GavekalDragonomics

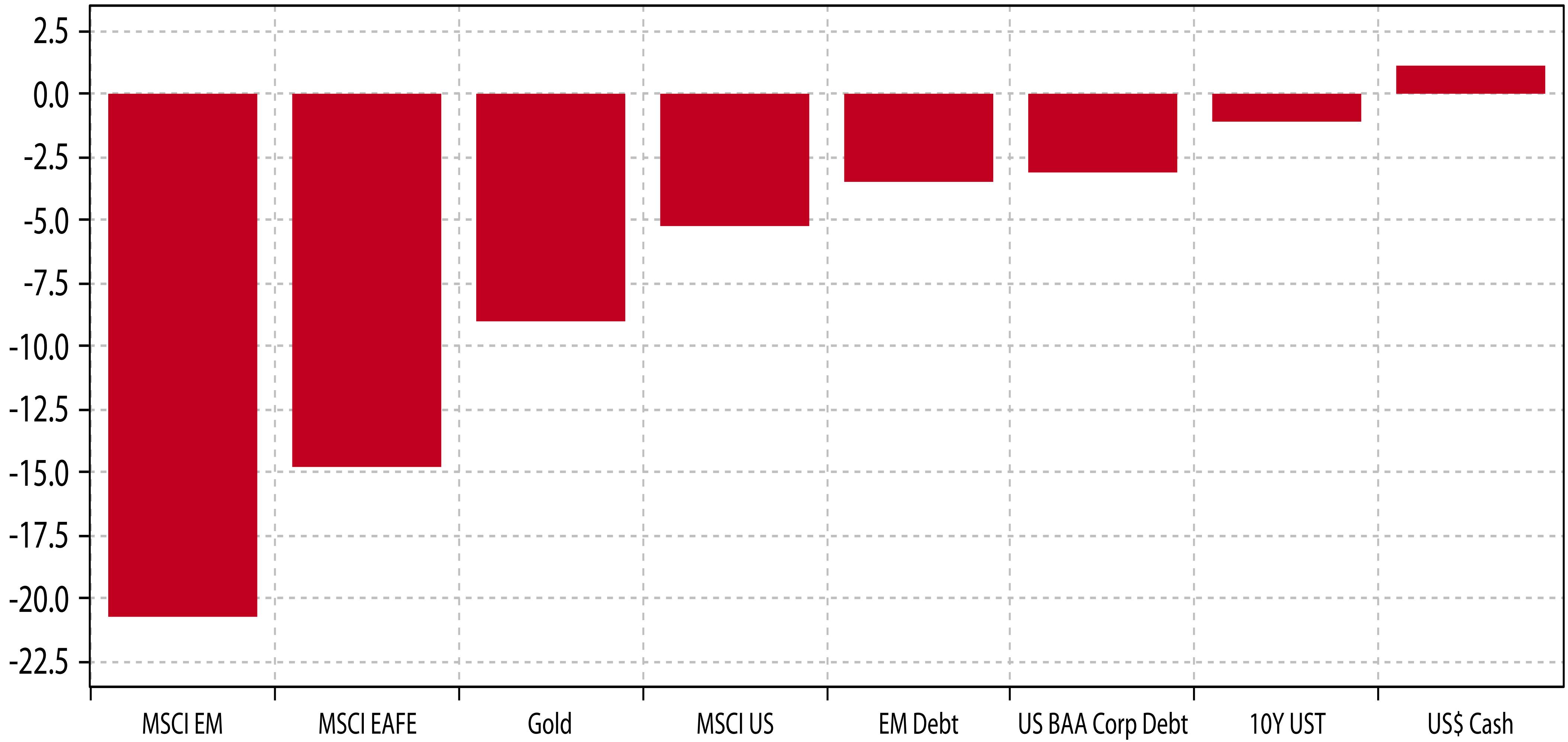
December 2018

An important crossroad

Louis-Vincent Gave

It's been a fairly miserable year, with every asset class underperforming cash

Total Returns of Various Asset Classes in US$, between Jan 31st 2018 and Nov 23rd 2018



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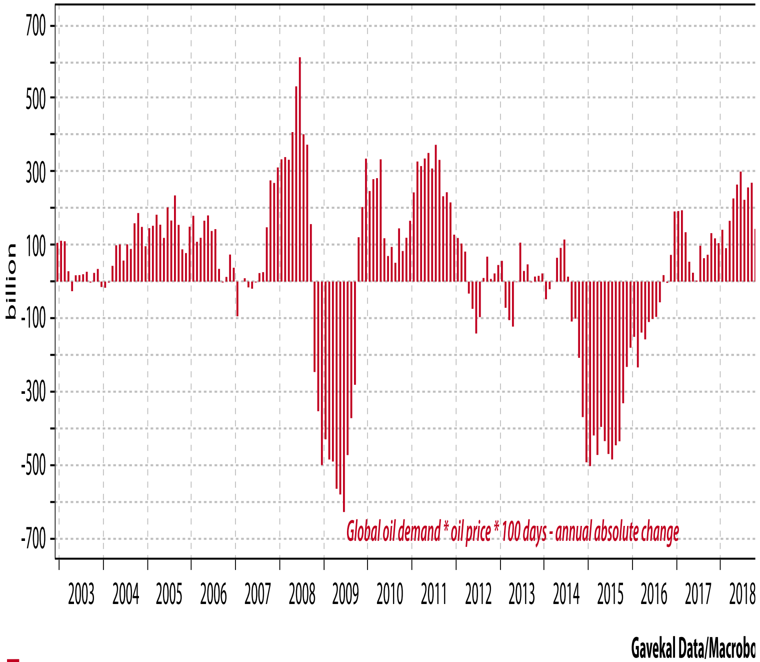
1- The simplest explanation: we have been in a massive liquidity squeeze

Why a liquidity squeeze?

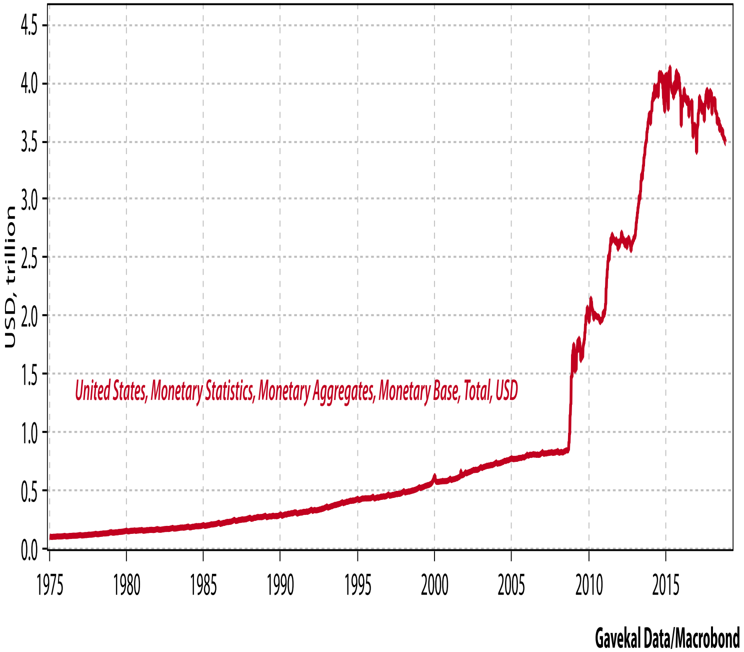
HIGHER OIL

Changes in the funding needs of the oil industry (assuming 100 days of inventories)



