THE National Investor

April 4, 2018 *You can get information anywhere. Here, you get KNOWLEDGE.* COMMENTARY

COMMENTARY:OUR M.A.D. POLICY WITH CHINA ... AND WHAT WE DO HAVE TO WORRY ABOUT!

By Chris Temple -- Editor/Publisher

Global markets have been increasingly roiled of late due to fears over an evolving trade war. It's been some time since the *overall* tenor on Wall Street was gripped by this particular worry; and **one that increasingly involves the long , *symbiotic* economic relationship between China and the United States of America.**

It's no secret to anybody that China has been a favorite whipping boy of President Donald Trump. On the campaign trail, his rhetoric had many believing that China is solely responsible for most every malady that has ever befallen the American economy or American workers; particularly, of course, in manufacturing, industries that China--with its cheaper labor and other advantages--has taken over.

President Trump has suggested even that it was a mistake to allow China membership into the World Trade Organization years back. Yet as president, he has also *at times* seemed genuinely desirous of some constructive solutions to what he more than most sees as the problem of America's massive trade imbalance. And it's a trade deficit which last year--despite the relentless (and *Trump inspired*, as I pointed out along the way) drop in the exchange value of the U.S. dollar--reached a nine year high. . **.and a record with China alone, at $375.2 billion.**

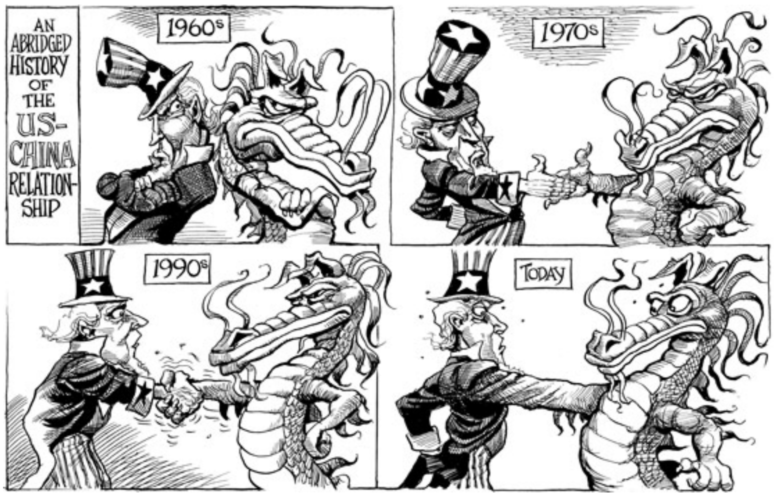
ANALYZING THIS "PROBLEM" FROM THE PROPER FOUNDATION

Bellicosity is often a tool used by politicians everywhere; not just a Donald Trump who tends to shoot from the lip at times and--as a diplomat--was never quite house broken. In talking specifically about these trade issues of late, I have quipped that the "quality" (and I use the term loosely!) of Trump's discussion and arguments remind me of those that Archie Bunker, Barney Heffner and their pals might well have had at Kelsey's Bar. He means well. He's not incorrect that American workers *and America's sovereignty* have been shafted over the years.

But while the president has not only identified *but rubbed raw anew* some of the consequences of long-running U.S. policy, **he falls woefully short in seeming to understand on any level the core *problems*.** For instance, those of you who follow me regularly know I have pointed out often the FACT that--by virtue of having the world's key reserve currency, the dollar (which accounts for *over 60% of every transaction on the planet*)--**America MUST by DEFINITION run trade deficits with other countries, on net.** After all, that is how they get the dollars in the first place with which to transact business otherwise.

