

# China Focus: Our 21 Lehman Systemic Risk Indicators



**THE BEAR TRAPS REPORT**

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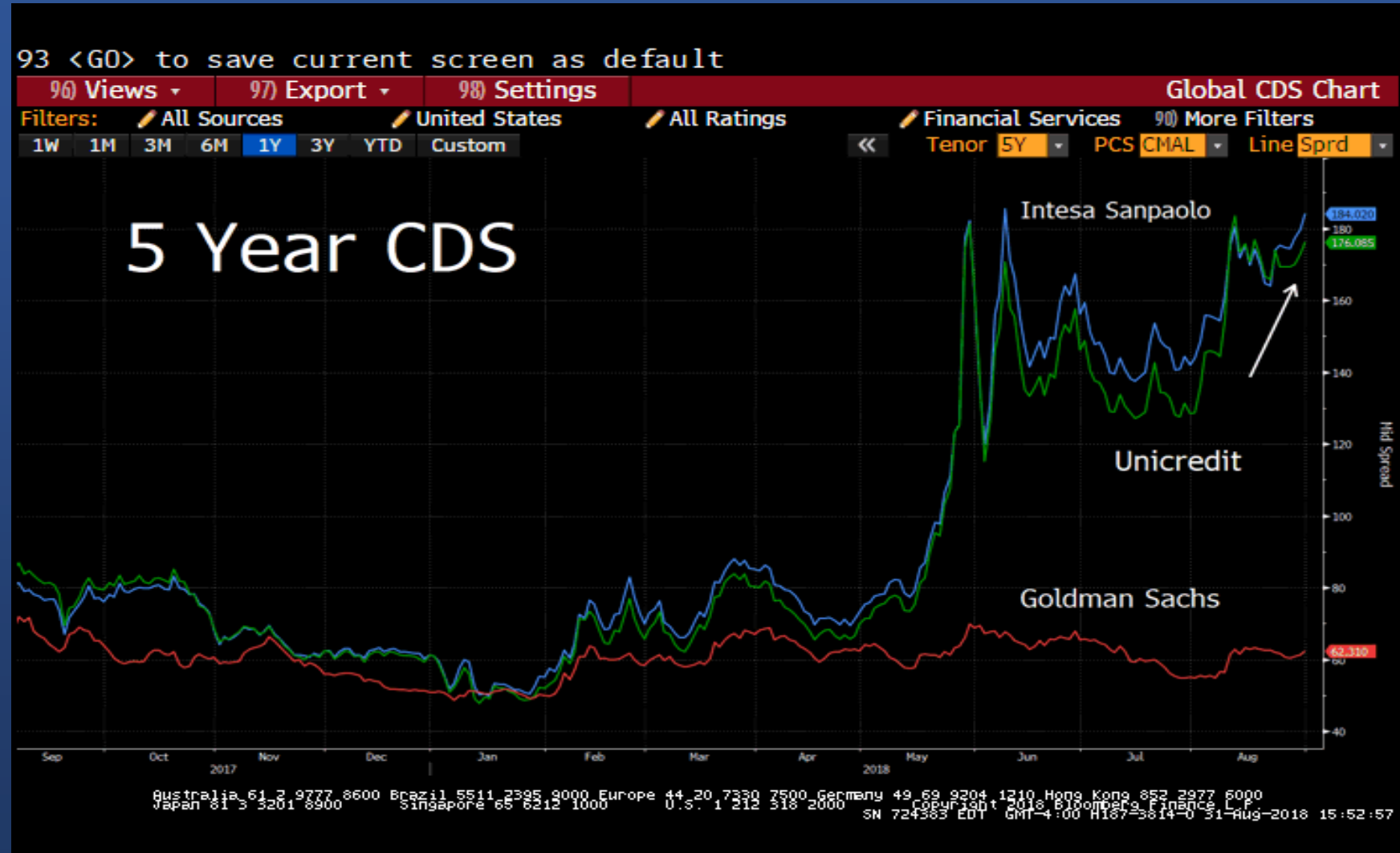
- The media noise is a traders best friend, it is consistently far too negative and has created a number of mispriced trades over the past 24 months
- There is a runway for Canada NAFTA in the next 2-3, NAFTA's conclusion will have a major impact on China
- Trump will use the NAFTA success as leverage against China in the near term

- Trump will turn up the heat on China, details on the \$200 billion product list will be announced in the next week
- The China deal will not come before midterms, but will most likely come at the G20 meeting, where Trump and Xi will meet (Nov 30)
- The China narrative is about to get very dark
- Trump's tactics and the way the media reacts has created one of the most bias mispricing's in the past decade

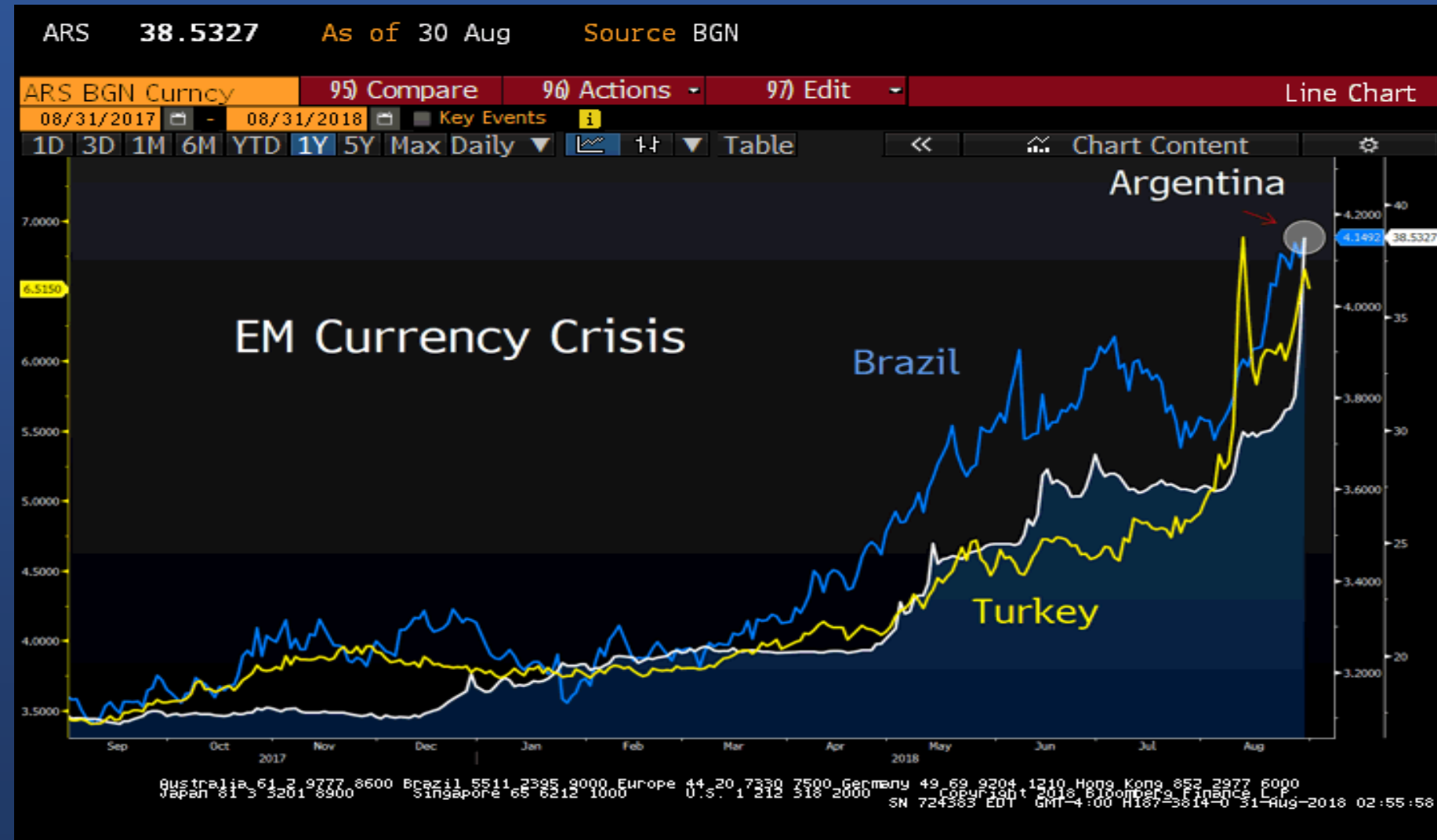
- U.S. Banks- Looking For Signs of Contagion



