

Strategy Monthly

Three Questions For The Year Ahead

December 2018

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Louis-Vincent Gave

Investors will be happy to bid farewell to 2018, a miserable year in which all assets underperformed US dollar cash. For next year, three questions are critical: 1) Will the US-dollar liquidity squeeze ease? 2) Will the expanding US budget deficit prove a decisive factor? and 3) Are we witnessing the slow-motion unraveling of the “Chimerica” synergy between the US and China?

Where We Stand: Our strongest views from the past month

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- Consequences of the Xi-Trump détente *Arthur Kroeber, Louis-Vincent Gave*
- China will get weaker before it gets stronger *Chen Long*
- In the US, political gridlock is good for growth and stocks *Will Denyer & Tan Kai Xian*
- Cold winter ahead for Europe *Nick Andrews*
- Emerging markets need a China boost to recover *Udith Sikand*
- However Brexit turns out, buy sterling *Anatole Kaletsky*

Indicators

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- Data Dashboard: A worsening growth outlook and the return of deflationary forces

Three Questions For The Year Ahead

Louis-Vincent Gave

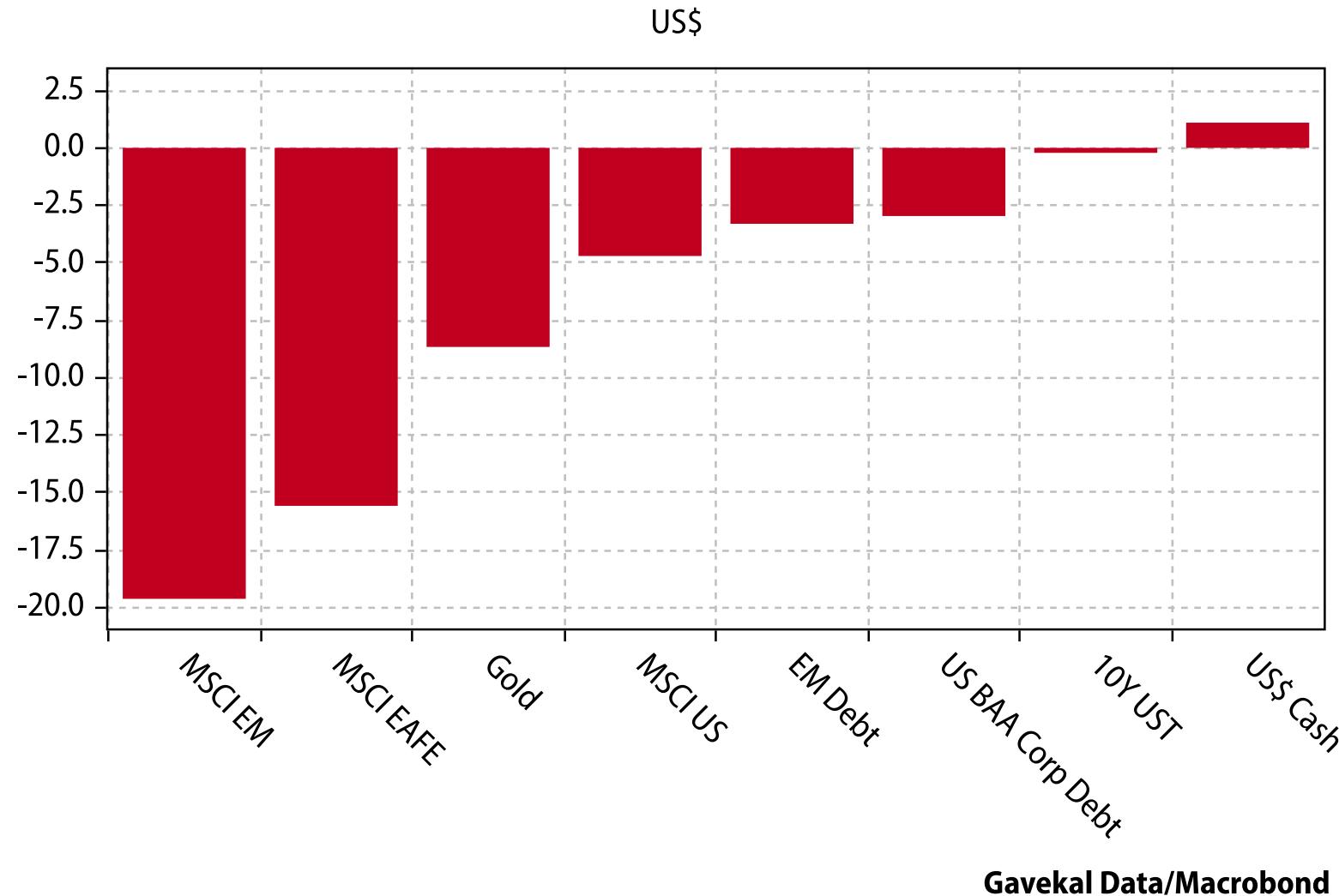
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Will 2019 be any kinder to investors than 2018?

- Early this year, we pointed out that a key risk to markets was tighter US dollar liquidity (see [**The Drains On Liquidity**](#)). By late summer this risk seemed acute, with the oil price rising, China and EM in free-fall and the dollar strengthening (see [**Towards A Global Liquidity Crisis?**](#)).
- Conditions have since eased: The oil price tanked, Federal Reserve boss Jay Powell hinted at an easier stance, and the US and China struck a trade-war truce. Heading into 2019, three questions loom:
 1. **Is the US dollar liquidity shortage really easing?**
 2. **Are rising US budget deficits creating an easy money/easy fiscal policy mix?**
 3. **Paradigm shift: Are we facing the end of “Chimerica”?**

Since the January peak, all assets underperform US dollar cash

Total returns of various asset classes between Jan 29 and Dec 5, 2018



Why is pretty much every asset class down?

Option 1: We are going through a typical liquidity squeeze thanks to a tighter Fed, higher oil and higher government spending



Consequences:
Fed & China will soon ease

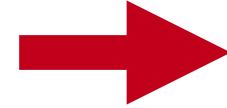


Sell the US\$, buy yield assets everywhere, buy EM

Option 2: Growth in the US budget deficit is crowding out everybody else



Consequences: This could be problematic as the 10-year US treasury is the foundation of the system



A possible paradigm shift for structural portfolio allocation

Option 3: The end of "Chimerica" means weaker returns and weaker growth across the spectrum



Consequences:
Also problematic



Hard to gauge the long-term investment consequences

Option 1: A liquidity squeeze, and how it ends

#1: Oil prices collapse



#2: China stimulates



#3: Fed injects liquidity



For

- Likely China/EM slowdown
- Possible repeat of EMU crisis (Italy...)
- Saudi pumps to squeeze Iran

Against

- Tight supply-demand
- Little capex in recent years & high wear/tear with fracking

For

- CCP won't want to risk debt deflation

Against

- Xi would lose hard-won policy credibility
- Could trigger another wave of capital flight
- What if China wants to play hardball?

For

- An Italian crisis?
- US housing & autos roll over?
- US stocks now rolling over
- Inflation is weak & weakening thanks to oil

Against

- The Fed is not in this frame of mind
- By resisting Trump pressure for easing, Fed safeguards independence

Has the oil price collapse started? Is this the way out?

Does lower oil mark the end of the liquidity squeeze?

The drop in oil price: -30% in a few weeks



Natural gas: up 60% in a few weeks



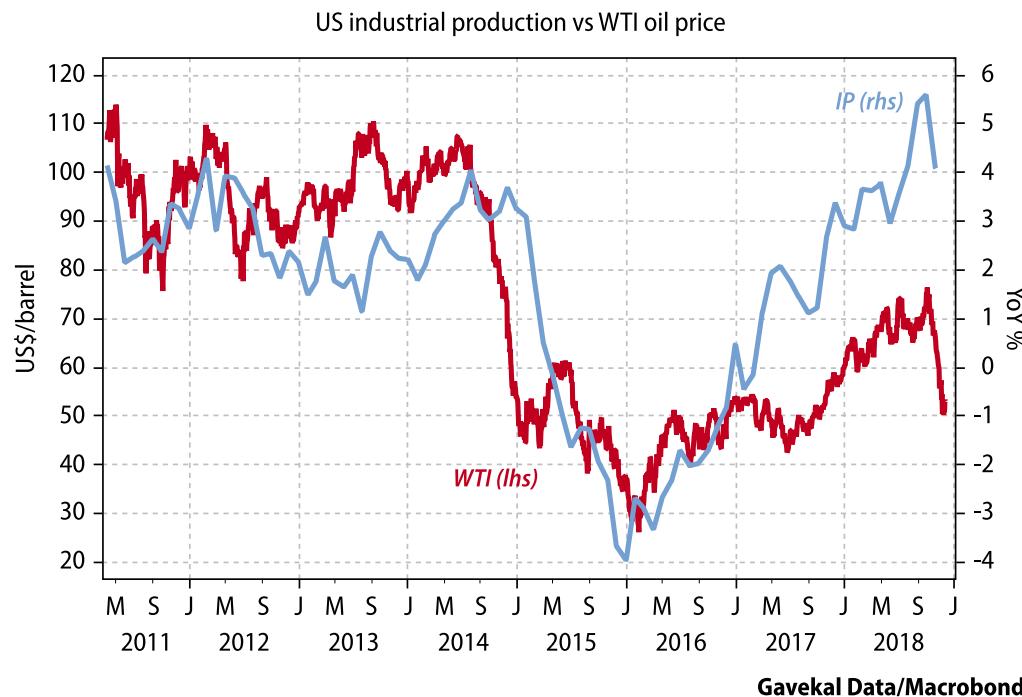
First, be careful about getting too excited about lower oil just yet. The fact that oil collapsed while the natural gas price surged would seem to indicate that recent moves had much to do with hedge fund positioning (long oil/short natural gas) and a possible squeeze. If this is the case, then there may be no case for another leg down.

