29 November 2019

China Weekly Letter

Phase one deal still in sight despite Hong Kong bill

- **US-China trade talks do not seem to be affected by Trump's signature of a Hong Kong bill. China sets new goals to fight IP theft.**
- **First sign of possible tech flight from the US due to export controls and trade war.**
- **Profit growth drops sharply but it should be the bottom.**
- **Pro-democratic candidates secured 90% of the seats in the Hong Kong district elections.**

Phase one deal still in sight before unofficial 15 December deadline

Markets got jittery this week as Trump put pen to paper and signed the Hong Kong bill, which works to support protesters in Hong Kong. As expected, China reacted strongly to the decisions and summoned the US ambassador in China, calling for the US to '*correct its mistake*'. However, there was no sign that the dispute would affect the negotiations to reach a phase one deal. On Wednesday, US President Donald Trump said that '*We're in the final throes of a very important deal. It's going very well but at the same time we want to see it go well in Hong Kong*'.

Over the weekend, China set new goals to fight IP theft in what seems to be another step closer to a deal with the US. The so-called 'guiding opinions' promise meaningful improvements with existing challenges in the process including '*difficulties in providing evidence, long processing times, high costs, and low payouts*.'

Meanwhile more stories are surfacing about ailing US farmers, who have *suffered a lot* from the trade war. Bankruptcies are up 24% since September 2018 and Trump's *approval among farmers is down* this year. A study by US scholars suggested the Republicans *lost five out of 40* seats in the House at the mid-term elections in 2018 as a direct result of the trade war. To add insult to injury a New York Fed study this week concluded that the *US pays the majority of the bill* from higher US tariffs on goods from China.

Comment. China has so far kept other cases of US confrontation separate from the trade talks and is likely to do the same with the Hong Kong bill. For example, the arrest of the Huawei CFO in Canada happened only a few days before Trump and Xi made a ceasefire (the first one) in December 2018.

We expect a phase one deal to be in place ahead of the unofficial deadline of 15 December, the date US tariffs on another USD160bn of goods from China will go into force unless Trump cancels them. However, this last tranche of tariffs will hurt the US economy more than previous tariffs, which Trump would most likely want to avoid. In addition, with falling approval among farmers, Trump is eager to get China to buy soybeans, pork and other farm products again. The farmers have generally supported Trump in 'taking on China' but have also been clear that it had to end with a deal that gave them their market back and preferably with even higher Chinese purchases than before the trade war. The latter would probably require a phase two deal next year, though.

Recent China Research

China Weekly Letter – Phase one deal hinges on tariff cuts by the 'tariff man', 22 November 2019.

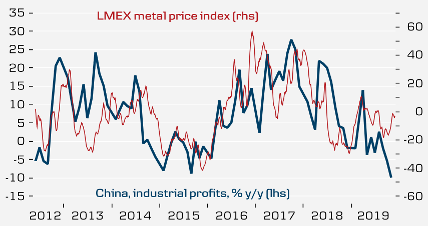
Postcard from China – From trade war to US-China decoupling, 21 November 2019

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

US-China Trade – 60% probability of an interim deal, 2 October 2019

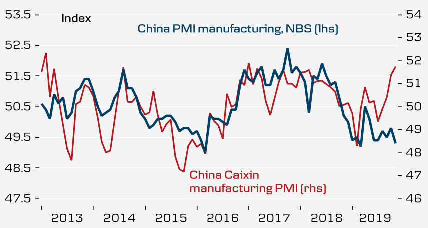
Link to all China research

Chart 1: Profit growth dives in October but it is likely the bottom



Source: Macrobond Financial, Danske Bank

Chart 2: Look out for PMIs over the weekend. Will the gap close?



Source: Macrobond Financial, Danske Bank

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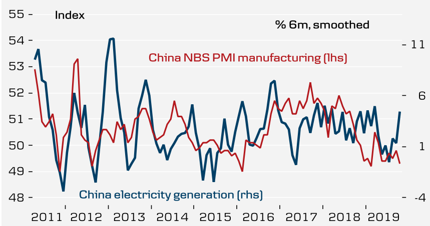
First sign of tech flight from the US due to geopolitical concerns

The US got a reminder this week that there is a ***cost to restricting exports of technology*** **goods to China**. The US-based RISC-V Foundation overseeing promising semiconductor technology will move to Switzerland due to concerns over US tech restrictions and the trade war. The non-profit organisation wants to make sure that universities, governments and companies outside the US can help develop its open source technology. The Chief Executive Calista Redmond said to Reuters that the foundation had not net met any restrictions but its members were '*concerned about possible geopolitical disruption*'. The organisation sets standards for core chip architecture and has more than 325 members, among which are big US and European chip producers.

US and Germany bumped their heads together on Huawei this week as Trump's ambassador to Germany hit out at Berlin over comments by the German economy minister Peter Altmeier. The German minister said on a German talk show that Germany 'had not imposed a boycott' on US tech companies in the wake of the NSA affair, that revealed the US had been tapping German chancellor Angela Merkel's phone some years back. It comes after US pressure on Germany to ban Huawei, something that Germany has resisted so far.

Comment. The US will face a rising dilemma in restricting exports of technology to China. With China being the biggest and fastest growing market in the world for many US tech companies, they could end up leaving the US in order to avoid the export ban.

Chart 3: Rail freight has picked up



Source: Macrobond Financial, Danske Bank

Profit growth falls sharply but it is likely to be the bottom

Chinese industrial profits fell sharply in October by 9.7% y/y, the steepest drop since 2009. It put another number in the basket that says Chinese growth is still weak.

Comment. The drop was bigger than expected but we believe profit growth will rebound in coming months as we look for a moderate recovery of Chinese industry. **Over the weekend we get the batch of PMIs from NBS and Caixin**. They show unusual divergence at the moment (chart 2). We believe the truth is somewhere in the middle and would expect the Caixin PMI to fall (possibly quite a lot) while the NBS PMI should increase. Not clear how markets would interpret this.

Big win for Hong Kong pro-democracy movement in elections

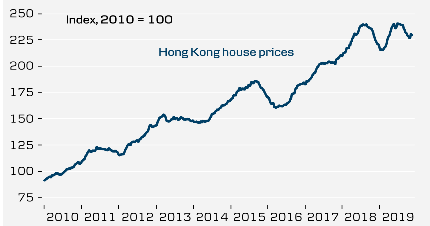
On Sunday the Hong Kong district elections saw a win for the pro-democracy movement as democratic candidates *won 90 % of the seats*. Chief Executive Carrie Lam in a *statement* said that the government '*will listen to the opinions of members of the public humbly and seriously reflect*'. Economic data continues to look dire. Hong Kong imports fell the most in 10 years (chart 4) and house prices have started to decline.

Comment. It is not clear what will happen from here. But we expect that the Hong Kong economy will see permanent damage, with stories emerging that some are starting to leave Hong Kong, not least mainland Chinese who feel a hostile environment there. It will put pressure on Hong Kong house prices and the risk of a long drawn-out growth crisis is real.

Chart 4: Hong Kong imports weakest since global financial crisis

Source: Macrobond Financial, Danske Bank

Chart 5: Hong Kong house prices at risk of falling in coming years



Source: Macrobond Financial, Danske Bank

Other China news this week:

First sign of ***recovery in Chinese pork production*** as the inventory of breeding sows saw the first monthly increase in October since the African swine fever broke out last year.

Alibaba had a ***strong start*** **on Hong Kong exchange** rising 6.6% on the first day.

VW's China Venture ***to invest USD4.4bn*** **in electrification** and SUVs. VW had a close to 20% market share this year, the highest in five years.

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