Finally Phase One... The U-turn in sentiment between Q3'19 and Q4'19 was driven by G-10 Central Bank easing, stronger US data, a pickup in global manufacturing (Global mfg PMIs now above 50), a Fed pause, the rollout of event risk (Brexit, trade deadlines) and 2 months of jawboning a US/China phase one deal that drove momentum in "trade hopes" and a rotation into cheap cyclical upsides. Now, two of the largest uncertainty overhangs, arguably constraints to the world economy — UK general Election/Brexit and the China trade war — was alleviated last week.

Below is a short take on the the actual trade deal and potential implications for trade sensitive metals - Copper and Gold

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SUMMARY:

- **Two of the largest uncertainty overhangs, or constraints to the world economy — UK General Election/Brexit and additional tariffs on China — was alleviated last week. The USCMA breakthrough, a bipartisan U.S spending bill and a convincing Fed pause, then provided additional positive risk-on tailwinds. However, some of these "positive outcomes" were already priced in (trade).**

- **The phase one trade deal is a timely 'mini win', not a convincing trade deal: its welcomed progress that is closer to a short-term truce (vs a reliable turning point that makes a durable and comprehensive resolution of trade tensions possible). Overall, there is still uncertainty over any *comprehensive* trade agreement; expect little aggressive trade escalation into the 2020 US elections (no respite either) as the US tries to jawbone a series of mini trade wins in order to maintain economic (and stock market) out performance.**

- **Phase one can't / shouldn't hurt risk appetite, but risk markets should be reminded that 1) this is still a whole new geopolitical ballgame - trade complicated by technology, climate policy, and civil unrest. And 2) the impact of the larger existing tariffs from both U.S. and China will continue to weigh on growth & sentiment**

- **The markets will look fill this event risk void - 'Trade' and 'Brexit' will take a backseat to driving intraday market price action, providing an opportunity for attention and drivers in 1) risk assets to turn away from sentiment to the fundamentals (company earnings, economic data), 2) gold markets to turn toward longer-term issues (political risk/elections, Fed & economic data points, US fiscal path), and 3) Copper markets to shift toward fundamentals (Chinese data outside of PMIs, supply side risks, spreads/physical premia & stock changes) and Emerging Market trends.**

- **GOLD: Theres a distinct resilient bid across havens - both Gold and bonds - despite the series of risk-on "wins" the market achieved the past week, due to a range of reasons. Gold is currently pricing in a ~$150 "fear premium"; that is a little lofty given current positioning (only ~1/5th of the trade war investment inflows have been unwound), ultimately providing a tactical headwind. From a structural perspective however, given historical "fear premium" peaks ($300 in recent cycle and $700 in 2011) and the fickle nature of policy decisions, unpredictability of geopolitical events witnessed the past year, and lingering sore/growth spots, theres an acceptance that tail risks require a hedge and Gold dips should continue to be capitalized on.**

- **COPPER: The floors are in as global manufacturing PMIs have started to bottom (and rise) in large part due to the support from the Fed/DM CB easing mid year and hopes over a phase one deal. Coppers repricing the past 2 months (+10%) in which HG paper shorts unwound 2/3rds of their large positioning (accumulated since the US/China trade agreement fell apart in May 2019) indicates trade is mostly factored in. For Copper to extend momentum and retest recent highs ($6400-$6600), sidelined investors need to re-commit long positioning which is unlikely into yearend and/or until trade details emerge; however those potential inflows are contingent on signs of improvement from Chinas demand-side which remain soft in addition to the bounce on the production side (PMIs). The markets attention and drivers should turn away from trade sentiment and toward fundamentals (Chinese data outside of PMIs, supply side risks, spreads/physical premia & stock changes), and also pay heed to dynamics in EM/EMFX (which are perking up), into the New Year.**

The U-turn in sentiment between Q3'19 and Q4'19 was driven by G-10 Central Bank easing, stronger US data, a pickup in global manufacturing (Global mfg PMIs now above 50), a Fed pause, the rollout of event risk (Brexit, trade deadlines) and 2 months of jawboning a US/China phase one deal that drove momentum in "trade hopes" and a rotation into cheap cyclical upsides. Now, two of the largest uncertainty overhangs, arguably constraints to the world economy — UK general Election/Brexit and the China trade war — was alleviated last week.