In fact, given the global supply-demand situation, the risk may well be that oil prices bounce back rather than head back down. Unless, of course, the continued slowdown in global growth entails weaker demand?

Another concern is that the trigger for the collapse was President Trump backing off on his Iran threats. But if Trump feels a need for a win, maybe squeezing Iran further will once again be an option?

If oil stays low, what does it mean for US growth and spreads?

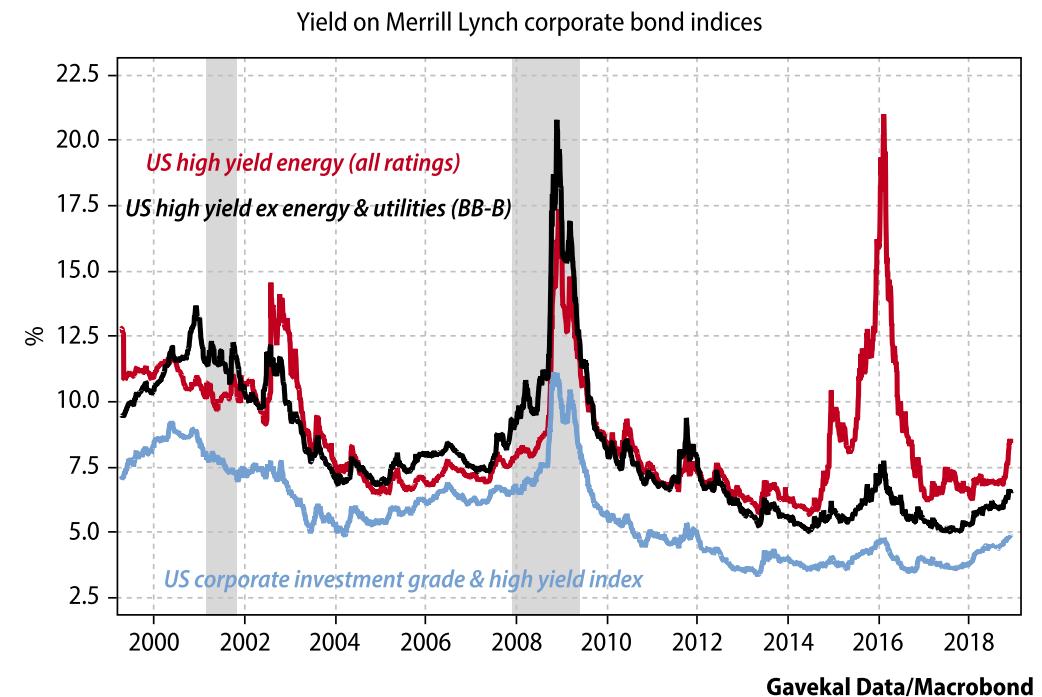
Can US industrial production stay strong with oil tanking?



If oil prices stay at current levels, or head lower from here, then capex in US oil fields will plummet, if only because most US oil fields are not profitable enough around US\$50/bbl.

Thus, if the rollover in oil prices is confirmed, we should probably expect a fall in US industrial production.

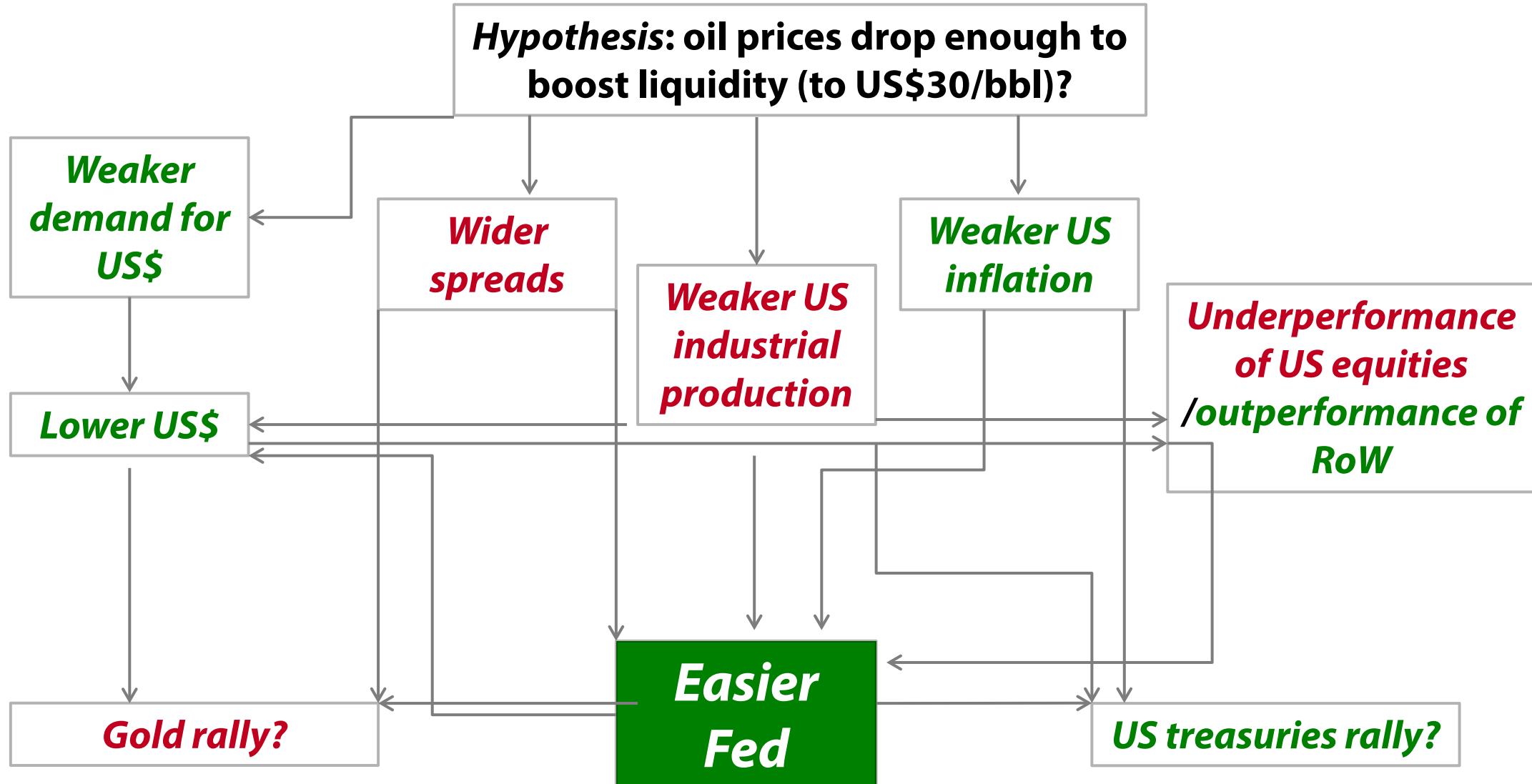
Corporate yields have risen since the summer, but to different degrees



More worryingly, weaker oil prices would most likely push spreads higher as well. At least, that is what happened in 2015-2016.

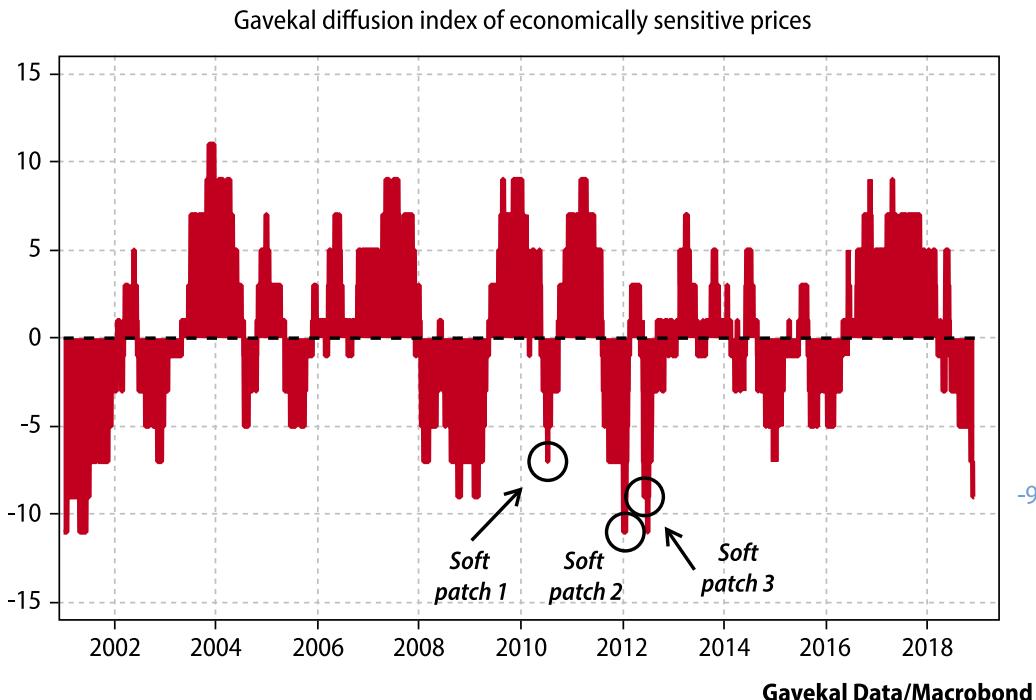
Indeed, given the capital-intensive nature of extracting shale oil, the energy industry has been a sizeable debt issuer over the past decade; thereby creating a somewhat new relationship between weaker oil and wider spreads.

Does lower oil start a chain reaction leading to an easier Fed?



Liquidity squeezes can also be resolved via lower growth...