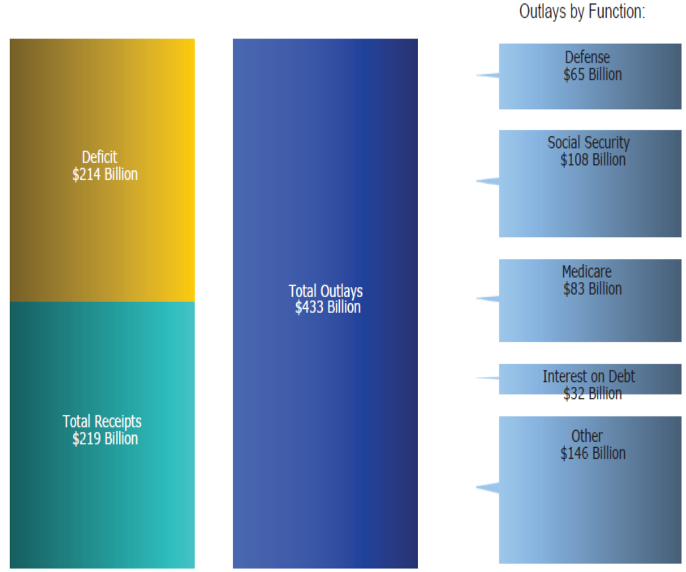
TIGHTER FED

United States, Monetary Statistics, Monetary Aggregates, Monetary Base, Total, USD



WIDER US BUDGET DEFICITS

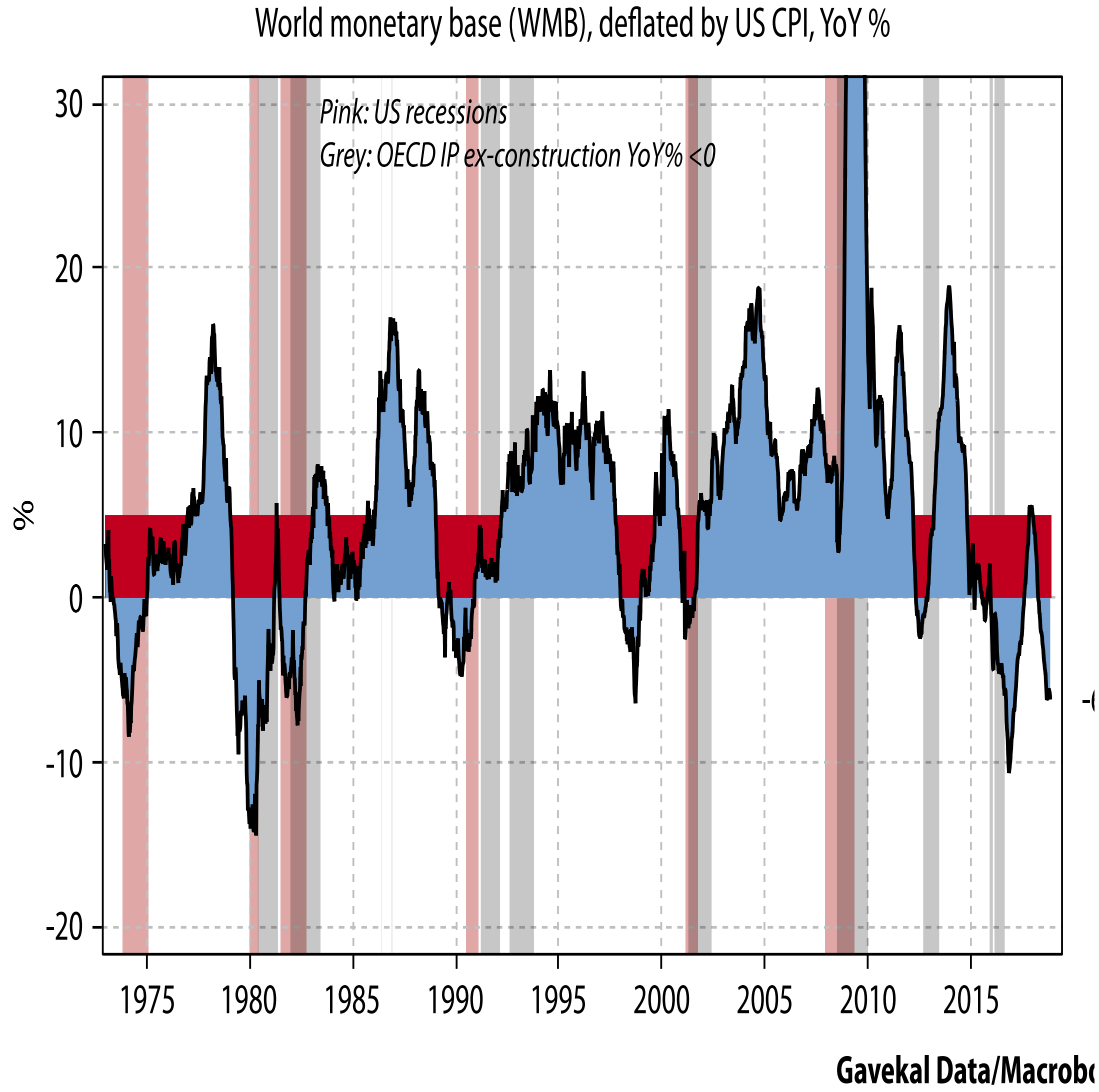
Receipts, Outlays, and Surplus/Deficit for August 2018