Below is a short take on the the actual trade deal and potential implications for trade sensitive metals - Copper and Gold.

Word Cloud of Most Read Bloomberg Articles before Trade Agreement in Q4'19: Trade Deals, Trump, China and Brexit dominate market focus... Major event risk removed (for now)

<u>**A timely 'mini win', not a convincing trade deal:**</u>

- The 2 sides have agreed on the text of a phase one trade deal, with the US agreeing to halve September tariffs (15% on $120 bn, to 7.5%), delaying the December 15th threatened tariffs (largely expected), BUT keeping all other major tariffs (25% on $250bn). In exchange, Beijing agreed to boost agriculture purchases and made new commitments on IP and the yuan (all details pending), and said they will suspend additional tariffs on certain US imports including refraining from implementing levies on autos parts.

- The deal occurred arguably in the 11th hour before the December 15th tariff deadline and ahead of the important US holiday season, where the markets have had ample time (2 months since the mid October tweet of a possible phase one deal) to effectively attempt to price in official confirmation.

- **This is NOT a "landmark deal" (USTR) or "amazing deal" (Trump), but welcomed progress that is closer to a short-term truce (vs a reliable turning point that makes a durable and comprehensive resolution of trade tensions even possible).** Thats because:

  1. *The threat of the worst case (Dec 15th additional tariffs) has been removed but theres some disappointment around no rollback on the old tariffs ($250 bn) which markets were hoping for*

  2. *There are few details on the actual enforcement mechanism (creating execution risk), and a lack of clarity around details and confirmation from China (especially around Ag purchases - $50bn worth of ags OVER 2 years is only $25/yr and similar or less than their pre-trade war pace of purchases)*

  3. *The medium of communication (Twitter), and the past U-turns in US policy indicates any 'good' can easily be undone where tariffs are merely pushed back to where they were*

  4. *Markets have to wait a few weeks until phase one is signed and sealed by Lighhizer and his counterpart, Vice Premier Liu and until the 86 page report is actually publicly released for clues on just how it will be implemented and details around the enforcement mechanism, ultimately creating additional 'execution risk'.*

- Nonetheless, the market has been increasingly driven by sentiment, so despite the mismatch between the communicated positive deal from US authorities and reality, the fact that key headline risk (additional Dec 15th tariffs) has been removed is risk-positive... HOWEVER that is largely priced into 'favored' trade proxies (Gold -$50/-5%, and Copper & SPX both up 10%, since mid October) but perhaps less so in 'unfavored' ones (certain EMFX, EM Stocks)

- Phase one can't / shouldn't hurt risk appetite, but markets should be reminded that: 1) this is still a whole new geopolitical ballgame - trade complicated by a technology war (eg: 5G/Huawei), by "climate tariffs"/policy, and by civil unrest and human rights issues (eg: HK). And 2) the impact of the larger existing tariffs from both U.S. and China will continue to weigh on firms & consumers, dent business confidence & investment and will continue to be a net headwind on Chinese growth which is already expected to nudge lower next year.

- The markets now have an event risk void to fill and will look to 'forward guidance' from the Tweet to refocus attention (phase 2 deal? domestic issues ahead of the US political campaign? impeachment risk? North Korea?). If 'trade' and 'Brexit' (given Johnsons landslide win) event risk takes a backseat to driving intraday market price action, markets attention and drivers should then turn to the fundamentals (company earnings, economic data).