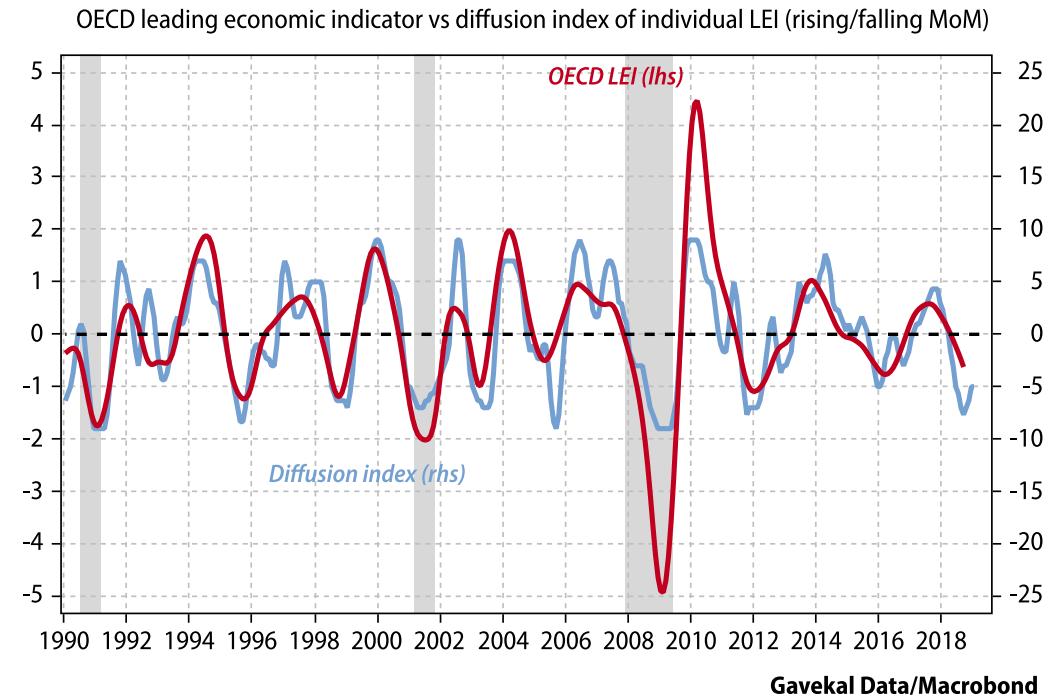
Our economic diffusion index is signaling slower growth



If a liquidity squeeze is not met by either a policy response and/or much weaker oil, another way for the global system to find its equilibrium is through weaker growth, or weaker inflation.

This seems to be unfolding: In China and in Europe, growth is weakening.

Leading indicators are heading down



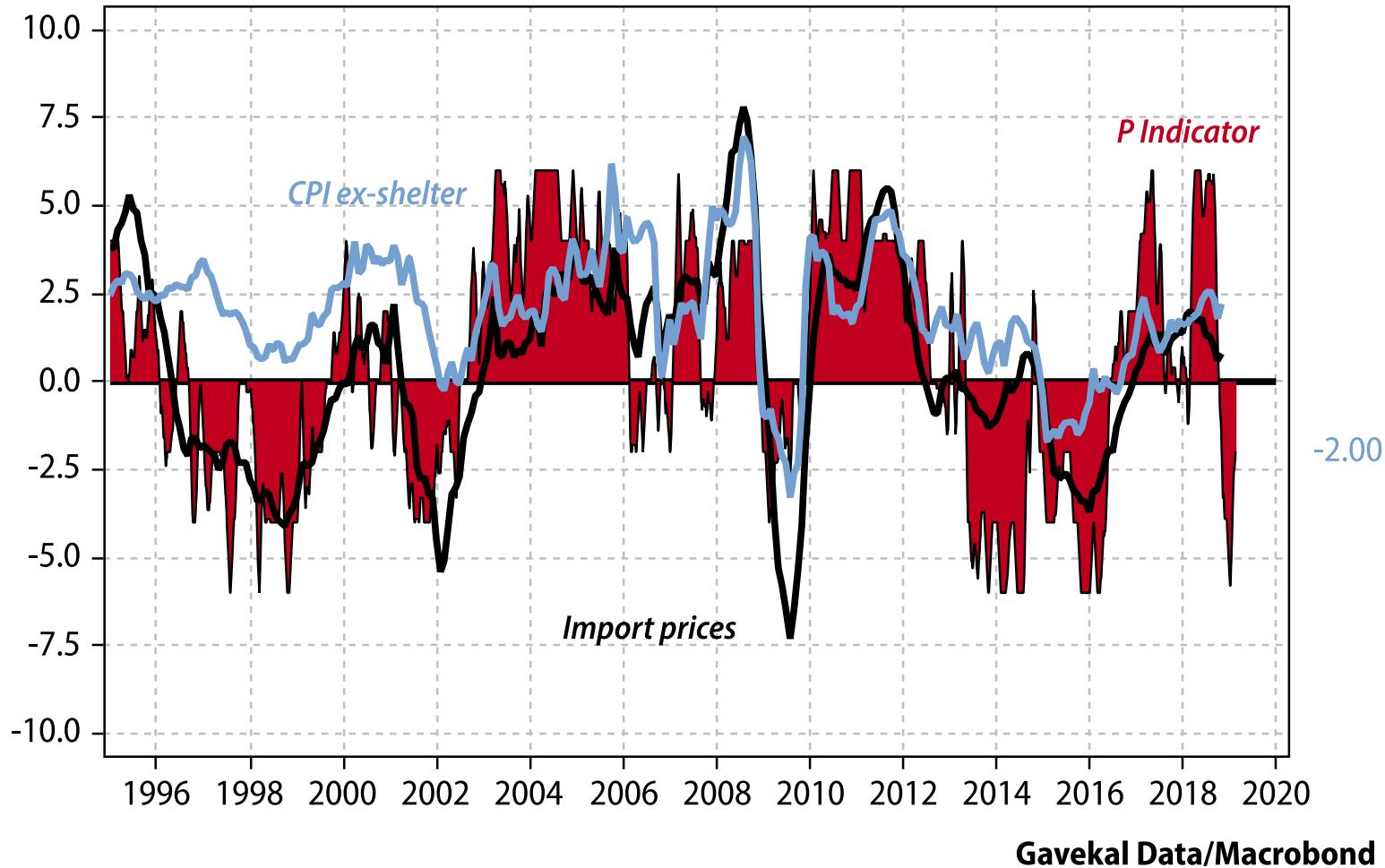
And even in the US, growth is starting to look shakier. After all, we now have the US housing sector, and the US auto sector, displaying clear signs of weakness.

And how many times have we seen the US economy boom with housing and autos rolling over?

...or by weaker inflation

Inflationary pressure seems to be easing

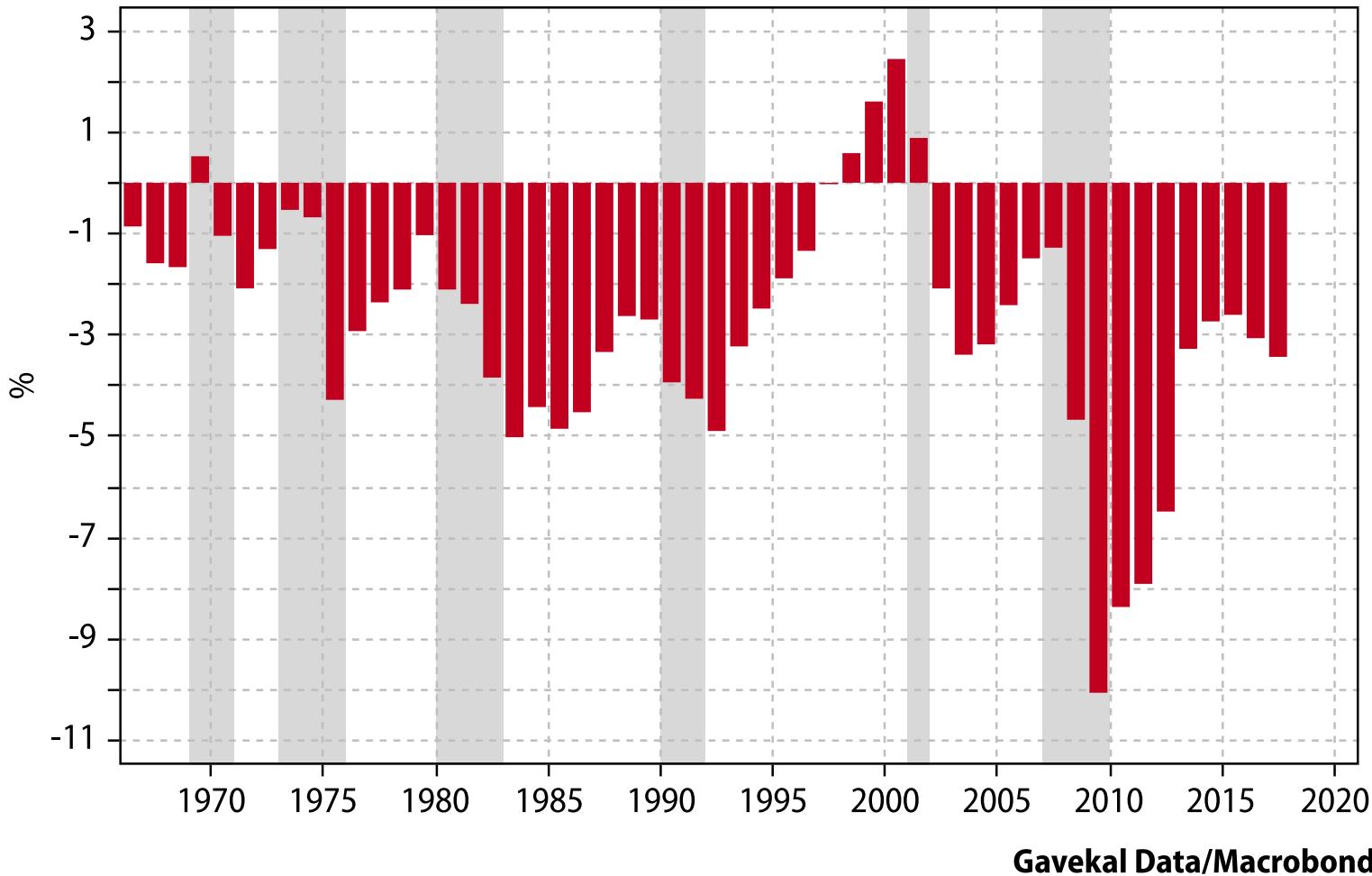
The Gavekal P indicator (inflation), US import prices and CPI ex-shelter



