GLOBAL VOLATILITY SUMMIT

April 2018 Newsletter

Dear Investor,

The Global Volatility Summit ("GVS") brings together volatility and tail hedge managers, institutional investors, thought-provoking speakers, and other industry experts to discuss the volatility markets and the roles volatility strategies can play in institutional investment portfolios. The GVS aims to keep investors updated on the volatility markets throughout the year, and educated on innovations within the space.

Think Tank Panelist Ryan Hass has provided the latest piece in the GVS newsletter series.

Cheers,
Global Volatility Summit

Event

The ninth annual Global Volatility Summit ("GVS") is scheduled for Wednesday, March 14th, 2018 at Chelsea Piers in New York City. Alongside our featured volatility managers, we are excited to announce the addition of a Quantitative and CTA manager panel, featuring prominent portfolio managers in the space to share their views on the volatility markets and resulting impact on these strategies.

2018 MANAGER PARTICIPANTS

36 South Capital Advisors
Argentière Capital
Artemis Capital Management
BlueMountain Capital
Capstone Investment Advisors
Capula Investment Management
Dominicé & Co
III Capital Management
Ionic Capital Management
JD Capital
Man AHL
Parallax Investment Advisors
Pine River Capital Management
True Partner

2017 Event Recap

The 8th annual GVS featured fifteen volatility and tail hedge managers and hosted senior investment representatives from the largest global pensions, sovereign wealth funds, endowments, foundations, and insurance companies. The 2017 keynote speakers were the Founder of The Huffington Post, Ariana Huffington, and Bestselling Author, Daniel Gilbert.

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CHINA: Markets Invested in a Benign Outcome That, if it Happens, is a Long Way Off

From: Kevin Nealer, Ryan Hass, Bob Goldberg, and Tom Gallagher
Date: April 5, 2018

Key Judgement:

- NEC Director Kudlow's comments on a possible trade deal were likely meant to calm markets, not a signal that de-escalation is on the horizon. No substantive talks are underway.
- Following the Cohn, Tillerson, and McMaster departures, trade hardliners (particularly Navarro and Lighthizer) are ascendant. They argue against the "Ross trap" of talks with Beijing until US demands are met.
- Hints of an "interim" NAFTA agreement may represent a desire to get a cosmetic trade "win" with allies and balance Chinese trade activism.
- China faces two problems: US trade demands are unclear, and Beijing does not know which administration officials have the authority to negotiate on trade issues. Xi believes he has a stronger hand than Trump (and is wary of looking weak) so he is unlikely to offer concessions.
- Treasury's biannual currency report this month may label China, Japan, South Korea, and India as currency problems; Vice President Wang Qishan's Washington visit this summer or early fall; and a Trump-Xi meeting at the G-20 in November are all risk indicators. A Mnuchin/Lighthizer/Navarro trip to Beijing would signal reduced tensions.

US stocks are now higher than when the US announced its section 301 case, as investors took NEC Director Kudlow's comments on the possibility of a deal rather than a trade war to heart. Kudlow's role likely was to placate markets rather than signal a softer White House line on China trade (market turmoil gives China leverage; calm markets remove a constraint on Trump). Our assessment of the incentives suggests a process that will be anything but benign. Both sides are likely to impose tariffs and resolving the underlying trade dispute could take a long time as each side tests the other's will.

US tariff actions and pending restrictions on Chinese investment in the US reflect an unresolved debate within the administration over the end-state goal with China. Should the US insist on systemic change to China's economic model (Lighthizer and Navarro) or would cosmetic concessions to address the trade deficit be enough (Mnuchin, Ross, and Kudlow).