- Overall, there is still uncertainty over any *comprehensive* trade agreement; expect little aggressive trade escalation into the 2020 US elections (no respite either) as the US tries to jawbone a series of mini trade wins in order to maintain economic (and stock market) out performance

GOLD: Golds shifting gears from being a trade war proxy to internalizing a potentially weaker US$ (stronger yuan/EMFX)

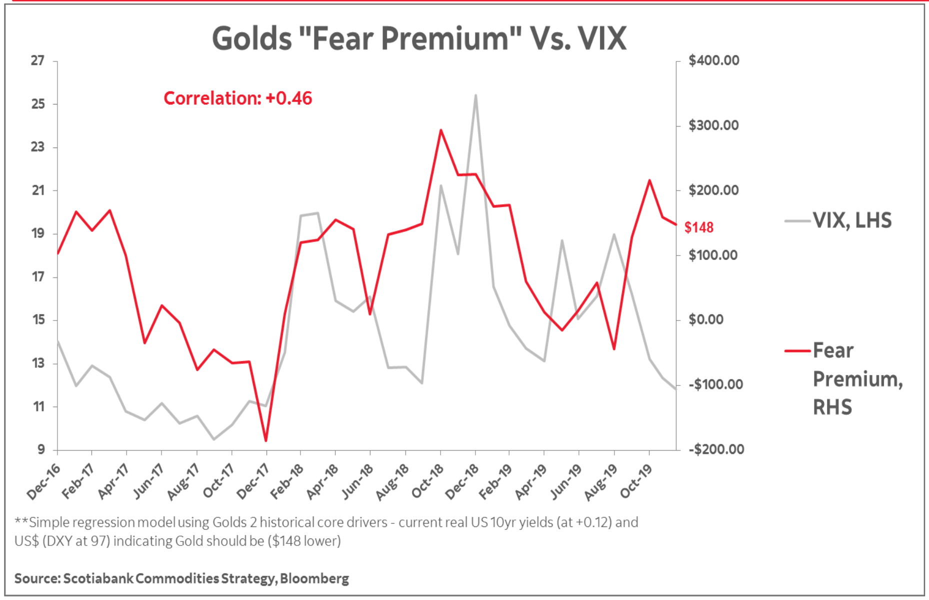
- **Theres a distinct resilient bid across havens - both Gold and bonds, despite the series of risk-on wins the market achieved the past week. The market sees a need to reduce recession / trade / growth hedges, but not completely unwind positioning. Price action should usually be respected. The unusual bid across Gold/ Bonds is likely due to a range of reasons:**
  - ⇒ Phase one deal was almost fully priced with Gold repricing to a less bullish trajectory (from a $1500-1550 asset in Q3'19 to a $1450-1500 asset in Q4'19).
  - ⇒ US$ beginning a technical weakening trend given EUR/GBP and some EMFX strength on UK elections and trade. Gold may rise on the fear of trade war impacting growth profiles ("trade escalation") but can also rise on trade "de-escalation", especially if that strengthens EMFX (especially the yuan!) which will uplift pent-up physical demand that was deterred in 2H'19.
  - ⇒ The Fed preemptively providing a very decent liquidity backstop into/over yearend with Treasury purchases (Feds Balance Sheet is $4.1tn, 1 year highs), keeping lower yields for longer and Gold in play.
  - ⇒ Inflation expectations have risen (US 5Y/5Y inflation swap back up at 1 year average) as the Fed hinted that they're OK with letting the economy run a little hot.
  - ⇒ Other key trade, growth and geopolitical risks remains - E.G: 1) Brexit challenges in forging an actual trading relationship with Europe after the withdrawal agreement passes through Parliament , 2) trade dispute between China and Germany over Huawei and in other regions, 3) Continued growth slowdown / manufacturing especially in Europe