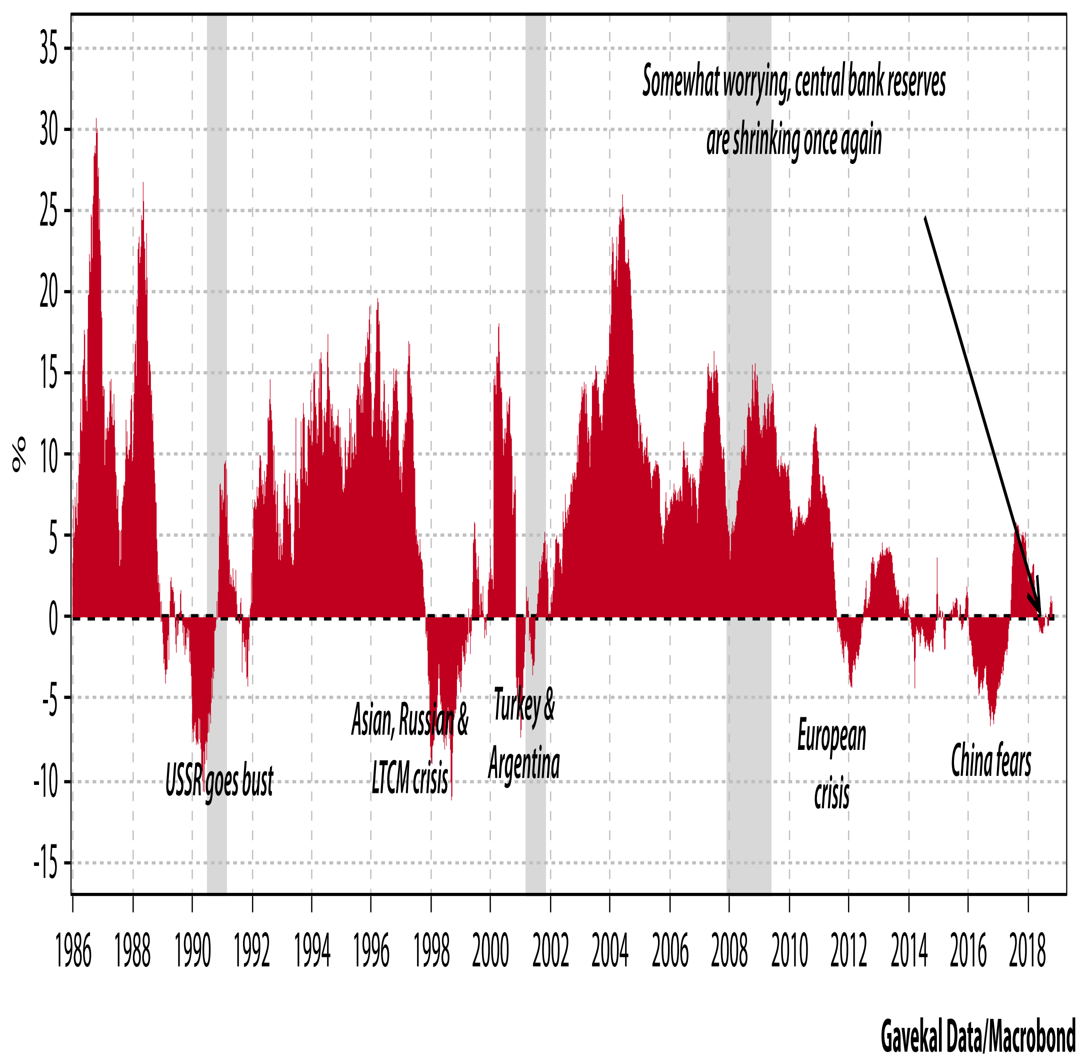
Serious Liquidity Drain

All the usual signs are there of a typical liquidity squeeze

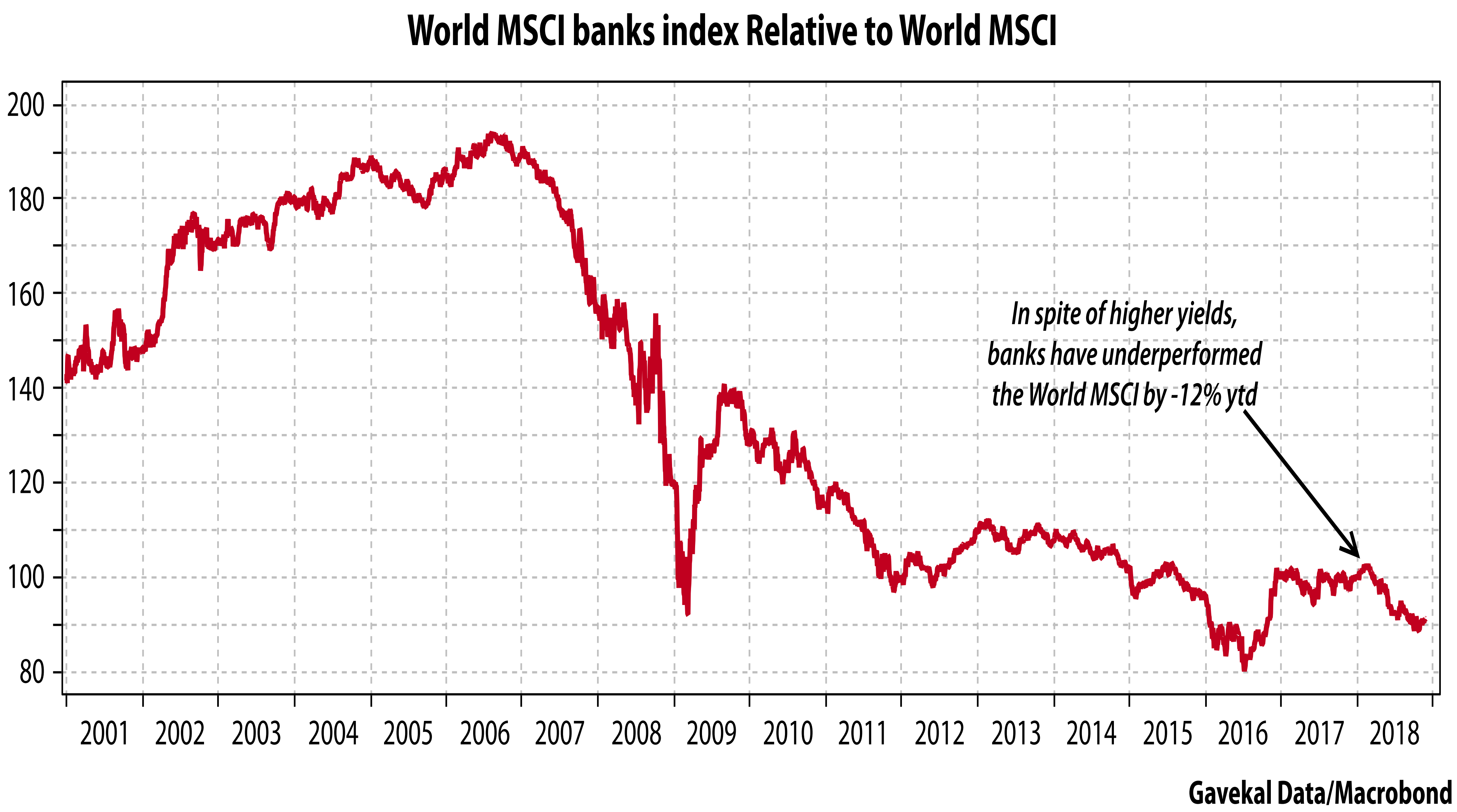
When the world monetary base contracts, trouble soon follows



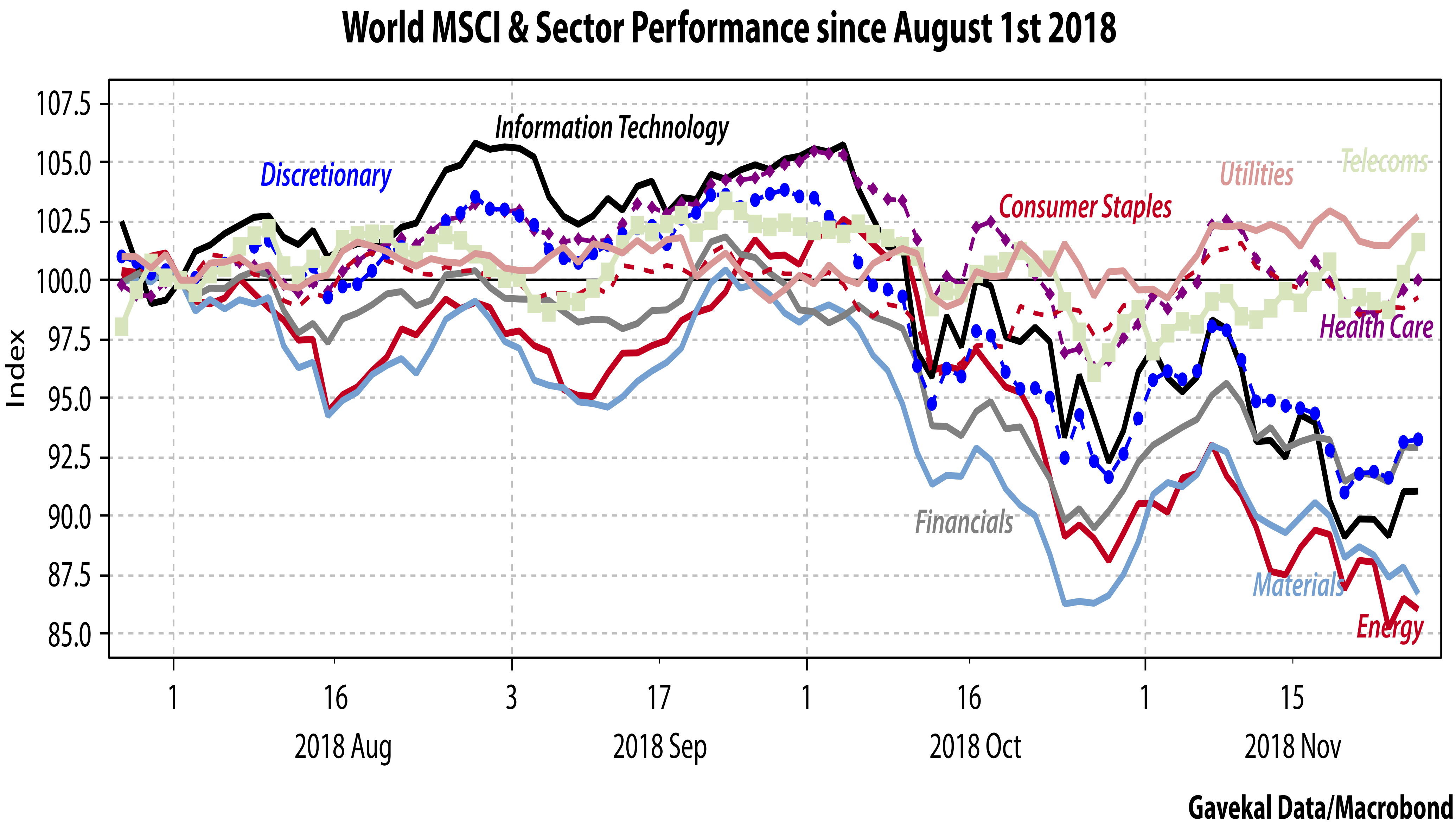
Real growth of foreign central bank USD reserves held at the Fed



