13 December 2019

China Weekly Letter

From escalation to de-escalation

- **With the prospect of a US-China phase one deal we have moved from 1½ years of trade war escalation to a phase of de-escalation. This is good news for the global economy.**
- **Rising copper prices send a further signal of a Chinese recovery.**
- **The Party's Central Economic Work Conference points to a growth target of around 6% for 2020 from 6-6½% in 2019.**
- **Defaults rise in China – and that's actually a good thing (mostly)**

Phase one deal to mark a change to de-escalation

US President Donald Trump brought a sigh of relief in markets on Thursday when he turned to his favourite channel of communication and tweeted 'Getting VERY close to a DEAL with China. They want it, and so do we!'. Later sources close to the trade talks in Washington said that **a phase one deal had been reached**. Michael Pillsbury, a close China adviser to Trump, said to *WSJ* that 'The president is upbeat and enthusiastic about this break-through'.

What's in the deal? At the time of writing no official statements are out but the sources point to 1) China buying agricultural goods, energy and other goods worth USD50bn in 2020, 2) US rolling back tariffs on USD360bn by 50%, 3) China tightening protection of intellectual property rights, 4) China opening up more for financial services and 5) a currency agreement implying no devaluation of USD/CNY, 5) a 'snap-back' clause that gives the US the right to put tariffs on China again if the deal is breached.

Comment. A phase one deal will mark a shift in the US-China trade war from 1½ years of escalation to a de-escalation phase. This is what we believe is important from a market point of view as it reduces the global recession risk further and underpins a recovery in 2020 in both China and the global economy. Why now? As we have argued, we believe the US election in less than a year is the main reason Trump is now eager to close a deal.

The next question will be if the two sides can close a phase two deal as well in the first half of 2020. This will be more difficult and may depend on how Trump is looking in opinion polls. Republican Marco Rubio and Democrat Chuck Schumer have already been quick to criticize the phase-one deal for not dealing with the real problems with China. Hence, Trump will be under pressure to close a phase two deal as well. We still put the probability of this happening at 50%.

Stock markets and the CNY gained on the news of a deal. We see further upside in both markets, with Chinese stocks likely to reach new cycle highs soon and the USD/CNY moving gradually towards 6.8 over the coming year.

Selected recent China Research

China Weekly Letter – Phase-one deal moves closer as 15 Dec deadline is near, 6 December 2019

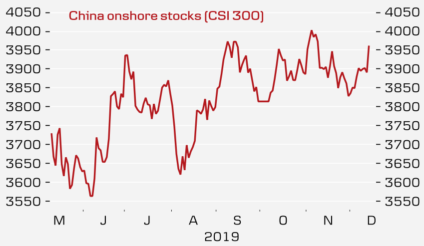
The Big Picture – Rays of light for the world economy (see pages 28-31 for outlook on China), 2 December 2019

Postcard from China – From trade war to US-China decoupling, 21 November 2019

China Weekly Letter – The tide has turned – we lower our USD/CNY forecast, 8 November 2019

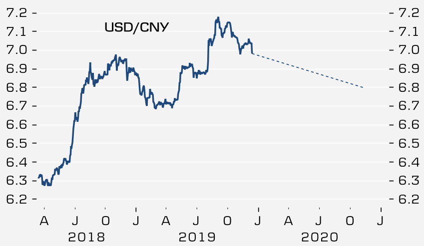
Link to all China research

Chart 1: Stocks jump higher on trade hopes...



Source: Macrobond Financial, Danske Bank

Chart 2: ... and CNY strengthens. More to come



Source: Macrobond Financial, Danske Bank

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Dr. Copper adds to evidence of recovery in China

Copper prices have edged higher over the past three months and took a jump to a seven-month high this week on the back of data on Chinese imports of copper on Sunday, which surprised to the upside (see charts 3 and 4).

Data on auto sales for November still point to soft sales but at least the big drop has come to an end (see chart 5). Data on PPI continues to show deflation but we expect this to end in early 2020 as commodity prices edge higher (see chart 6).

The Communist Party now acknowledges the recovery in data and last week stated that: '*The latest economic indicators such as factory and service activities, and trade growth all rebounded, pointing to the effectiveness of pro-growth policies and the economy's resilience*.'

The Central Economic Work Conference this week set out the path for the coming year. The message was that economic policies would be kept stable and that the focus will be on making them more effective. The conference also suggested the growth target for 2020 will be around 6.0%, but the actual announcement will not come until the annual People's National Congress in March.

Comment. We continue to see signs of a moderate recovery and we look for the big drag from the auto sector to fade in 2020. The effects of stimulus measures already taken and easing trade tensions are other drivers of the recovery. We don't expect much further stimulus from here.

Defaults rise even for SOEs – and that is a good thing (mostly)

China has faced a big rise in defaults over the past year and is *set to reach a new record* in 2020. This week China suffered the *biggest dollar bond default* by a state-owned company in two decades as a major commodities trading company announced a debt restructuring involving big losses for investors. Defaults by state-owned companies have doubled in 2019 compared to previous years.

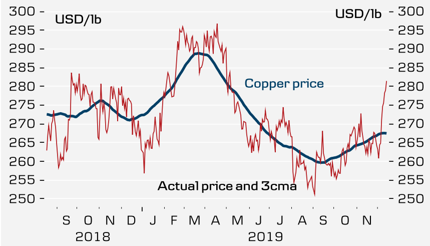
Comment. A rising number of defaults is normally a bad thing, and of course it should also be seen as a sign of economic pressures from the economic slowdown. However, we see it as a positive sign because it highlights that China is getting serious about making budget constraints harder for state owned companies – a necessary step to increase efficiency. The deleveraging and harder budget constraints will lead to higher losses for banks and put downward pressure on growth. But this is a necessary step to clean up bad debt and put the financial system on a sound footing. It will take years but the first steps have been taken. It is also part of the 'quality over quantity' focus in China, which has been a centrepiece of the economic strategy.

Other China news this week:

China *bans foreign equipment* for public procurement in retaliation move of US export controls.

Huawei may need *two to three years* to recover from the US trade ban according to the company's CEO.

Chart 3: Copper prices move higher...

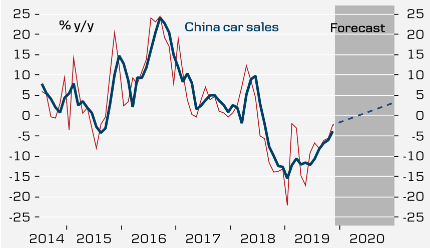


Source: Macrobond Financial, Danske Bank

Chart 4: ... as Chinese demand is rising again

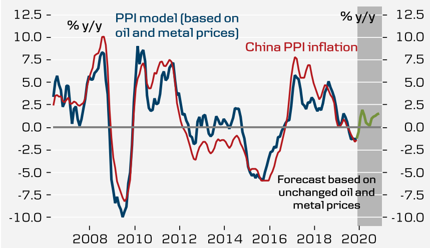
Source: Macrobond Financial, Danske Bank

Chart 5: Auto sales no longer falling and drag should fade further in 2020



Source: Macrobond Financial, Danske Bank

Chart 6: PPI deflation to end in early 2020



Source: Macrobond Financial, Danske Bank

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Allan von Mehren, Chief Analyst.

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