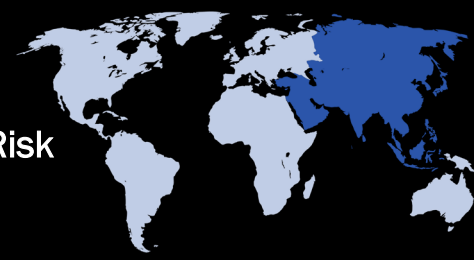


AT Capital Asia Geopolitics Update

China-Driven Geopolitical Risks Will Escalate – Stay Short India Risk

Key Highlights

- *The current China-India border crisis is consistent with China's plan to capitalize on Covid to establish itself as Asia's dominant hegemon at the expense of the US*
- *President Xi could not be happier with the weak response by Modi which China will see as capitulation and will embolden greater assertiveness as part of his "China Dream".*
- *This follows on from a limp response by President Trump to the China's plans to impose a national security law on Hong Kong after last month's NPC.*
- *Xi will push further not only on India but also in the South China Sea and Taiwan.*
- *The news coming from Bolton book on Trump asking Xi for help on elections only adds to pressure on President to act decisively on China ahead of Nov.*
- *Kim's latest actions in blowing up the Inter-Korean Liaison Office on June 16 and a follow up threat to send troops into the demilitarized zone adds Asia volatility.*
- *Global markets complacency on the heady cocktail of unprecedented Covid monetary and fiscal stimulus is not pricing in these geopolitical risks. • Moreover, an assertive China is unlikely to agree to major concessions on missed Phase 1 trade deal targets to buy US goods.*
- *Being short India risk is attractive given prospects for further military conflict, an ongoing acceleration in Covid 19 cases, and likelihood for -6% GDP growth.*
- *The Indian Rupee is likely to weaken towards 80 versus the USD and a Nifty Fifty target below 9000 on a 3 month view.*
- *The rapid recovery in Indian sovereign and corporate USD spreads in the face of massive global liquidity is also set to reverse.*

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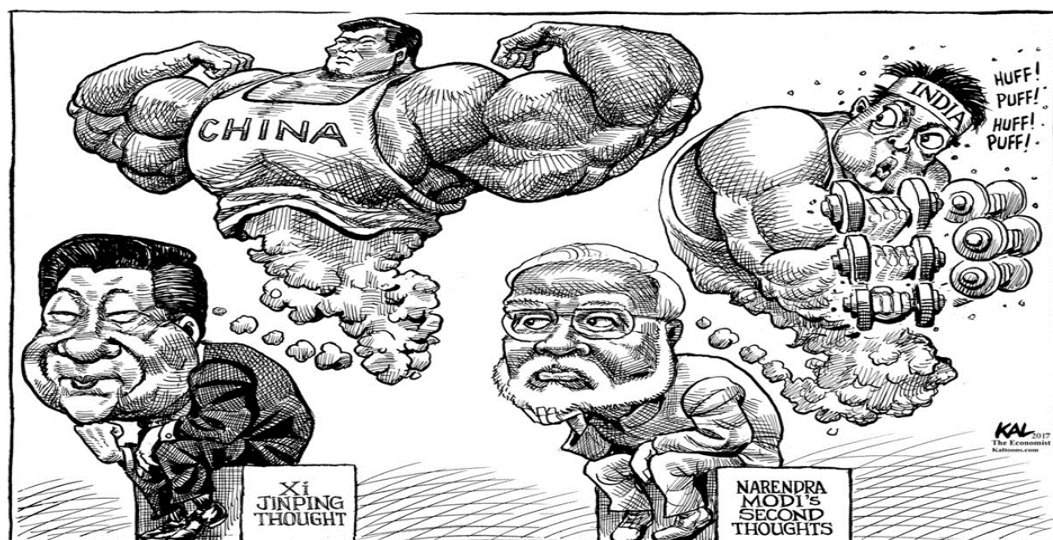
The current border confrontation between China and India in the Galwan Valley is a not an isolated or accidental incident, but rather consistent with a new strategic geopolitical assertiveness by China in Asia in the aftermath of the Covid crisis. The first casualties suffered in 45 years in the long running border standoff is undoubtedly a major inflection point in Sino-India relations. But it also has broader regional and global geopolitical implications and is part of a broader strategic initiative by China to strengthen its status as the dominant hegemon in Asia at the expense of the US. It should be seen as a continuation of the more assertive and confident China foreign policy stance that led to the proposal at last month's NPC to impose the National Security Law in Hong Kong despite the almost certain international backlash.