Banks' dismal performance would indicate possible liquidity squeeze



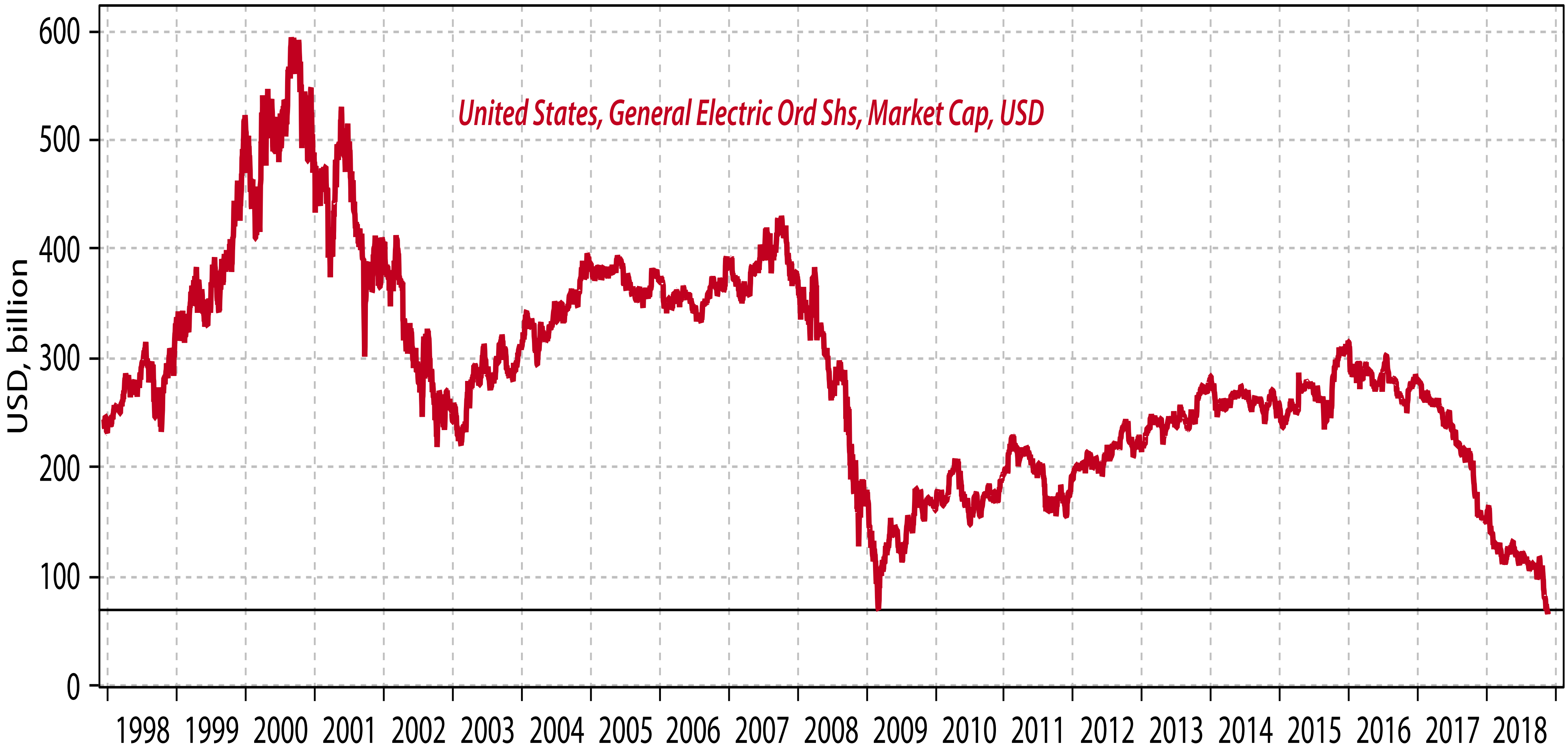
Significant outperformance of defensives



The fish have emerged, now where is the whale?

Is GE the whale?

Is this the whale?



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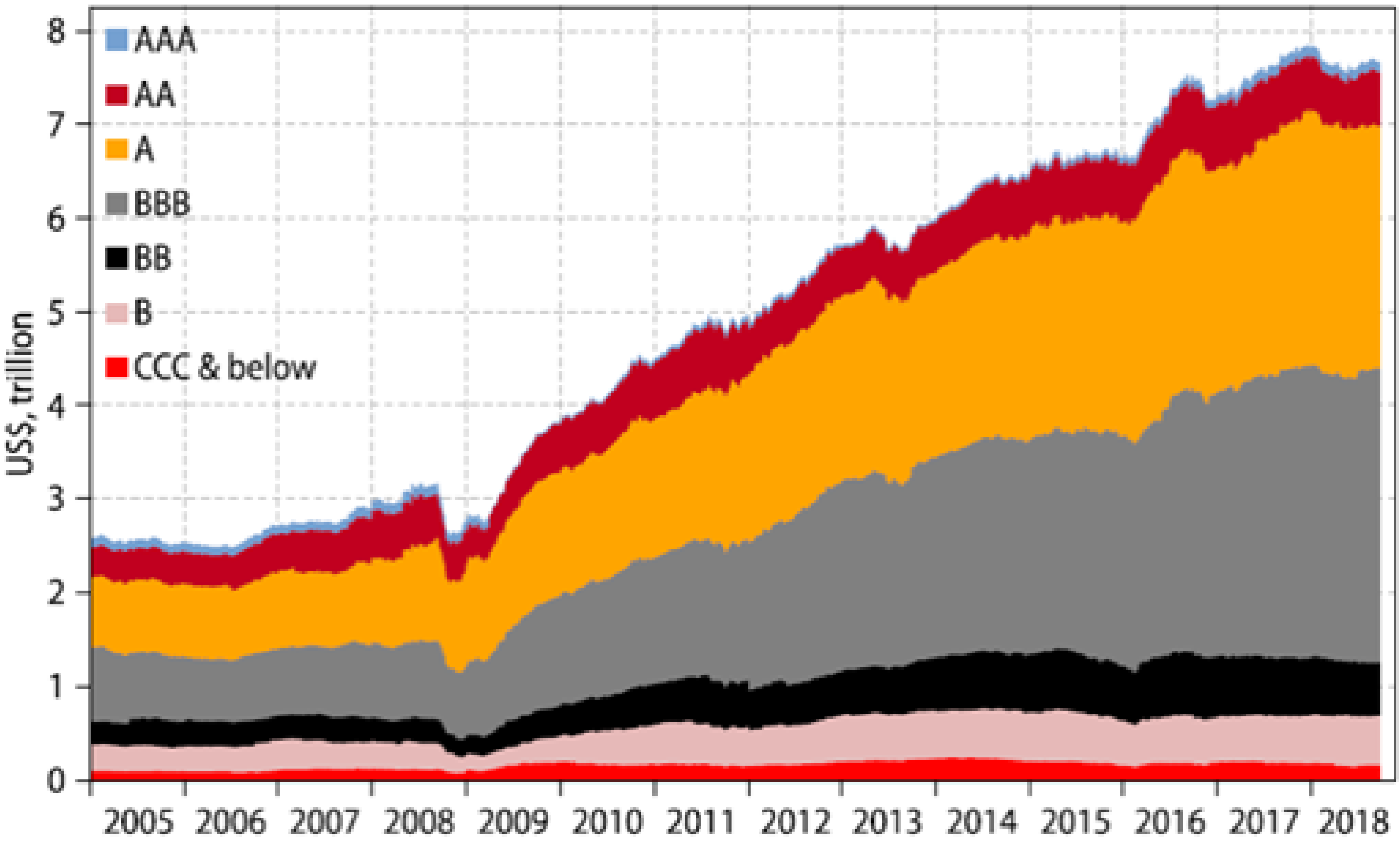
A GE downgrade would wreck havoc on the US corporate bond market