Take China's long-running role in what in a sense has been, as one pundit terms it "the greatest vendor financing scheme in history." You will occasionally hear promoters trying to scare you into some kind of action by warning--especially now with this nascent trade war, if that's what it *really* is--that China might "retaliate" by punishing Uncle Sam and refusing to buy Treasury securities; perhaps even dumping what it already owns. But on several levels that is silly. For what came along with a record trade deficit with China in 2017, pray tell? **The highest level of net PURCHASES of Treasury securities in seven years by China.**

Indeed, I have long compared the situation economically with China with what once existed between the U.S. and the former Soviet Union militarily. **It was simply referred to as M.A.D.: Mutual Assured Destruction.** Each side knew that if it picked a fight with the other with nuclear weapons, *both* would be obliterated. So that is a big reason why we never did have nuclear war with the Soviets. Likewise, *China especially*--as I will detail below--is in no place to risk a *major* blow up in this symbiotic relationship with America.



Digging even deeper into *the root cause* of what is now being agonized over by everybody--particularly the president--let us not forget that (as was, frankly, the Soviet Union decades back) **China in its modern-day form is to a great extent also an American creation.** Specifically, long ago (mostly) U.S.-based corporations and financial institutions realized that *their profits* could be increased by jettisoning U.S. factories and workers in favor of lower costs for both in China. One of the better analyses and history lessons of this came several years ago from Lew Lehrman in his article, "China: American Financial Colony or Mercantilist Predator?" from September, 2011 in the *American Spectator* magazine (at https://spectator.org/37018_china-american-financial-colony-or-mercantilist-predator/.)

While I think Lehrman's currency-only solution for this is a bit simplistic, his main point is indisputable: that successive American administrations either enabled (or looked the other way during) Corporate America's building up of a country now deemed an "enemy" of sorts. That is now water under the bridge, however; whether we like it or not. And unfortunately against a backdrop of a public discourse in this country these days more concerned with labels, whose feelings get hurt and such other superficial and inane "news," I suppose I shouldn't expect in the first place that even the financial press will really dig deep, as we are here.

So that leaves us with the present question: are we in reality heading for a trade war of such magnitude that it will trash the global economy, and markets with it? My own view at present is that we are *not*. Keeping in mind that pretty much all of the tariffs recently announced back and forth will not even be implemented for weeks *if not months*, I am of the view that both "sides"--beyond the sometimes combative rhetoric--realize they need to stop short of such a thing. Though he is fairly naïve about these root causes of our trade imbalances, I think President Trump is looking for *some* relief he can sell to the electorate and hang his hat on. In this sense, I believe with others that he is using these tariffs, and threats of more, as bargaining chips. Both sides have a lot to lose here if they go too far; *especially China*.

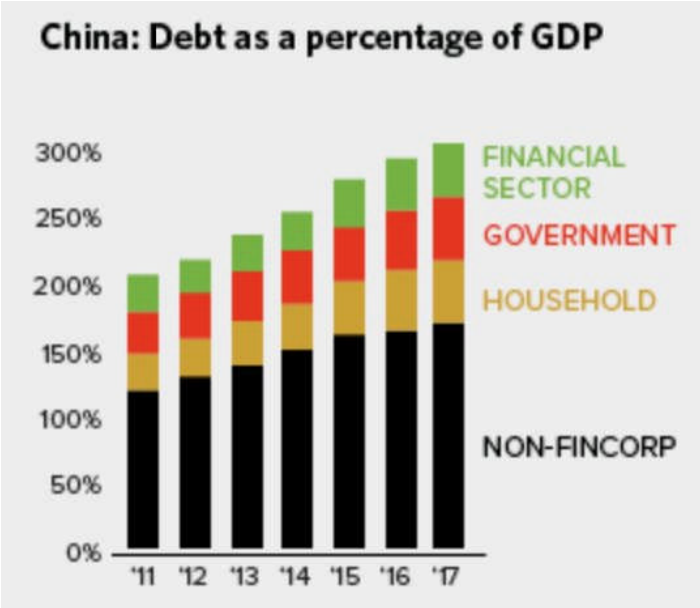
CHINA WANTS -- *AND NEEDS* -- TO BE A CONSTRUCTIVE TRADING/MARKET PARTNER

I have no doubt that China sees itself regaining one day its glory from millennia past as a great empire. I also have no doubt that--notwithstanding the fact that it was American capital, corporations and complicit governments in years past that were very instrumental in making it what it is today--China when it becomes convenient will have little if any sense of allegiance. Far from the assisted suicide of the American economy that has been taking place for a long time, China knows much more how to look out for Number One. And also unlike the U.S., it can see and think past next week; years if not decades into the future as it plots its strategy to become Asia's (at least) unquestioned dominant power.

