



Changing Trade Probabilities: Will the US Decouple from China?

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Summary

- Coolabah Capital Investments previously assessed that a myopic and mercenary President Trump would want to strike an expedient trade deal with China well in advance of the 2020 election to maximise his economic momentum heading into that crucial cross-roads.
- After extensive due diligence with Chinese and US intelligence, defence, and political experts around the world, we have recalibrated our probabilities to a much more finely balanced outcome.
- This reflects an internal struggle within the White House between the market-friendly “Goldman Sachs consensus” (our phraseology), led by Treasury Secretary Steve Mnuchin, that want a deal to be done to staunch market fears of a catastrophic decline in global trade and those who adhere to a much more realist (or “hawkish”) strategic view that judges China on its actions and internal ideology. This latter camp, which we refer to as “Bannon’s Hawks”, believes that China is a fundamentally malign actor seeking global economic and military supremacy in order to sustain President Xi’s dynasty. This cohort includes Trump’s influential chief negotiator, Robert Lighthizer, who has been dealing with the Chinese on trade for decades, and Trump’s economic adviser, Peter Navarro.
- As China has reneged on, and remains resistant to, an all-encompassing trade deal that would—through strict monitoring and regulatory reform—finally force it to compete on a level playing field with other nation states, we sense that the balance of power is swinging back towards Bannon’s Hawks, who are winning bipartisan support across the US polity and indeed the West at large in favour of giving China a binary choice: either belatedly adhere to the terms of the Western liberal-democratic free and fair trading order, or be actively excluded from it via US led “de-coupling”, which would involve migrating supply chains out of China through the imposition of punitive tariffs.
- We currently believe that there is a circa 50% probability that either (1) Trump folds and does a weak trade deal to satisfy financial markets and take a superficial win to the 2020 election or (2) President Xi relents and signs-up to a comprehensive trade deal that he has no intention of complying with in the long-run, but which would buy China more valuable time to strengthen its geo-political leverage. We believe this latter option is Xi’s best current solution given the awkward situation he finds himself in where he has both lost face through his bruising entanglements with Trump and ostracised China from much of the developed world via his heavy-handed foreign policies.
- Alternatively, we think there is a circa 50% probability that no deal is struck, and wittingly or unwittingly, China and the US economically “decouple” via the application of 25% tariffs to all Chinese exports, which would fatally undermine its

historic cost and trade advantages. Low cost competitors and Western firms would then have an incentive to shift their supply chains (and trade) to more benign counterparties around the world. This might induce more short-term market volatility, but would ultimately be positive for long-term geo-political and financial system stability by preserving the Western liberal democratic model, which has maintained peace and prosperity since the Second World War.

- We think that markets will respond positively to any deal being struck given this cauterises short-run geo-political risks. While markets might react very negatively to the failure of Presidents Trump and Xi to reach an accord at the G20 summit, and to Trump carrying out his threat to apply 25% tariffs to all Chinese exports by mid July, it is also possible to conceive of mitigants. Trump could seek to soothe markets, which do appear to be experiencing trade fatigue, by claiming he is committed to doing a deal, which he could signal was still being negotiated. The Fed also has ample room to cut rates and inject stimulus into the economy with a trade stale-mate potentially providing the perfect reason to doing so.

The Goldman Sachs Consensus

We have been doing a great deal of due diligence on the trade wars—engaging with government officials locally and overseas and numerous Chinese and US intelligence, defence and political experts—and believe the probabilities have shifted materially from our previously held benign modal case in which China and the US resolve a deal towards much more polarised, or bi-modal, outcomes involving a deal or no deal with each contingency appearing just as likely. This could elevate volatility, which will beget investment opportunities.

The changing probabilities have emerged as President Trump seeks to straddle two conflicting internal schools of thought on how to manage the challenge posed by the rise of a totalitarian, one party (increasingly, one person) political system that actively seeks to dominate its domestic and foreign counterparties, including America, to secure and sustain its aspirational primacy.