The size of corporate debt one rung above junk has never been greater

Market capitalization of US corporate bonds by credit rating



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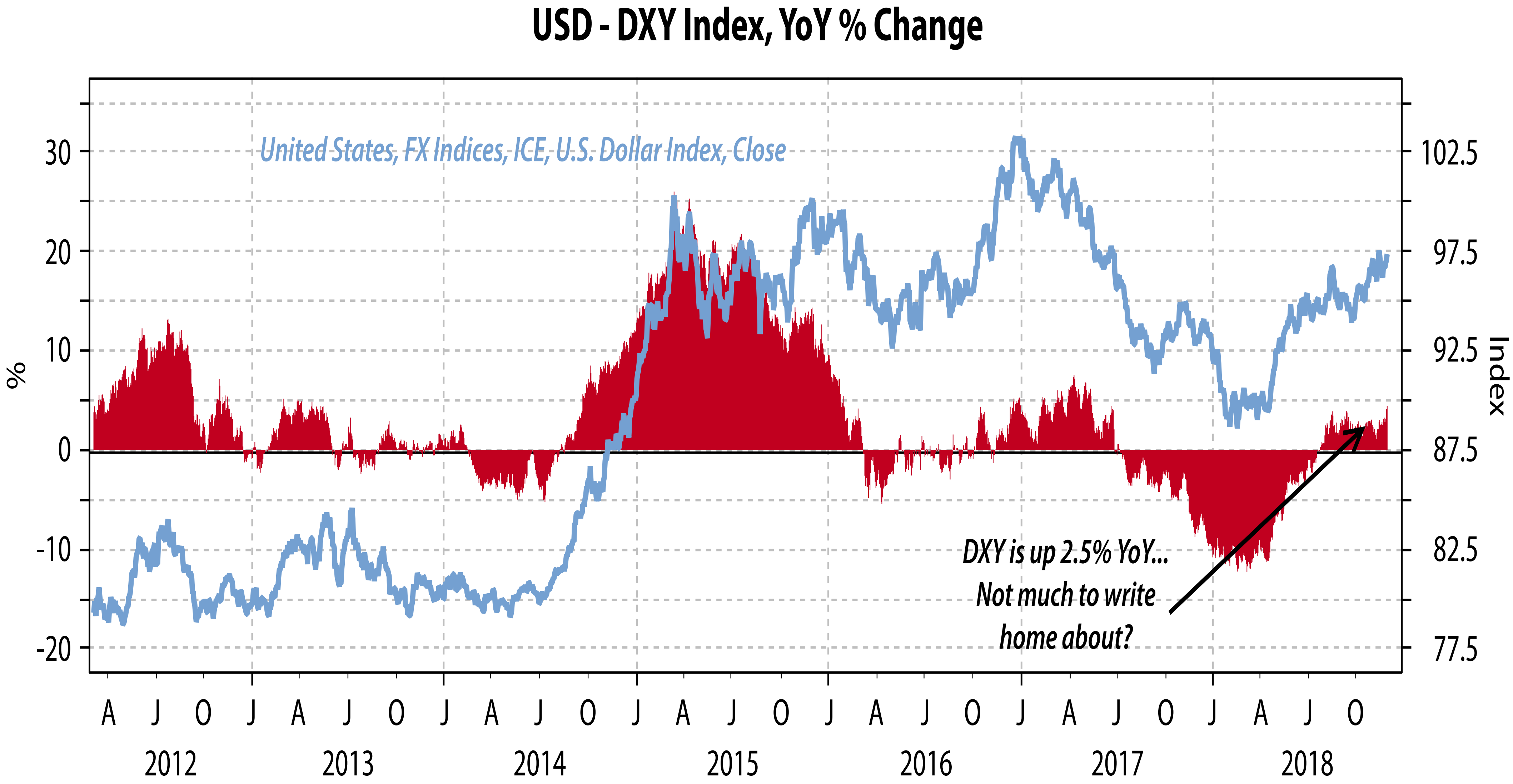
2- But if we are in a liquidity squeeze, why haven't yields fallen and the US$ rallied more?

If we are in a liquidity squeeze, why isn't US$ much much stronger?



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Let’s face it: almost all the news-flow has been very bullish US$

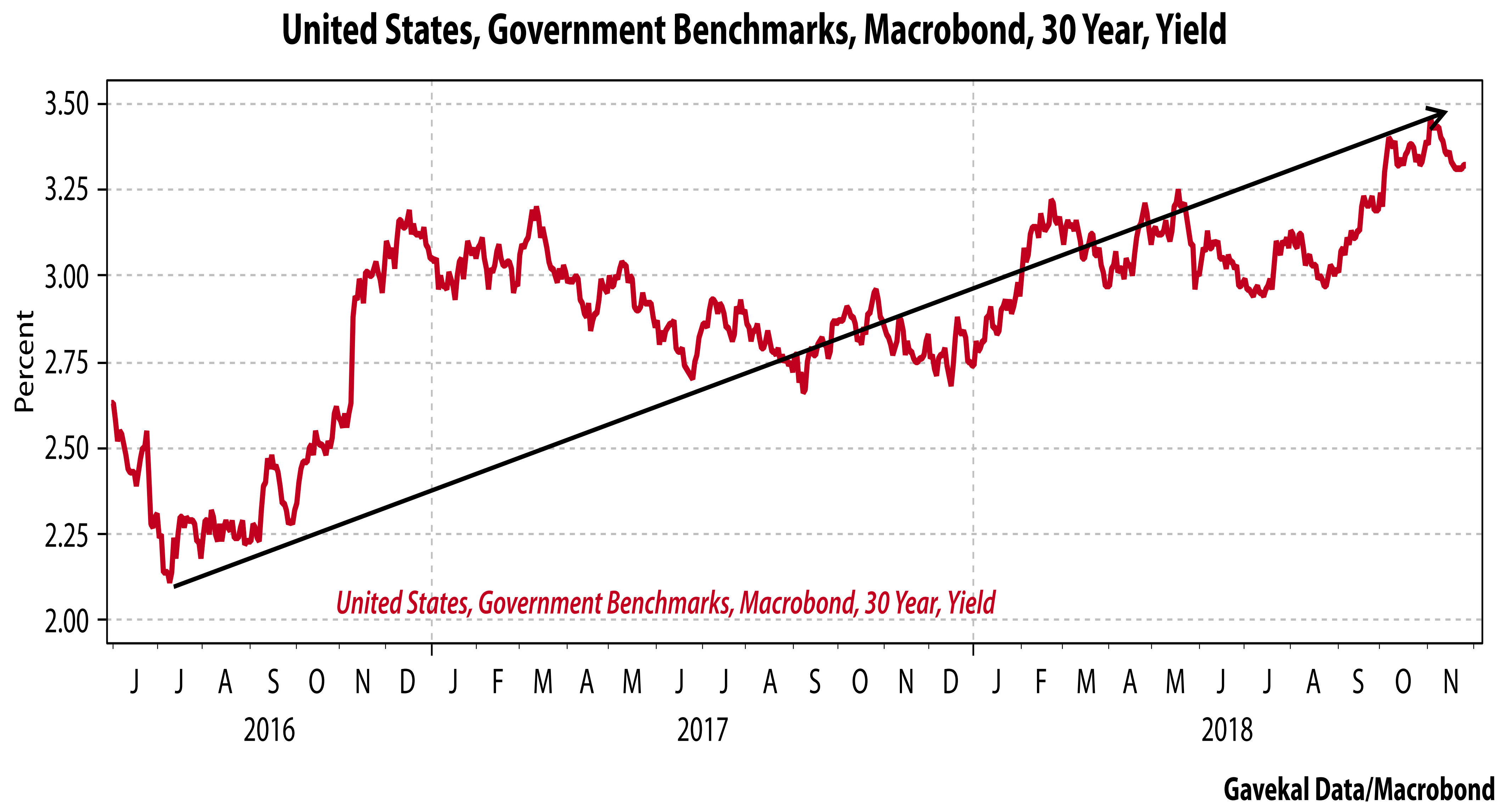
So far this year, we have witnessed:

- An implosion in emerging markets
- A more hawkish Fed than was originally expected
- A renewed crisis in Italy
- Significant outperformance of the US economy against most other DM & EM
- A higher than expected oil price
- Much higher long term interest rates in the US than other DM
- A significant ‘risk-off’ in global equity markets in early October 2018