Option 2: Growing US budget deficits are crowding out the private sector

Three years of widening budget deficits without a recession

US federal deficits, % of GDP (shaded grey: US recessions)



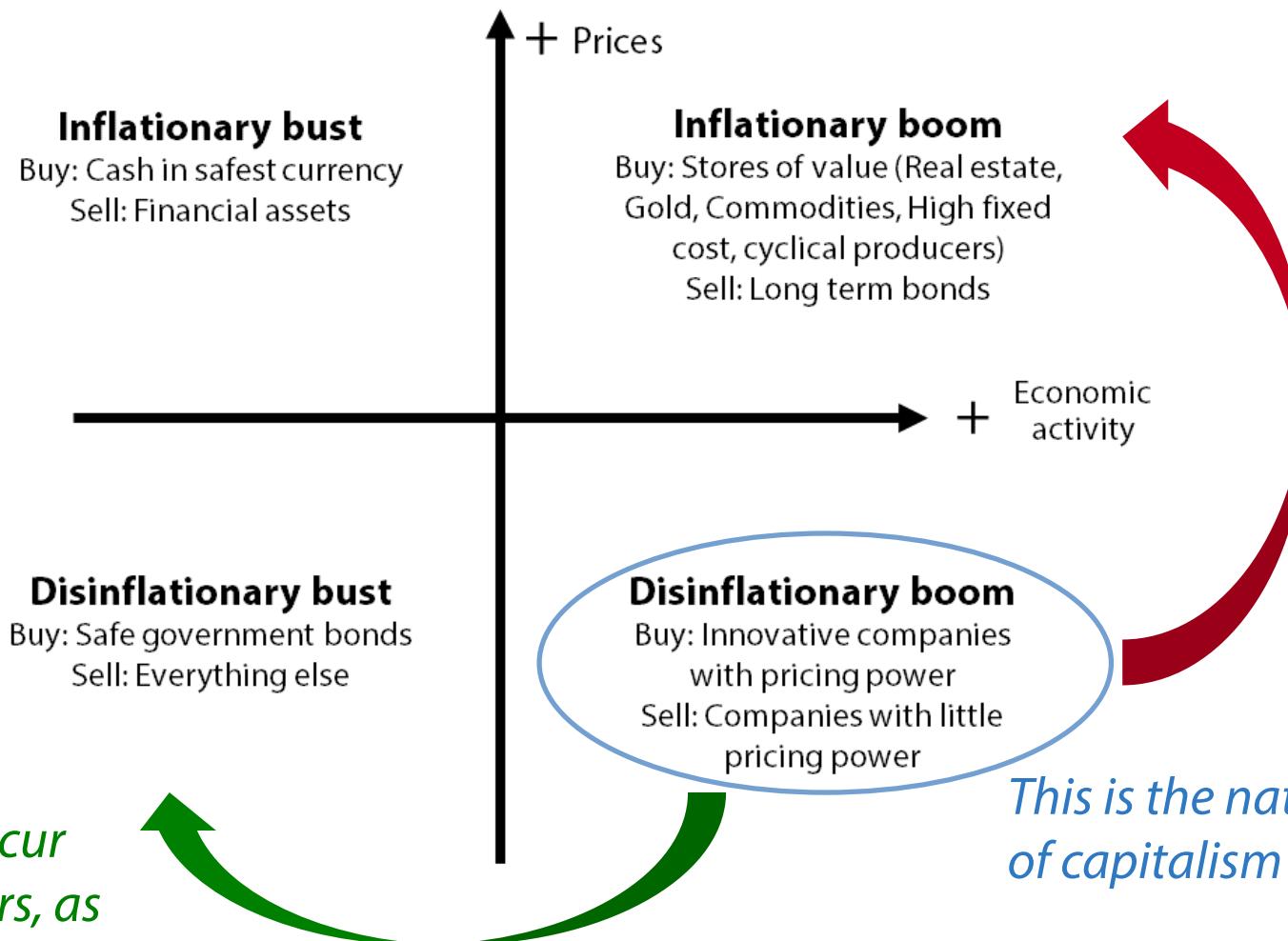
Despite record-high tax receipts, the US budget deficit once again expanded in Fiscal 2018. **This is unprecedented.** We have never seen consecutive deficit expansions outside of a recession.

So what happens next? Will the US government:

- 1) shrink spending,
- 2) increase tax revenues, or
- 3) continue to expand deficits?

If so, then will easy fiscal/easy money mix end the deflationary era?

The Four Quadrants framework

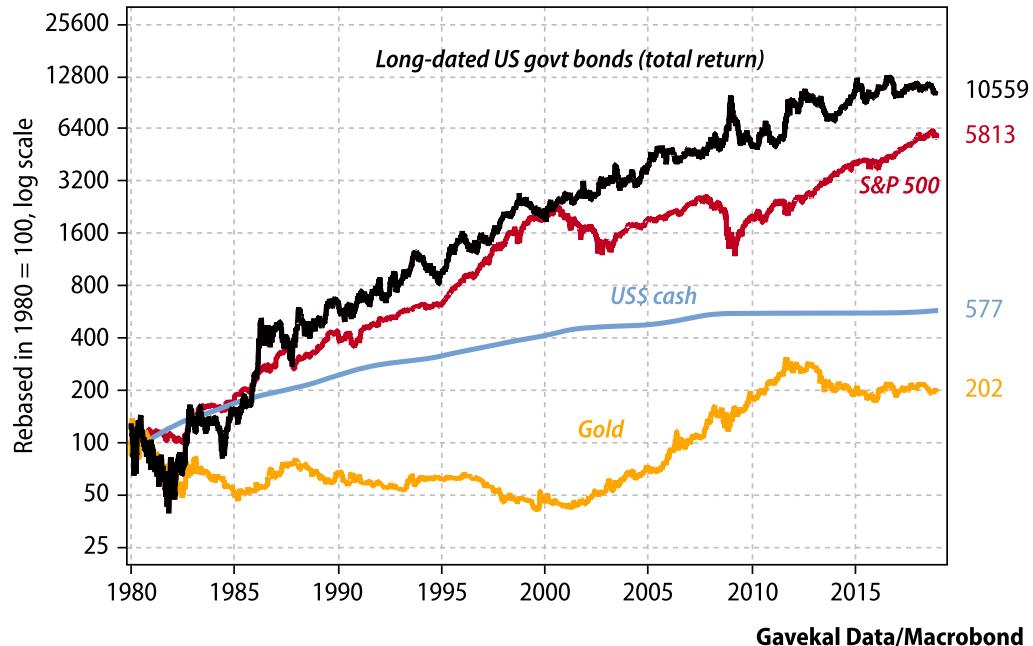


These shifts occur every 30-40 years, usually because of policy mistakes

This would have massive consequences for portfolio construction

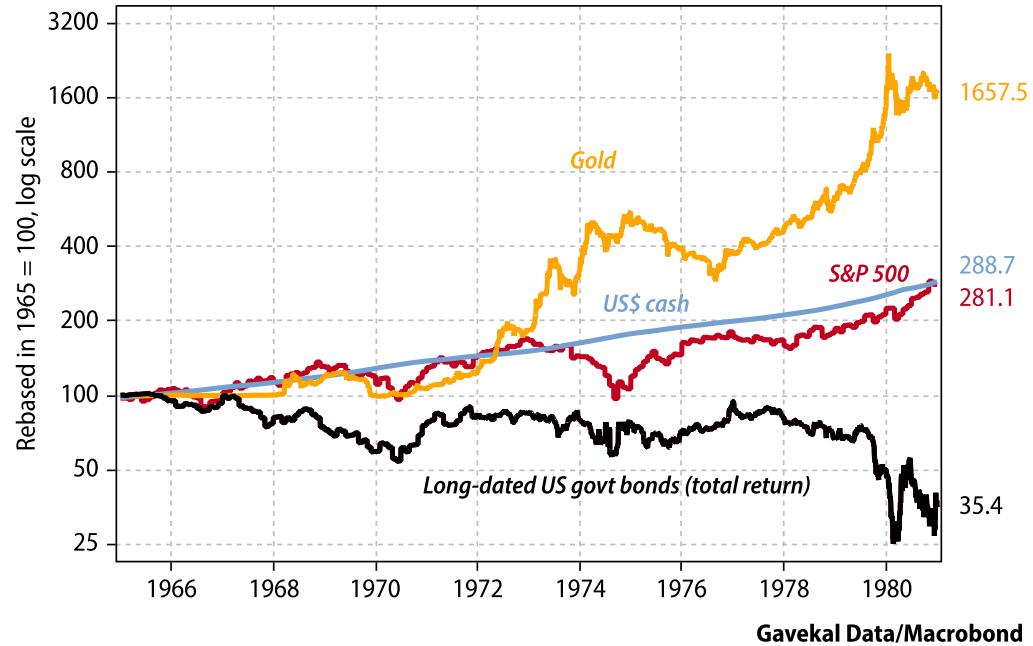
In disinflation, long bonds offer the superior hedge

S&P 500, US long bonds, gold & US\$ cash in a disinflationary period



During inflation, the best hedges are cash and gold

S&P 500, US long bonds, gold & US\$ cash in an inflationary period



Since 1980, a broadly disinflationary environment has meant that long-dated US government bonds offered the best hedge, outperforming even the very strong stock market returns.

Cash and gold substantially underperformed.

But in the inflationary 1960s and 1970s, long bonds did terribly, and equity portfolios were best hedged with gold and US dollar cash.

