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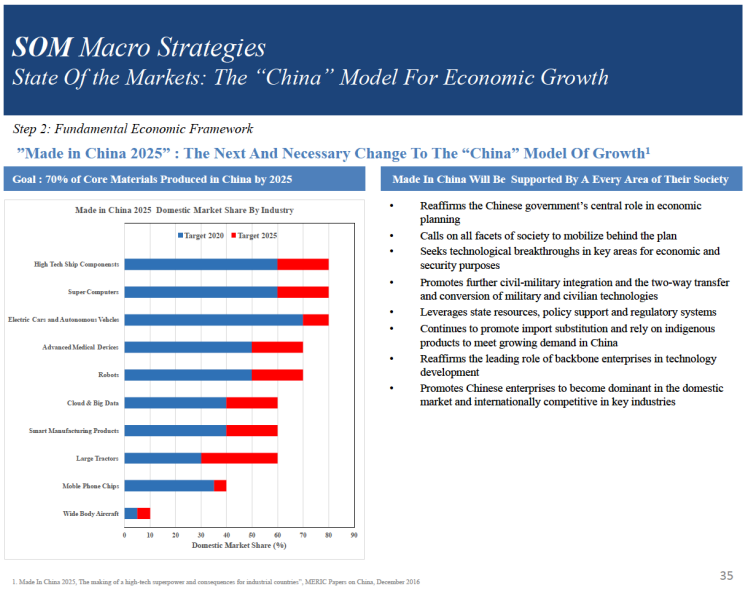
State Of the Markets: Macro Commentary

The China/US Economic War And Global Slowdown

Why I Think It is More Likely That There Is No Deal Between the US and China

As I have written about numerous times (look on my web site), I do not see the US and China coming to a substantive agreement anytime soon. At its core, the issue is about Chinas needs to move up the food chain into technology driven manufacturing to sustain their growth engine and the push back from the US about the method China is using to acquire this technology. From China's perspective this move into technology driven manufacturing is crucial for them to offset the negative headwinds from an aging population, low levels of productivity, and the ending of the trade engine in 2008. Their plan for developing this technology domestically is outlined in their "Built in China 2025" that they rolled out in 2015. Figure 1 outlines the plan and is taken from my SOM China Model Piece. The goal of this plan is having a significant portion of this high-end manufacturing being produced in domestically.

Figure 1



This includes airplanes, robotics, AI, electric cars. However, they are confronted with two key implementation problems. First, the time frame is short and even shorter now. And second, this technology is owned by the advanced economies, particularly the US. So, China's solution is to ramp up their acquisition of high-end technology harnessing all areas of their economy to basically steal it directly or indirectly. Not that they haven't stolen technology before but rather it is the scale of it that has created such a push back not just by the US but by the rest of the world. Consequently, the US and China need to come to an agreement in which the Chinese stop stealing and agree to be a verifiable enforcement mechanism, not called WTO. My view is that both of these issues are difficult to solve.

In addition, the pressure on Trump is not to come to a just any agreement with the China but rather to come to a substantive agreement. Such an agreement needs to include a reduction in stealing and one that will force China to really open up their economy to US companies. The allure of a 1.6 billion person China market open for US companies pushed the US to allow China into the WTO in the first place in 2001 and kept pressure on the US government to overlook Chinese violations of their WTO agreements, of which there were many since then. However, after 18 years, the allure is gone. First, major US

companies such as Facebook, Google, and Amazon are not really allowed into China. US super computer manufactures sold their local factories to Chinese competitor companies. The goods trade deficit with China is over $700 billion a year and growing. Second, both political parties have recognized the political power driven by resentment in the rust belt (swing voting states) from the loss of jobs and a good chunk of their economies to China.