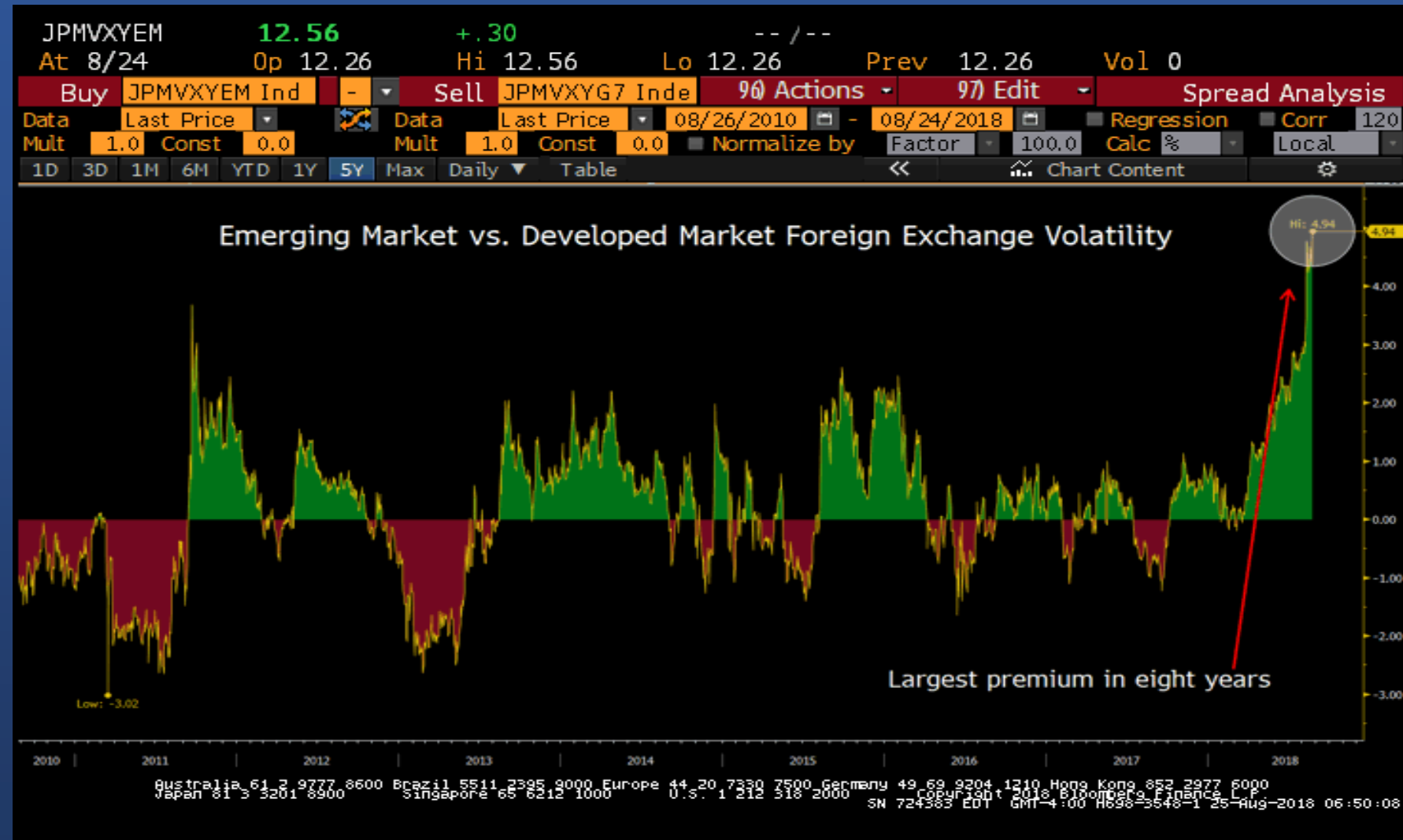
- Seeing meaningful credit divergence in Europe
- China economic weakness, tariffs, sanctions