So a crucial question for money managers is whether we are making a secular shift from a disinflationary to an inflationary era—thereby requiring a change to the defensive component of the portfolio.

Option 3: The end of “Chimerica”

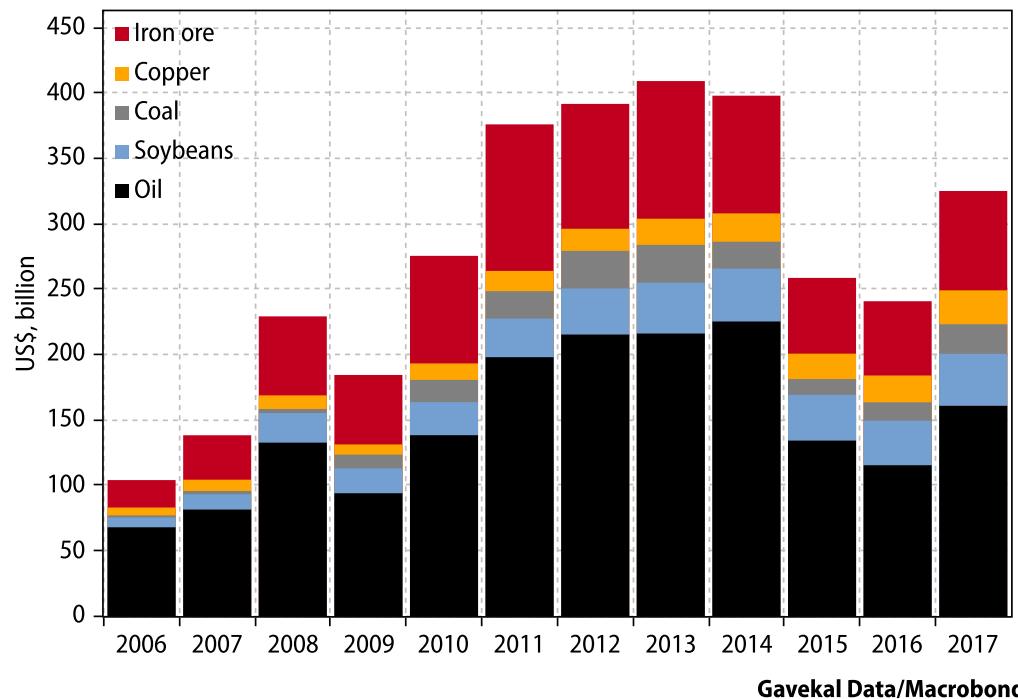


This year's single most important event has been the rise in China-US tensions. Are these tensions:

1. A by-product of President Trump's negotiating methods, so that by April a deal will be struck which brings us back to something approaching the previous *status-quo*?
2. The direct consequence of the fact that so many Trump advisors see China as a long-term threat to the US and want China to be cut down to size through an economic cold war?

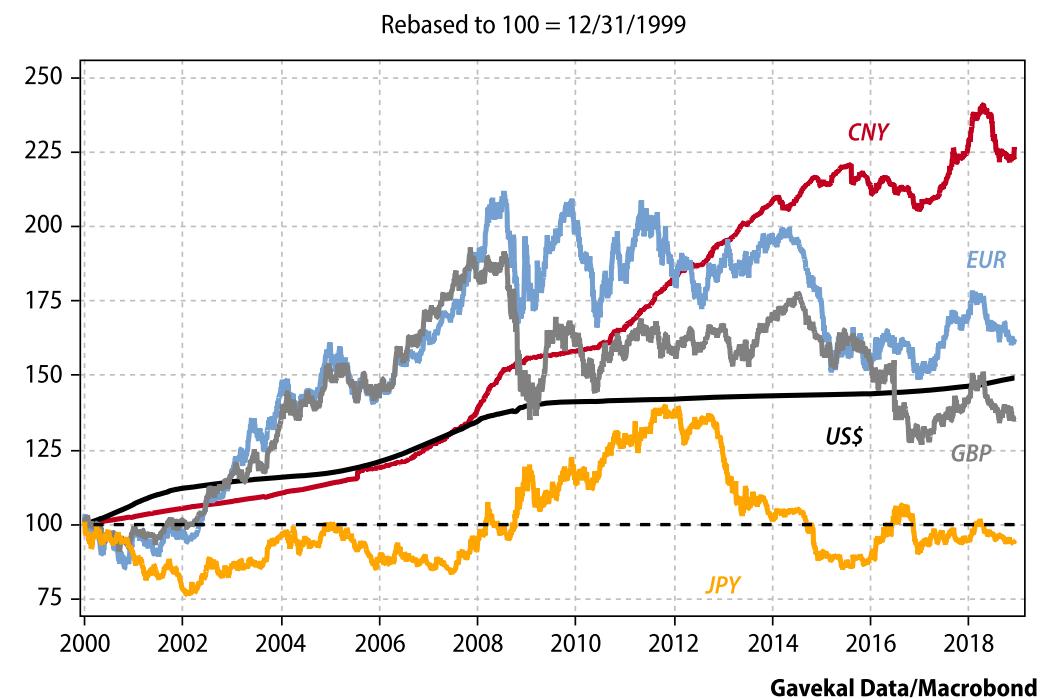
China's response: de-dollarization

China's "big five" commodity imports cost US\$250-400bn a year



China remains highly dependent on resource imports priced in US dollars. To reduce its dollar-dependence at a time of rising conflict with the US, and to advance its own imperial ambitions, China has an incentive to de-dollarize commodity prices, and promote greater use of the renminbi.

Total return of cash holdings in US dollars based on 3m interbank rates

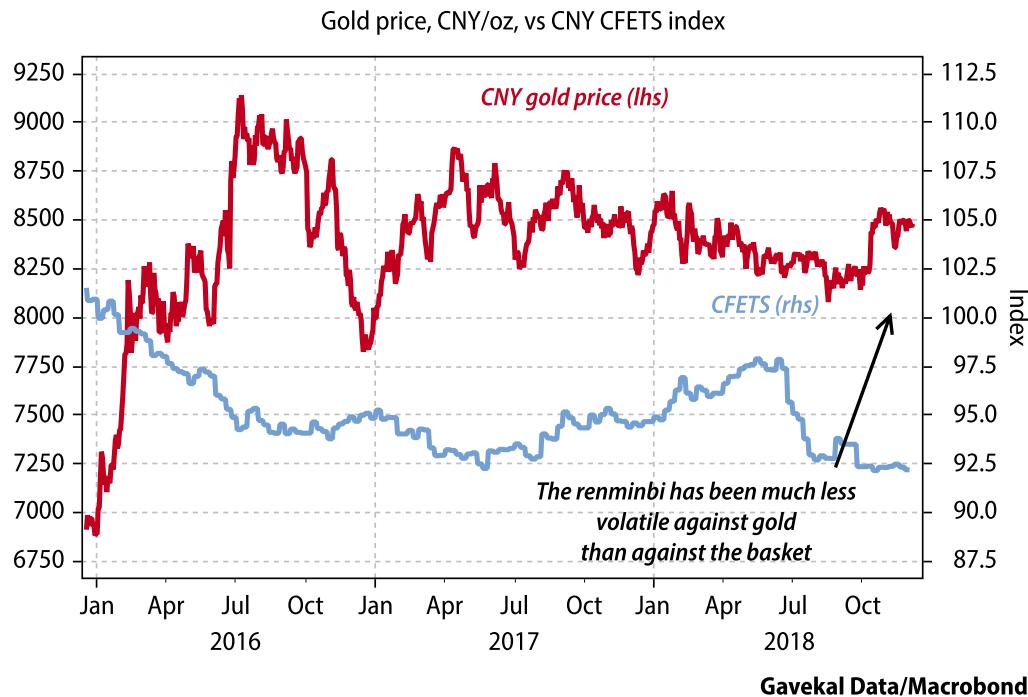


To shift Asian trade and commodities pricing away from the US dollar, the renminbi needs to be a credible alternative.

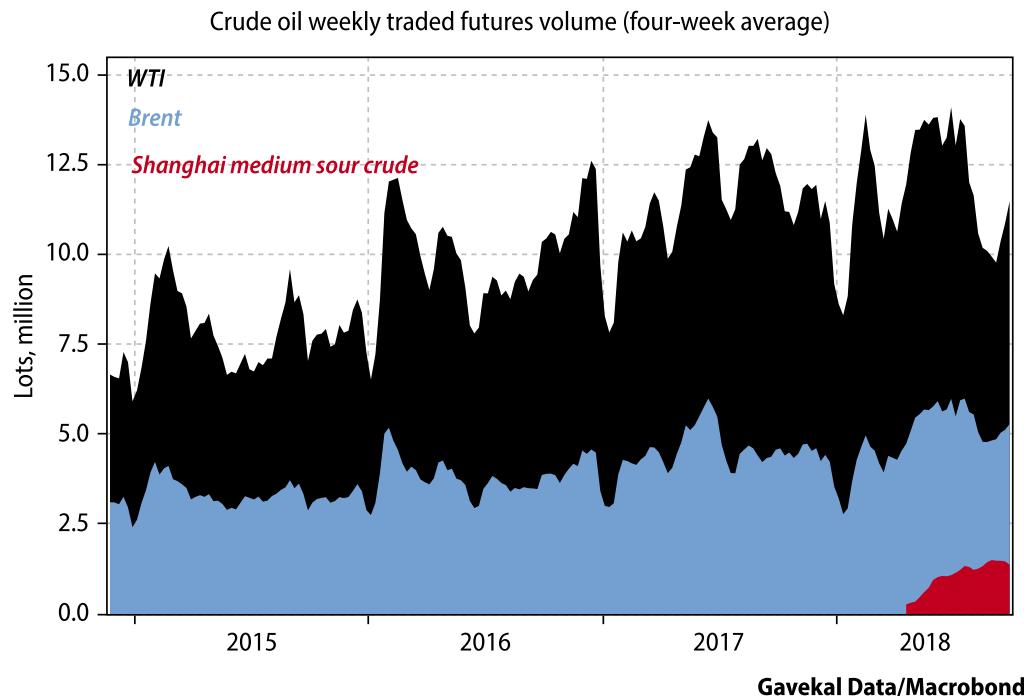
One step in this direction is establishing a track record for the renminbi as a strong currency—as illustrated by the strong returns of renminbi cash over the past two decades. Another is the creation of renminbi-denominated oil futures and gold futures.