One forecasting complication is that nobody really knows which of these two camps Trump will commit to. His long-time secretary once said that the only constant with Trump is his intrinsic unpredictability, which his former adviser Steve Bannon described as his only “super-power”.

In 2018 we held the view that a transactional (corruptible?), market-focussed, myopic and mercurial President Trump—who appears desperate to impress his contemporary Wall Street and corporate oligarchs—would strive to secure a pyrrhic trade victory to promote heading into the 2020 presidential election. It was assumed that this deal would be struck irrespective of whether it addressed the growing concerns China hawks like Bannon have regarding the Middle Kingdom’s “predatory” behaviours.

By predatory, Bannon means the systematic program China has been carefully implementing for decades to sling-shot both its economic and military development to the point where it emerges as a global hegemon. This of course involves appropriating foreign technology, intellectual property and military expertise to enable China's ascendancy while the state unfairly subsidises local enterprise to obtain global market share from offshore competitors playing by the rules of a completely different game (aka open, fair and free trade). And there is nothing remotely bilateral about these interactions: China does not allow foreign entities to easily invest in its domestic domain nor extract any exclusive know-how from their activities within her territories.

The relentless unilateral appropriation of foreign states' competitive advantage is, as we will discuss later, a means to assuring the objective of unquestionable primacy and is accompanied by exceptionally sophisticated and pervasive counter-subversion and offensive information projection capabilities designed to thwart any perceived or actual threats to President Xi's supremacy.

Our 2018 interpretation of Trump's more mercenary character traits reflects the prevailing wisdom in the economics (or markets) community, which we call the Goldman Sachs Consensus, that getting a deal done was more important to Trump than the substance of that deal. Whenever Trump has deviated from the path espoused by the Goldman Sachs Consensus, he has been punished by markets through negative, sometimes savagely so, price action. Markets have, in fact, been trying to reassert their will in May.

The Goldman Sachs Consensus appeared to be validated over the last 18 months by Trump and his Treasury Secretary, Mnuchin, who have sought to repeatedly assuage investors that some kind of deal will be struck. And investors have become arguably emboldened by the efficacy of their own reflexivity whereby "Ticker-Tape-Trump" has been forced to sprout much more conciliatory and deal-friendly rhetoric every time his hawkish hyperbole precipitates a market melt-down.

It is certainly hard to recall any US president, or any leader of any other nation state, who has been more beholden to the vagaries of their stockmarket than Trump, who boasts on Twitter every time the Dow Jones Index hits a new high watermark and clearly adjusts his behaviours in response to the index's fluctuations.

Before moving to consider the rival paradigm inside the White House, it is worthwhile stressing here that the stereotype of Trump is an intensely impatient, hedonistic, and short-term optimiser who has never displayed much appetite for immediate sacrifices to obtain advantages in longer-term strategic games. But it is possible this analysis is wrong? Perhaps Trump's visceral short-term optimisations have the ability to subconsciously lead him into much more nuanced and strategic long-term, solutions. How, for example, did he manage to pull off one of the most historically unlikely presidencies? Here it is sobering to reflect on the observations of one Trump nemesis, former FBI director James Comey:

“I don’t buy this stuff about him being mentally incompetent or early stages of dementia,” Comey said. “He strikes me as a person of above average intelligence who’s tracking conversations and knows what’s going on. I don’t think he’s medically unfit to be president.”

Bannon’s Doctrine

The reason this is important is because it is precisely what the geo-political hawks are asking of Trump: they want him to weather near-term financial and economic storms to preserve America’s own hegemony, which is predicated on the rules-based, liberal-democratic order where everyone broadly competes for free and fair trade on equal terms without extensive state subsidies and/or interference.

This is Steve Bannon’s eloquently-articulated doctrine that for the first time is gaining significant bi-partisan currency throughout America. According to what we call Bannon’s Hawks, China is engaged in a multi-decade mission to wrest economic, military and hence geo-political supremacy away from the US and its allies.

The intensity of this mission has been significantly accelerated under the auspices of President Xi, where Xi is regarded as the most powerful and ideological Chinese leader since Mao, and in 2018 removed all term limits to establish a perpetual legacy.