- EM currency values are plummeting against the Dollar

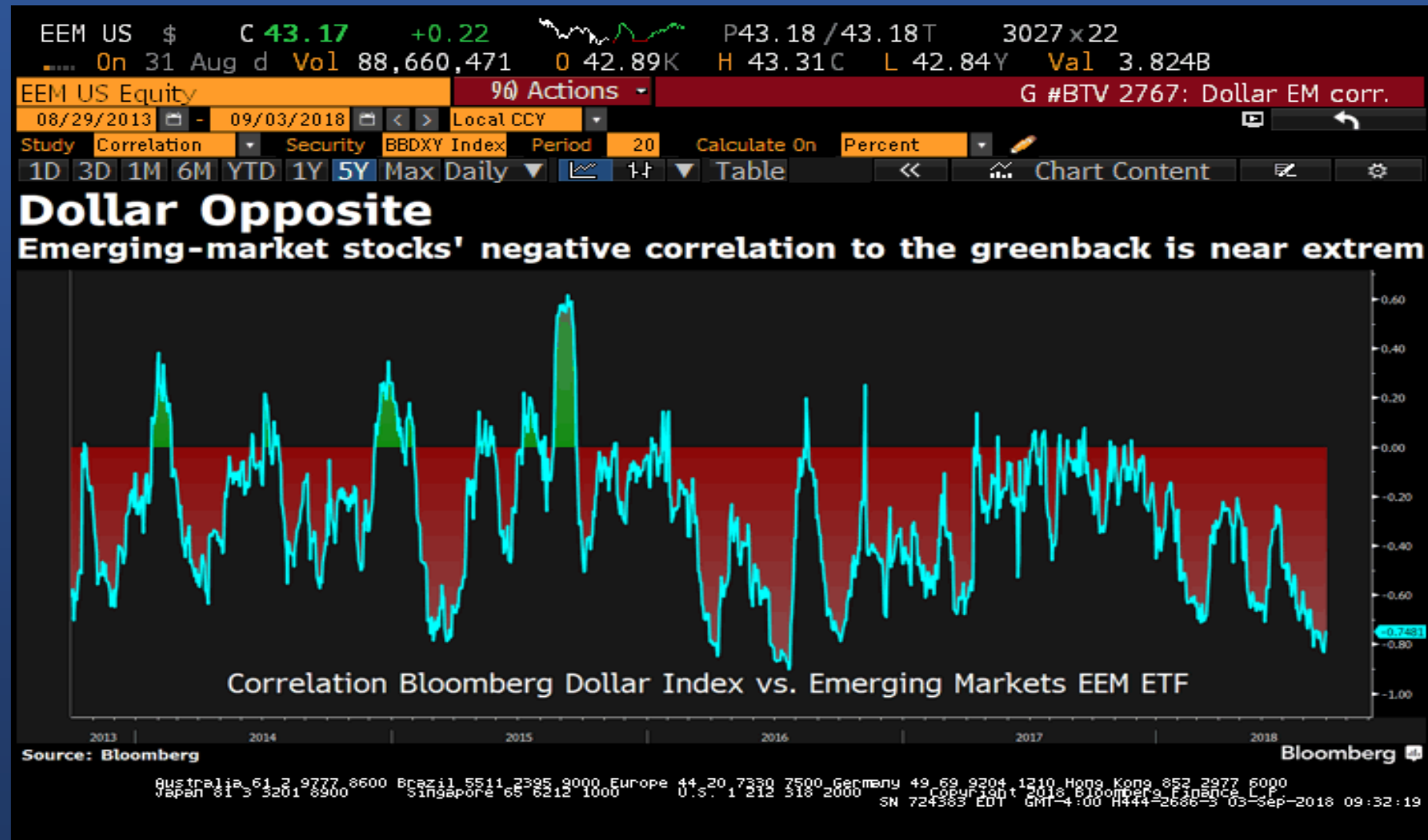


- The sell-off has been skewed towards EM
- The Fed is the root cause





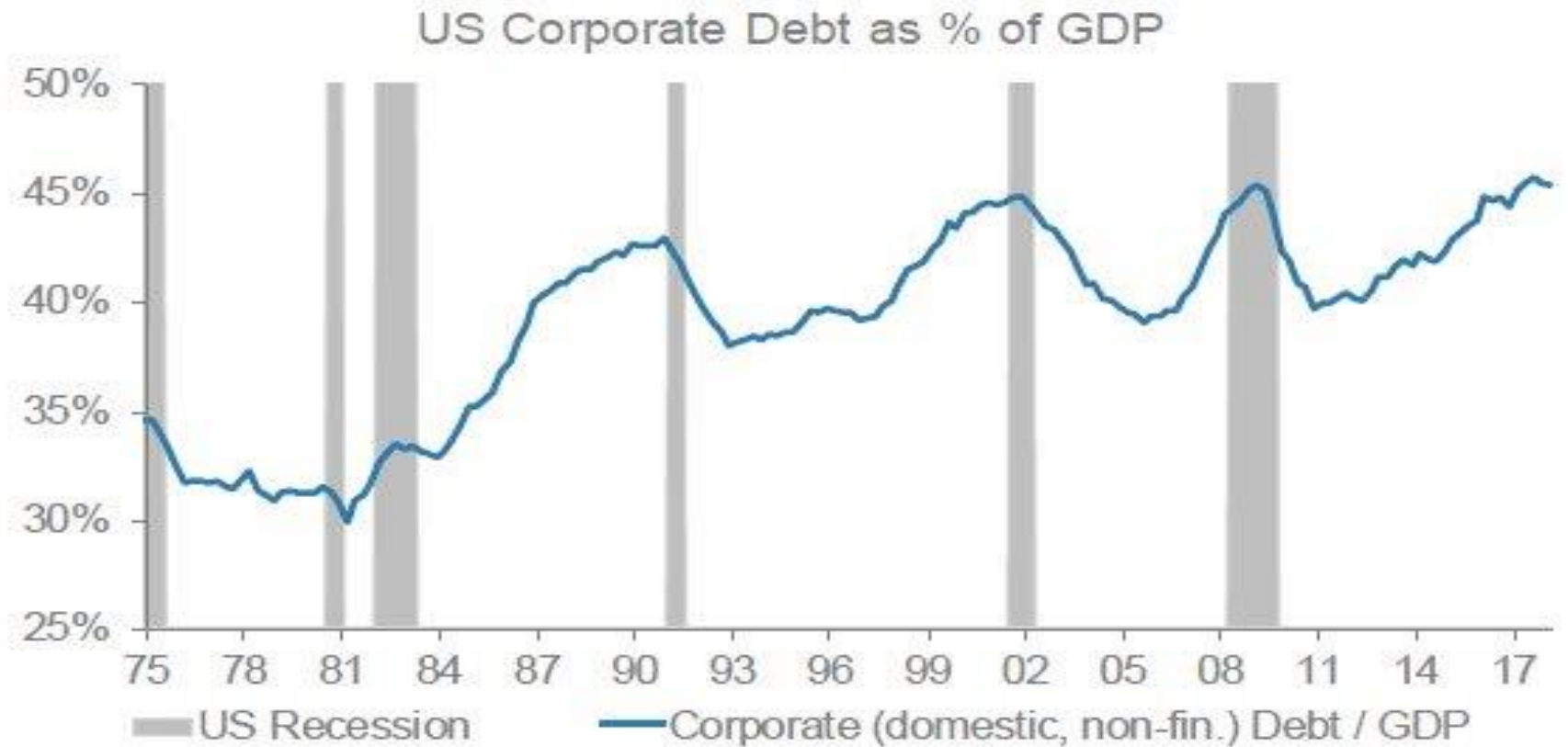
- Global wrecking ball that is the U.S. Dollar