Is the renminbi managed against a basket? Or against gold?

Is the PBOC now managing the renminbi against gold?



The Shanghai renminbi oil futures contract is picking up market share



An interesting side note on the renminbi: It fell sharply this summer, not only against the dollar, but against the CFETS trade-weighted basket that is supposedly the target of PBOC policy. Yet it barely moved against gold. This could be a coincidence—or evidence of Beijing's long-term plan of de-dollarizing commodity prices. More evidence: The Shanghai renminbi oil futures contract, which has picked up market share from Brent and WTI.

What's the connection? Swapping the renminbi for the dollar in commodities trading carries a risk for Beijing: Loss of control over its exchange rate. By linking the renminbi to gold, even if loosely, it can create an alternative for international payments, without losing control of its currency (see [Does Beijing Really Manage The RMB Against A Basket?](#)).

Renminbi bonds are a hedge against the dissolution of “Chimerica”

Evolution of US\$100 invested in 5y govt bonds, 5y CGB and treasuries



If the pattern of the past five years is maintained, US treasuries should soon start to outperform renminbi bonds.

Given similar yields, this can only really happen through a stronger US dollar. But how will the dollar get stronger when:

- A global equity meltdown does not boost the dollar
- Dovish words from ECB and BoJ have no impact
- Stronger US growth and US inflation do nothing
- A hawkish Fed has no impact

Does a trade war do the trick?

Very different portfolio hedges for the different scenarios

	Scenario 1: Liquidity Squeeze	Scenario 2: Economic Downturn	Scenario 3: Paradigm Shift
Cause	<ul style="list-style-type: none"> - Fed tightening - US budget deficit - Higher oil 	<ul style="list-style-type: none"> - China & EU slowdown - Excess corporate debt - Trade war disruptions 	<ul style="list-style-type: none"> - Chinese ambitions - US weaponizing US\$ - Runaway US deficits
For	<ul style="list-style-type: none"> - Shrinking CB reserves - Growing tensions - Bank underperformance 	<ul style="list-style-type: none"> - OECD LI rolling over - US housing rolling over - Defensive sectors outperforming 	<ul style="list-style-type: none"> - UST/gold behaviour - Fed hawkishness - Managers feeling lost & miserable
Against	<ul style="list-style-type: none"> - Spreads remain tight - US\$ not so strong - US treasury weakness - Gold behavior 	<ul style="list-style-type: none"> - Data weaker but OK - Absolute levels of interest rates not so high - Weak US treasury rally 	<ul style="list-style-type: none"> - "Different this time" - Who can replace US\$ when every other currency stinks?
Impact	<p>If we are in a liquidity squeeze, markets will likely suffer until either the Fed or China eases</p>	<p>If the global economy is slowing, position portfolio for an easier Fed very soon</p>	<p>Continue de-risking portfolio. Gold and renminbi bonds may be the only hedges</p>

Where We Stand

Our strongest views from the past month

Where We Stand

- **The Durability Of The Trump-Xi Rally**

Arthur Kroeber is skeptical that the US-China truce reached at the G-20 summit will yield a sustained rally, since the fundamental issues remain unresolved. **Louis-Vincent Gave** thinks Trump will now pick a fight with Europe, so investors should avoid EU assets and shift to Asia (see [The Next Target Of Trump's Firepower](#)).

- **China: Worse Before It Gets Better**

Chen Long reads the latest data from China and finds that the biggest problem is weakening credit growth, despite six months of cautious policy support. Credit, and GDP, are likely to remain weak until 2Q19.

- **Gridlock Is Good**

Will Denyer and Tan Kai Xian think that the divided government delivered by the US midterm elections enables an environment that is still positive for growth and equity markets.

Where We Stand

- **Winter For Eurozone Credit Growth**

Nick Andrews expects that growth in the eurozone will continue to slow, led by weaker credit growth, and that European stock prices face further downside as a result.

- **EMs Need More Than A Bear Hug**

Udith Sikand examines the train wreck of emerging market equities, which were down -25% between late January and late November. He doesn't see much chance of a strong rebound unless and until China decides on a stronger fiscal stimulus.

- **The Winding Road To Vassalage**

Anatole Kaletsky suggests that the never-ending Brexit saga will lead either to a Norwegian-style “fake Brexit” or to a fresh referendum. Either way, sterling assets are a buy (see **It's Finally Safe To Buy Sterling**).

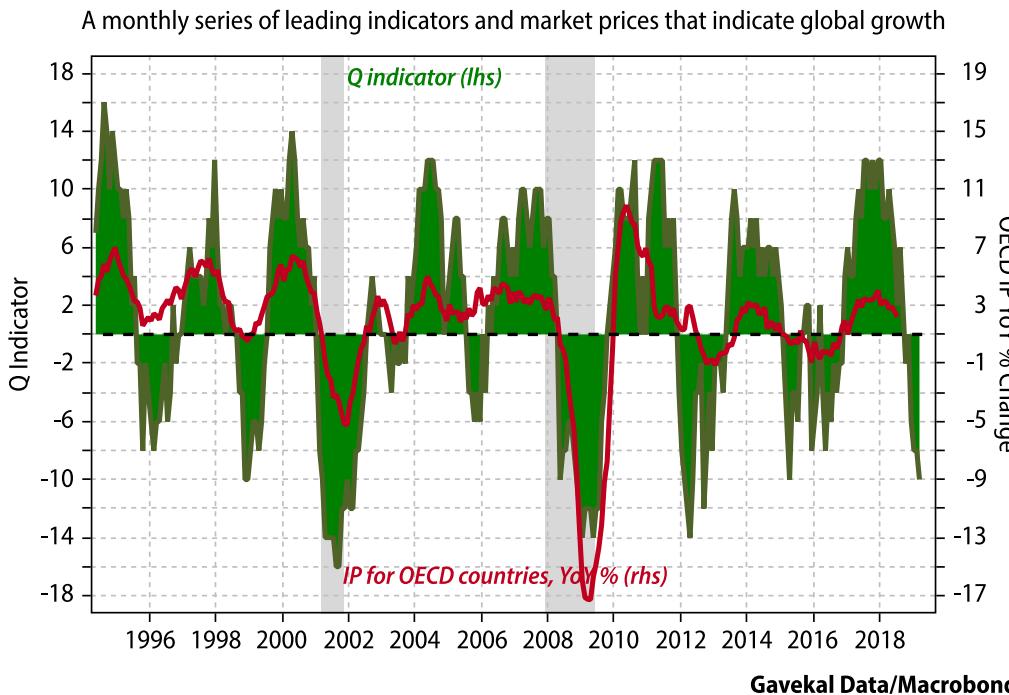
Indicators

A worsening growth outlook and the return of deflationary forces

*Continuously updated charts of all our main indicators
are available on the [Gavekal Indicators Dashboard](#) page on our website*

The global growth outlook is deteriorating

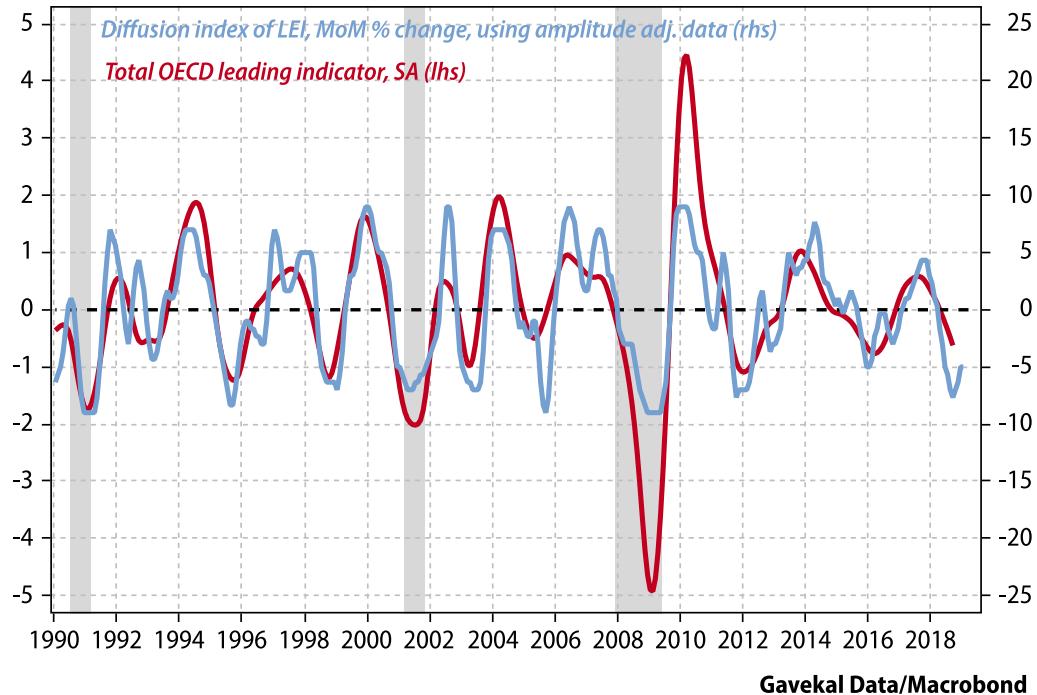
The Gavekal Q indicator



As has been the case for a few months, our global growth indicators continued to weaken in November.

The eurozone looks to be the region slowing the most, but the same dynamic is affecting all major economic areas.