Engaging with leading Chinese cultural, political and intelligence experts, we have arrived at the conclusion that one cannot rationalise China’s decision-making model using a logical financial markets or Western democratic framework.

Xi May Want a Trade War

President Xi and his acolytes are convinced that China has always required an existential challenge, if not an outright kinetic conflict, to galvanize her people to unite as one to overcome said threat to their existence where Xi himself, the Chinese state, the Chinese Communist Party, and the Chinese people are increasingly fused into a single, indivisible entity.

President Xi’s purported end-game is a utopian nirvana (socialism) that is never actually obtained. This aspirational objective is, however, the unifying ambition that binds the Chinese people together in support of maintaining the primacy of the Chinese Communist Party, which is really a vehicle to preserve the power and control of several key Chinese dynasties, the current apex of which is represented by Xi’s reign.

Put differently, communism with Chinese characteristics is a control system to perpetuate the power of ruling elites—the most recent incarnation of which are princelings like Xi and his fellow conservative hardliners (juxtaposed against treasonous reformers) that

understandably perceive the West, liberalism, democracy, civil society, capitalism and free markets as a direct and inherent threat to their totalitarian longevity.

The real end-game is survival, a necessary condition for which is struggle followed by dominance. This requires China's vast and Byzantine intelligence gathering and influence apparatus to engage in continuous and unremitting campaigns to acquire and burnish competitive advantages in the commercial and military spheres while simultaneously crushing internal and external threats to Xi's regime through both positive and negative incentives (or bribery, corruption and retribution).

This characterisation does not remotely do justice to the complexity of the subject matter and we would advise readers to take time to absorb two iconic tomes authored by one of the world's best China analysts, John Garnaut (see his essay on Chinese ideology at [Sinocism here](#) and another on Xi's business model over at [The Monthly here](#)). John has spent large slabs of his life living in Beijing, was previously Prime Minister Malcolm Turnbull's China adviser, and led the Australian government's inter-agency report analysing the extent of Chinese espionage and influence operations in Australia.

Garnaut's research facilitates several important insights in the context of the current trade ructions. First, any deal that involves strict monitoring and surveillance of China's adherence to terms that require it to operate on a level playing field with the rest of the world is seemingly incompatible with Xi's mission to secure unassailable dominance that insulates his regime from internal and external risks. (Unless Xi can still find some credible way to cheat.)

Xi's mission is not yet complete (indeed, the end-game is arguably 10-20 years away), and he knows that China cannot currently win by innovating independently, regularly bemoaning the paucity of creativity and ingenuity in the Chinese economy, which is the inevitable result of corrupt, non-market incentive structures.

Trump may be a Game-Changer

This could explain why at the 11th hour China red-lined huge sections of the trade deal Trump thought his team, led by hard-line trade hawk Robert Lighthizer, had negotiated. This deal would have forced China to engage in unprecedented reforms that would directly constrain its ability to dominate global industry—and secure President Xi's Made in China 2025 objective—in the short-to-medium term.

We nonetheless believe that President Xi could have signed-up to this deal and still stealthily cheated in a less brazen and explicit fashion to what China has historically done while buying himself more time to secure unquestionable technological, economic and military leverage over the rest of the world. Indeed, miscalculating Trump's reaction function may have had catastrophic consequences for the tenability of Xi's project.

Wittingly or unwittingly, Trump is the first leader of a modern nation state to genuinely push back on China's quest in what ostensibly appears to be a credible and strategically thoughtful fashion. As one analyst opined, it could just be the entirely random coincidence of madness and strategy in Washington.

In the past when China retaliated against attempts to staunch what it regards to be its exclusive sovereign right to steal, cheat and compete unfairly with the rest of the world, global counterparties have backed down. This included prior American administrations.

It is plausible that Trump initially approached these negotiations with a simple mental model that free and fair trade was ultimately in everyone's best interests, and something that should not be terribly difficult to convince China about, especially given his persuasive powers, which Trump seems to consistently overestimate.