- U.S. Non-Fin corporate leverage at all-time highs

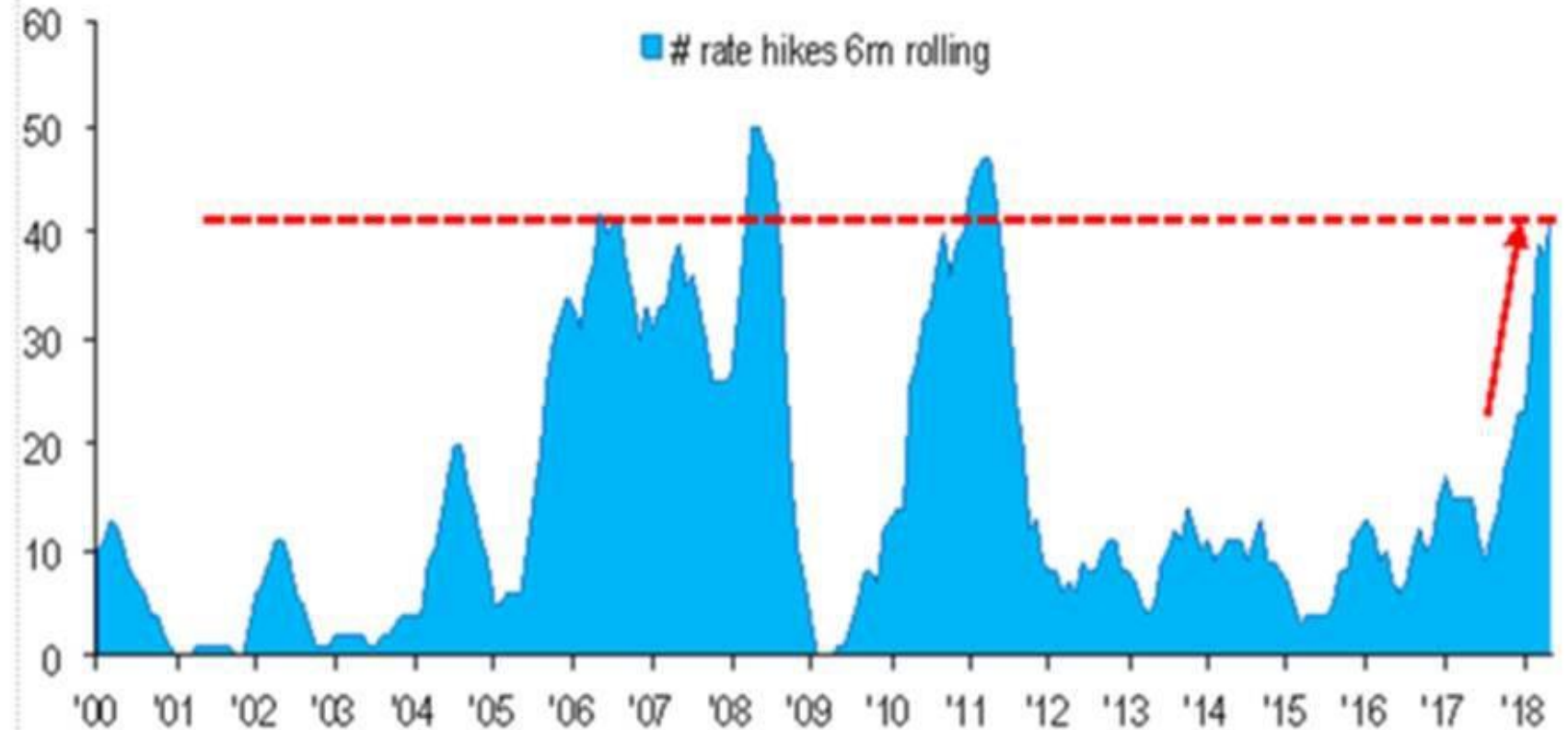
## Even on the Broadest Measures, Non-fin Corporate Leverage Remains High



Source: Morgan Stanley Research, Federal Reserve

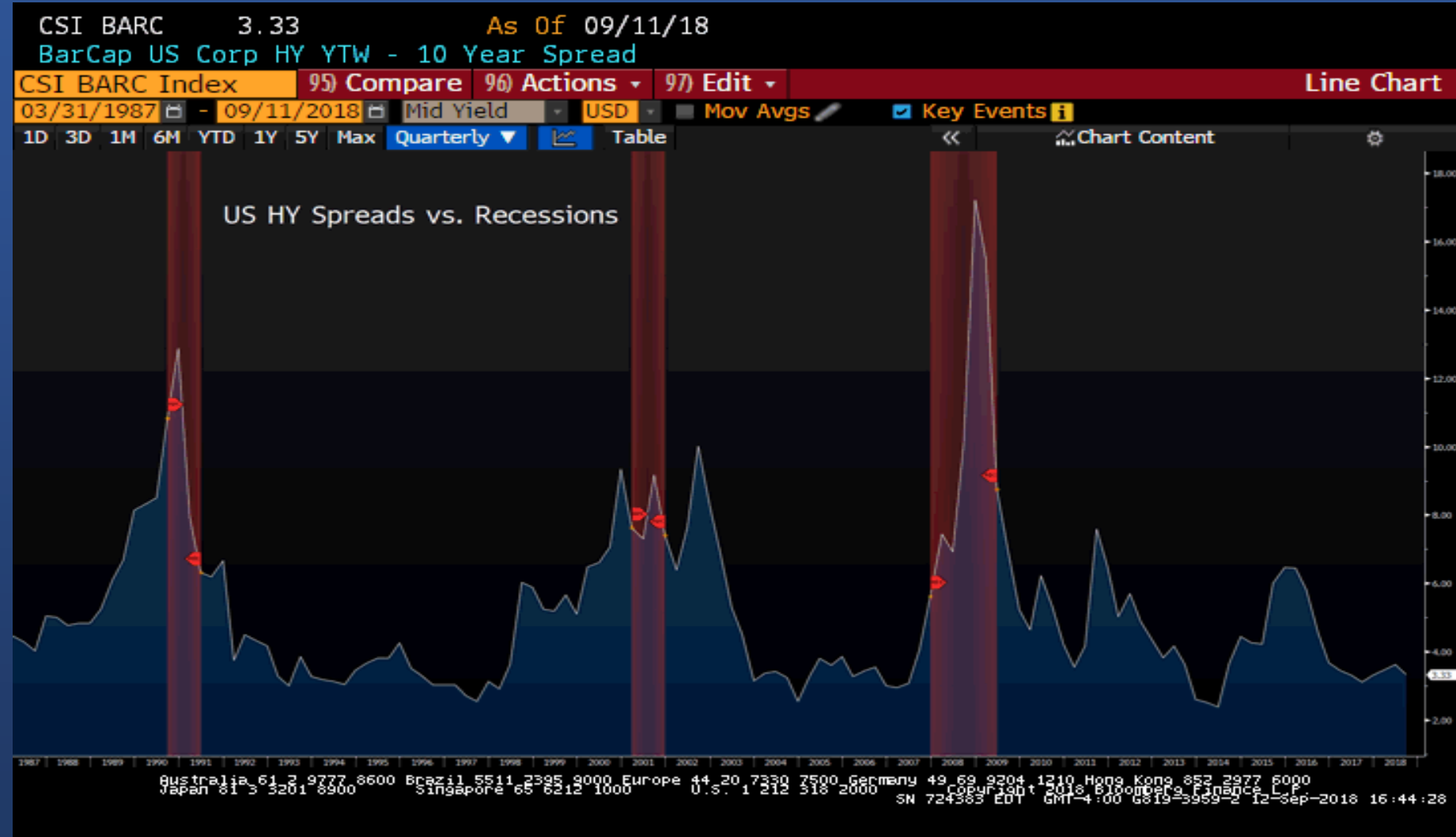
- Global financial conditions, tightest in a decade

Tightening like it's the boom times? 6m rolling sum of CB rate hikes across the globe - big liquidity withdrawal, on par with pre-Lehman times