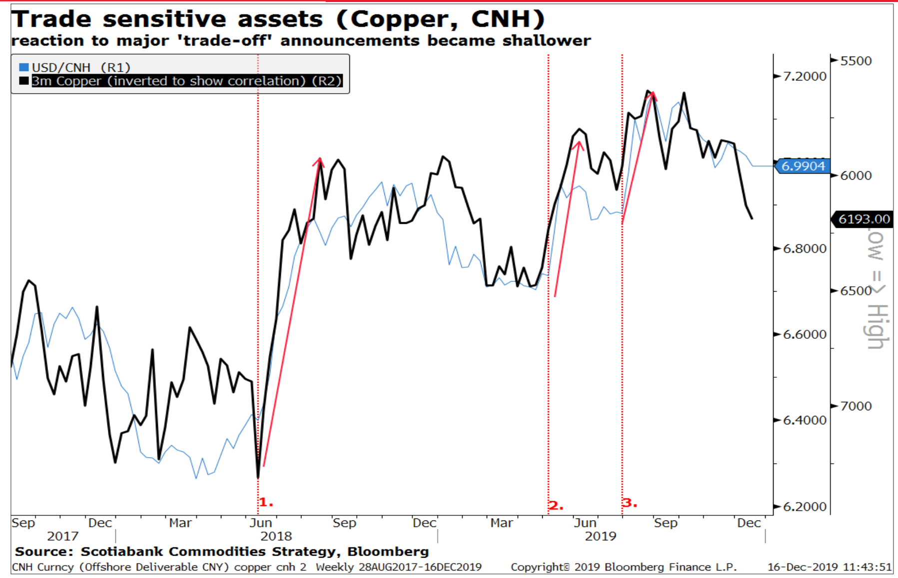
- Even with the trade deal (more complacency with US equities making record highs) and the reflation reprieve our model shows Gold is currently pricing in a ~$150 "fear"/ geopolitical premium* (vs current 10yr yields and DXY). That is understandable but perhaps a little lofty given current positioning (only ~1/5th of the trade war investment inflows have been unwound since the US/China trade deal collapsed the end of May), ultimately providing a tactical headwind. From a structural perspective however, historical Fear premium peaks ($300 in recent cycle and $700 in 2011) and given the fickle nature of policy decisions, unpredictability of geopolitical events witnessed the past year and lingering sore/growth spots, theres an acceptance that tail risks require a hedge and Gold dips should continue to be capitalized on.

- With the trade headline roulette removed (for now) until details on phase 1 emerge (January) and/or rhetoric around phase 2 ramps up, Gold markets attention and drivers should turn to longer-term issues (political risk/elections, Fed & data points, US fiscal path)

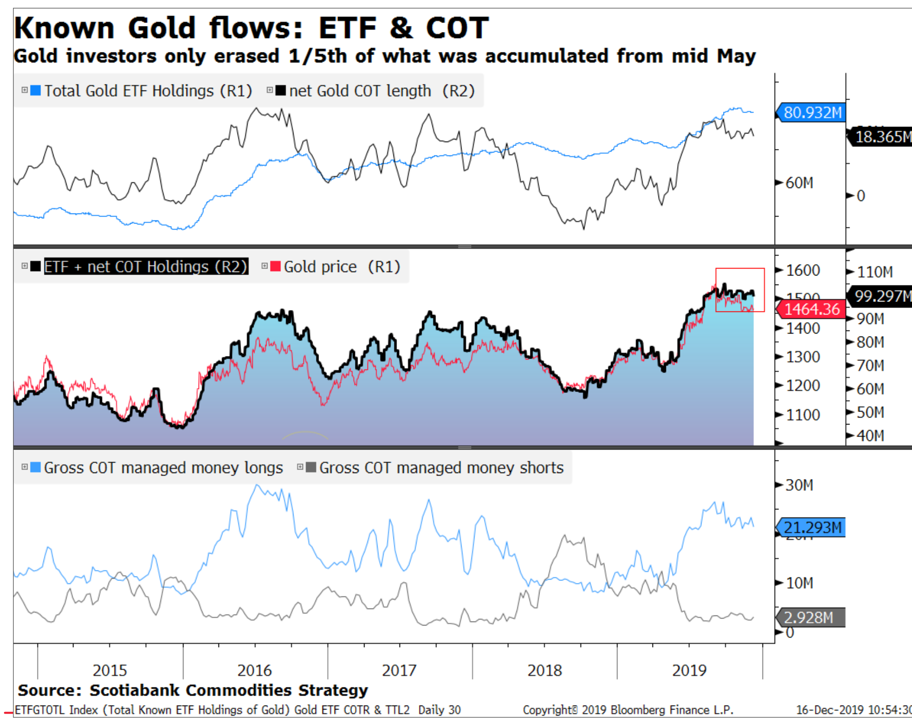
COPPER: floors are in on trade, manufacturing PMIs and CB easing, but Chinese data needs to convincingly improve for momentum to extend.