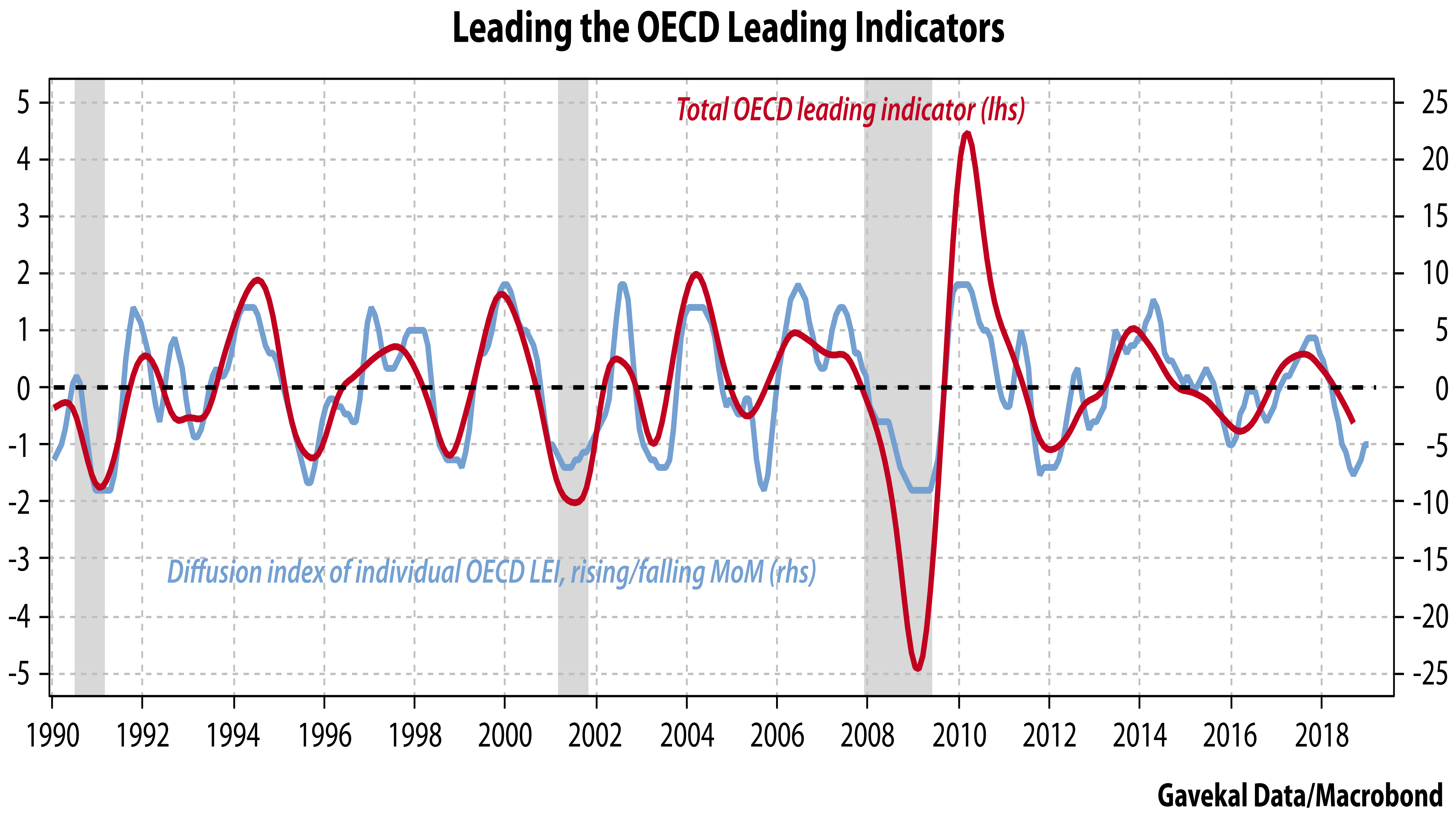
Yet, with all of this, the US$ hasn’t rallied very much, if at all.

In other words, the US$ is increasingly behaving like a stock that “doesn’t go up on good news”. Is this because everyone is already very long? Or because the market is starting to anticipate some tougher news ahead for the US? Or something else?...

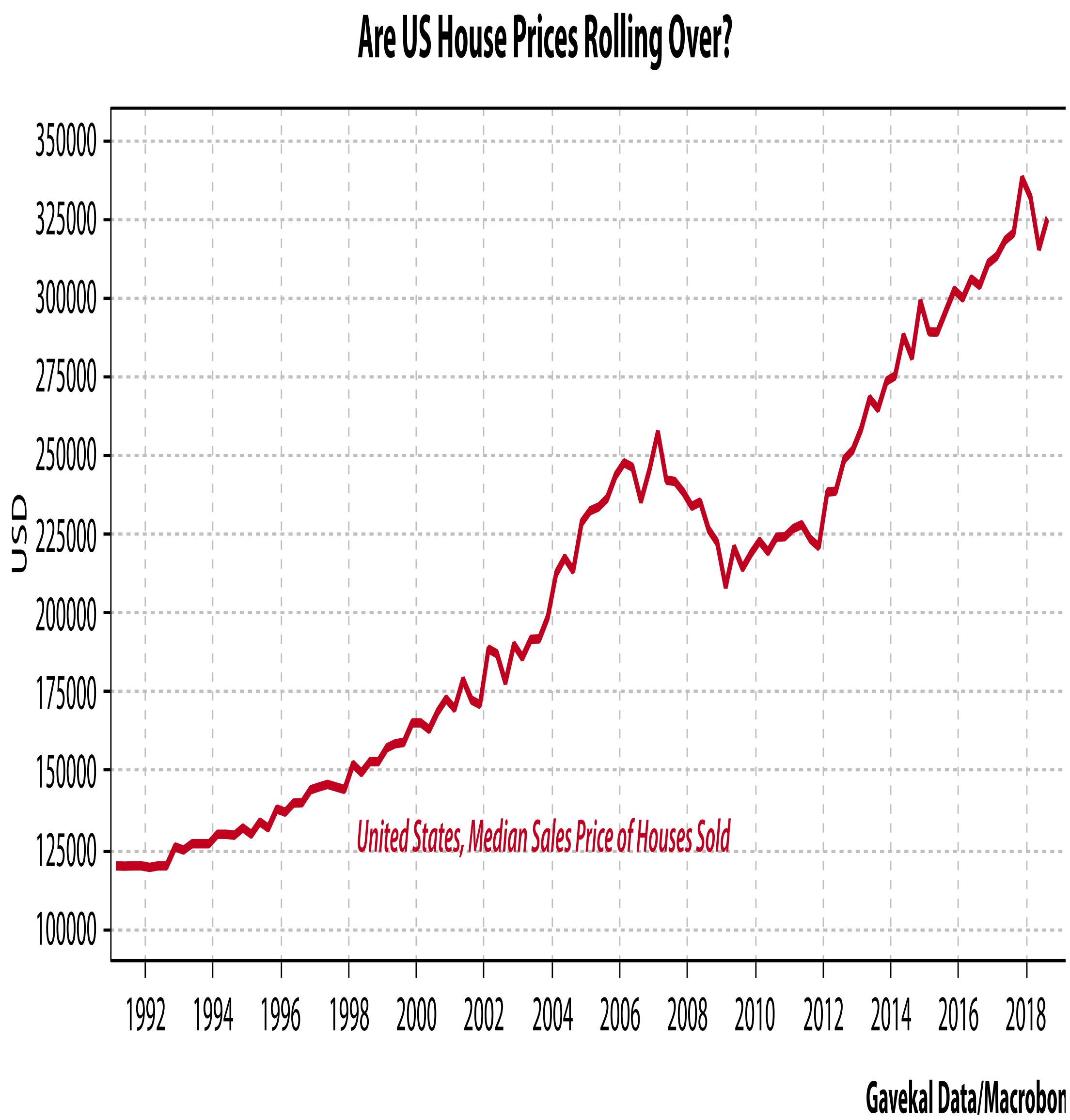
And if we are in a liquidity squeeze, why aren't UST doing better?