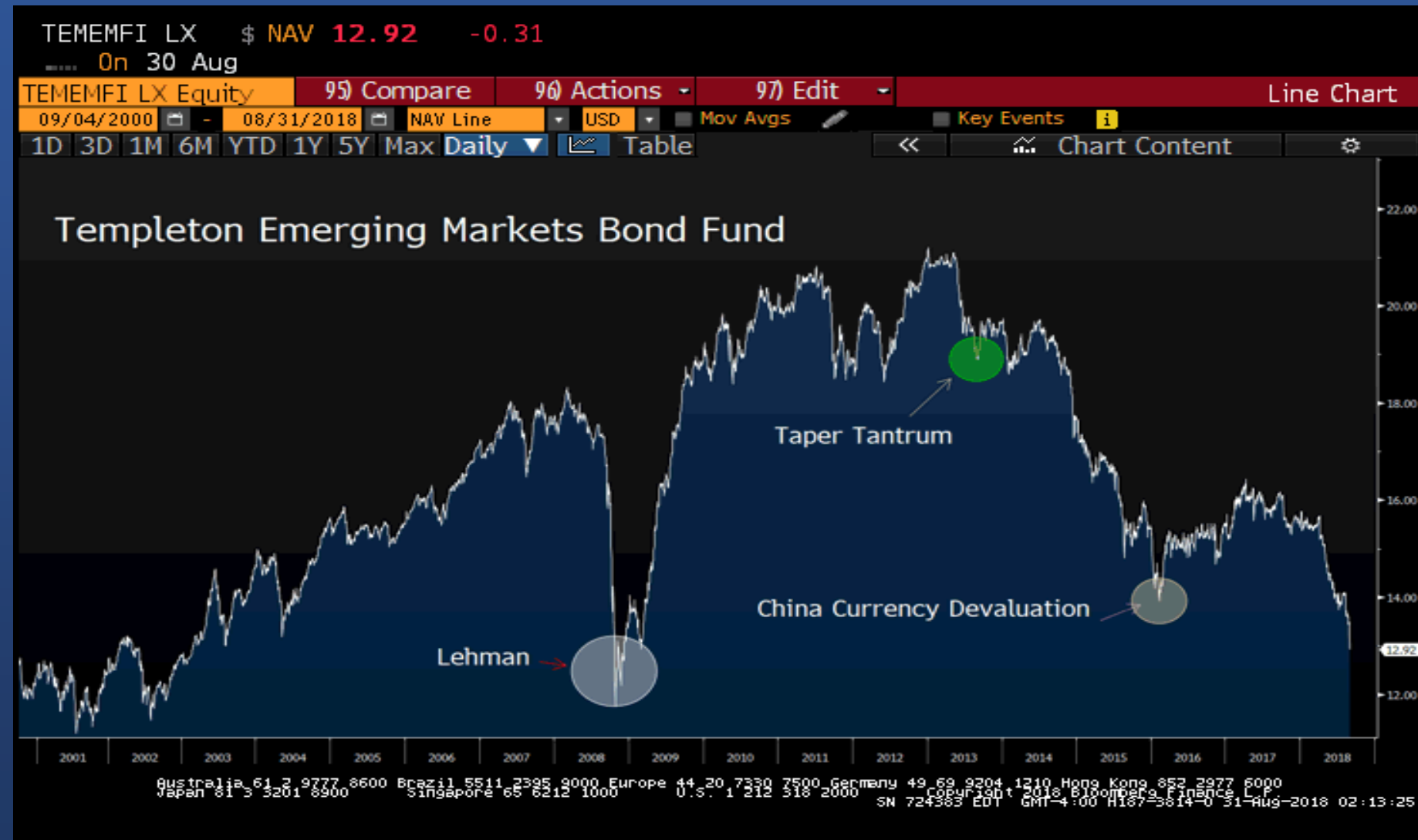


Source: Bloomberg. Rolling 6m sum of global central bank rate hikes. Note that the data contains some double counting in instances where a central bank moves more than one reference rate.