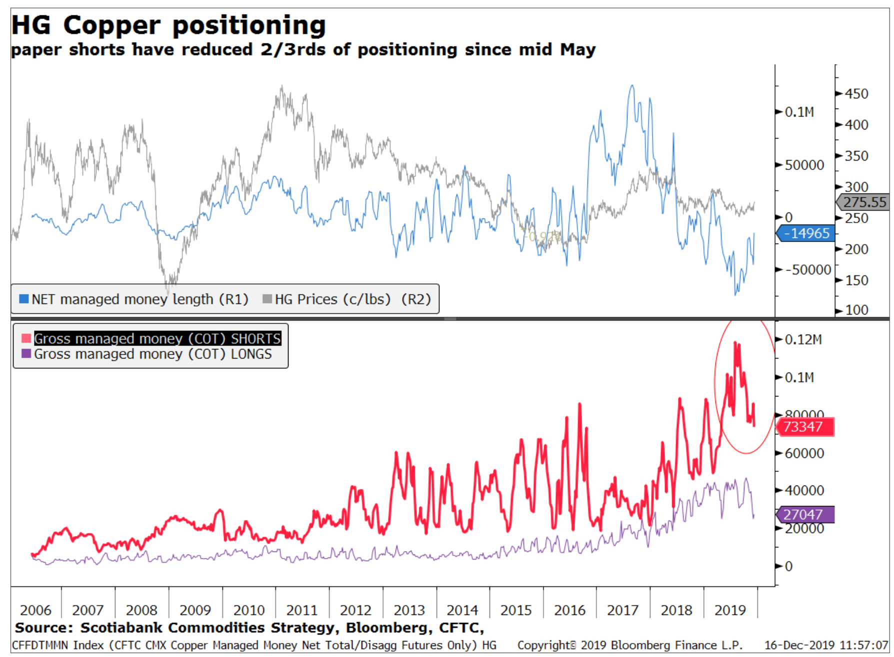
- The floors are in as global manufacturing PMIs have started to bottom (and rise) in large part due to the support from the Fed/DM CB easing mid year and hopes over a phase one deal (the rotation into cyclicals finally shifted into the commodities asset class).
- That is most evident in Copper repricing the past 2 months (+10% since mid October since markets began factoring in a phase one deal) and in positioning, in which HG paper shorts have unwound 2/3rds of their very large positioning (that was accumulated since the US/China trade agreement fell apart in May 2019). There are still minor additional tailwinds possible from this crowd, but for Copper to extend momentum and retest recent highs ($6400-$6600), sidelined investors need to re-commit long positioning and thats unlikely into yearend and/or until trade details emerge.
- Those potential inflows will likely be contingent on signs of improvement from Chinas demand-side which remain weak (South Korea exports extended slump, factory deflation continued, vehicle production and floor space completions soft) in addition to the bounce on the production side (global manufacturing PMIs). In addition, Copper has overshot its trade war sister (the yuan) in response to Fridays announcement.
- Supply risk (e.g: Chile) is still not being factored in and LME stocks have consistently fallen providing a potential tailwind. The markets attention and drivers should turn away from trade sentiment and toward fundamentals (Chinese data outside of PMIs, supply side risks, spreads/physical premia & stock changes), and also pay heed to dynamics in EM/EMFX (which are perking up), into the New Year.





1. US/China trade dispute begins. 2. US/China trade deal collapses.
2. 3. US levies (new) tariffs on China after FOMC; China devalues through 7 per-US$





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