But just as the weak response from President Trump in the measures he announced in response to HK measures has emboldened China, Indian's PM Modi's limp reaction on June 17 will also give China a greater confidence to test India's resolve further. Moreover, in addition to further fighting and casualties on the India-China border, we also believe it increases the chances of a China testing US resolve on South China Sea and even Taiwan.

At the time of writing June 18 we are getting initial comments from the June 17 meeting in Hawaii between Sec State Pompeo and China Foreign Minister. Beijing said its top diplomat Yang Jiechi had a "constructive dialogue" with US Secretary of State Mike Pompeo in Hawaii, and the two nations have agreed to take actions to improve their worsening bilateral relations. The China state-run news agency Xinhua reported Wang and Pompeo had an "in-depth discussion" over China-US relations, and international and regional issues of common concern. "Both sides have fully expressed their stance and believe this is a constructive dialogue...". "Both sides agreed to take action to seriously implement the consensus reached by their leaders, and to continue communication". In our view, It seems likely that both sides just re-iterated their stance and nothing substantive was agreed and no new progress made.

The incendiary claims by former NSA John Bolton that President Trump urged president Xi to buy more agricultural product to help him win the election turbocharge China as being a dominant focus for the Nov elections along with race relations. President Trump has already been wounded by his response to the George Floyd killing and cannot also afford to be weak on China. It is worth noting the comments by former White House senior advisor Steve Bannon in a recent interview in Asia Times ("Bannon tells Asia Times: US Election is all about China").

We discussed the impact of the Covid crisis in deepening the US-China in our June 2 report.





Covid-19 is Accelerating The Thucydides Trap in US-China Relations

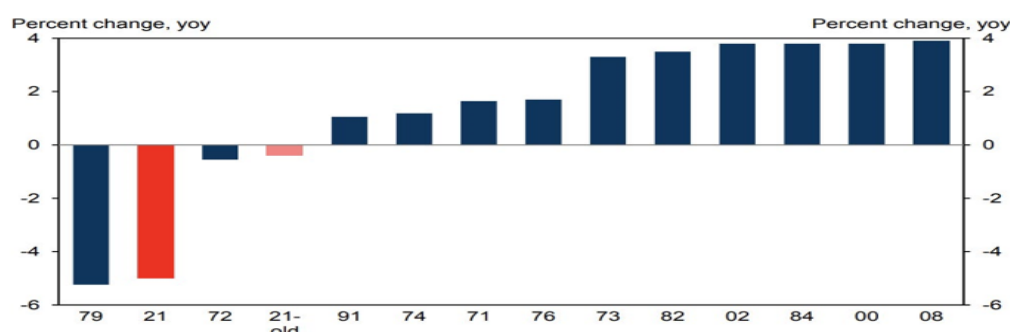
While financial markets have continued in “risk-on” mode in the aftermath of strong retail sales and a hyperactive Fed, we would also argue markets are grossly underestimating the impact of heightened geopolitical risks from China’s “Wolf Warrior” expansionist policies in Asia. North Korea’s President Kim’s decision to demolish the Inter-Korean Liaison Office on June 16 and a follow up threat to send troops into the demilitarized zone is further evidence of impact of the Covid crisis in catalyzing volatility in the region. North Korea’s economy has been badly hit by sanctions and Covid and Kim is trying to pressure for new concessions and to exploit renewed tensions between the Trump Administration and South Korea over cost-sharing of US troops stationed there.

PM Modi is already drawing flak domestically for his weak response to the latest border conflict with China that has claimed more than 20 lives. An article in Asia Times “India is paying price for Modi’s myopic China Strategy.”

