A D.I.M.E. Framework for China, Trade & Strategic Competition

In last weekend's T-Report, we debated whether this would be another December to Remember. It concluded that we were unlikely to see a repeat of last year's stock market and credit market, Fed induced, lack of liquidity fueled, meltdown, but **only if we could avoid an escalation on trade with China.** By Wednesday of this week, we were **wildly unchanged** on the 10-year treasury. It started the week rising from 1.77% to 1.86% on Monday on trade/tariff headlines. On Tuesday it reversed course, plummeting to 1.69% on trade/tariff headlines, only to bounce back and get above 1.8% on Thursday, again, largely due to trade and tariff related headlines. By the end of the week, it climbed higher, to 1.84%, but at least this move was attributable to a very strong jobs report. Both the Nasdaq and S&P 500 finished the week **wildly unchanged** despite large swings during the week.

The market was memorable last week, but mostly for how difficult and treacherous it was to trade and how linked it has become to trade and tariff related headlines. Many were questioning why yields didn't rise further on Friday. There were a lot of potential reasons why yields didn't rise further, but I think many investors wanted to own long-dated treasuries coming into this week as a hedge against any escalation with trade. Risk Parity Lite™ is alive and well.

This Week Should Provide Answers

While nothing will be solved in terms of trade with China, we should get some clarity between now and next Monday on what is coming next with China, tariffs and trade. By December 15th (next Sunday) we should see one of three things occur:

- **New or increased tariffs imposed by the U.S. on China.** While I would like to see this as a zero-probability event, I think there is a real risk that the President decides to go this route. If we get this, I'd expect the stock market to drop 10% in a matter of days and the 10-year treasury to test 1.5%. This risk, which I put at a 10%-15% probability, given what I'm hearing, is the reason I think long dated treasuries were so well bid.
- **An extension, where no new tariffs or increases are imposed.** I think this is the highest probability event, because we cannot cut tariffs without an actual deal in place, but this is an easy, and likely necessary step to keep negotiations moving along. This is the most basic version of the Trade Truce we've been viewing as our base case. This seems like a 50% to 60% probability. The market is largely pricing this in, though I'd expect stocks to give up some of the gains from late in the week and treasury yields to drift higher with the 10-year getting back above 1.9%.
- **A reduction in tariffs.** This can only occur if we are going to get something that is being labelled as a Phase 1 deal (which I continue to view as much more of a truce than the comprehensive deal I'd like to see). Stocks rally further, though with sector rotation being the real opportunity and the 10-year yield should break above 2%.

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I had the pleasure of spending last week on the road with General (Ret.) Walsh. China and trade came up at every meeting, from asset managers, to corporations, to government entities and everything in between. China, trade and tariffs are driving markets, potentially the 2020 election and it is what everyone wanted to discuss.

As we start this pivotal week, I think it is important to take a step back with General (Ret.) Walsh and examine the **D.I.M.E. framework (Diplomacy, Information, Military and Economics) as it relates to our dealings with China and how to handicap the possible outcomes in the coming days, weeks, months and even years.**

We touch on this subject on Friday in our latest edition of [Around the World] but it is so important to our analysis that I want to highlight this again.

Strategic Competitor

General (Ret.) Walsh helped shape the national policy that labelled China as a Strategic Competitor. While this view had been in place since 2017, it was only in early 2019 that it seemed to come to the forefront of the trade and tariff debate. Our policy with China has been shifting over time and it is now clear to many that treating China as a Strategic Competitor is driving our decisions on many fronts. So, understanding what our policy is, will help navigate the global economy and markets for the foreseeable future.

From D.i.M.e. to d.I.m.E

While it is always dangerous as a strategist to step too far back into time, I think the General's discussion points are well worth listening to.

In the era of the Soviet Union we relied heavily on Diplomacy and Military. It was the era of military might and we had clearly identifiable enemies – the Soviet Union and Communism. It is interesting, that as far back as Nixon and Kissinger a decision was made to work with China. To try and bring China into the 'Western' fold. My understanding was that it had more to do with China not being aligned with the Soviet Union and wanting to ensure that wedge remained, than a real difference in what type of communism China practiced, but that is way above my pay grade.

Ultimately, we won the cold war. As General (Ret). Spider Marks has mentioned time and again, once we won the Cold War, we weren't sure what to do next. We are very good at mobilizing and defeating an enemy and that 'competitor' is now China and we are mobilizing against them, but **this time the battleground is Information and Economics** rather than Military (it should still be Diplomatic).

The Shift to Economics

It is important to understand General (Ret.) Walsh's unique experience as we move further. He witnessed, first-hand, from his role as a General Officer responsible for procurement, amongst other duties, a shift that occurred with this administration.

It started with something as simple as progress reports on various programs he was working on. **This shift was subtle but crucial to think about.** Traditionally, when asked how a program was doing, the answer was dependent on if they were getting the equipment on time and were paying for it and whether the program seemed on solid footing going forward. Now, the administration was questioning if the program even made sense. Why are we buying this? Is this still something that we should be procuring because it fits with our current National Defense Policy or not? Who are we buying it from and why?

In a nutshell, the new administration was doing two things:

1. Aligning procurement with current National Defense Policy.
2. Bringing a 'is this good business' mentality to decision making.

This shift, while subtle is appearing over and over. **We can even look at what has occurred with NATO in the past couple of years under the same lens.** NATO, to some extent had two major issues that were frustrating this administration:

1. Countries that were committed to paying but weren't paying.
2. An agenda, that maybe had lost sight of what was most important for Western security.

