Daily Note

TRUMP'S CHRISTMAS GIFT TO XI

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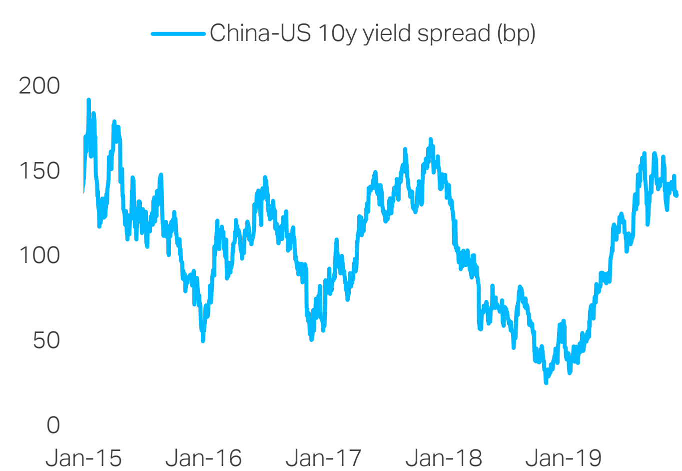
- **"The Phase 1" deal will likely hold until the US presidential election**
- **The underlying tensions will then re-emerge, but meanwhile …**
- **Expect a stronger yuan and stabilization in China's economy in 2020**

Just over two years ago, Donald Trump paid a "state visit plus" to China, heralding what was portrayed as a warmer chapter in relations between the two countries. Just three months later, the US President imposed the first set of tariffs on Chinese imports. Since then, financial markets have been buffeted between cycles of escalation and de-escalation in the deteriorating relationship of the world's two largest economies. But on Friday, Trump handed Beijing a major concession, rolling back some tariffs while forgoing earlier demands for China to adjust its economic practices. This should put to rest for the time being the "trade war" volatility factor in markets, which has become a dominant theme over the past year and a half. Still, as our head of Political Research Christopher Granville noted last week, "Our view on the US-China trade/tech war is tactically positive but strategically negative".

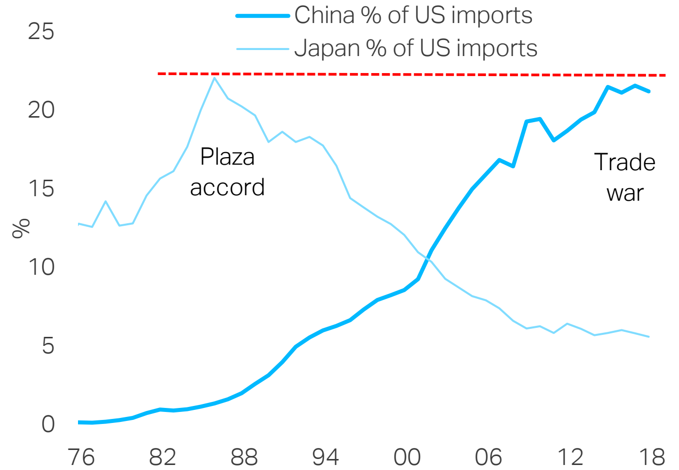
The text of the deal is yet to emerge, but joint statements from the US and China say it will cover four broad areas: (i) reduction in goods trade deficit; (ii) agreement to keep the yuan within a bounded range; (iii) improved IP protection and protection against forced technology transfer; and (iv) greater access to China's financial markets. There are no major discrepancies between the US and Chinese statements, as there have been on previous occasions. However, we are concerned that the detailed translation work has not been done. Procedural elements around

China-US spread should narrow



Source: Bloomberg

China similar to 1980's Japan (% US imports)



Source: CEIC; TS Lombard

the signing of the deal, such as translation or whether the deal should be implemented in a legal or regulatory framework, could lead to negotiations breaking down at the eleventh hour.

Despite these risks, we are not expecting a re-escalation between now and the US presidential election. The linkage between equity market performance and consumer confidence is particularly strong in the US, meaning reigniting tariffs would dampen the "feel good" sentiment before the vote. This "historic deal" is already being rightly criticized for, in effect, letting Beijing off the hook, but such criticism will not push the President into changing track before next year's ballot. The US electorate will be focused on other issues when it votes.

This brief interlude of calm for the China-US relationship presents some investment opportunities, particularly since the trajectory of the yuan will now be more stable. Our Macro Strategy team, reckoning that the spread between China and US 10y rates are near the top of its recent range, last week bought Chinese 10y local bonds funded with US 10y bonds (see left-hand-side chart above). The yuan breached the 7USD level in August, prompting White House accusations of "currency manipulation" and a deceleration in foreign purchases of CGBs. But as the currency stabilized, foreign investors picked up a record US$10bn worth of government debt in November. We are also forecasting a stabilization in the Chinese economy in 2020, so if the current truce is not broken, higher-yielding Chinese CGBs will grow in popularity, especially in an environment of low-yielding treasuries in developed markets.

This is a contest for global economic and political primacy, which will see an inexorable decline in China-US relations. While the deal looks set to hold until the 2020 election, its failure to address China's state industrial policy or data protectionist practices, as well as the unrealistic demands placed on Beijing to reduce the trade deficit, means it is likely to unravel soon after. Democrats and Republicans are deeply divided on almost all political issues, apart from China. Legislation attacking China's record on human rights and Hong Kong has breezed through Congress, while other initiatives have fallen victim to the legislative gridlock on Capitol Hill. A Democratic President would keep up the pressure on China to reform its economic practices and would probably be more vocal about Beijing's treatment of the Uighurs in Xinjiang.

The intent of waging the trade war was not just about reducing the trade deficit and bringing jobs back to the US but also about improving working conditions for foreign companies operating in China. Our conversations with foreign companies in China, as well as the series of negative reports from foreign commerce chambers, show that life is getting tougher for those firms - despite assurances from Beijing of better treatment. Apart from the few foreign companies identified by Beijing as helping in strategic industrial objectives, expanding business in the mainland is becoming harder. Added to this is the pressure of "patriotic purchasing", whereby the government promotes import substitution in the drive for economic self-reliance – in the latest move, foreign medical equipment providers have been taken off the approved list of suppliers sent to hospitals.

Trade wars take place against a backdrop of shrinking global commerce when tariffs can be explained as a push to gain a bigger slice of a shrinking pie. As Shweta Singh notes in our Global Fractures series, total trade has been shrinking since the global financial crisis, with the pullback linked to worsening credit conditions, which limits the ability of global value chains (GVCs) to grow. Shweta argues that since the crash, banking regulations and the dollar strength have placed constraints on the growth of more value-generating parts of global trade. So, while the "Phase 1" deal will bring some temporary relief for markets, the underlying political and economic dynamics that explain the origins of the trade conflict have not gone away.