14 December 2018

China Weekly Letter

Improvement in Trade War, deterioration in Tech War

- **Positive signals on the trade front despite tensions in other areas**
- **The 'tech war' moved to the next level – US tech could be caught in the crossfire**
- **More signs of economic weakening – it gets worse before it gets better**

Both sides keen on making a trade deal

While the US-China 'tech war' has moved to the next level (see below), we keep getting positive signals on the trade front. This week **China bought the first batch of soybeans** from the US since the ceasefire deal. China has also **agreed to cut car tariffs on US cars** to 15% from the current 40% rate for three months starting on 1 January. It will likely be a permanent reduction if a trade deal is made. In addition, several media reported that China has **agreed to make changes to its industrial policy 'Made in China 2025'** strategy, which is China's strategy to take the next leap in technology. According to some sources, China may delay some of the targets by a decade to 2035, see *Bloomberg* and *WSJ*.

In another sign that US President Donald Trump is keen on making a deal, **Trump stated he could intervene in the case of the arrest of Huawei's CFO**: 'If I think it's good for what will be certainly the largest trade deal ever made, which is a very important thing…I would certainly intervene, if I thought it was necessary'. According to experts, this would actually be legal, although it would set a bad precedent, see *New York Times*. In a tweet Trump also said 'Very productive conversations going on with China. Watch for some important announcements'. US Commerce Secretary Wilbur Ross also struck an optimistic tone in a Bloomberg *interview* mentioning that China had so far delivered in a range of areas since the ceasefire deal was made including measures to increase protection of intellectual property rights.

__Comment.__ In our view, there are **clear signs that both the US and China are keen to reach a trade deal this time** and agree on keeping the trade track separate from other tracks that strain the relationship. Under normal circumstances, Trump would have used the Huawei case to put more pressure on China. *Politico* had an interesting story this week on Trump's fear of recession in 2020 and the need for a trade deal. On China's side, they have continued to deliver on points agreed upon in the ceasefire even after the Huawei case broke out. It suggests that they also very much want an end to the trade war. **We continue to look for a trade deal between US and China within the next 3-6 months**, see also *US-China Trade – Ceasefire paves the way for the real deal in 2019*, 2 December 2019.

Tech war to next level – US tech could be caught in the cross fire

While things look good on the trade front, the US-China relationship has moved to a new level when it comes to the 'tech war' and cybersecurity. The **arrest of Huawei's CFO has sparked a very strong reaction in China**, both from the leadership and the Chinese people. So far, China has mainly retaliated against Canada for arresting the CFO of Huawei (who got out on bail on Tuesday). **Two Canadian citizens were**

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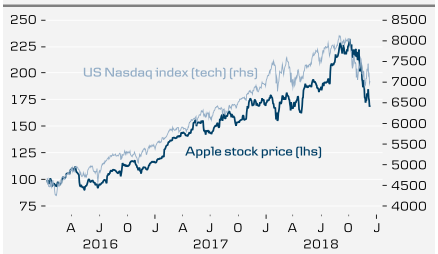
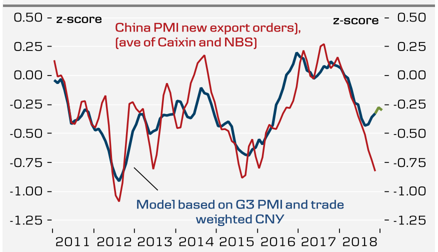
Tech stocks not least Apple - could face headwinds if Tech War escalates



Source: Macrobond Financial, US Census Bureau

Chinese export engine hurting from trade war



Source: Macrobond Financial, US Census Bureau

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arrested in China this week based on claims of threats to national security, see *SCMP*. The former US ambassador to China, Gary Locke, asked rhetorically in a Bloomberg *interview* 'When have we prosecuted high-level executives of companies that have violated Iran sanctions?' and called it a very delicate issue. Media reports suggest executives of US high-tech companies are now thinking twice about going to China, vice versa, see *NYT*.

The Trump administration is apparently preparing actions to condemn China over hacking and economic espionage, see *Washington Post*. Among other things, the Justice Department is expected to announce indictments of hackers suspected of working for Chinese intelligence service.

In a sign of how the US tech industry could be caught in the crossfire of the rising tensions on the tech and cybersecurity front, **a Huawei supplier decided this week to punish employees that buy iPhones** over next three years, *SCMP*. This week also **Apple lost a case in a China court to Qualcomm,** which resulted in a ban on selling a range of (older) iPhone models in China, see *CNBC*.

Comment. The **tech war is here to stay** as a long-term strategic rivalry has begun. The intensifying government-wide US approach to confront China was already signalled by Vice President Mike Pence in his *speech* at the Hudson Institute in October. We expect to see a range of measures from the US to follow up on that over the next year. From China's side there are many ways in which they can retaliate on the tech front, for example by putting up regulatory and administrative obstacles for US tech companies in China, see *Washington Post* for examples.

More signs of Chinese slowdown - more stimulus coming

Economic data this week confirmed that Chinese growth is slowing further going into year-end. **Export data were soft and industrial production and retail sales both disappointed** (see top chart on this page). On the inflation front **producer price inflation** fell again and our model suggests it could dip into deflation territory over the next six to nine months. Finally **money and credit growth for October were also still weak.**

Comment. It's clear that the Chinese economy is slowing further at the moment and we expect it to get worse before it gets better. Chinese policymakers gather next week for the annual Central Economic Work Conference that sets out plans for the coming year. **We expect them to announce more stimulus** shortly after, most likely in the form of further tax cuts for households and companies. We look for a recovery of the Chinese economy from Q2 based on a US-China trade deal and the effects of the stimulus.

Other China news:

China poised for the first time to attract more venture capital than US for early-stage start-ups in 2018**,** see *SCMP*.

China's financial opening continues – financial flows into China are about to eclipse inflows from foreign direct investments, see *FT* analysis.

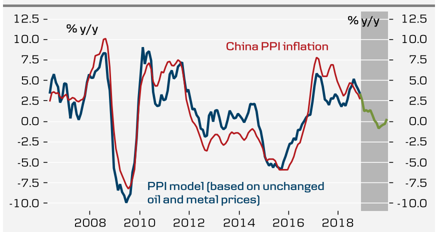
China's politbureau led by Xi Jinping vowed on Thursday to continue reform and opening up: 'China should continue to take pursuing supply-side structural reform as the main task, deepen market-oriented reform, expand opening up at a high level, and speed up the building of a modernized economy', see *Xinhua*.

China's Vice President Wang Qishan vows to keep 'strategic focus' amid mounting challenges of trade war, see *SCMP*.

More signs of economic slowdown

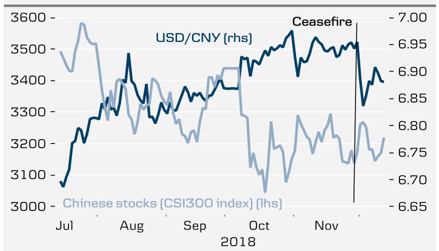
Source: Macrobond Financial, NBS

Chinese producer price inflation heading for 'deflation' again?



Source: Macrobond Financial, NBS

Equities continue sideways pattern, CNY to stay around 6.9 for a while



Source: Macrobond Financial

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