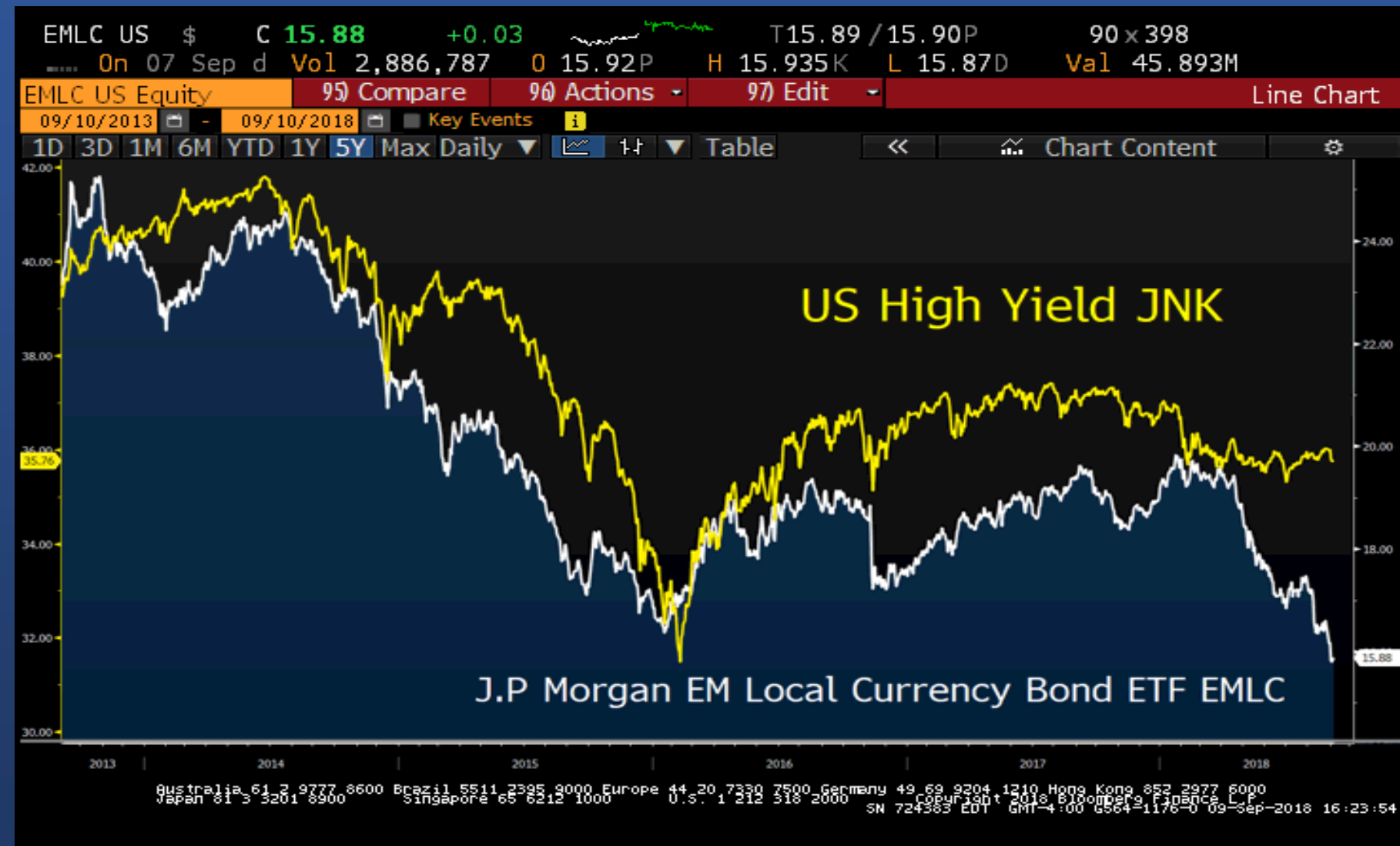
- U.S HY spreads overlooking leverage



- Extreme credit risk being priced in



- U.S. high yield has become a safe-haven
- An unsustainable dislocation





- U.S. equities in “Danger Zone”
- Managers paying up for front month protection



- Consumer staples, the best leading recession indicator

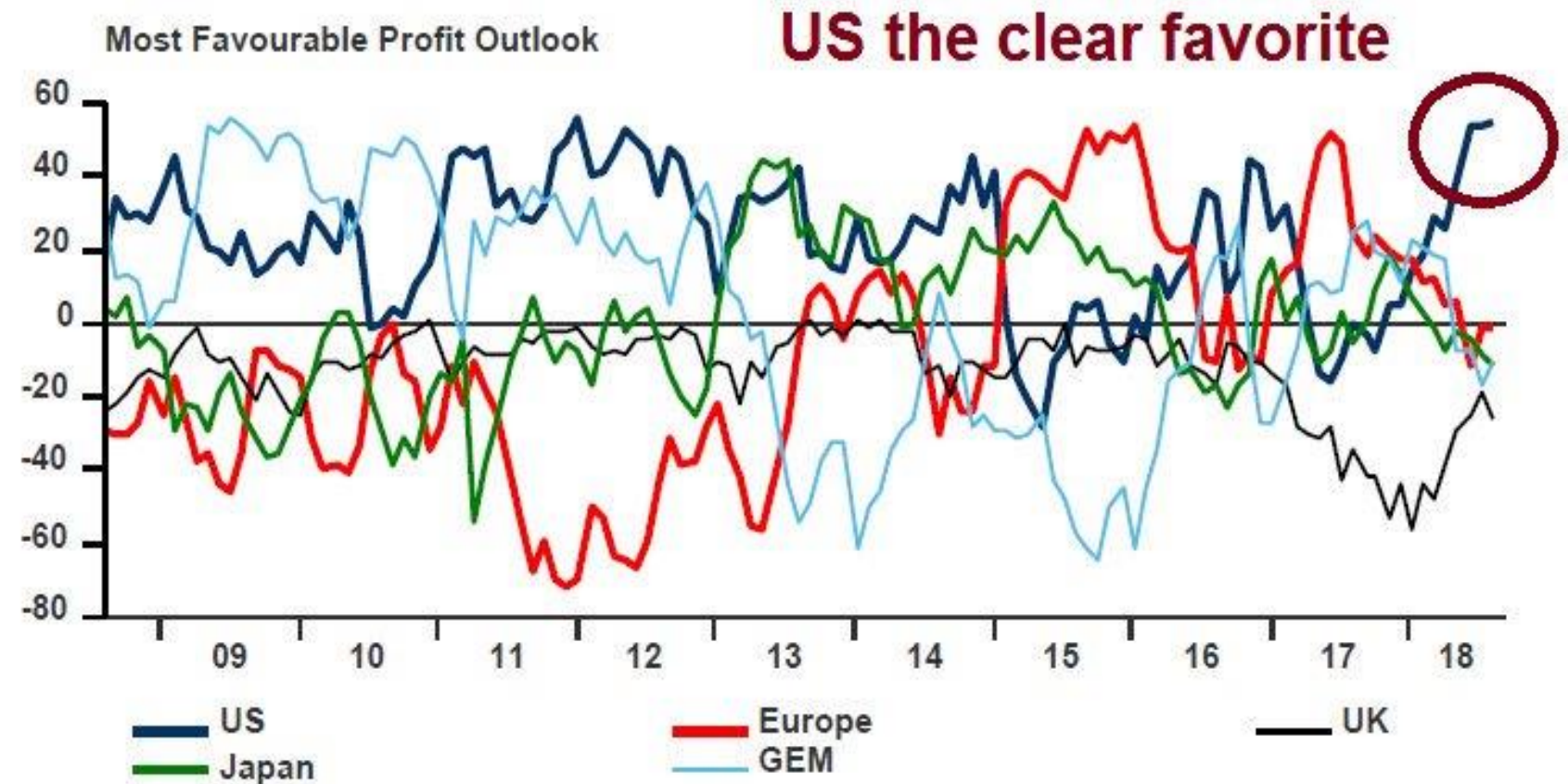




# Market Dislocation

- One crowded trade

Exhibit 19: In which Region is the Profits Outlook Most Favourable / Least Favourable?



Source: BofA Merrill Lynch Global Fund Manager Survey

- Large dislocation in equity markets
- This trend in unsustainable



- S&P outperformance vs. China, unprecedented



- S&P 500 large dislocation from Chinese equities
- Investment opportunity now exists



