

China Weekly Letter

US pulls out the heavy weapons by targeting Huawei

- **The US blacklisting of Huawei is a clear escalation of the trade war; Xi-Trump meeting in June could be at risk**
- **Xi Jinping prepares people for a new ‘Long March’ and calls for self-reliance**
- **Poor US manufacturing data challenges Trump’s ‘maximum pressure’ strategy**

US ban on Huawei is significant

This week it became clear that the US is pulling out the heavy weapons to pressure China into offering concessions in the trade war. After Washington put Huawei on the so-called ‘entity list’ a wide range of US suppliers to Huawei *announced* they had to halt deliveries. Among the companies were chip makers Intel Corp., Qualcomm Inc. and Broadcom Inc. *Google has cut off* the supply of hardware and some software products to Huawei, meaning that Huawei mobile device users will not be able to use Google apps such as Gmail, YouTube and its Google Play app store. The ban also affects international companies outside the US if their products have more than 25% content of US products. It led several global technology companies to put a halt to deliveries as well. The US Commerce Department granted a *90-day reprieve* on the ban, but the move was limited in scope and mainly to give users time to adjust to the change.

China has not yet retaliated to the blacklisting of Huawei, but Chinese Commerce Ministry spokesman Gao Feng *said* at a weekly briefing that negotiations can only continue if the US ‘correct their wrong actions’. He added that **China would closely monitor relevant developments and ‘prepare necessary responses’**.

Huawei founder, Ren Zhengfei, *said* a clash with the US had been ‘inevitable’ because Huawei’s aim to be a global leader threatened US interests. Ren claimed Huawei has been preparing for this and that the ban would not impact Huawei’s 5G plans. According to some analysts, *Huawei has built an inventory* of US product supplies to maintain production for the rest of the year. Huawei’s own chip company HiSilicon struck a defiant tone on Friday last week, saying the company had prepared for a US ban for some time through development of its own chips and that Huawei will aim to be self-reliant going forward. However, *tech experts are not convinced by Huawei’s back-up plan*, as Huawei most likely still depends on US and other foreign technology companies in many different areas.

US President Donald Trump *hinted on Thursday that the Huawei ban could be part of a trade deal*. On the prospect of a deal he stated “It’s happening, it’s happening fast and I think things probably are going to happen fast with China because I cannot imagine that they can be thrilled with thousands of companies leaving their shores for other places”. A China adviser *this week said* the latest events meant that a **Xi-Trump meeting at the G20 meeting in Osaka in late June was now ‘up in the air’**.

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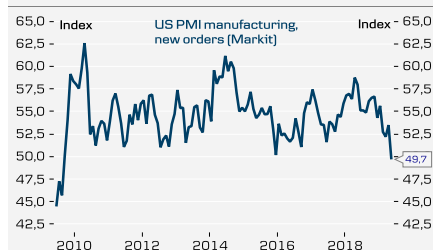
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Weakest order situation in US manufacturing since 2009



Source: Macrobond Financial, Markit

US again having upper hand in relative stock market performance



Source: Macrobond Financial, Bloomberg

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Comment: Blacklisting Huawei is a very serious move, in our view, and even if the ban is lifted as part of a deal, considerable damage will likely remain. In future, mobile phone buyers will wonder whether they can rely on access to Google apps such as Gmail and YouTube. Half of Huawei's 200m unit sales are generated outside China.

Apart from being a bargaining chip in the trade talks, the ban may also be an attempt to halt Huawei's rollout of 5G networks in China as well as in other countries. Huawei is widely known to offer the best 5G network in the world and by not allowing it in the US, American companies will be at a disadvantage in sectors such as Artificial Intelligence and the Internet of Things. Other countries may also think twice about choosing Huawei for 5G networks as the threat from the US will not go away. It remains to be seen if China will retaliate and, if so, how. Xi Jinping visited a rare earths facility this week, which may be a signal to Trump that China is considering restricting US access to rare earths. Rare earths are needed in many high-tech products such as mobile phones, electric vehicles and missiles. China is estimated to have 90% of global rare earth production. Xi was accompanied by China's chief negotiator in the trade talks, Vice Premier Liu He.

The move on Huawei is also seen in China as the US speaking with two tongues. On the one hand, the US claims Huawei is dangerous because it is affiliated with the state. On the other hand the US government itself is exercising its own power on US tech companies.

Xi prepares for a new 'Long March', calls for self-reliance

On top of the defiant tone in state media, China this week sent another signal, that the country is not about to give in to US pressures but instead is preparing for a long drawn-out conflict. Xi Jinping visited the place in Jiangxi where the so-called 'Long March' started in 1934. It lasted for a year after a strenuous march of 4,000 miles following a defeat to the Nationalists. "We are now embarking on a new Long March, and we must start all over again", Xi said. On the trip to Jiangxi Xi also called for self-reliance within technology and said "Only if we own our own intellectual property and core technologies, then can we produce products with core competitiveness and [we] won't be beaten in intensifying competition". A senior official said on Friday that China will increase its support and subsidies for tech companies amid rising protectionism from the US.

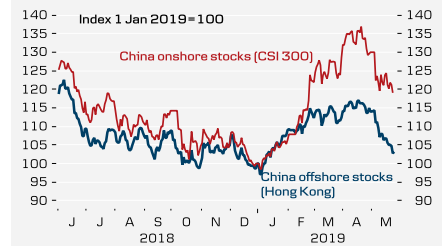
Comment: It is clear by now that China is vulnerable as long as it depends on US technology. China is thus likely to double down on its technological ambitions. It will only add to the global tech race and rivalry with the US.

US manufacturing takes a hit, and consumers feel higher prices

In a survey by the American Chamber of Commerce in China, 74.9% of US businesses say that tariffs are having a negative effect on their business. The US economy may increasingly feel the headwind from the trade war as the PMI new orders index in May dropped to the lowest level since 2009. A New York Fed report also estimates that the latest tariff increase by Trump raises annual costs for US households by USD831. Next week's Chinese PMI will give the first indication of how the trade war escalation is affecting China's economy.

Comment: While trade talks are in deadlock right now, we believe that a trade deal will be back on the table when the damage to the US economy and markets becomes more apparent. The poor manufacturing data may be the start of this. It's hard to see a deal without pressure from a further sell-off in US stock markets, as China is digging in and stock market weakness is likely needed for Trump to soften the current stance. If China decides to cancel the Xi-Trump meeting in June, this could be a catalyst for a further market sell-off, in our view.

Chinese offshore stocks doing even worse than onshore market



Source: Macrobond Financial, Bloomberg

CNY and CNH weakness coming to a halt for now



Source: Macrobond Financial, Danske Bank

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