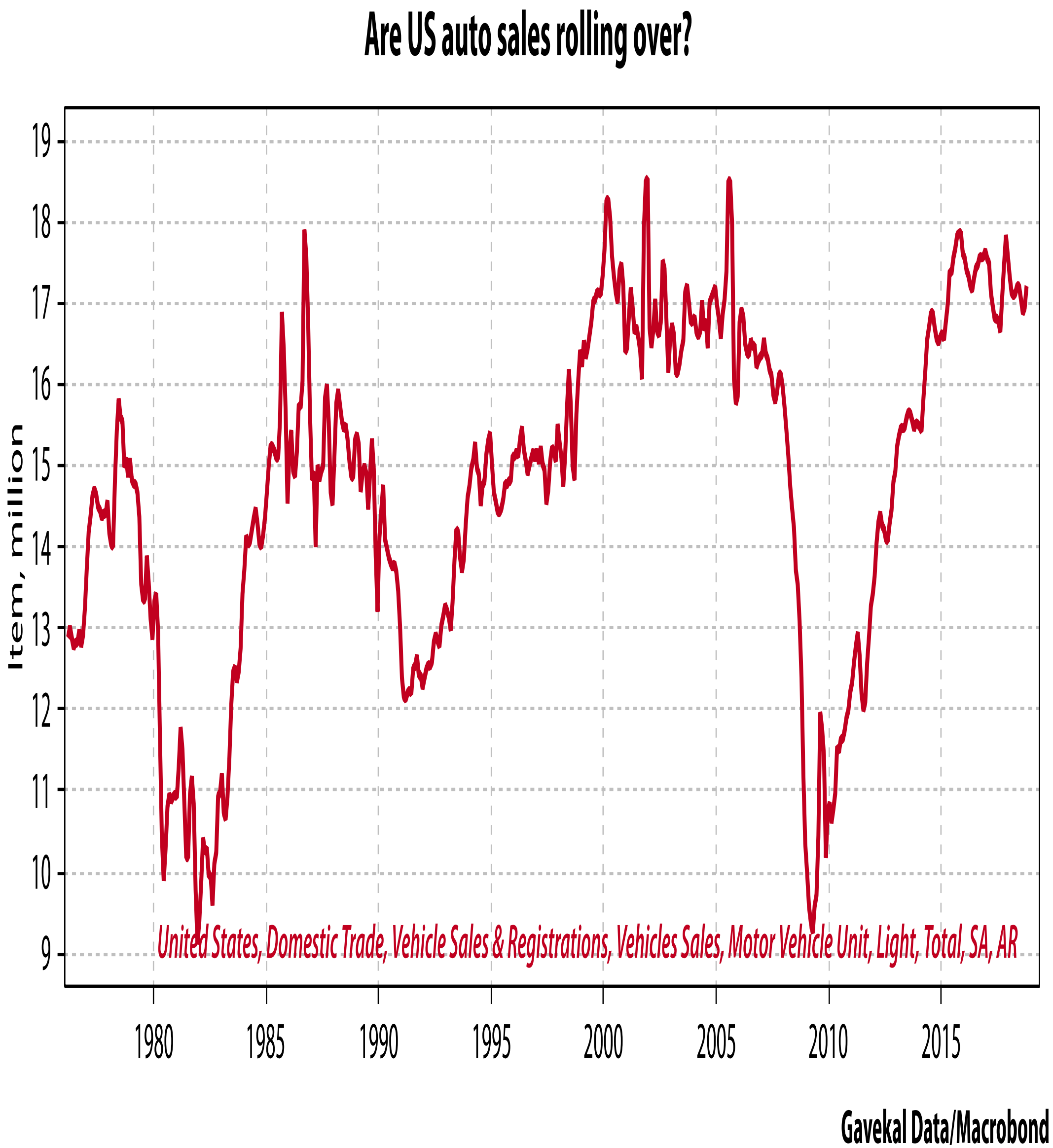


After all, there are increasing signs that growth is abating



Even the US may turn out to not be an island of prosperity after all?