An article in the Global Times, recognized as a mouthpiece for Chinese Communist Party thinking, published an article on June 17 “Modi needs sound economy to ease border tensions “ in which they linked border tensions to the desperate state of the Indian economy. The article also told the US to mind its own business. It stated that “...a positive relationship between China and India is not just paramount to Asia but is also crucial to the global economy, which is why Tuesday’s border clash has captured the world’s attention. Even the US is “closely monitoring the situation,” according to a US State Department statement. However, it should be noted that neither China nor India needs a third party, especially the US, to intervene in their border issue at this sensitive time. As the US-China rivalry on multiple fronts is driving the two countries toward a new Cold War, the extent of the USChina decoupling in trade, investment and financial market exchanges appears to be much greater than it was during the trade war. At this juncture, the US needs to avoid opening up a new front in its standoff with China over the China-India border issue. The border dispute involves a country’s territorial sovereignty, and no other countries are qualified to point fingers at the issue. If the US were to intervene in the China-India dispute, it would be a very grim signal for US-China trade relations, which would also hinder future economic and trade development between China and India.”

Moody’s downgraded India’s sovereign credit rating to Baa3, the lowest investment grade and one notch above junk. Moody’s also retained the negative ratings outlook saying it reflected mutually reinforcing downside risks from the potentially deeper stresses in the economy and financial system that could lead to a more severe and prolonged erosion in fiscal strength than the agency currently projects. Former finance secretary Subhash Chandra Garg expects the economy to contract by 10% this fiscal year. As the chart below illustrates, Goldman Sachs are forecasting the worst recession since 1979.

Figure: Goldman Sachs is forecasting a “recession” similar to the deepest India has experienced till date



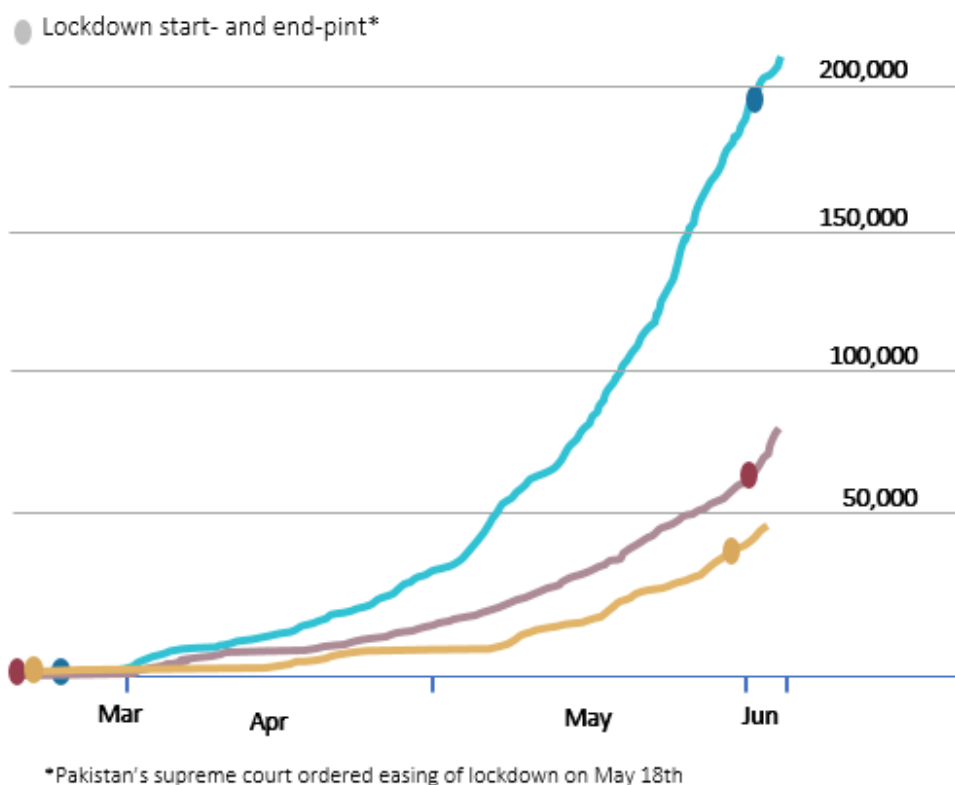
Source: Haver Analytics, Goldman Sachs Global Investment Research



We believe that the heightened risks of further military conflict, an ongoing acceleration in Covid 19 cases, along with the prospects for a severe recession (GDP contracting more than 6% in FY 20/21) makes India the attractive “Risk Off” trade in global markets. The Indian Rupee is likely to weaken towards 80 versus the USD and a Nifty Fifty target below 9000 on a 3 month view. The rapid recovery in Indian sovereign and corporate USD spreads in the face of massive global liquidity is also set to reverse.

