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The bull in the China shop

China-U.S. trade outcomes range from very good to not good at all. However the talks shake out, this bull should continue to roam.

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With the Federal Reserve on hold pending this summer's expected economic reacceleration, the fate of the bull now lies squarely in the China shop. Word coming out of the China negotiations is positive, but skepticism remains about the breadth and permanency of the deal being worked on. Once we emerge from the natural break created by the mid-March end to the National People's Congress and approach the late March meeting between Presidents Xi and Trump in Mar-a-Lago, the final details of the deal are likely to emerge. If the final product, and its aftermath, is as positive as we expect, it will be good news for the bull's continued run. If on the other hand the deal blows up at the last minute, hold on to your hats. It could be a bumpy ride. This note summarizes the range of possible outcomes and our probability assessment of each, but the conclusion is the same regardless: S*tay long stocks. The bull has plenty of room to roam.*

CONSENSUS SCENARIO: 'NO BIG DEAL'

Our view of the market consensus on China is that the deal emerging is not likely to be a big one. China will drop its recently imposed tariffs on U.S. soybeans and energy products, and agree to buy more of both to cut back its U.S. trade surplus. (Note: if this were all they did, it would largely just shift part of the U.S. trade deficit from China to other the other countries to whom the U.S. is currently selling those products and no longer would.) The U.S. would agree not to impose the threatened additional hike in tariffs on Chinese imports from 10% to 25%, but would keep the first round of tariff increases imposed last summer in place. There would be some loose language around intellectual property protections and information technology theft, with vague enforcement mechanisms that would unlikely affect the status quo. Basically, a return to "business as usual" pre the start of the trade war in 2018. Frankly, even if this is all we get, it's probably good news for the bull, or at least not bad news. The rally we've seen off the Dec. 24 lows, but not yet back to last September's highs, has been driven by a combination of the Federal Reserve backing off on rate hikes and the anticipation that the China trade news flow would not get any worse. So the consensus "No big deal" scenario should be good enough to keep the bull upright without a major pullback.

DOWNSIDE SCENARIO: 'NO DEAL'

The downside scenario is scary, even if unlikely. In this case, despite all the leaked progress to date, somehow, at the last minute, President Trump would pull the old New York sidewalk negotiation trick of simply walking away from the guy hawking fake Louis Vuitton pocketbooks on Fifth Avenue. (This technique almost always, but not 100% always, extracts a final concession from the pocketbook vendor as he anxiously chases you down the sidewalk. Try it sometime.) President Trump seems to have deployed this tactic with North Korean President Kim Jong-un; we'll see how it turns out. The market seems ill-prepared at this point for a sudden, negative lurch in the trade talks, so this outcome would surely cause pullback at least. Amid the chaos, worries would re-emerge that China's soft patch was extending into a recession, with negative global implications. Should this scenario unfold, we'd view it as a short-term negative but not a long-term problem for the bull. The very volatility this scenario would unleash in China and U.S. financial markets would itself incentivize both parties to go back to the negotiating table and find a way forward. But in the meantime, brave investors would have a shot at adding to equities back near the December lows, or at least near 2,600 on the S&P 500.

UPSIDE SCENARIO: 'BIG DEAL'

In this scenario, Presidents Xi and Trump not only agree to a return to the prewar status quo, but also to something more: a near tariff-free zone between the world's two largest economies, and a broad agreement on intellectual property and information technology protections and a cooperative process for resolving future issues. The two presidents "kiss and make up" over a round of golf at Mar-a-Lago and a fine steak dinner afterwards. We enter a period of mutual cooperation and respect between the two superpowers. The confidence-eroding impact on business people on both sides of the Pacific who until now have been uncertain about the rules of trade that will govern their future investments lifts, spurring new a round of investments in both countries. By summer, the world enters a period of synchronized global reacceleration, and all the talk about being "late cycle" fades. With central banks everywhere in hold or ease mode, stocks melt through the September 2018 highs, and the bull charges a new hill: 3,100.

PROBABILITY ASSESSMENT

"Buying low and selling high" is easier said than done. "Low" and "High" are in the eye of the beholder, and the key to success is when your scenario is more likely than the market thinks, resulting in stock prices being "low" relative to your own, correct assessment. We continue to think we are at such a juncture, though less so than we were in early January when we had a full five positive surprises awaiting us. (See **Top five upside surprises for 2019** and **Positive surprises update: 2 out of 5 ain't bad**.) My own informal polling tells me that the market consensus, broadly, is 60% "No big deal," 30% "No deal" and 10% "Big deal." For what it is worth, I am nearly at the opposite: 30% "No big deal," 10% "No deal" and 60% "Big deal," or at least something close to it.

So the bull is now in the China shop. If we're right, it's likely to bust out, roaring higher.

TAGS

EQUITY | INTERNATIONAL/GLOBAL | MARKETS/ECONOMY

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