Mizuho Brief: US-China Risks

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MIZUHO

Don't Bet on Beijing Folding (Or Risks Simply Evaporating)

"Without pain, without sacrifice, we would have nothing" **– Fight Club**

In a Nutshell:

- Despite many countries exercising restrain on reciprocal tariffs, in hopes of negotiation with the US, **Beijing is not taking this lying down**.
- **Tit-for-tat tariffs of 34% on the US** (matching the reciprocal tariffs announced) with ban on rate earther exports to the US to boot is a **marked shift in Beijing's stance**, which **makes it clear China won't fold**.
- Fact is, **Beijing is both amassing and exploiting its leverage**, making it abundantly clear that US does not hold all the cards.
- The bluff Beijing is calling is evident. **Imports substitution is simply not an option for the US**. Not right now.
- This **escalates US-China trade antagonism**, *hobbling hopes of defusing terse trade conditions and heightened uncertainty* in the near-term.
- ***Barring an unscheduled phone call between Presidents Xi and Trump suspending (or deferring) reciprocal tariffs***, **US-China antagonism and associated economic risks are likely to mount**.
- FX: **Softer CNH is a tool on the table** for providing some buffer via a ***although the PBoC will not desire sharp depreciation that jeopardizes stability***. Consequently, **AXJ** are **vulnerable to higher-beta downside risks**.
- **AUD is at the sharp end of the hurt** on a conspiracy of energy, commodity (led by copper), and China proxy amplifiers of FX pressures.
- Rates: **Lower rates and wider spreads are par for the course given mounting economic gloom and rush to re-price risk.**

- Beijing Ups the Ante: **Optimists looking for a quick resolution on reciprocal tariffs ought to reserve hope** as **China's tit-for-tat retaliation this time has upped the ante**.
- Departure from Differential Response: Tellingly, this clearly a **hawkish departure from** Beijing's distinctly *measured, and purposefully less forceful* in its *response* to the **earlier** episodes of tariffs from Washington (involving two instalments of 10%-pt tariff increments).
- Gloves are Off: This quite clearly indicates that the gloves have come off, and **Beijing is set to confront rather than concede** ground (at the risk of losing more). The message is clear in its **matching 34% tariffs**, with a **ban on rare earth exports** (to the US) and greater scrutiny on US firms to boot.
- Leverage is a Game Two Can Play: Arguably, *China is not doubling down for an all-out trade war,* which it **would still much rather avert**. *But* **amassing leverage** for (presumably upcoming) **negotiations is in Beijing's interest** as the stake get precariously high. And **two can play**.

- Cards No Monopolized by the US: And to be clear, the **US does not hold all the cards**. In fact, the structural shortfall in, and economic non-viability of, **US industries/manufacturing capabilities desperately require that global imports** to continue.
- Imports Substitution a Pipe Dream at Best: The **narrative of manufacturing** (and jobs) **shifting back to the US** is highly contingent and **at best a long game**.
- & Attempts to Hasten Invite Acute Near-Term Pain: Whereas **near-term pain all around** (US included!) **is guaranteed if the US does not dial-back on blanket tariffs** as *industries are hit by margin squeeze* and *households are hammered by acute affordability woes.*
- Beijing Sees & So, May Not be Quick to Blink: The **Beijing is fully aware** of **US vulnerabilities to its own tariffs** and *happy to exploit this obvious self-harm by the US in future negotiations.* In other words, it would be a **cavalier miscalculation to assume Beijing will be quick to blink**.
- Brace for US-China Confrontation: The upshot is a more acute **US-China confrontation in the near-term hard to dodge** as *Beijing builds leverage* and *Trump digs his heel in with more chest-thumping.*
- Off-Ramp Hopes Bleak: Consequently, the **hopes for an off-ramp to imminently defuse the situation look bleak**.
- Hope, But Brace: ***Barring a phone call between Trump and Xi to suspend tariffs***, chances are that things will **probably get worse before it gets better**. **Markets ought to brace for more tensions *even if (longer-term) hope lingers*.**
- Collateral Damage: In the meantime, **needless devastation by way of collateral damage** all around will be **hard to avert** as *aggregate demand slumps* accentuated by a **sharp drop in demand for capital goods** as **uncertainty paralyzes investments**.
- Cash Conservation Risks: **If sentiments worsen**, the **instinct to conserve cash could kick in**, exacerbating hard-landing risks.
- & Deeper Differentiation: In any case, **risk re-pricing** already underway **will be amplified** (with *starker quality differentiation*), albeit not dependent on, such **inadvertent liquidity squeeze**.
- Hamstrung by US-China Risks: With **Beijing's retaliation elevating US-China trade war threats, global downturn will dominate the risk environment.**
- CNH Cushion, Not Capitulation): Beijing's more strident stance on US tariffs could align with **some softening in CNH to better absorb in-coming shocks**. *But* PBoC will **not desire or pursue sharp depreciation** as financial (capital market) stability features.
- AXJ on the Hook (for Risk Re-pricing): Accordingly, **AXJ is on the hook** as this is **set to disproportionately hurt high-yielding, exports-reliant FX** amid trade shocks fears and wider risk re-pricing. And **likely, with higher-beta on CNH downside**.
- AUD at the Sharp End of Global Demand Hit Via Commodities & China: **AUD is at the sharp end**, taking a *direct hit via hard commodity (led by copper) and energy channel*s *sensitive to global demand fears.* Especially, as *China's "bite-the-bullet" turn* to confront *amplify potential for adverse shocks.*
- Lower Rates & Wider Spread: Whether driven by monetary policy inclinations or flight to safety, **lower baseline yields/rates and wider spreads are par for the course**.

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