Figure: Bending the wrong way

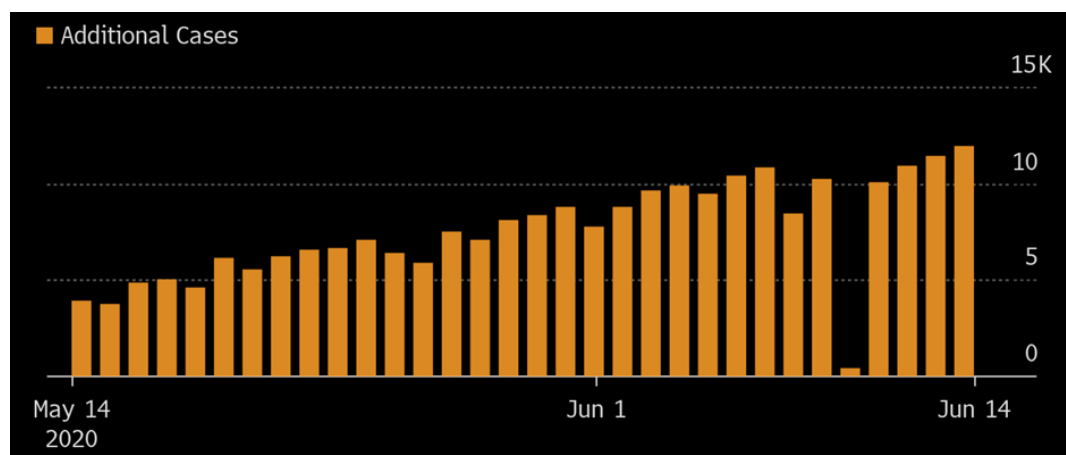
Cumulative confirmed cases of Covid-19 (As of June 4th 2020)



