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Weekly Update: I'm told Buenos Aires is beautiful this time of year

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It’s late spring there, with the jacaranda trees’ purplish flowers in full bloom. It’s where President Trump and China President Xi Jinping are scheduled to meet in two weeks, away from other G20 leaders as they gather in Argentina. What happens then may decide whether stocks experience their usual post-midterm year-end rally or another bout of volatility. Deutsche Bank puts odds of some sort of deal at 50-50, although it acknowledges the path of the negotiations over the past six months shows positive signals don’t always lead to positive outcomes. On what might the two agree? China may promise to buy a large amount of U.S. goods such as agricultural products and airplanes, lower tariffs on many U.S. products such as cars, open its service sector to U.S. firms and phase out joint-venture (JV) requirements on U.S. companies doing business there. The U.S., in turn, may promise to lift the current 10% tariff on about $250 billion of Chinese imports and more importantly, do away with plans for costlier 25% tariffs on about $550 billion of imports set to start in January. If the Chinese just offer soybean and other commodity purchases, Trump is almost sure to walk. But if there are meaningful moves on tariffs and foreign company restrictions, that’s a deal he can make. The Chinese already are moving to the U.S. position by lowering tariffs on non-U.S. goods and ending JV requirements for automakers.

If a trade deal is struck, it almost assuredly won’t mean the end of the economic cold war with China. The underlying issue is China’s lead in several key technology areas, particularly artificial intelligence (AI). The race to AI dominance is on and China’s stated goal is global leadership by 2030. It already is ahead in some fields. A recent Bank of America Merrill Lynch study found Chinese patent applications in AI and the related field of deep-learning are running at 5-to-7 times above those of the U.S. Data growth is AI’s fuel—and UBS says China has advantages in scale and regulations that allow for far greater data collection and usage than in the U.S./Europe. One example is its government’s commitment to Xiong'an, an entire city dedicated to AI development. China’s success hinges on two key uncertainties: 1) whether data availability and use become more regulated/restricted outside China—UBS says Chinese citizens' willingness to share data is 1.3 times greater than in the U.S. and about 3 times greater than in Germany; and 2) the openness of markets—especially the free trade of enabling technologies, components and code. Then, of course, there’s the whole issue of intellectual property (IP) theft. Any long-term agreement is going to require Beijing to improve IP protections for U.S. companies and researchers. Some question whether China will feel the need to do much of anything. The Institutional Strategist (TIS) said a common theme during its recent visit there was that China’s leaders think they can wait out a Trump presidency, then U.S. trade policy will change. It seems an Oct. 4, anti-China speech by Vice President Mike Pence that was little noticed in the U.S. still stings in Beijing (*more below*). But the administration’s approach to China has bipartisan support, suggesting the cold war on trade will go on whoever occupies 1600 Pennsylvania Avenue.

China could feel compelled to act out of its own self-interest. A closely watched private indicator of business activity recently plunged, adding to concerns about China’s slowing economy and raising the question of whether conditions may be worse than official statistics show. For most of the 300 respondents surveyed, “business has never been worse.’’ Market expectations on China’s macro outlook have been deteriorating amid signs of a consumption slowdown and investment sluggishness. The impact of tariffs have started to weigh, but it’s believed the biggest drag has been a government-orchestrated growth deceleration strategy that began in the spring of 2017, when Beijing raised rates a sharp 200 basis points, actively appreciated the yuan about 14% and sharply decelerated new bank loan growth from 30% year-over-year (y/y) to 0%. The deleveraging initiatives caused China’s official real GDP growth to fall to a decade-low 6.5% y/y in the third quarter, and Bank of America projects it could hit 6.1% next year. But along with others, it doesn’t foresee a hard landing as Beijing is expected to push through more fiscal stimulus to offset weaker investment and trade risk, with the Trump spat providing cover to so. Its Politburo called for “timely implementation of countervailing policies” at its late October meeting. I’ve never been to Buenos Aires but have read that the sweet aroma of the jacaranda trees' beautiful blooms have soothing qualities, an observation tied to the fact they open around the same time college students complete final exams. Perhaps Trump and Xi should meet outdoors!

Positives

- **Is that Santa I see?** October retail sales rose strongly at the headline level, led by volatile autos and a hurricane-recovery jump in building materials. Excluding those factors, the increase was moderate and in line with recent trends, suggesting a healthy but not necessarily spectacular holiday season. The National Retail Federation projects spending this month and next to increase 4.3-4.8% over 2017, above the average 3.9% bump over the last five years.

- **Small business confidence stays strong** The National Federation of Independent Business (NFIB) said optimism among members this month held near August's 45-year record high, consistent with strong economic growth. Job openings also set a record as survey respondents complained it's tough to find qualified workers.
- **U.S. recession watch** Two early takes on November manufacturing were mixed—the Philly Fed said manufacturers in its region reported a softening in new orders and optimism, while the New York Fed's Empire survey reflected the opposite as both rose measurably. Combined, the reports indicate activity continues to be expansionary, just not accelerating.

Negatives

- **Global recession watch** Germany's and Japan's economies contracted in the third quarter, eurozone GDP growth rose at its slowest pace in more than four years and China retail sales dropped to a 5-month low, adding to worries about a global slowdown that sent oil prices plunging in recent weeks. West Texas Intermediate crude is now trading roughly 25% below its early October peak.
- **This won't deter the Fed** Consumer prices rose in October at their fastest pace since January, although a lot of that had to do with higher oil and gasoline prices that have since fallen dramatically (*as noted above*). The core y/y rate actually moderated. In other signs of budding price pressures, the NFIB said the share of small businesses planning to raise prices shot up to 28%, the most since August 2008, while import and export prices accelerated.
- **Contrarian negatives** Conference Board consumer confidence and Investors Intelligence bulls-bears readings reflect "extreme optimism" that's historically associated with stock market tops, adding to worries that include slowing global growth, falling oil prices, a China trade war and a Fed that appears committed to its rate-hike path.

What else

Orwellian tactics? In his Oct. 4 speech to the Hudson Institute, the VP accused China of waging a "whole-of-government" campaign to erode American industrial advantages, attempting to push the U.S. military from the Western Pacific and buying off Latin American countries with "debt diplomacy." The speech, considered by many as a watershed moment that escalated the current U.S.-China trade war to one of global supremacy and geopolitics, was quickly followed by UN Ambassador Nikki Haley's keynote at the Chiefs of Defense Conference Dinner in Washington. Her address was particularly critical of Beijing's crackdown on Uighur and other Muslim minorities in China's northwest, labeling it "straight out of George Orwell."

What, me worry? During its visit to China and Asia, the TIS was puzzled by the lack of response to steep equity losses over the past 10 months. There was no sense of panic, despite a squeeze on heavily indebted borrowers as the dollar rises and Asian growth slows. If China's economy weakens too much in 2019, it believes an Asian crisis is possible, the difference this time vs. the mid-1990s being that the Fed may let it run—until it hurts America.

In China, being a billionaire isn't all the special Not when two are being minted every week! Reflecting their role in the country's extraordinary economic success, there were 373 Chinese billionaires at the end of 2017, 97% of whom were self-made. This phenomenon has happened in little more than 10 years—as recently as 2006, there were just 16 Chinese billionaires.

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Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

The Conference Board's Consumer Confidence Index measures how optimistic or pessimistic consumers are about the economy.

The Investors Intelligence bull–bear ratio is a measure of market sentiment derived from a weekly survey of individual investors who are asked to rank themselves as bullish or bearish.

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