And yet as China has relentlessly resisted and re-traded through 18 months of negotiations, Trump might have inevitably come to the conclusion that China is, in fact, malign and will never sign-up to any fair trade deal precisely because it fundamentally contradicts Xi's core mission, which Trump has slowly come to understand.

Bannon' Solution: Decoupling

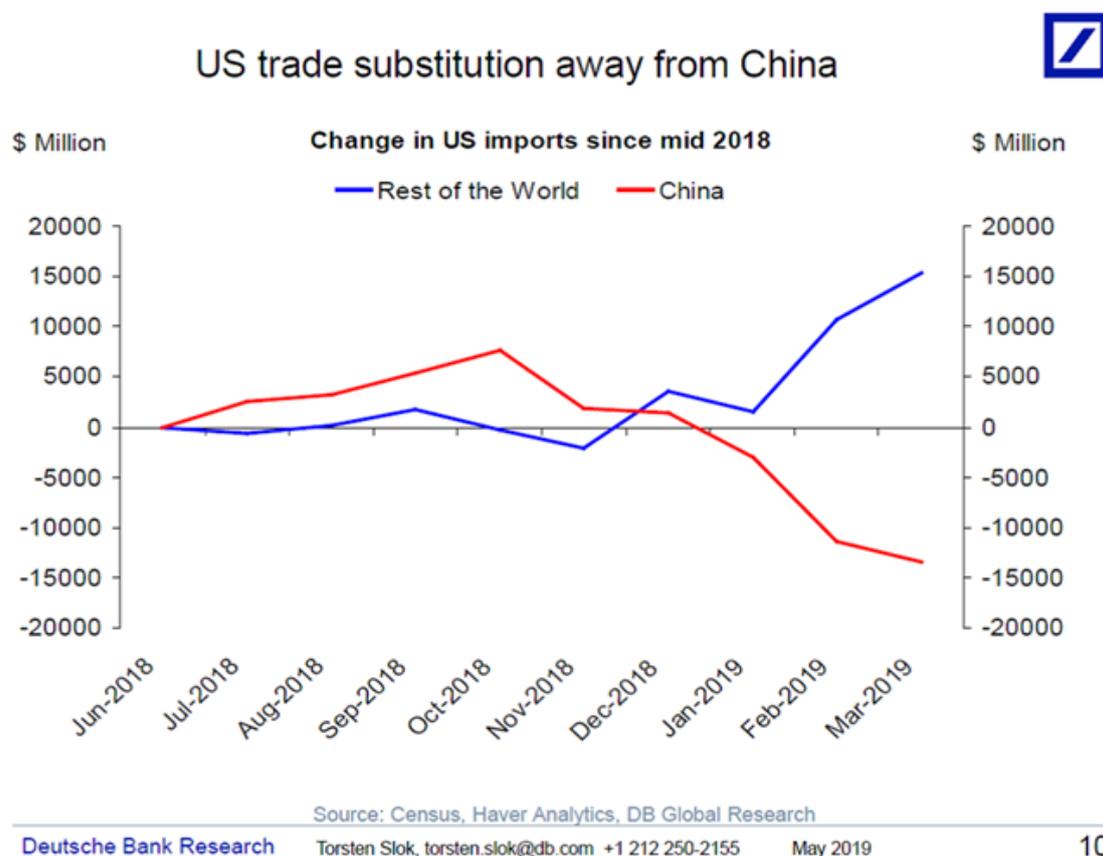
This could explain why Trump has shifted course—though we don't know if he really has—and become more partial to Bannon's Hawks. Accepting Xi's dynastic aspirations, Bannon does not believe China can be credibly convinced of the merits of changing course. His doctrine perceives China to be an insatiable economic predator that is moving irresistibly up the food chain every day as it consumes other nation states' competitive advantages until it supplants the Western capitalist free-trading order as the pre-eminent operating system. The conclusion of this process is that the West is subverted to becoming a slave servicing Xi's legacy. To borrow the words of one Chinese scholar, "free markets belong in a Communist cage".