Source: John Hopkins University CSSE and The Economist

Figure: Steadily worse

India is adding a greater number of new coronavirus cases each day



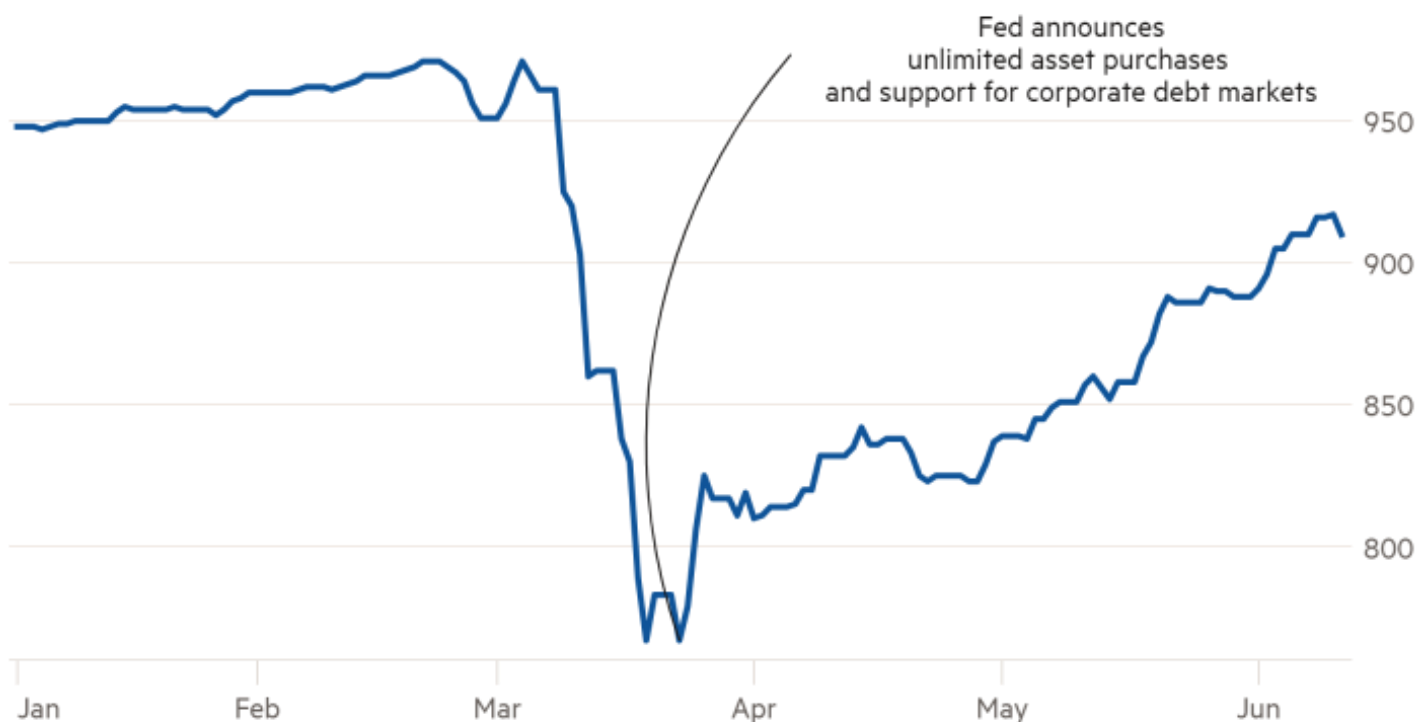
Source: Bloomberg



Figure: US Dollar/ Indian Rupee



Figure: Emerging market sovereign bonds rebound from March Lows
JPMorgan EMBI Global Diversified Index



Source: JPMorgan, Bloomberg



Figure: Nifty 50 Index





How India-China Border Tensions Erupted

The Indian army initially said a colonel and two soldiers had died. It later said that "17 Indian troops who were critically injured in the line of duty" had died from their injuries, taking the "total that were killed in action to 20". It was reported that there were 75 Indian soldiers versus 300 Chinese. Although there were no shots fired, the Indian soldiers were beaten to death and/or pushed down a ravine into a frozen river. PM Modi's response was very restrained saying that "India wants peace but, if instigated, it is capable of giving a befitting reply." He went on to say that the Indian deaths "will not be in vain" and that India would be "proud that our soldiers died fighting the Chinese" in the clash in the Ladakh region. But this is hardly going to cause Beijing to have second thoughts. By contrast, PM Modi will be well aware of the humiliating defeat India suffered in the 1962 war as well as the massive military inferiority of India's army with a defence budget 25% of China's.



A phone conversation between the respective foreign ministers on June 17 failed to stabilize sentiment. An Indian government statement following the phone conversation said that Chinese troops had tried to put up a structure on the Indian side of the de facto border, the Line of Actual Control (LAC), in the strategically important Galwan Valley. It described this as "premeditated and planned action that was directly responsible for the resulting violence and casualties" and urged China to "take corrective steps".

Meanwhile a Chinese statement quoted Foreign Minister Wang Jiechi as saying: "China again expresses strong protest to India and demands the Indian side launches a thorough investigation... and stop all provocative actions to ensure the same things do not happen again... Both sides should resolve the dispute through dialogue, and keep the border safe and tranquil.."

Moreover there was strong rhetoric from the Western Theater Command of the Chinese People's Liberation Army. The Chinese statement accused India "of going back on its word" and "violating commitments." The commitments were the ones made earlier this month at high-level military talks at the corps commanders' level. Zhang Shuili, a spokesperson for the PLA's Western Theater Command added that the Indian Army "violated its commitment and crossed the Line of Actual Control (LAC) again, illegally and deliberately launched provocative attacks, triggered fierce physical confrontation between the two sides, resulting in casualties."



Source: BBC

The immediate background to the current crisis was an initiative by the Indian army to catch up with China's superior border defences and logistics by building infrastructure including roads and an airforce base on the Indian side. An increasingly assertive China clearly decided that it needed to re-assert the initiative and momentum by encroaching into disputed territory that India claimed for itself in the Galwan Valley. It's worth noting that The LAC is poorly demarcated. The presence of rivers, lakes and snowcaps means the line can shift. The soldiers either side - representing two of the world's largest armies - come face-to-face at many points. Border patrols have often bumped into each other, resulting in occasional scuffles. The last shots fired and casualties on the border happened in 1975 when four Indian soldiers were killed in a remote pass in the north-eastern state of Arunachal Pradesh. One attempt to minimize conflict was a 1996 bilateral agreement that says "neither side shall open fire... conduct blast operations or hunt with guns or explosives within two kilometres of the Line of Actual Control".

The military imbalance between China and India can be seen in the table below. It actually understates the military superiority since it doesn't capture the far greater technological superiority of the Chinese forces.