To get to its destination, China knows that to at least some extent it needs to play ball even with Donald Trump. It can ill afford to ruffle *anybody's* feathers very much. **As I have been discussing for a while--and will repeat below--it *desperately* needs the trend which is bringing it more into global capital markets to continue.**

China is making a conciliatory gesture to America in central banking: Vice Governor Yi Gang (left) will take over the People's Bank of China from outgoing Zhou Xiaochuan. As a

Reuters report on this news put it, "...His appointment is a surprise to those who believed he was ruled out by his status as a 'sea turtle' – slang for Chinese with significant overseas experience. But for this job Beijing needed more than reform credentials – it needed a technocrat who could win the trust of foreign investors, and warm relations with a suspicious America." So, while there were some raised eyebrows in China over this, Yi--a former professor at Indiana University and, naturally, fluent in English--is now going to run China's central bank. (Part-paradoxically and part-comically in light of my own above comments, there are those hard nationalists in China who see Yi's elevation as proof that China STILL IS when all is said and done a "colony" of American/larger moneyed interests!)



It's no secret that--more than any other country, in relative terms--China *exploded* its debt levels higher since the 2008 financial crisis. Pretty much the *only* reason it has not already imploded on them is that--contrary to Western nations, as I have long pointed out--*China's central bank answers to the central government*. And for quite a few years now, government decree--and little else--has kept the country's *skyscrapers* of cards from coming down.

It is for this reason--and the fact that the HUGE capacity of manufacturing in China has a LOT of debt and hungry Chinese mouths associated with it--that **it would be suicide for China especially to risk a trade war that would inevitably lead to a collapse.** For all its administrative and near-dictatorial advantages, even the central government may not be able to keep all the balls in the air. Thus, it needs an "Americanized" President Yi at the P.B.O.C. who can instill confidence in markets. And it needs to dicker with Trump on trade, and especially intellectual property; giving some ground in areas where its position is weakest. . .allowing Trump to declare some "victory". . .and in the end, not unduly upending the status quo.

Make no mistake: Job One in China is managing to keep its stressed financial structure and banking system from imploding. In the last few years, a key part of this is that the country has taken steps to be more integrated with the broader *global* capital and investment markets. While it still has a fair bit of work to do in this regard, it has made its markets more transparent and with at least *some* Western-style "rule of law." Acknowledging China's ascendance, the International Monetary Fund now counts Chinese yuan with other major world currencies in its SDR (Special Drawing Rights) basket. Last summer, it was announced that some Chinese mainland stocks will now be counted in the overall global MSCI Emerging Markets Index.

Most recently--*and perhaps most importantly*--it was announced that Chinese debt is to be added to one of the most closely followed global bond gauges. Renminbi-denominated securities will be added to the Bloomberg Barclays Global Aggregate index over a 20-month period beginning shortly. Once the inclusion has been completed, it's reported, the benchmark will include roughly 386 Chinese securities which would represent 5.49 per cent of the $53.7tn index. That will pretty much *automatically* add about $3 trillion of built-in, passive market support for Chinese debt.

And attempting to cement its long-term *regional* strength, **China also just launched its own futures market for oil which will be settled in yuan.** Over the very long term this *could* set up China's currency more strongly as at least a regional reserve currency. Yet for present purposes, this is insignificant compared to the above, which increasingly makes all of the world's liquidity fair game for China's stock and bond markets.