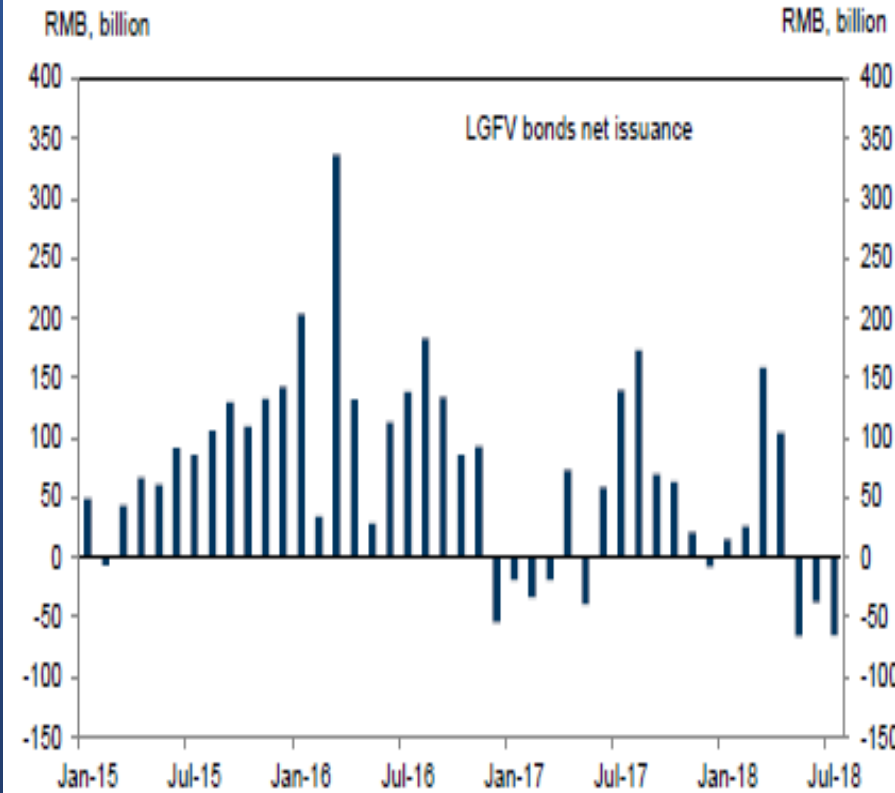


- Value has vastly outperformed
- Pivotal level

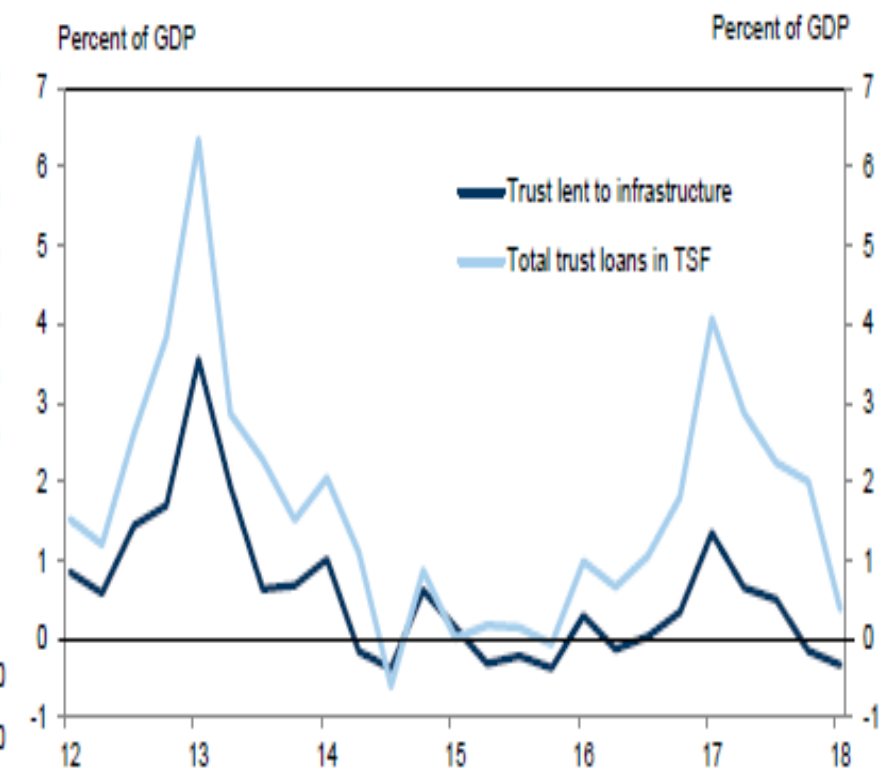
Figure: MSCI World Growth and Value relative price performance (vs MSCI World) past 45 years  
Since 1974



- China has been recently deleveraging
- Tariffs now pose a problem

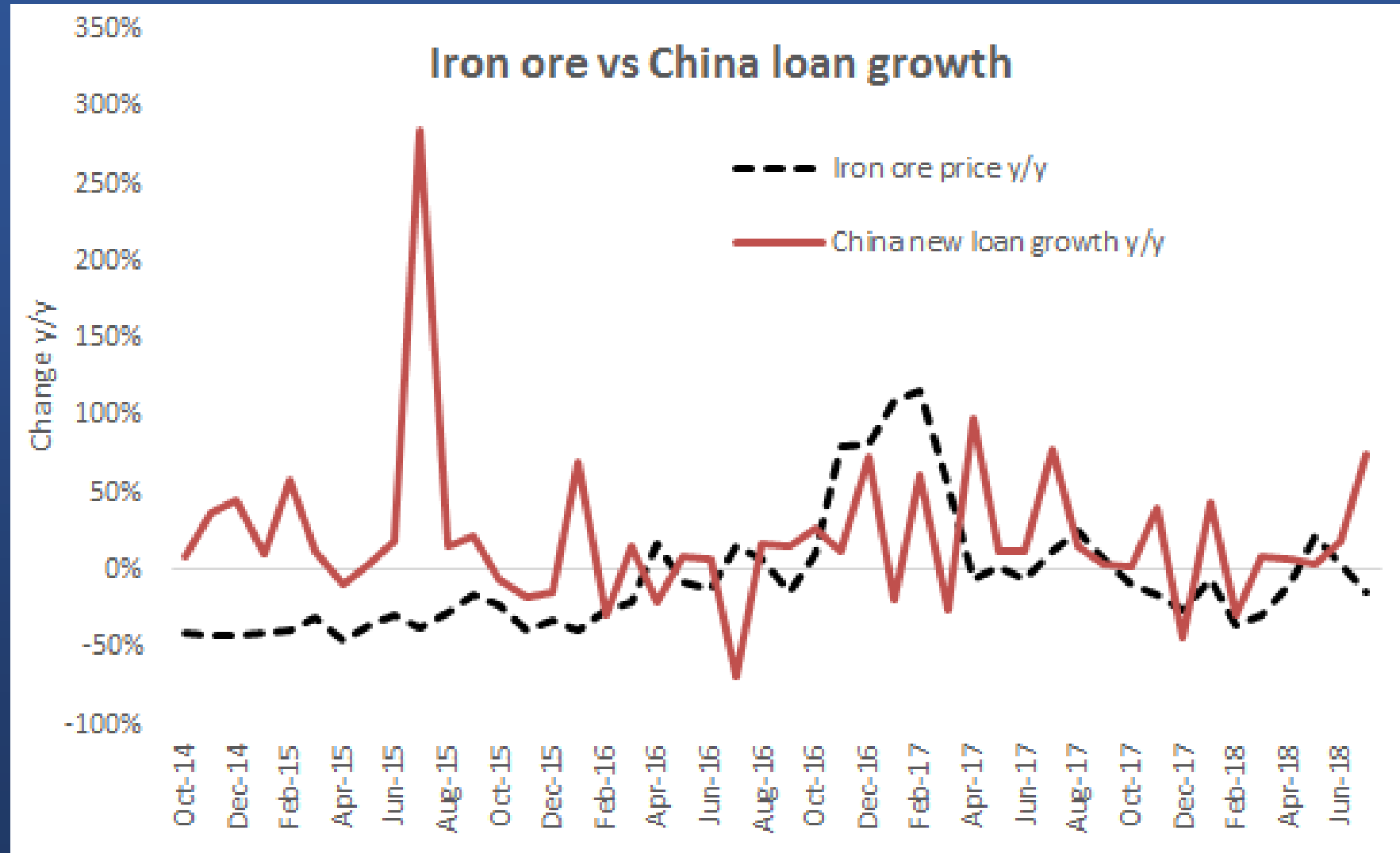


Source: Wind, Goldman Sachs Global Investment Research



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- China is now leveraging-up again
- Fueled by monetary and fiscal policy





## Monetary Measures:

*First;* China has depreciated their currency to offset the already announced U.S. tariffs on Chinese imports. The near 10% decline in the Yuan, almost neutralizes the initial round of 25% tariffs on exports to the U.S

*Second;* liquidity. The reserve bank has cut the Reserve Requirement Ratio (RRR) three times this year and even further rate cuts are expected in the second half of the year to boost liquidity conditions.

*Third;* dovish guidance. The PBOC's quarterly report extends the dovish tone on monetary policy. The report highlighted that fiscal, regulatory and structural support is required to ensure effective monetary policy transmission.

*Fourth;* Regulation. The China Banking and Insurance Regulatory Commission (CBIRC), which is under the purview of the PBOC, requested that commercial banks step up loan supply to private companies and SMEs as well as for infrastructure projects and exporters.

## Fiscal Measures:

So far, 760 billion Renminbi (\$111B) worth of tax cuts have been announced, targeting SMEs and startups. In June, China proposed individual tax cuts via lifting the tax-free threshold on personal income from 3,500 yuan (\$511) a month to 5,000 yuan (\$730) a month.