INDIA & CHINA- MILITARY COMPARISON

SUBJECTS	INDIA	CHINA
TOTAL MILITARY PERSONNEL	3,462,500	2,693,000
DEFENCE BUDGET (USD)	\$ 55.2 BN	\$ 224 BN
TOTAL AIRCRAFT	2,082	3,187
HELICOPTERS	692	1,004
FIGHTERS/INTERCEPTORS	520	1,222
ATTACK AIRCRAFT/HELICOPTERS	694/17	1,564/281
TANK STRENGTH	4,184	13,050
ARMORED FIGHTING VEHICLES	2,815	40,000
TOTAL NAVAL ASSETS	295	714
SUBMARINES	16	76



Source: www.globalfirepower.com

China May Also Be Reacting to Indian Move on Kashmir in 2019

A belated response to India's revocation of Article 370 on Kashmir autonomy might also have played a part in the latest Chinese aggression. In a June 16 article in "Foreign Policy", Anik Joshi noted that Ending Article 370 of the Indian Constitution, on the autonomy of Jammu and Kashmir, has been a longtime goal for the ruling Bharatiya Janata Party in India, and the party won two successive landslide victories in 2014 and 2019 partially based on its stance on this issue. In August 2019, the Indian parliament voted to abrogate Article 370. That autonomy had always been somewhat illusory, but it was powerfully regarded within Kashmir—and India accompanied the change with a mass crackdown in the region, including cutting off the internet and arresting local politicians. The bill didn't stop there. It also bifurcated the territory into two states—Jammu and Kashmir, and Ladakh— further cementing India's control." Integrating the Kashmir region further into India also presents issues from a military perspective—Kashmir existed as a buffer zone of sorts in a way that the two new union states might not. That gave China a strong interest in the issue, too. China agreed with its ally both for diplomatic reasons and for domestic ones. Part of the new territory of Ladakh contains land that Pakistan gave to China in the agreement in 1963. China sees both the abrogation of the article and the formation of the new state as a kind of aggressiveness, which is one reason for its own assertive moves on the Chinese-Indian border in the last few weeks.

Earlier this year, China has demanded in foreign-policy talks with India the revocation of the new legislation creating Ladakh. This is a different way of objecting to the revocation of Article 370 as a whole, and the move benefits China on multiple fronts. It allows it to strengthen its alliance with Pakistan at very little personal cost. But, perhaps more importantly, it allows Beijing to seek a protective cover of sorts for its actions in Xinjiang.