Yes, President Trump can be an overly simplistic, bombastic boor at times. Yes, many of America's allies may make nice in public, but cringe privately over having to deal with such a man. But for those of you who don't get it yet--and no matter how naïve Trump truly is at times on substance--**he has the majority of the cards in his hands; certainly where America's specific relationship with China is concerned.** And again, it's my view that--not unlike the several instances of isolated tariffs put on various trading partners under most presidents from time to time--these are most likely to also be proven as more negotiating tools. And they, too, will pass, together with the markets' (for now) disproportionate fixation on and worry over this (which, truth be told, would receive 10% of this coverage if, say, a Barack Obama was attempting to similarly deal with China.)

HERE ARE TWO THINGS I AM WORRIED ABOUT

If I've said it once lately I've said it 100 times: instead of obsessing over U.S. stock index charts that *finally* show an actual correction (albeit barely for now) WATCH CHINESE STOCKS!! A big part of China's strategy to keep its debt from imploding is to foster a sufficiently hospitable environment that will encourage holders of that debt to convert it into equity. A trade war will not do that. The ensuing fears of recession will not do that.

This is a big part of the reason why China is going to be the first to "blink" if I am correct in my analysis. Only by reassurances that Trump and China's President Xi Jinping can work together and make some kind of acceptable deal will the belief remain that what for a while now has been respectable global growth won't be torpedoed.

The alternative if I am wrong is that overextended Chinese businesses and its shadow banking system can't even *service* debt any longer, if they can't convince holders to convert to stock ownership of stressed companies and if growth slows too much. If the present correction for U.S. stocks turns into a cyclical bear market (a 20% drop in contrast with the 11% or so we've seen) that *probably* won't in and of itself cause a liquidity-draining crash. **But China's stock market--as is its whole credit structure--is**

considerably more vulnerable. I don't think *global* markets would weather a 20% drop in the Shanghai composite without *major* trouble. So its own ability to hold a double bottom (or not) has my eye.

Outgoing P.B.O.C. President Zhou famously warned not that long ago of a possible/coming "Minsky Moment" for China if it is unable to keep this whole credit bubble from breaking. That term, if you are a little rusty, was named for economist Dr. Hyman Minsky, who years ago warned of how credit excesses and speculation that run well ahead of organic economic growth inevitably are unsustainable and--when critical mass comes--can unravel "in a moment." (See a great Wikipedia piece at https://en.wikipedia.org/wiki/Minsky_moment for more color on this.) That is one thing that worries me: not that a trade war or overly exaggerated present fears of one will do much damage, but that even the change in mood it fosters in already-overextended markets will be the tipping point causing that Moment.

Second, as I opined in my podcast on the K.E. Report several days ago, I am concerned that some in Trump's disturbing inner circle want to use these current trade disputes to REALLY knock China down a peg or two. **Right after the election, in fact, one of my commentaries had to do with the fact that some would like to see the same approach toward China as the Reagan administration took toward the Soviet Union back in the 1980s.** Back then--though at the expense of an explosion in America's debt, which fortunately was more manageable in those days--Reagan's strategy of militarily outspending and eventually bankrupting the Soviet Union seemed to work (and had the intended, nice benefit of further enriching the Military-Industrial Complex.)

Especially as Trump is bringing ever more war-thirsty neoconservatives and Deep State functionaries into his inner circle, I am worried anew that these trade disputes will morph into a broader effort to outflank China *militarily* as well. That country is attempting to recapture its past military strength; and disputes have arisen with several of its neighbors.

If left to his own devices, I *still* want to believe that Trump does NOT want such military confrontations and would personally stop at such an escalation/strategy. But we cannot be sure about that. In several other ways, the America-first stance of *Candidate* Trump when it comes to foreign entanglements has already been neutered by what even he has alternately called the Deep State or The Swamp.

Developments in this area will also be every bit as important to watch as the trade/economic ones. And this will be a story for another day as well. . .

For more information or to become a Member and receive ALL of Chris' specific, actionable recommendations, visit https://nationalinvestor.com/