Questions On The Changes Of The Past Two Months

Louis-Vincent Gave
lgave@gavekal.com

When meeting with clients in North America last week, I made a presentation that recapped a number of our more recent themes, namely:

1) The simultaneous surge in government bonds, precious metals and the Japanese yen this summer smacked of a buying panic (see **The Surge In Anti-Fragile Assets**).

2) A factor driving this buying panic was fear that a "Tiananmen-like event" in Hong Kong could unleash a chain of events causing a breakdown in the global trading system that would be even more disruptive than the crisis that followed Lehman Brothers failure.

The summer saw a "buying panic" that forced up the price of anti-fragile assets

3) However, as it became clear that the Chinese Communist Party had little interest in spilling the blood of Hong Kong students, the air would start to come out of the global fixed income bubble (see **The End Of The Panic**).

4) To be clear, having US$17trn of global debt offering a negative yield amounted to the greatest bubble anyone alive had seen. This was based on the usual bubble-defining assertions that (i) this time is different and (ii) buying worthless bonds makes sense because some other sucker will be forced to buy them at a higher price down the road (see **The Age Of Range Trading** or **Gavekal September Research Call**).

5) In recent weeks, other factors have led to the outperformance of global equities versus US equities; the outperformance of cyclicals/financials over stable growth stocks; a steepening of the US yield curve and a stalling in the US dollar rally. Those changes are:

In recent weeks, a range of factors have caused a rotation toward global equities and cyclicals...

   a) The Federal Reserve moving from quantitative tightening to some form of quantitative easing (see **Back To Balance Sheet Expansion**).

   b) China and the US both sounding like they want a truce in the trade war (see **Trump's Unreal Deal With China**).

   c) Europe and the UK appearing to be burying the hatchet and moving forward on some sort of deal—a shift which makes Europe investable once again (see **Europe's Brexit Booster**).

   d) The Riksbank publicly denouncing the idiocy of NIRP (see **A Swedish Canary In The Coal Mine**).

   e) Emerging markets embracing much easier monetary, fiscal and regulatory policies (see **Where Will Growth Come From Now?**).

   f) The bursting of the "unicorn bubble".

...the combination of all these factors has made for a potent brew

6) Any one of the above changes would be important by itself. Together, they make for a potent combination.

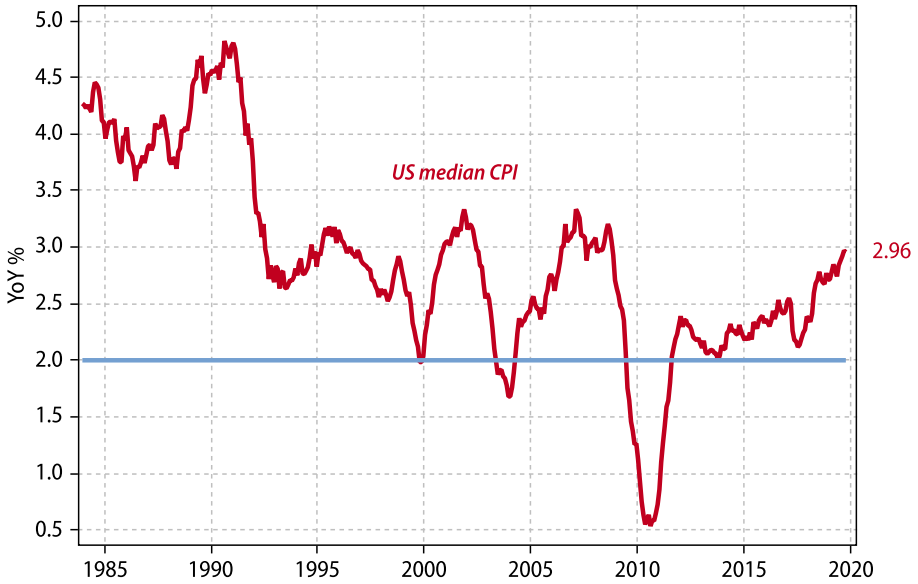
There is now a synchronized expansion of fiscal and monetary policy going on

In essence, we now live in a world where almost every central bank and every finance ministry is stimulating at the same time. This is a big difference with previous waves of stimulus. When the Fed did QE2 and QE3, both the US government (under the orders of a Tea Party-run US Congress) and the European governments (under the orders of Brussels/Berlin) were tightening their belts. This is also the first time that the European Central Bank, Bank of Japan and the Fed have all simultaneously done QE. Basically, everyone in the world is stimulating aggressively—at least, everyone but China. And this record, globally-synchronized stimulus is happening at a time when:

- Unemployment rates in the US, Japan, Germany and the UK are at generational lows.
- Stock markets in a number of countries stand at highs in nominal price terms. And for US stocks, it is not far off hitting a record valuation high.
- Core CPI in the US is at a decade high and median inflation stands at 3%.