Last November's Trump/Xi meeting – announcing $250B in Chinese investment in the US – led Beijing to believe Trump would be satisfied with face-saving gains. With Cohn, Tillerson, and McMaster gone – and difficult midterm elections approaching – advisors supporting trade conflict over a quick win now have the upper hand. **There are no substantive talks going on, only a perfunctory exchange of papers and a few inconclusive phone calls reviewing the issues (and lack of progress) following Liu He's Washington meeting.**

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Beijing has decided that Mnuchin, the designated interlocutor, is unreliable and has created expectations he cannot fulfill. For instance, he has so far failed to schedule a discussion that Beijing sought to host this month. Again, hardliners warn of the "Ross trap" – a cycle of meetings with Chinese instead of deliverables. **The administration's current view on China is simple: meet our demands, then we'll talk.**

(We note that **hints of a breakthrough on an "interim" NAFTA deal before the July 1 Mexican election may be an effort to get a cosmetic trade win**: both to reassure markets and as a counterbalance to Chinese activism. The "lesson" is: Give us what we want and we will be your friend.)

The problem Beijing confronts is two-fold: 1) Trump's team has yet to spell out its demands, leaving the Chinese to guess. In the absence of a roadmap, the Chinese are left with the sense that no matter what they do, it will not be enough; the administration will pocket concessions, then publicly seek more. That has been Trump's pattern in every arena, from taxes to immigration. **2) A corollary to Beijing's complaint that it does not know what Washington wants is the lament that "we don't know with whom to talk".** Kushner has stepped back and Cohn and Tillerson are gone. While Pompeo is slated to have his confirmation hearing next week, he is unlikely to be confirmed quickly, and meanwhile State Department vacancies remain. **The announcement today that Mnuchin, Lighthizer, and Navarro will "jointly" lead any talks with Beijing will deepen China's concern. As Liu He discovered when he was surprised by the steel/aluminum announcement during his Washington talks, Trump is the only authoritative spokesman on US trade policy.**

There is a similar problem on the Chinese side. Xi a) believes that the economic effect of Trump's proposed tariffs will be negligible for China's economy; b) believes he has a higher pain tolerance than Trump; c) is loath to invite domestic criticism for caving to U.S. pressure and; d) won't take reform measures outside of the Five Year Plan and "China 2025" goals that could inject volatility into China's economy. **Most important, he judges that Trump needs him more (e.g. on North Korea) than the reverse. Consequently, Beijing is unlikely to table any package that would significantly ameliorate Washington's concerns regarding the trade deficit or China's industrial policies.**

This is fortified by Beijing's view of the intent of Trump's resort to tariffs. By applying a prohibitive 25% tariff, Trump is hoping US buyers go elsewhere. He is not trying to raise revenue; $50B is the extent of damage he wants to inflict on China's economy. Thinking about it this way underscores the "negative sum" nature of the tit-for-tat protectionism that is being applied to "teach China a lesson" about its US market risk.

Trump personally believes stoking trade tensions with China is appealing to his base which is embittered by his failure to fund a border wall, indifferent to his signature tax bill, and stunned by a debt deal that conceded social issues to Democrats while exploding the deficit. Thus, a trade dispute with China is a campaign promise kept. Only a steep and persistent decline in equities would inspire Trump to reconsider a position he has held for three decades.

Beijing has adjusted strategy to this reality. Thinking in China is also being reshaped by a perceived US re-examination of US policy toward Taiwan. That is something Xi cannot disregard in domestic politics, and which threatens to become worse if John Bolton's thoughts on discarding the "One China" policy become policy.

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What do next steps look like? Treasury's biannual currency report is due this month. It may not name violators, but China, Japan, South Korea, and India could be identified as currency problems, based on the trade imbalances as much as any other fundamentals. The report may provide the administration the occasion to roll out new restrictions on Chinese technology investment in the US.

Absent any plans to revive the economic dialogue or the Liu He-led discussions, the next bilateral meeting could be Vice President Wang Qishan's expected Washington visit this summer or early fall. Thereafter, Trump and Xi will meet in November at the G-20 in Argentina. We sense no urgency from US officials to accelerate the timetable for meetings.

Market sentiment could provoke a change, but the pre-election policy goals seem to favor a steady increase in China trade conflicts with the objective of undermining Xi's "China 2025" economic goals. Announcement of a Mnuchin/Lighthizer/Navarro trip to Beijing would signal a risk reduction, but is not likely to produce a US policy change, absent a market correction.