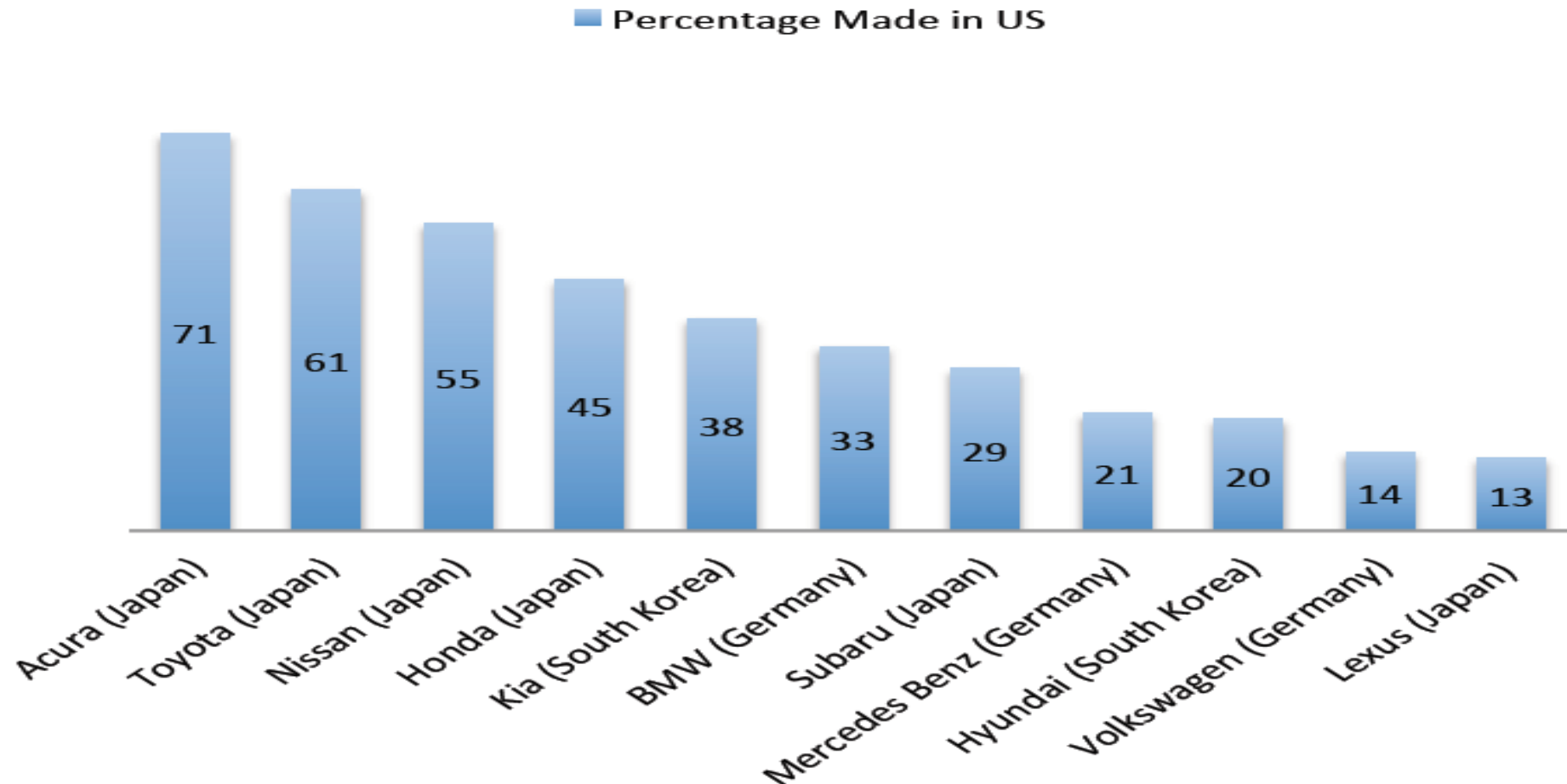
## Trade Conflict Resolution

**U.S. trade negotiations are interconnected – how NAFTA concludes will effect negotiations with Europe and China**

### **Successful NAFTA Agreement Will:**

- Give President Trump important political victory before U.S. midterm elections on November 6<sup>th</sup>, 2018
- Strengthen North American supply chains and end business uncertainty
- Put additional pressure on the European Union in negotiations with the United States
- Reduce the necessity of the United States accepting a deal from the EU or China in short order

## Percentage Made in US



- President Trump is focused on European auto imports – European makers produce a significantly less amount of their vehicles in the United States
- President Trump rejected EU offer to eliminate auto tariffs
- EU commitments in Juncker deal are loose:
  - Agriculture – EU soybean purchases dictated by market and were going to happen anyways
  - Energy – infrastructure to receive large increase in U.S. LNG shipments is years away
- President Trump does not want to undermine gains for auto manufacturing secured in NAFTA victory
- China is state-controlled economy and can more easily accede to U.S. demands in trade negotiations than consensus-based Europe

*“No one controls the process about trade. We meet with the President on a regular basis, often several times a week... The guy who controls the process is the President.”*

– National Economic Council Director  
Larry Kudlow

## Impose Tariffs:

- Section 232
- Section 201
- Section 301

## Negotiate Trade Agreements:

- NAFTA
- China
- European Union
- KORUS

# Imposing Tariffs – Trade Investigations

## Section 232 Investigations:

- President Trump has imposed tariffs of 25% on imported steel and 10% on imported aluminum
- President Trump has initiated an investigation into whether imports of automobiles and parts threaten U.S. national security—could result to auto tariffs.

## Trade Act of 1974—Section 201 and Section 301 Investigations:

- President Trump has imposed tariffs on \$50 billion worth of Chinese products across several sectors and threatened to impose an additional \$200 billion in tariffs.
- President Trump imposed tariffs on imported solar products and washing machines under Section 201.

## Negotiating Trade Agreements:

- Europe?

## Trade Promotion Authority (TPA) – Fast-Track Authority:

- Legislation that defines U.S. negotiating objectives and priorities for trade agreements
- Establishes consultation and notification requirements for negotiations
- At the end of the negotiation, the trade agreement is submitted to Congress for an up-or-down vote without amendments



- President Trump initiated talks to renegotiate and modernize NAFTA in August, 2017
- On August 27<sup>th</sup>, 2018, the United States and Mexico reached an “*agreement in principle*” on a bilateral deal.

### Significant Changes (Pending Canada’s accession):

- Rules of Origin for Automobiles: Criterion needed to determine the national source of a product and qualify for duty free trade
  - Regional content requirement – 62.5% → 75%
    - USTR originally sought an 85% regional content requirement and a 50% U.S.-specific content requirement
  - High-wage labor requirement – 40-45% of content must be created by workers making at least \$16/hour
- De Minimis Threshold: Monetary value under which an international shipment incurs no duties and has minimal clearance procedures and data requirements
  - Imports to US – \$800
  - Imports to Mexico – \$50 → \$100
  - Imports to Canada – \$20 → ???

## China

*“They [China] want to talk... it’s just not the right time to talk right now, to be honest.”*

– President Trump after announcing U.S.-Mexico trade agreement on August 27<sup>th</sup>

### The Issues:

- China joined the World Trade Organization (WTO) in 2001
- United States claims that China is not living up to its commitments
- U.S. trade deficit with China was \$376 billion in 2017
- This summer, FIRRMA was signed into law to halt the transfer of critical U.S. tech to China

## Existing Tariffs:

- President Trump has imposed a 25% tariff on \$50 billion worth of Chinese products
  - Targets sectors deemed important to China's "*Made in China 2025*" industrial initiative, including: industrial machinery, aerospace parts, communications technology and semiconductors
- China has imposed a 25% retaliatory tariff on \$50 billion worth of U.S. products
  - Targets politically sensitive products, including agriculture and automobiles
- President Trump has threatened a 25% tariff on an additional \$200 billion worth of Chinese products
  - Public review period on these \$200 billion ended September 6<sup>th</sup> – Trump Administration can announce tariffs any time thereafter
  - President Trump threatened tariffs on an additional \$267 billion worth of Chinese products
- China has threatened to impose retaliatory tariffs on \$60 billion worth of U.S. products