The median rate of US inflation has risen to a decade high

The median level of US CPI is at a 10-year high



Gavekal Data/Macrobond

It would seem that the overall investment environment has changed

No wonder yield curves are steepening and cyclicals in the equity markets are starting to outperform. The logical conclusion from the events in recent months is that the investment environment is changing, as shown by bond yields no longer falling and the US dollar no longer rising. Portfolios that do well in this environment will likely differ from those that have thrived over the past few years (see The Danger Of A Dumbbell Portfolio).

Below is the push-back most frequently received from clients.

Question: How can you be sure that the situation in Hong Kong will not deteriorate further from here? The TV images are really troubling and all my contacts there tell me the situation has no easy answer and could last a long time. Isn't there still a strong risk that China just loses patience?

Answer: I do not mean to belittle the challenges that Hong Kong faces. But the important question is whether it could evolve from being a "local problem", to a "global problem". And the reality is that the only way it becomes a "global problem" is if China decides to roll the tanks down Connaught Road Central. This is highly unlikely to happen for a number of reasons:

a) Even after six months the Hong Kong riots have not spread to the Mainland (see **The Implication Of Hong Kong For China**).

b) The number of demonstrators has dwindled in recent weeks. From the 1.5mn people that took to the streets in the summer heat to demand the Hong Kong government shelve the extradition law, there are now only a few thousands actively demonstrating and demanding full democracy and police accountability. Meanwhile, with 31,000 men and women in uniform, the Hong Kong police have the resources to handle a few thousand demonstrators; the police does not need PLA back-up.

The situation in Hong Kong has substantially stabilized

c) China is angered by Hong Kong protesters campaign, but is unlikely to risk an international embargo in order to prove a point. Instead, it will likely sit back and hope that, at some point, the Hong Kong population will turn on the student protesters.

On this score, Hong Kong is scheduled to hold elections this Sunday for 18 different district councils across the territory. Needless to say, the vote will not be driven by local issues but instead will be used by the population as a referendum on both the government and the student rebels.

If Hong Kong government-linked parties do well in this weekend's District Council elections then the government will get a legitimacy boost

Undeniably, anger against the Hong Kong government is high. It lacked vision in the years before the crisis and has been shown up as condescending, heartless, and simultaneously gutless and brainless during the crisis. Yet, it may be that, out of a desire for "law and order", the population votes heavily for "pro-government/pro-Beijing" parties. The fear may be that a big turnout for the pro-democracy/student affiliated parties causes more political and economic uncertainty. Thus, come Sunday the Hong Kong government could have a political legitimacy it clearly lacks today. This legitimacy would allow it to tell the students to go back to their books—or else.

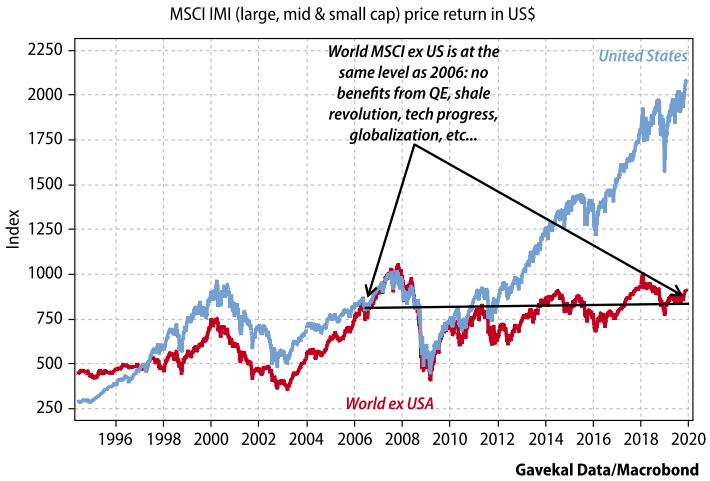
Question: You advocate the purchase of cyclicals and financials. But we are a decade into what has already been one of the longest economic expansions on record. Why would I even consider buying such stocks now?