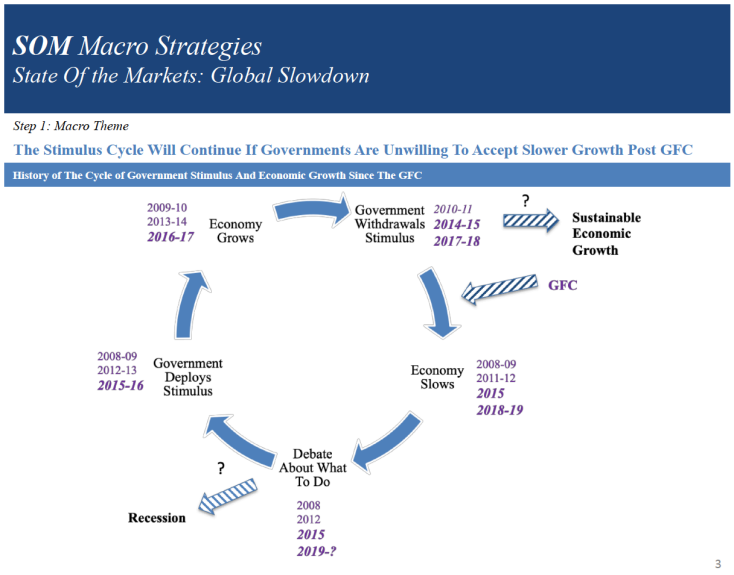
What Happens Next

Global growth continues to slow, including the US**.** In my view China is very reluctant to unleash another credit stimulus pulse to support growth given the risks. They will instead continue to use fiscal and non-credit monetary policy. However, a non-credit stimulus even if it works for China has less of an impact on growth in the rest of world. China clearly does not want to use a surge of credit growth as a tool for driving growth as they did in 2009, 2013 and 2016. First, they believe credit fueled growth is not sustainable and leads to all sorts of inefficiencies and problems, such as the resulting NPLs that hammer the regional banks. Second, they believe that this growth helps the rest of the world as much as it helps them. Their run rate from nominal credit growth is about $4 trillion USD equivalent (roughly 30% of GDP). A staggering number given the size of their economy which has a per-capita GDP of Iraq. Adding another 10-20% of GDP of credit growth on top of that means that most of it gets effectively shipped overseas. Third, they have spent the last few years cleaning up their financial system reducing the riskier type of lending, e.g. the shadow banking system. This reduces their capacity to originat loans on balance sheet.

Where does that leave the Fed? They are caught between a rock and a hard place. I am sure their economic models are already scaling down project US growth given escalating trade tensions. However, they are constrained to some degree from acting aggressively because of the continuing strength of the labor market. My view is that will continue for a while with the consequence that when the labor market does start to weaken the Fed will be behind the curve.

Both of these forces suggest that global slowdown continue to be the main driver of asset valuations in the near term. However, I believe the next set of trades will be in capturing the upside in risk assets when China and Fed cave and start the policy/growth cycle that has been ongoing since 2008, Figure 2 below. So, basically looking for tells for the timing of a more aggressive China stimulus and a more proactive Fed. However, for now its global slowdown.

Figure 2.

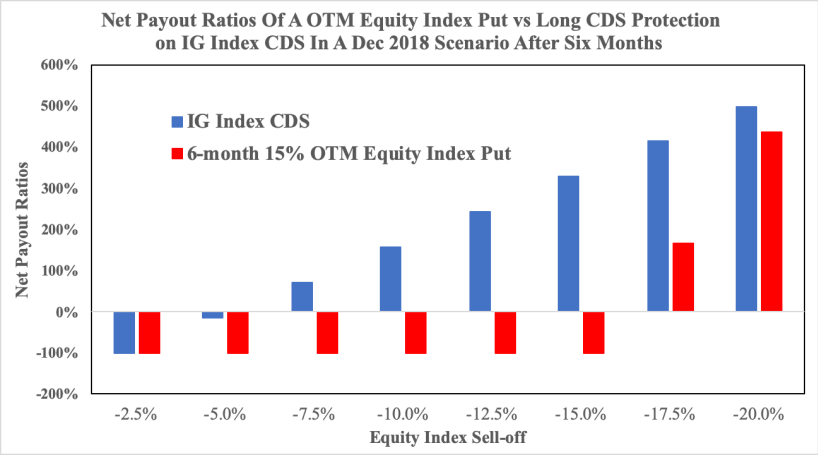


What To Do

1. Buy CDS protection on the US IG Index.

My rational for buying protection on IG is given in my recent piece "Corporate Debt is The New Subprime." While there are many ways to implement this theme, Figure 3 below shows why I chose CDS rather than equity puts. One of the ways I looked at this trade and any trade is based on net payout ratios. A net payout ratio is (Gross Return on Trade – Cost of Trade)/ Cost of Trade. I use a threshold of a net payout ratio of 2.5 for implementing asymmetric trades. Next I run a horse amongst the potential implementations and choose the winner. So, in this case, the race is between a 15% OTM S&P Put vs 5-year long CDS protection on the IG index using a scenario of the sell-off during October-December 2018 period (In that scenario, S&P was down 17% and CDS widened 50 bp). In this figure, the winner of the race was CDS on IG. I am putting out a piece later in the week that will give a more detailed explanation of my corporate debt piece and of this trade analysis.

Figure 3.



My latest SOM portfolio update contains the rational for the last three trades, which is up on my web site.

2. Position for lower US rates (buy curve caps)
3. Buy EM Local currency debt of Russia, Mexico and Brazil
4. Short CNY vs USD