Hawks like Bannon think that Western appeasement of China has allowed it to modernise its military and technological industrial base much more rapidly than any analysts projected 10 to 20 years ago, putting it within a decade or so of its final hegemonic destination. Along these lines, the Goldman Sachs Consensus has propagated American (and Western) decline as financial market elites accept sub-optimal deals with China that transfer enormous wealth to them personally in the short-term while ceding US wealth creation opportunities to China over the long-run.

Bannon firmly believes that strategic time is running out: it is vital that the West acts promptly in the finite window that it still has left to excise the Chinese cancer from the global economy. This project, which has gained unprecedented traction amongst Democrat and Republican leaders during Trump's term, therefore advocates "de-coupling" the Western and Chinese economies as the least-worst option given China's irreversible course.

Under Bannon’s doctrine, tariffs are actually positive because they work to reverse China’s competitive cost advantages and encourage China’s rivals to develop substitutable products and services. This is why we are hearing more and more about shifting essential supply chains out of China into alternative domains. At a minimum, it means aping Japan’s “China + 1” supply-chain model, which involves having fungible substitutes for Chinese services in the event that it seeks to exercise geo-political power through trade-based dependencies.

We have seen this evolution in the development of redundancies in rare earths mining and refining in Australia and critical infrastructure manufacturing returning to the US and its partners.



The Indivisibility of Economic and National Security

Bannon’s doctrine equates economic stability with national security, which has become an increasingly common call to arms in Washington. Once you understand China’s intent, economic and national security are inseparable. It is accordingly imperative to minimise economic dependencies, which China can maliciously exploit for national security purposes.

One striking illustration of this has been the radical change in the global approach to dealing with Huawei—one of China’s national champions and the world’s largest telecommunications equipment manufacturer—which has metamorphosed from being heralded as the next Apple to a core national security threat to all Western states.

When I used to write on security matters for the AFR, I broke global news stories with interviews on Huawei with the heads of ASIO, ASD, the CIA and NSA that revealed for the first time publicly their belief that Huawei was spying for China. This should not have been a shock, because Telstra in Australia and Cisco and AT&T in the US, are all compelled to serve as “corporate partners” of their foreign intelligence gathering services.

And yet the widespread ignorance of the risks presented by Huawei embedding itself into the core telecommunications infrastructure of so many nations has only been relatively recently pierced.

The coordinated and demonstrably strategic efforts by the current US administration to aggressively exclude Huawei from all key Western 5G networks, and ban it as a commercial counterparty for all US companies, will effectively destroy much of its foreign business. While this might be just a high stakes negotiation tactic, it could also signal that the balance of power in Trump’s capricious mind is shifting towards his hawks.

Balance of Power Shifts

Another indication that the Goldman Sachs Consensus was losing momentum materialised in early May. After China re-traded at the last minute on its commitment to a comprehensive trade deal on the weekend before it was supposed to be signed, unexpectedly excising vast sections of the agreed document, Trump retaliated with surprising speed and savagery, hiking existing tariffs from 10% to 25% and further committing to impose a 25% tariff on all Chinese exports to the US. Up until that point, this had been considered a nuclear option that might irreversibly damage US and Chinese relations.

While this was an arguably justifiable reaction to relentless Chinese deceptions, it was also humiliating for President Xi, who presumably expected Trump to fold and agree to some sort of compromise in the name of belatedly getting the long-promised deal done. We have heard consistent reports that the Chinese thought Trump was deeply enamoured with his great friend Xi, who likely assumed he could run, Putin-style, strategic rings around the blinkered American.

If Trumps follows through with the final tranche of tariffs, the Chinese may have been snookered into a de-coupling ambush prepared by Bannon’s Hawks. They may have hyped internal expectations for an entirely fair deal they bet Xi would never buy into, which was precisely the recalcitrance they needed to eventually convince a frustrated Trump that there was not, in fact, a benign bargain on the table. If there is one thing Trump should have

learned over his many years in business, it is the tell-tale sign that inconsistent re-trading means your counterparty actually has no interest in agreeing to an accord that benefits both parties.