Answer: Without wanting to be rude, this is a fairly US-centric view of the world. Yes, the US is 10 years into an expansion. But the rest of the world (ex-China) definitely isn't. Europe isn't (large swaths of Europe flirted with recession in 2019). Neither is Japan, Latin America, or most of Asia.

Take stock markets as a rough indicator of this idea. Undeniably, US equities have experienced a terrific decade. But meanwhile, stocks outside of the US trade at similar levels to 2006 (see left hand chart overleaf). That's 13 years of going nowhere.

Just as importantly, cycles do not die of old age. Signs of a late-cycle environment usually include (i) tightening by central banks (today they are easing), (ii) rising energy prices as demand overwhelms supply (energy prices have remained stable) or (iii) rising labor costs (as labor shortages run rampant). Right now, the only one of these that is evident is rising labor costs, which could yet spark more productivity-enhancing capital spending.

The divergence between US & ex-US equities



Chinese inflation is on the rise

Question: Global industrial production is shrinking. Over the past 15 years, each time this happened, China threw caution to the wind, geared up balance sheets and re-ignited the global economy. With that in mind, (i) why won't China do the same this time around, and (ii) if China doesn't stimulate, and continues to slow, then where will the growth come from? After all, China is roughly half of global GDP growth in any given year.

China will not stimulate growth if that means pumping up an already frothy housing market

Answer: There are many reasons not to expect much stimulus from China this time. Two, however, stand out for me: when China wants to stimulate, it gets the most "bang for its buck" by boosting the property sector. Yet the property sector is the one part of China's economy that has kept humming along in recent quarters. Thus, by stimulating today, the Chinese authorities risk adding fuel to the fire of an already buoyant market (and setting themselves up for problems (see **Read My Lips: No Housing Stimulus**).

The second reason is that the inflation rate in China stands at a (most likely massaged) seven year high of 3.7% (see right hand chart above).

China's leaders also remain wary of the risk from elevated food price inflation

Now, the Chinese leadership may not look, or act, very communist any more. But they were still brought up in the "Marxist church". And any believer in the Marxist creed will fear inflation, and especially food price inflation (which happens to be what is unfolding in China today), as the rock upon which revolutions are built. This means that, of all the policymakers around the world, the last true set of inflation hawks today sit in Beijing.

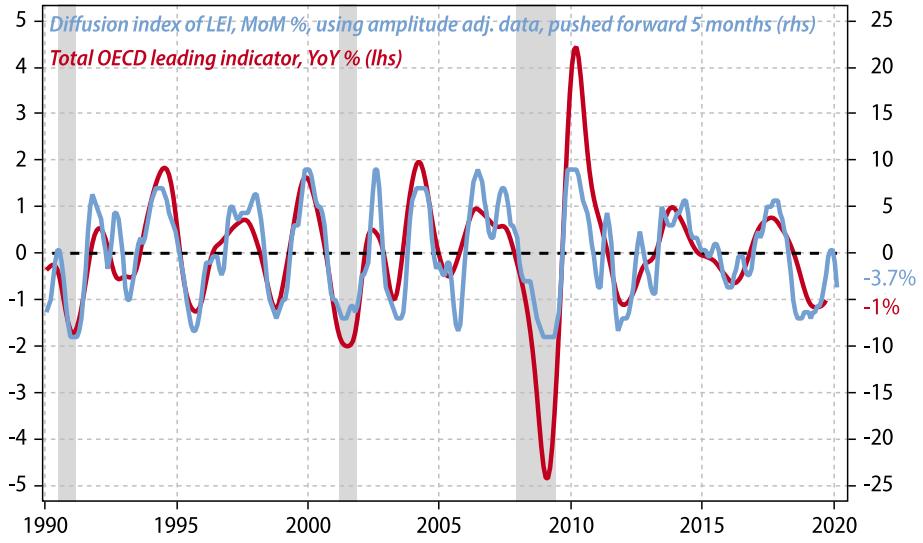
Thus, while a large part of the world is currently experiencing the combination of much easier monetary policies with very lax fiscal policy, for once China will not be leading the "easing" charge.

