, because it will supposedly trigger a large infrastructure stimulus.

Yes, there will no doubt be a stream of project announcements – a perpetual feature of China's policymaking landscape. The problem, as always is in the financing. Chinese credit growth was near 12% last year and they still struggled to finance sufficient make-work investment to reach the GDP target.

This year, before they finance any infrastructure, the Chinese government is going to have to finance a massive subsidy program in some form to avoid widespread bankruptcy. I'm not sure why the market seems confused about this, but **China will require a large burst of credit merely to get back to "even"** with pre-virus economic conditions - that's before a single bridge, tunnel or airport is funded.

Last year, new credit in China totaled RMB 26.6T or $3.8T. **To generate a positive "credit impulse" in 2020, China will have to *first* fund the subsidization of lost industrial and service sector activity, and *then* generate in excess of $3.8T additional credit *on top of that.***

That ain't happenin'.

Michael Pettis
@michaelxpettis

Spending plans are starting to come in. Last night Beijing announced that it would push forward CNY 252.3 billion of urban projects, which "will include 100 infrastructure projects, 100 livelihood improvement projects and 100 high-tech industrial...
en.people.cn/n3/2020/0223/c...

11:08 PM · Feb 23, 2020 · Twitter Web Client

...projects." The fact that there are a perfectly round 100 of each type of project suggests that these were not developed organically based on what someone thought Beijing needed but are rather the result of someone ordering Beijing to come up with 100 of each.

Also last...

...night, I am being told (but haven't been able to confirm), Yunnan, one of the poorer Chinese provinces, with a population equal to about 3.5% of China's total population and a smaller GDP, announced CNY 3.6 trillion of infrastructure investment. This probably includes a...

...proposed Maglev train (estimated at CNY 100 billion). To get a sense of magnitude, CNY 3.6 trillion is roughly 4% of China's annual GDP, although I don't know if the spending plan is just for 2020.

We'll probably get more spending announcements in the next few days and...

...weeks. NDRC announced this morning that major economic targets (including the GDP growth target) will be met this year. With the opening of the spending floodgates, already some of my well-connected friends are betting that GDP growth this year will match or even exceed 2019.

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The Fed Can't Print a Vaccine

It's a funny line, and self-evidently true. But it's beside the point. While virus-related disruptions impose an adverse supply shock, **in the existence of high-leverage, a supply shock can easily morph into a deflationary demand shock** if perceived risks cause a contraction in financial liquidity (a la 2008). While demand stimulus can't address the real-side effects of the supply shock (i.e. it can't "print a vaccine") but can only serve to push prices higher, in the current context it would be far better to do so than to not.

I attended the Chicago Booth Monetary Forum on Friday, at which Clarida, Bostic, and Brainard spoke, among others. The take-away - a feature of the event for the past several years - is that in the absence of a formalized process for fiscal-monetary cooperation**, central banks are restricted to a set of sub-optimal tools at the zero lower bound**. There's high uncertainty about which ZLB tools actually work, how they work, and how they should be calibrated. For all the academic studies and musings by Fed Governors about novel, alternative approaches, the general sentiment is more along the lines of "**God, please don't make us go there again**."

All they can do to minimize the likelihood of "going there" again is to unleash their conventional weapon as effectively as possible. John Williams laid this out in a speech last year (HT Narayana Kocherlakota via Bloomberg yesterday):

> *"monetary policy can mitigate the effects of the ZLB in several ways: The first:* ***don't keep your powder dry****—that is, move more quickly to add monetary stimulus than you otherwise might. When the ZLB is nowhere in view, one can afford to move slowly and take a "wait and see" approach to gain additional clarity about potentially adverse economic developments. But not when interest rates are in the vicinity of the ZLB. In that case, you want to do the opposite, and* ***vaccinate against further ills****. When you only have so much stimulus at your disposal, it pays to act quickly to lower rates at the first sign of economic distress."*

Prescient wording there, perhaps. If the virus remains uncontained come March FOMC, **don't discount a 50bp rate cut** – it's all they've got, and it's better than nothing. Fed action won't fix the supply problem but **it would buoy markets** by cutting off the tail risk of compounding the supply shock with a deflationary liquidity event.

Tactical Recommendations

- U.S. indices are technically "broken" now – we're in the midst of another "vol episode" until some good news emerges on the virus or the Fed acts. Neither seems imminent: tactical trading should short-biased until further notice.

- It's not too late to get long USDCNH.

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