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Flash Comment

US-China relations on a concerning path - part 2

China overnight denied yesterday's news story that China's US Treasury bond purchases related to trade policies and that China was considering reducing purchases. China's State Administration of Foreign Exchange (SAFE) sent out a statement denying this. The statement said the news may 'quote the wrong source of information, or it may be false news', stating that FX reserves are conducted in accordance with the principle of diversification and ensuring overall safety of foreign exchange assets and 'maintain or increase their value'.

What to make of this? It is possible that China is considering slowing down treasury purchases but this can be fully justified from a market point of view. Many big investors such as Bill Gross (fund manager at Janus Capital Management and sometimes called the 'bond king') have warned of a bear market in US Treasuries. Scaling down treasury purchases could be fully justified from a professional portfolio point of view due to US fiscal stimulus, Fed tightening and low unemployment in the US.

So, was this simply all a big mistake? This is hard to know. The unofficial sources *did* mention yesterday that the considerations related partly to trade tensions. It is hard not to believe that (1) it *has* been discussed in relation to trade or (2) that China deliberately planted the story as a friendly reminder to the US but then denied it afterwards so as not to provoke Donald Trump, who has proved quite unpredictable for the Chinese.

Either way, the genie is out of the bottle and, if it were ever in doubt, China has reminded the US that it has tools to hit back at the US if protectionist measures against China are coming. It also gives a **helping hand to the pragmatic camp within the US** administration, which has warned Trump against triggering a trade war. It has been reported previously that this camp is quite big but opposed by the trade hawks consisting of Wilbur Ross (the Secretary of Commerce), Robert Lighthizer (US Trade Representative) and Peter Navarro (the Director of the National Trade Council within the White House). Trump is leaning towards the hawks but has so far refrained from taking any significant action. It has mostly been harsh rhetoric. However, since Trump came back from his trip to Beijing in early November, he has raised his voice again on trade and suggested trade measures against China are on the way (see *Flash Comment – US-China relations on a concerning path*, 19 December 2017).

The latest measures against China are the blocking of Ant Financial's purchase of MoneyGram and AT&T walking away from a deal to sell the Huawei smartphone Mate 10 to customers in the US, allegedly due to political pressure from Washington. A letter from Washington lawmakers to the Federal Communications Commission last month said Congress had 'long been concerned about Chinese espionage in general and Huawei's role in that espionage'.

We do not expect China to sell US holdings but it may slow down purchases, from a purely portfolio point of view based on a view of a US bond bear market that many other investors share. However, China may use the threat to sell US bonds to deter the US from taking protectionist measures against China. This is just one of many areas where China can retaliate. Making life difficult for US companies in China and restricting sales of the rare earth minerals used in many high-tech products such as mobile phones (where China has close to a monopoly) are just a few of these (see *Flash Comment – What Trump means for China*, 9 November 2016.

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Chief Analyst
Allan von Mehren
+45 45 12 80 55
alvo@danskebank.dk

Is Trump reconsidering Taiwan as a bargaining chip?

Adding to recent tensions, there are also signs that Trump may revert to playing the Taiwan card as a bargaining chip (see *South China Morning Post*, 10 January). The House in the US Congress has passed two pro-Taiwan pieces of legislation. The bills still need approval by the Senate and the President but the issue is highly sensitive. As we wrote after Trump's election for President, the Taiwan issue is a line *not* to be crossed for China (see *Flash Comment: A clash between US and China a rising risk for markets*, 12 December 2016). Playing the Taiwan card could backfire on Trump – and Taiwan. Of Taiwanese exports, 30% go to China and, as exports are 70% of GDP in Taiwan, this corresponds to 20% of Taiwan's GDP. China has a lot of leverage over Taiwan on the economic front but would clearly prefer not to have to go down that road. However, if anyone questions the 'one-China policy', the situation could escalate and China would respond.

The passage of the bill in US Congress comes a month after a decision by Trump to sign the National Defence Authorisation Act, which, among other things, allows the US military to have warship port calls in Taiwan. This triggered a strong response from Beijing and the Chinese embassy in Washington. Li Kexin from the embassy said that '**The moment a US warship called on Kaohsiung port [on Taiwan] would be the time the People's Liberation Army took Taiwan by force'** (see *Reuters*, 11 December 2017). The words illustrate how sensitive the issue of Taiwan is for China.

Today's *China Daily* quotes Foreign Ministry spokesman Lu Kang as saying that the **Taiwan Travel Act passed by the US House seriously violates the 'one-China policy'** and principles established in three joint China-US communiques. Lu Kang urged the US to handle the Taiwan question carefully, to refrain from any official contact with Taiwan and to take concrete action to maintain China-U.S. ties. The Taiwan Travel Act approved by the US House of Representatives would allow US government officials to travel to Taiwan and meet counterparts there.

US-China relations on a concerning path

As we wrote in December, US-China relations are on a concerning path and we probably have to get used to a higher level of tension between the two countries. However, no country would benefit from a trade conflict and we hope the US and China can get back on a track of dealing with their differences through co-operation. However, the recent development does suggest that the risk of a trade war has increased and we cannot rule it out in 2018.

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