Leading the OECD leading indicators



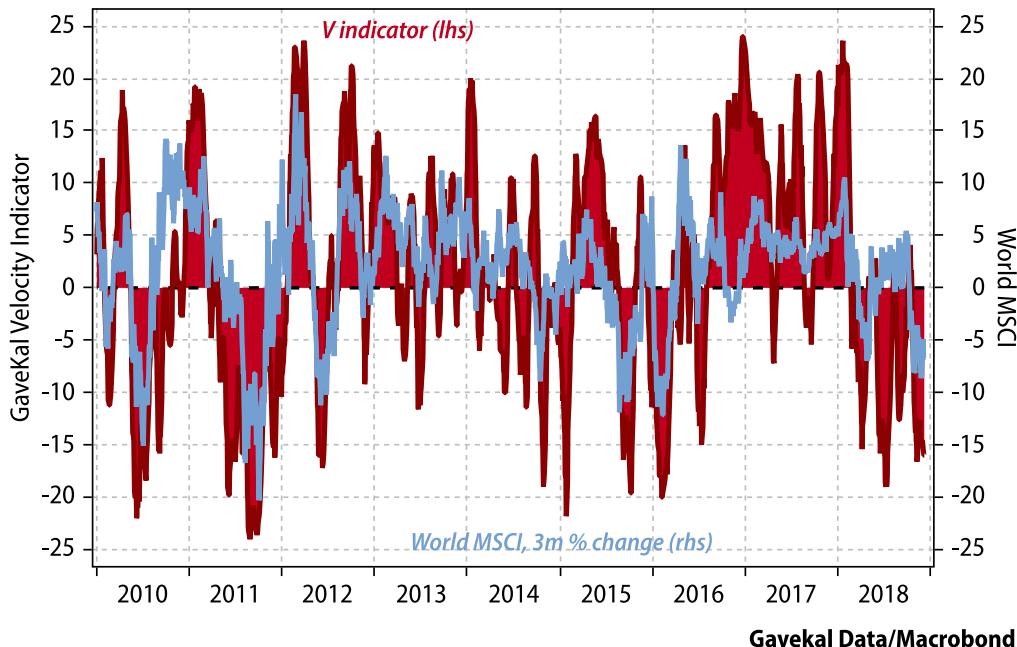
Even the US, which has been a beacon of strength this year, has started to weaken. Housing activity and auto sales are slowing, and there is concern that decent import numbers are explained by US companies having front-run the anticipated imposition of new tariffs.

If that is the case, then an inventory overhang may materialize at a time of weakening domestic demand.

Investment appetite remains largely negative

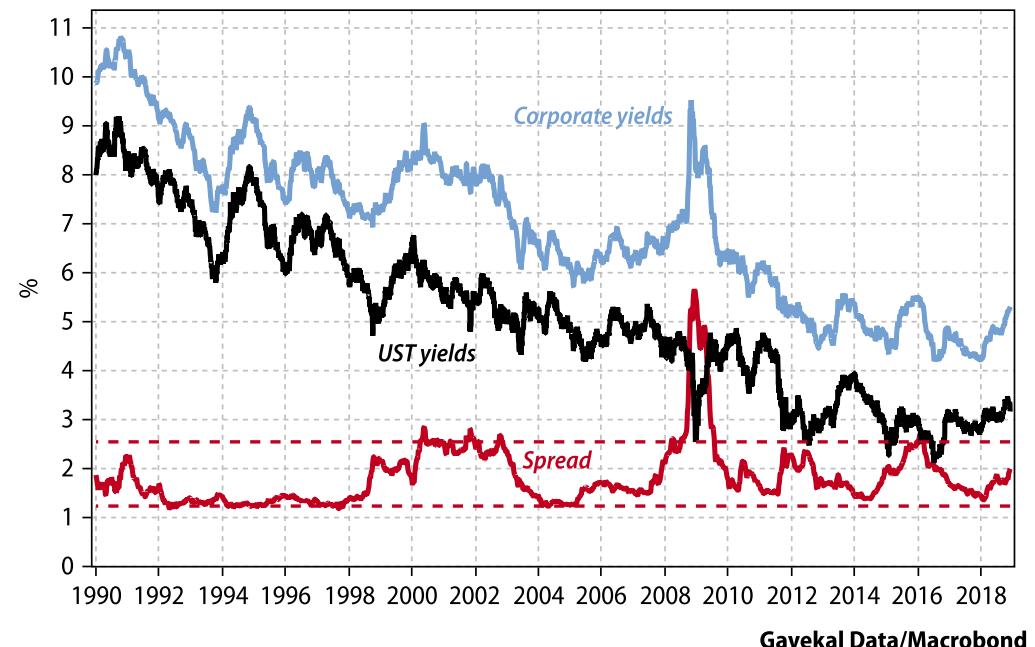
Gavekal velocity indicator

Combination of market-based spreads & fundamental data aimed at estimating risk appetite



US corporate spread

Baa seasoned corp benchmark is closer to 30y duration than 10y, so we compare to 30y UST



After a very vicious October, November saw some relief for risk assets.

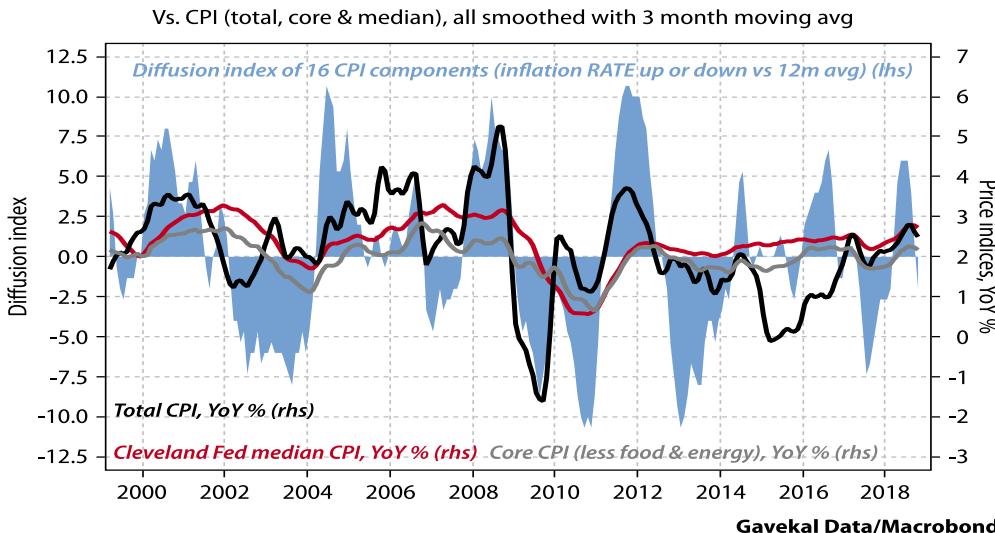
On the equity side, the World MSCI eked out a near 1% gain. Asian stocks did very well, shooting up by 5%.

These gains seem to have been short-lived as December has seen a rocky start for risk assets. This despite 1) falling oil prices, 2) a weaker sounding Fed and 3) a potential truce in China-US trade tensions.

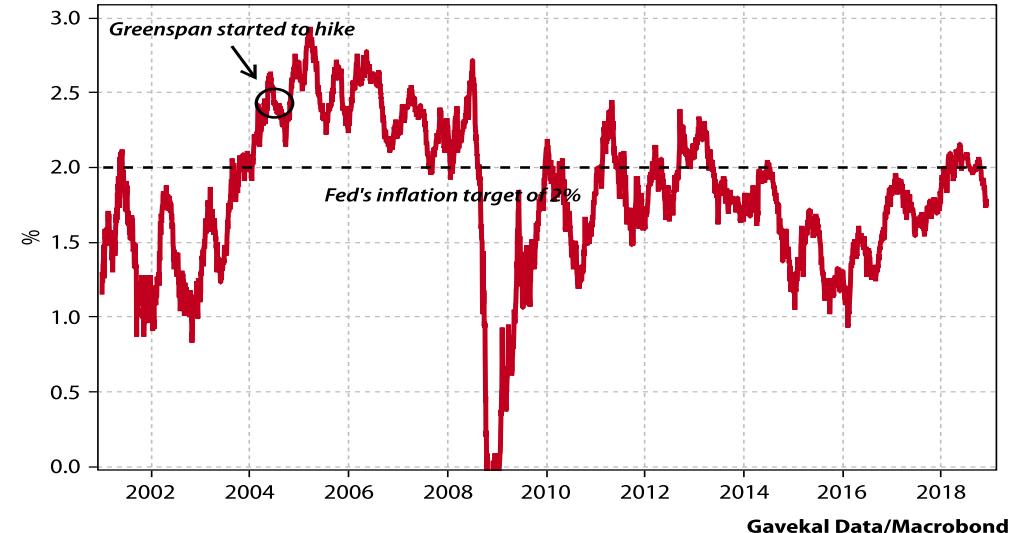
This situation is a worry, for whenever stocks fail to rise on good news, investors should sit up and take notice.

Inflation – is deflationary pressure returning?