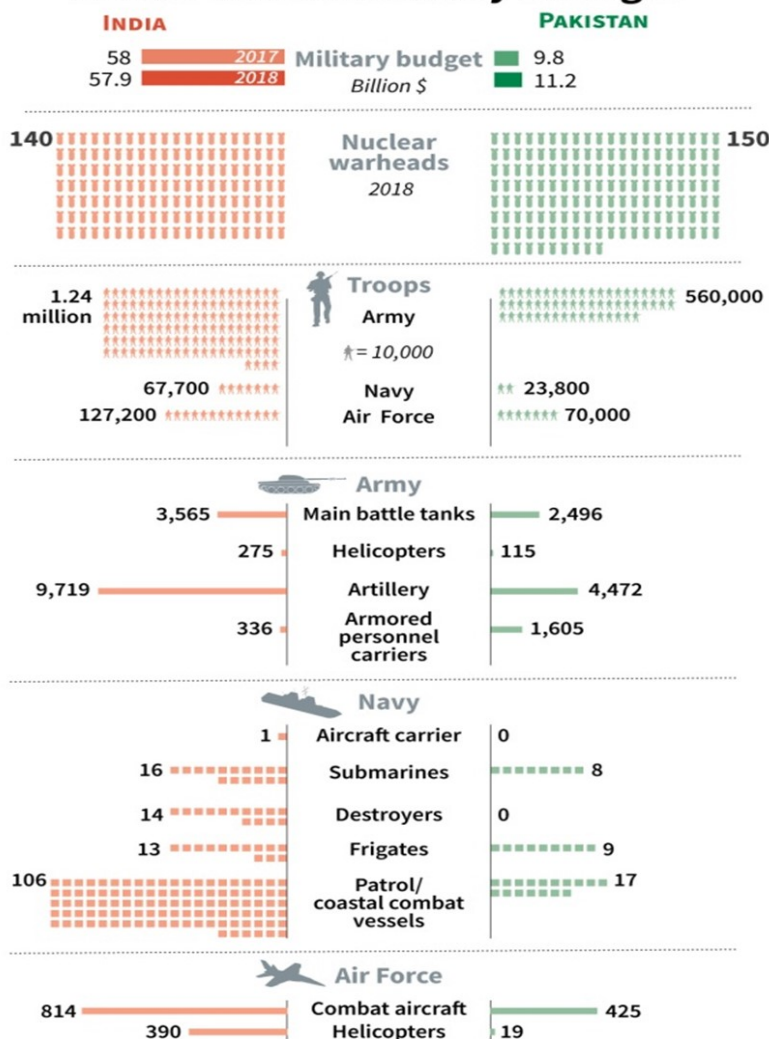




“String of Pearls” Indian Fears Exacerbated by Pakistan and Nepal Events

Adding to Delhi’s paranoia about rising Chinese influence in the region, the so called “String of Pearls” theory, was the abduction and torture of two Indian High Commission officials by close Chinese ally Pakistan’s Intelligence forces in Islamabad on Monday June 15, the same day the latest border crisis flared up. An Indian Foreign Ministry Press Statement noted that “India strongly condemns and deplores the action of the Pakistani authorities in this regard... This premeditated, grave and provocative action on the part of the Pakistani authorities, preceded by intensified surveillance, harassment and intimidation of Indian High Commission personnel over the past several days, was designed to obstruct and disrupt the normal functioning of the Indian High Commission in Islamabad... The attempt by Pakistani authorities to levy false accusations and concocted charges on the officials of the High Commission is rejected in entirety... Such continued unilateral actions by Pakistan, aimed at escalating tensions, will not succeed in diverting attention from the core issue of Pakistan's continued hostile activities and sponsorship of cross-border terrorism against India”. Pakistan has been had far more frequent clashes with India over Kashmir than China has.

India-Pakistan military strength



Sources: International Institute for Strategic Studies Military Balance 2019/
Stockholm International Peace Research Institute

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Another country growing closer to China, Nepal, has also seen heightened tensions with Delhi. On May 8, India's defence minister virtually inaugurated a new 80 km-long road in the Himalayas, connecting to the border with China, at the Lipulekh pass. The Nepali government protested immediately, contending that the road crosses territory that it claims and accusing India of changing the status quo without diplomatic consultations. As a recent Brookings paper by Constantine Xavier has noted, Among the many escalatory moves since then, Nepal deployed police forces to the region, summoned the Indian ambassador in Kathmandu, and initiated a constitutional amendment to formalise and extend its territorial claims over approximately 400 sq km. India, on the other hand, has conveyed its openness to a dialogue but does not seem to share Nepal's sense of urgency: its initial statement agreed to a dialogue, but only after the COVID-19 crisis. Xavier also noted that "Nepal has one of the world's youngest populations and, especially after India's implicit support for the 2015 blockade on the landlocked country, anti-Indian sentiments have been running high. This offers a new generation of Nepali politicians a powerful fuel to mobilise the electorate."





Expect India to Reach out to D10 Allies to Isolate China

Finally, expect India to reach out to allies, the US, Euroland, UK, Japan and Australia to counterbalance China. An article on June edition of India's Frontline Magazine "New Alliance against China" noted that "Prime Minister Boris Johnson of the United Kingdom floated the idea of creating a new international platform—D10, or Democracy 10 alliance. The D10 is to comprise the Group of Seven (G7) states and three others; it will be discussed formally at the G7 meeting in June. The proposed members of the alliance are the G7 countries (Canada, France, Germany, Italy, Japan, the U.K. and the U.S.), along with Australia, India and South Korea. The purpose of this alliance is not entirely for mutual benefit. The agenda, Boris Johnson suggests, is to attack China." But while the D10 initiative is likely to accelerate in the aftermath of the China-India tensions as well as HK Security Law, it is only likely to fuel further nationalist sentiment in China. Geopolitical tensions are set to rise in Asia for the foreseeable future and a major incident is likely to test the Fed liquidity fuelled complacency in global markets



AT Capital Asia Geopolitics Update

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