Now, several countries are making their contributions, but the U.S., in its leadership role, has shifted the NATO conversation to include China much more than it ever has in the past. The President made a lot of noise about 'why should the U.S. foot the bill', and the U.S. is no longer footing as much of the bill and NATO seems to be working better. Whether you like how the President went about getting to this conclusion, it is a good result for the U.S., and was a clear example of his focus on economics and paying their share, that got results.

With this backdrop in mind, let's explore some other regions where we have seen it at work.

The Shift to Economics – India vs Pakistan

Pakistan has helped, to varying degrees, with the war on terror. But, as this administration did a cost/benefit analysis, it clearly decided to shift away from the war on terror to the competition with China.

Policy currently seems to have shifted favor of India over Pakistan. That may or may not impact the war on terror significantly, but it could have an enormous impact in the battle for economic supremacy with China.

India has almost as many people as China, has a political system that is several steps closer to ours than China has, and, very importantly, India is not allied with China.

It is hard to create a better example of how this shift in mentality is playing out on the geopolitical stage than how we are interacting with India and Pakistan.

The Shift to Economics – Iran and Venezuela

I won't belabor the point, but the U.S. (and Saudis) have shown incredible restraint in response to Iranian attacks and have relied heavily on sanctions. We have chosen not to use Military to the extent we could and have instead focused on Economics, which are working in Iran.

Venezuela is a less clear example from my perspective, but one insight that General (Ret.) Walsh brought up that I found interesting, at least from an intellectual standpoint, was:

> *"in the past, we would have supported Maduro to gain influence and create stability, but now we are working to effect real and lasting change"*

It was such an interesting point I felt compelled to mention it, though I'm not completely sure how I feel about it or how it fits into the framework of China, but it seems like something we should be mulling over.

Information – America First

The concept of making "America First" seemed to shock the world. Much of the world was aghast at such a brazen statement, despite the fact that Canada should put Canada first. France should put France first. We sure as heck know that China puts China first. Now, the world seems to be accepting this realistic view that leaders of countries represent their countries. It isn't to say that we cannot work together, but it must lead to outcomes that are good for both sides.

This messaging is loud and clear. We have been much clearer on Intellectual Property and National Security and what that means to us. We are 'informing' the world what we want and what we expect (though I have to caveat that with the frustration of complete mixed messaging via tweets over the short term, but that's another issue).

China – Ahead in the War?

For the past two decades, China has been very active on the Information and Economics front.

The Belt & Road Initiative is a strong economic policy designed to achieve their objective. We are seeing **Debt Diplomacy** play out in real time. China lends money to projects that cannot be sustained without Chinese help. China has been using economics as a weapon for years and we are just starting to use it more seriously, at least in our battle with China.

Another personal favorite is the WTO:

- China is in the WTO but barely adheres to its rules and principles.
- The U.S. isn't in the WTO, but largely adheres to its rules and principles.

Not a big deal on its own; but yet, another thing that is bothering this administration.

How Does DIME Lead to Trade Truce?

At a high level, I have been using the Strategic Competitor view and this DIME framework to tie together everything else we are hearing, seeing and anticipating in terms of the ebbs and flows with China and trade. **This will be a long process.** Here are some of the most common questions and thoughts we get in trade and how I think they will play out:

- **Why doesn't China wait until after the 2020 election?** National Security as an issue is not going away. That genie is out of the bottle. Many whose decisions made them want to cling to the belief that China would become more like us are not longer influencing decisions. **This might be one area where there is bipartisan support.** I think only one person voted against the bill supporting Hong Kong. China should not want to bet that a deal gets any easier after the 2020 elections.

- **Can't China play the "long game"?** Yes and no. While their leadership doesn't have the same constant cycle of elections to worry about, they do have to worry about the trajectory their economy is on. Their debt is rising much more rapidly than GDP. As they have built up a middle class, those people will not be as easy to placate as they were in the past. Food shortages cannot be ignored. Also, while China can suppress information about Hong Kong and even misinform the mainland about what is occurring, they cannot allow any level of opposition to develop in mainland China. This all points to a truce of some sort.
- **Why would China give up on Intellectual Property Protection?** Because they have leveled the playing field in the past decade, there are areas that China has IP that they want to protect and it is ultimately hard to enforce, so why wouldn't they?
- **Do they want President Trump to win in 2020?** There are many who believe, and I'm one of them, that the Chinese think they understand Trump well and can manipulate him when necessary (his constant tweeting, need to win and linking himself so closely to the stock market are all things that some in China believe can be used to their advantage). So that group in China may want to see him get a second term, but since it is too early to tell who will oppose Trump, why not provide a Trade Truce and wait until closer to the election to figure out the next step?
- **Does the President need a deal now?** No, but I don't think he can afford escalation either. It is too far from the election to get a big win now. Whatever positives come from a deal could have played out by the election. **I think, escalation now is too risky of a strategy, but I'm not positive the President sees it that way.**

Bottom Line

Lean towards Trade Truce but be nervous about escalation.

I apologize for the somewhat disjointed (more disjointed than usual) approach to this topic but there are a lot of concepts here. There are short term and long-term considerations, that are often pulling in opposite directions. I also think it is important to understand the history of how we got here.

Despite that apology, I think the China as a Strategic Competitor and the DIME framework have been very helpful in navigating the ebbs and flows of trade and will continue to be so.

Good luck and hopefully this week isn't as 'memorable' as last week!

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