Diffusion index of 16 CPI components - accelerating or decelerating

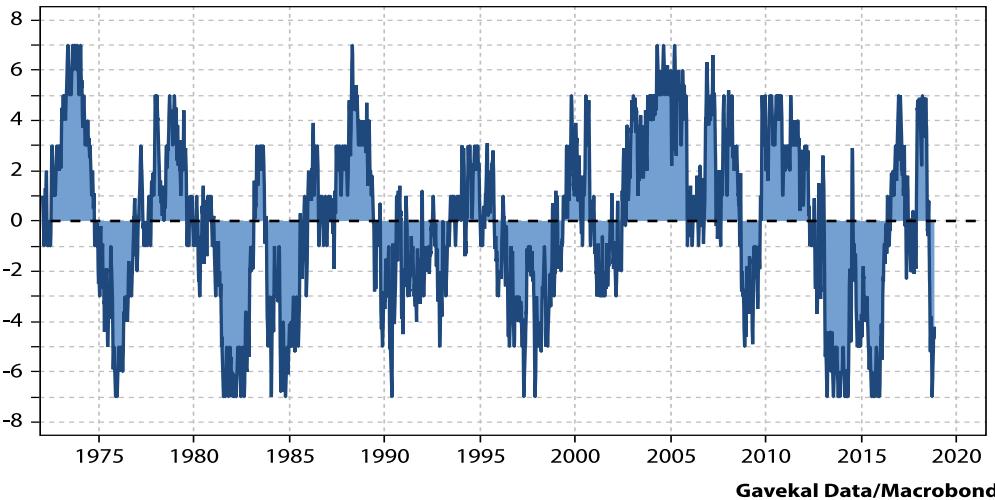


Break-even inflation rate for 5 year TIPS



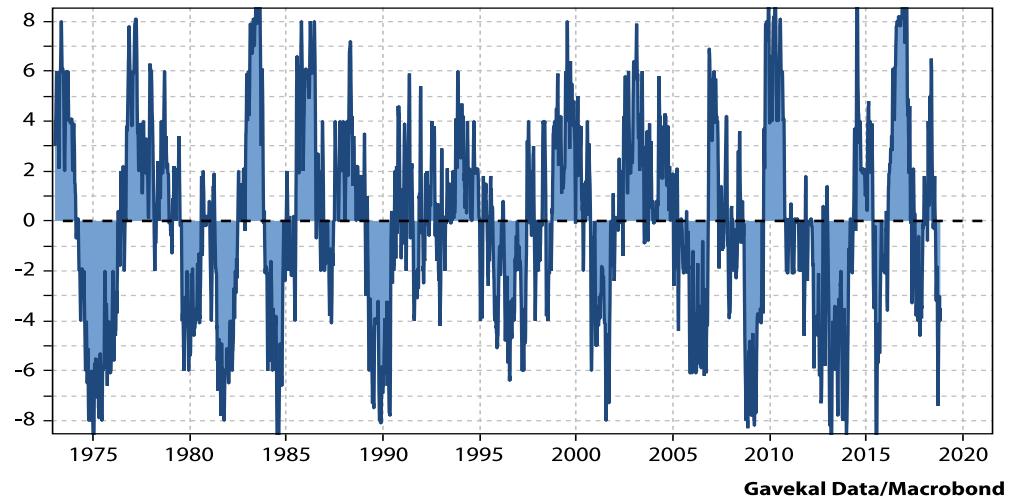
The new Gavekal P indicator

Various market-based and fundamental data aimed at gauging future price movements



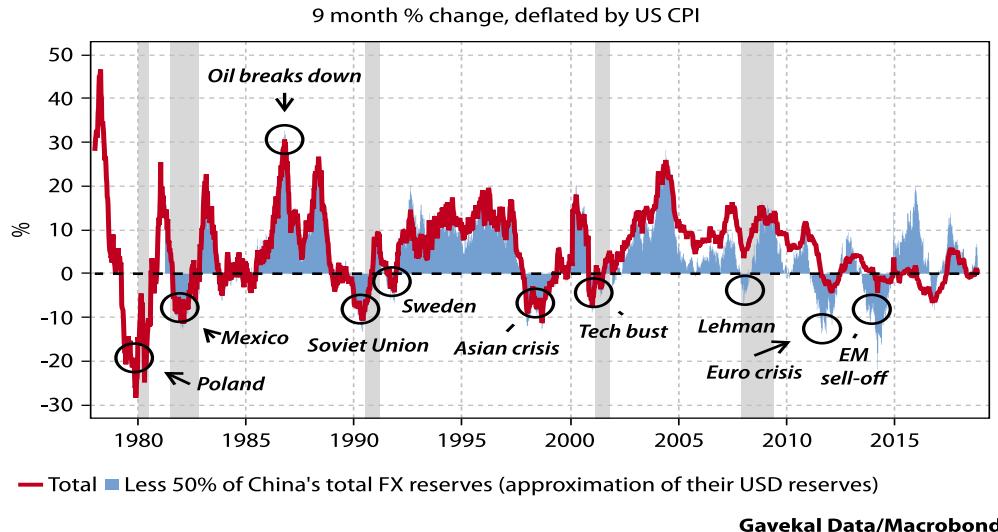
Momentum of the new Gavekal P indicator

Various market-based and fundamental data aimed at gauging future price movements

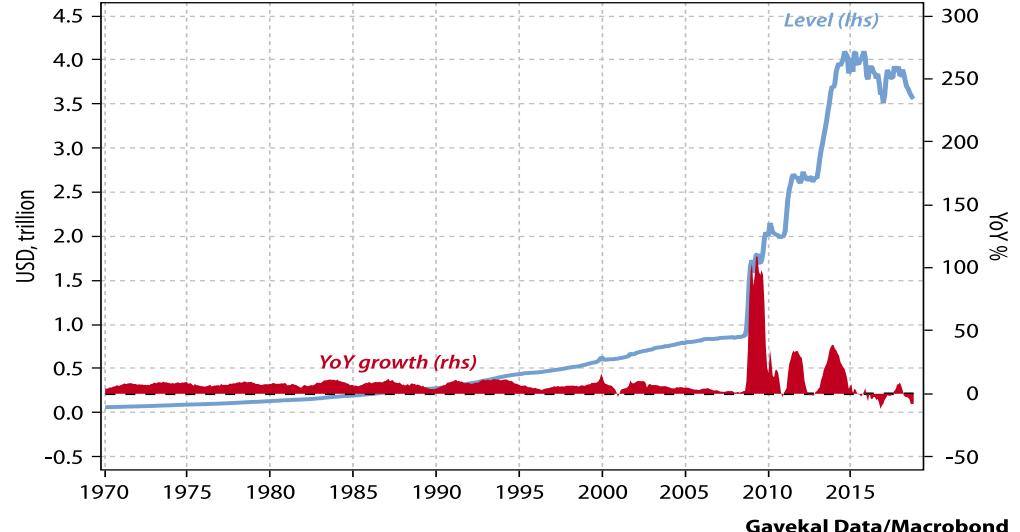


Currencies – CBs still in a tightening mode – but for how long?

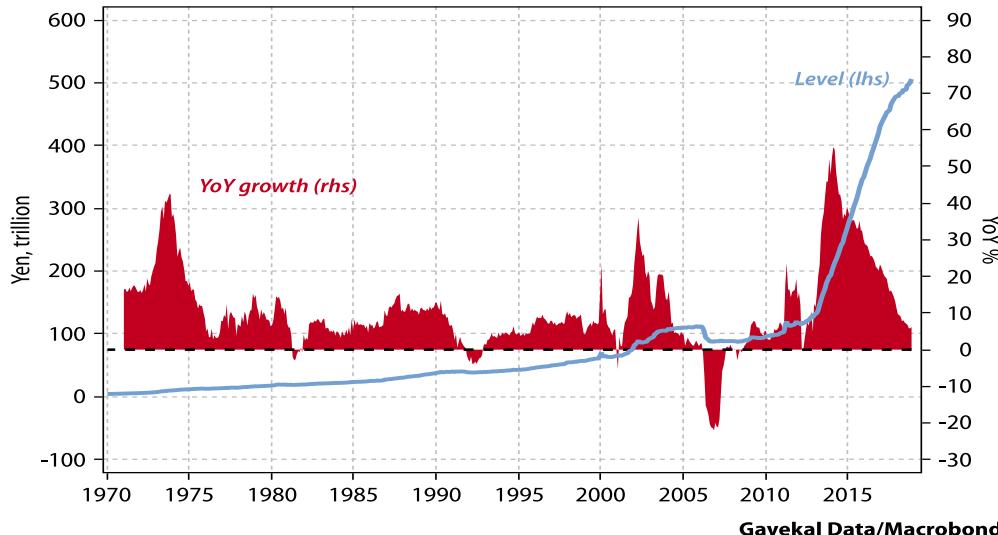
Real growth of foreign central bank USD reserves held at the Fed



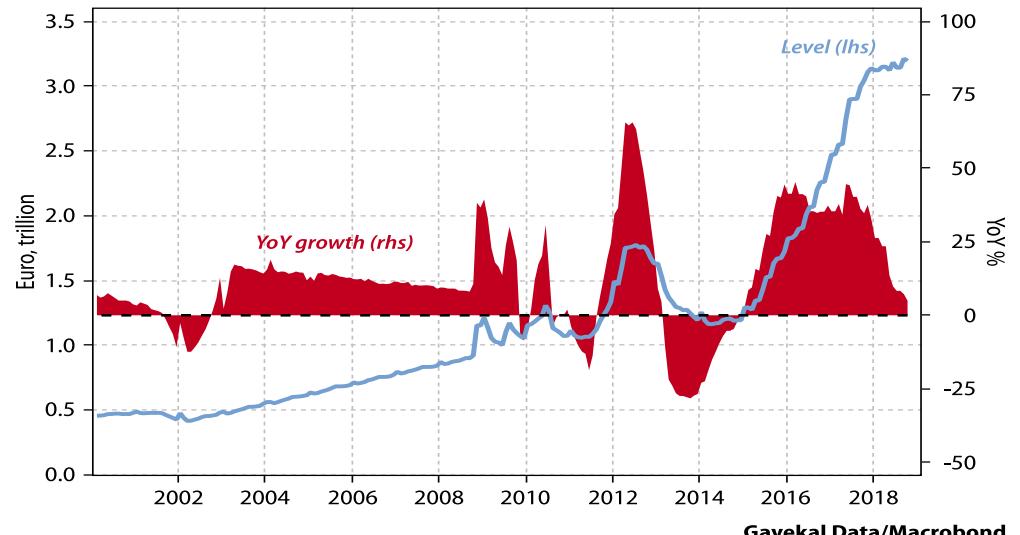
US monetary base



Japan monetary base



Euro area monetary base



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