Here there is a case that President Xi has systematically miscalculated his foreign policy since he has come to power, overplaying his hand time and time again. He has managed to ostracise most key actors (and near neighbours) across the Indo-Pacific with his imperial construction of numerous militarised artificial islands in the contested waters of the South China Sea.

Likewise, Xi's ultra-assertive efforts to project military parity with the US—through publicising new stealth fighters and bombers, aircraft carriers, and nuclear submarines—has only fuelled extreme suspicion in Washington, creating China hawks of most Democrat and Republican politicians.

And Xi's recent refusal to sign-up to a free and fair trade deal with arguably the most commercially mercenary president the US has ever had has inadvertently unleashed a bipartisan campaign to economically marginalise his country.

In the opening salvos of the trade war, China attracted global sympathy when confronted by Trump's bellicose trade talk and unilateral tariffs, especially from other nations facing similar rhetoric. Yet the effluxion of time has seen Western public opinion coalesce around the idea that China is indeed a malevolent predator, animated by case study after case study documenting China's espionage, theft, and malignant global influence. After years of insouciance, the sudden change in the Western zeitgeist apropos China has been stunning.

Parallels in Turnbull's Arc

Trump's trajectory traces that of Australia's former prime minister, Malcolm Turnbull. A long-time Sinophile and sceptic of US intelligence, Turnbull actively lobbied for many years to have Huawei included in Australia's national broadband network (NBN) alongside foreign minister Julie Bishop and trade minister Andrew Robb.

This was despite repeated official rejections of this possibility by the Australian intelligence agencies and the Labor Party, which has historically been more sympathetic to Australia's largest trading partner. Even after direct briefings with intelligence officials, Turnbull staunchly maintained his view that Huawei was [not a serious national security threat](#).

In 2011 he also [argued](#) that China's rise posed no credible military concerns for the West and that its activities in the South China Sea were benign. This, of course, preceded China's establishment of its artificial islands to explicitly serve as military bases emblazoned with gun and missile batteries, and equipped with ports and runways to service destroyers and fighter jets.

Yet during his tenure as prime minister—and presumably after accessing the most sensitive Western intelligence—Turnbull morphed into a China hawk, and has since publicly implored countries like the UK to [block Huawei from their 5G networks](#) because of the [national security risks](#). It is hard to imagine a more striking, 180 degree turn.

Shifting Probabilities

What does this mean for investors? We still think that a decent trade deal could be struck by Trump if (1) markets go into free-fall and the Goldman Sachs consensus prevails and/or (2) Xi realises he has made a horrible mistake by unwittingly precipitating decoupling, which will only serve to sap China’s main source of power and influence, which has been its incredible prosperity extracted from (unfairly) trading with the global capitalist system.

The option still exists for Xi to sign-up to some sort of comprehensive deal, but then gradually over time back out of it and/or stealthily cheat, which is the most optimal path given Xi’s objectives. We still, therefore, attach a 50 per cent probability to a deal being done one way or another, which is lower than our previous estimates that anticipated a central case involving clear resolution.

We assess that there is an equal probability that no deal is done either because (1) China miscalculates and refuses to sign-up to one on the basis Xi welcomes a nationally unifying existential crisis, or (2) because Trump becomes enamoured with the political benefits of being seen to be tough on China, and saving the US economy from being disintermediated by its most important geo-political rival, through decoupling.

To be clear, we believe that China is miscalculating because there is no way it can win in taking on the West in a global trade (or, for that matter, kinetic) war today. Supply chains will irreversibly shift to China’s distinct detriment, and it will be permanently locked out of the international trading system that powered its historic prosperity while being denied access to the innovation, technological progress and competition that is essential to sustaining its long-term productivity.

The probability of this second scenario has increased since Joe Biden, a notorious China dove, entered the presidential race and argued that China “was not bad” and “not competition for us”. This appears to have emboldened Trump to wedge Biden on America’s China choice, which Trump thinks will play out in his favour at the 2020 election.

This is a highly fluid environment, and we will continue to adjust our decision-making probabilities in real-time as new information emerges.