But the fact that China is not aggressively easing does not mean that the world is condemned to negative manufacturing growth. Far from it. After all, if the world depended on Chinese capital misallocation to sustain growth, it would be a sad indictment of capitalism! Instead, as the auto market likely starts to bottom around the world, as Boeing returns to producing the 737 Max, and as capital spending picks up in the face of rising labor costs, perhaps we should expect a fairly typical recovery for 2020.

There are good reasons to think that the world economy will see a fairly normal expansion in 2020

Leading the OECD leading indicators

Shaded grey: US recessions



Gavekal Data/Macrobond

Question: If, as the polls indicate, Elizabeth Warren is the Democratic Party's presidential candidate next year, doesn't that crush your growth outlook? After all, a Warren candidacy will likely spark reduced US capital spending and a softer stock market. And such an environment will hurt President Trump and thereby boost Warren's odds.

A factor that could upset the US apple cart would be Elizabeth Warren being the Democrats' presidential candidate

Answer: Given that "a week is a long time in politics", it is still early days to know who the Democratic nominee will be. With "Super Tuesday" happening in early March, the political race could narrow down quickly, or the markets may need to start planning for a brokered convention.

Still, if Warren is nominated, an interesting question is whether investors react by selling US equities, or instead dump the US dollar. After all, the market's core conviction today is that the US is the "cleanest dirty shirt". Therefore, foreigners have deployed capital in the US for the past decade. However, will they still like the US's relative cleanliness with a potential president threatening to break up US big tech, ban fracking, nationalize health care, re-regulate finance massively and up-end education? After all, tech, energy, health care, finance and education are really the core industries in which the US has a clear comparative advantage. Would the US maintain an advantage in these key industries following massive government interference? Like second marriages, that would be the triumph of hope over experience.

Thus, the threat of Warren (or the threat of runaway US government spending under almost any candidate including Trump) may hurt the US dollar before impacting the US stock market. And from there, it is possible to imagine a more constructive chain of events whereby (i) a weaker dollar helps boost manufacturing employment across the Rust Belt, while (ii) emerging markets get a growth boost and (iii) this combination helps boost corporate earnings across the globe, and so cushion any drop in equity markets.

If a warren presidency meant an end to fracking, the US oil sector could face a supply shock

Question: But Warren promises to ban fracking on her first day in office. And some 60% of US oil is produced through fracking today. Such a decision would trigger a supply shock of epic proportions. And in the meantime, any US oil producer is likely to cut back on capital spending and so set us up for shortages. In short, are you not worried that a politically-driven spike in oil prices completely derails your rosy scenario?

Answer: Yes. The past decade has seen a transformation in left-wing parties all over the world. They used to defend workers' rights and, in a Marxist dialectic, force more of the spoils of production to fall into workers' pockets rather those of owners. However, workers have by and large been abandoned by left-wing parties (shoving them into the embrace of the populist/far-right parties). And the new cause embraced by the left is now saving the environment and addressing climate change.

The reality is that there are two separate ways to deal with the perceived threat of climate change. The first is to look at the world's energy needs and conclude, as Bill Gates has done, that given humanity's long-term energy needs, the only viable solution is for the world to embrace nuclear energy. In that regard, anyone genuinely concerned about climate change should be a massive advocate for nuclear energy. Yet, very few left-wing politicians are.

Left-wing parties globally want to ration energy usage through higher prices

Instead, most left-wing politicians would prefer to ratchet up energy costs either by raising taxes (Emmanuel Macron's fuel tax, which triggered the *Gilets Jaunes* revolt), or by regulating and restricting the extraction of commodities (Warren's plan to ban fracking). The general idea being that a higher price (even one that proportionately penalizes the working class) will force people to change their power consumption habits. But at the end of the day, we are indeed left with a higher price as the "clearing mechanism" to deal with climate change.

So assuming that most left-wing parties in democracies are effectively calling for higher energy and commodity prices and that pendulums in most Western democracies tend to swing from left to right and back again, at some point polices will be adopted that force energy prices higher.

As such, the "balanced portfolio" of the future may not be growth stocks hedged with government bonds, but instead growth stocks hedged either with inflation-protected bonds, or growth stocks hedged with commodities or commodity producers.