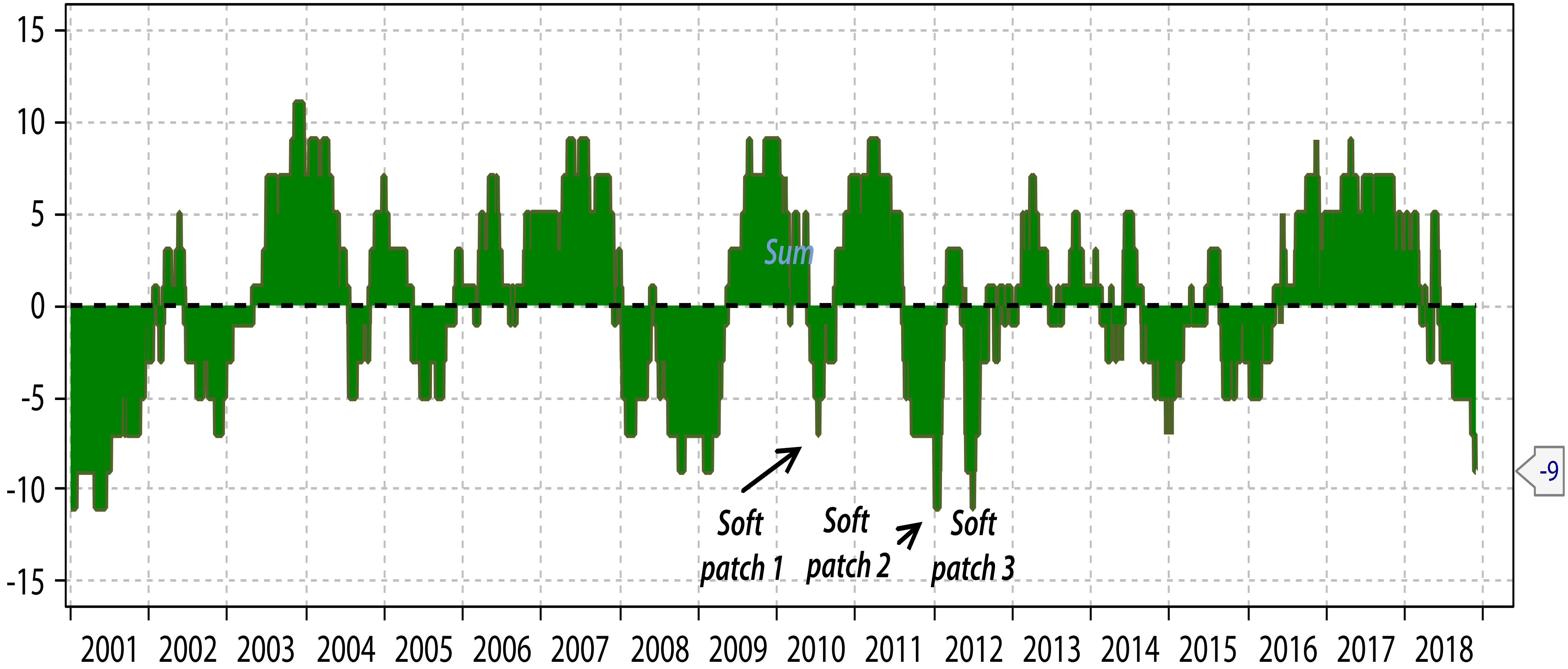




Market sensitive prices are definitely getting concerned

GaveKal global diffusion index of economic sensitive prices

A daily series of various market prices that indicate global growth



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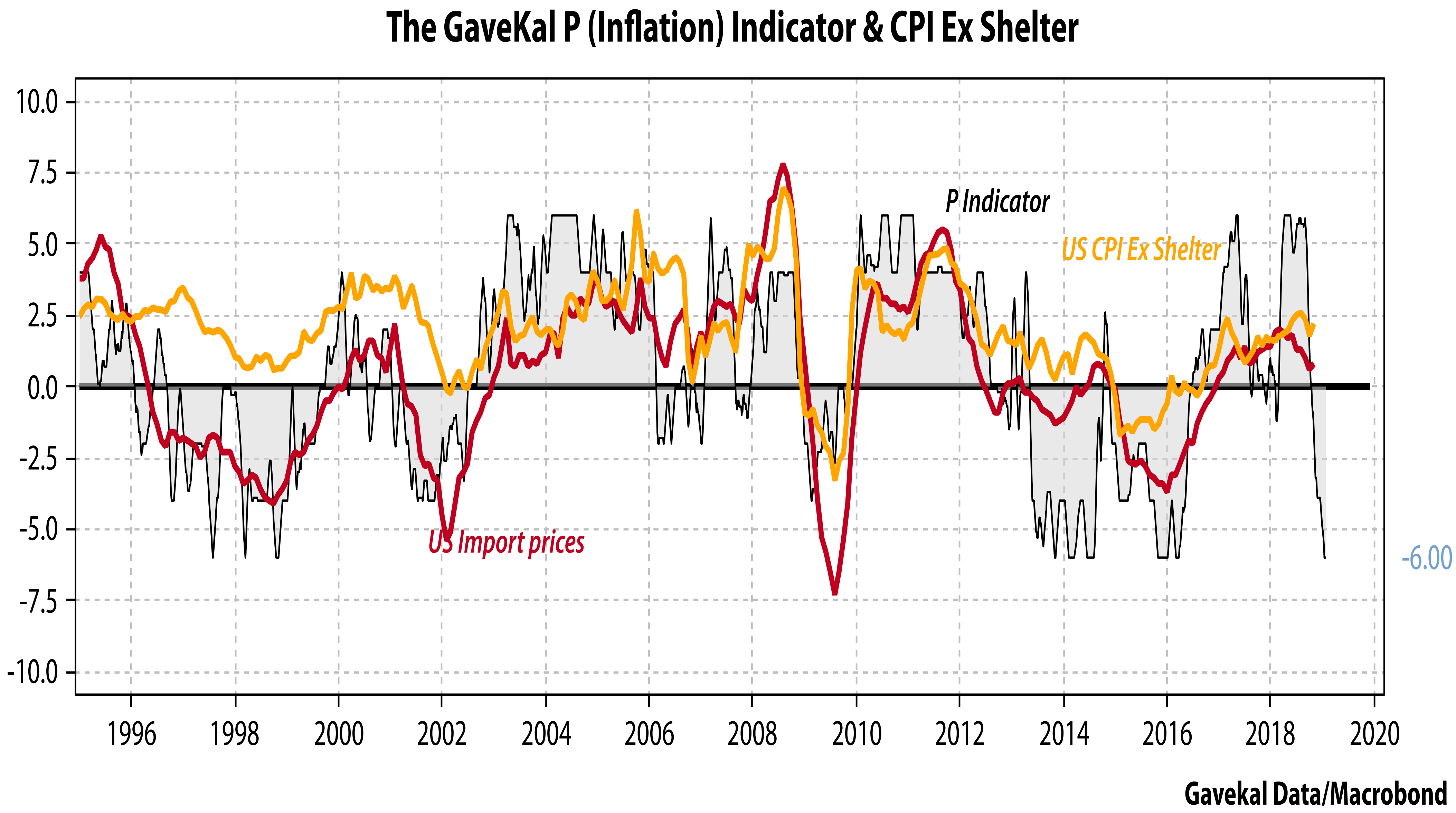
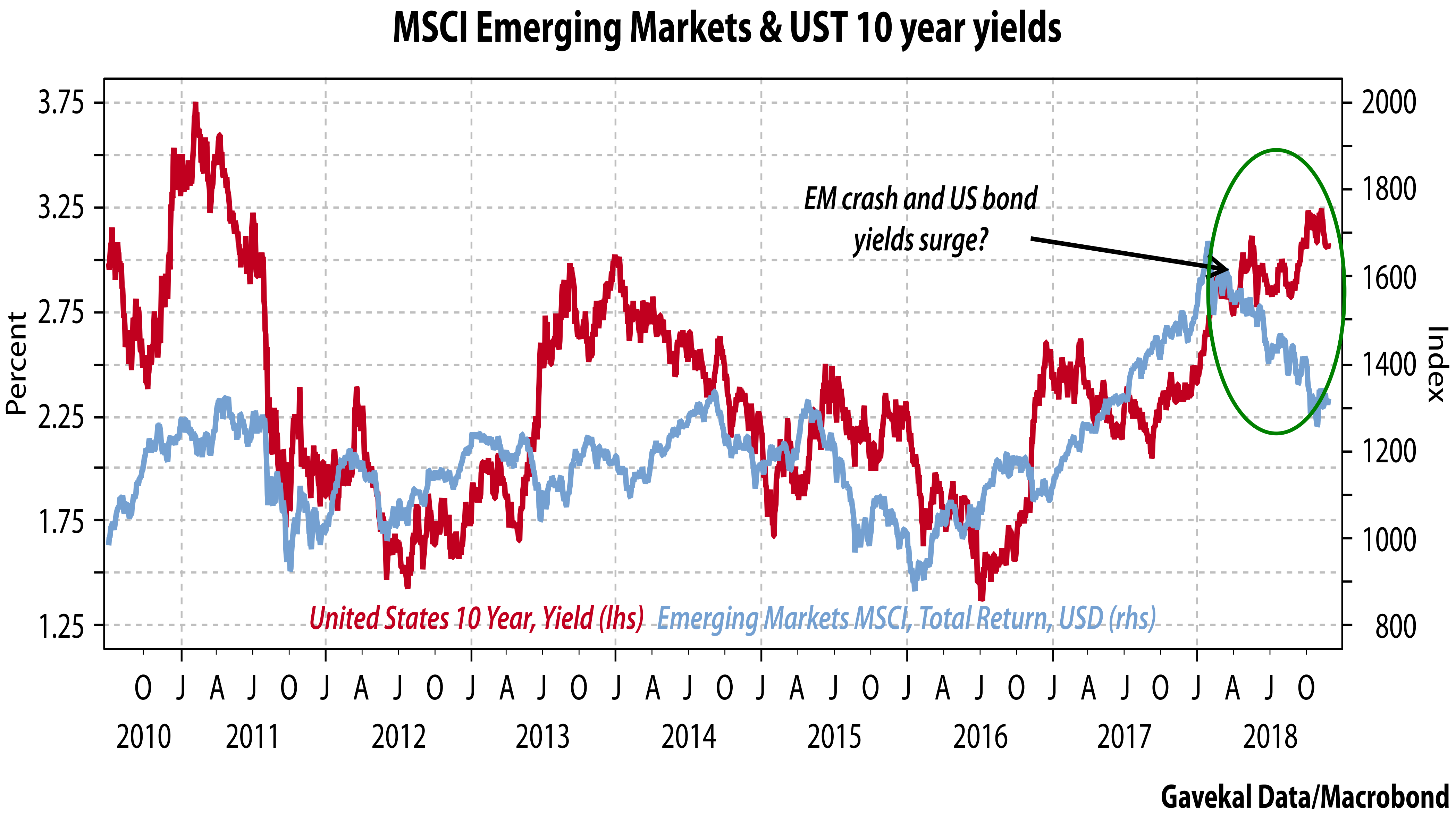
And all signs are that inflation should start rolling over soon



The past few months' dichotomy between yields and risk asset perf is odd



Why haven't the US$ and UST rallied more in the face of liquidity squeeze?

Why aren't UST and US$ much stronger?

Option 1: *Market is now driven by algos, which are themselves driven by headlines*

Our take: *possible*

If this is the explanation, then we should position for a big rally in yield sensitive assets

Option 2: *Exit out of liquidity squeeze will happen through lower oil and easier Fed*

Our take: *Could this be already unfolding?*

Position portfolios for weaker US$ and big rally in Asia

Option 3: *We are entering unchartered territory in terms of US deficits and supply of UST overwhelming demand*

Our take: *This is equivalent to saying "it's different this time"*

If UST issuance is now 'crowding out' other assets, making money will be tough

Option 4: *We are living through the start of a paradigm shift in our global financial architecture*

Our take: *This has been our scenario for the past few years*

Very hard to gage the long-term investment consequences

3- An exit through lower oil, and ultimately an easier Fed?

If we are in a liquidity squeeze, then there are three way out

#1: Oil prices collapse

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

#2: China stimulates

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?

#3: Fed injects liquidity

For

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

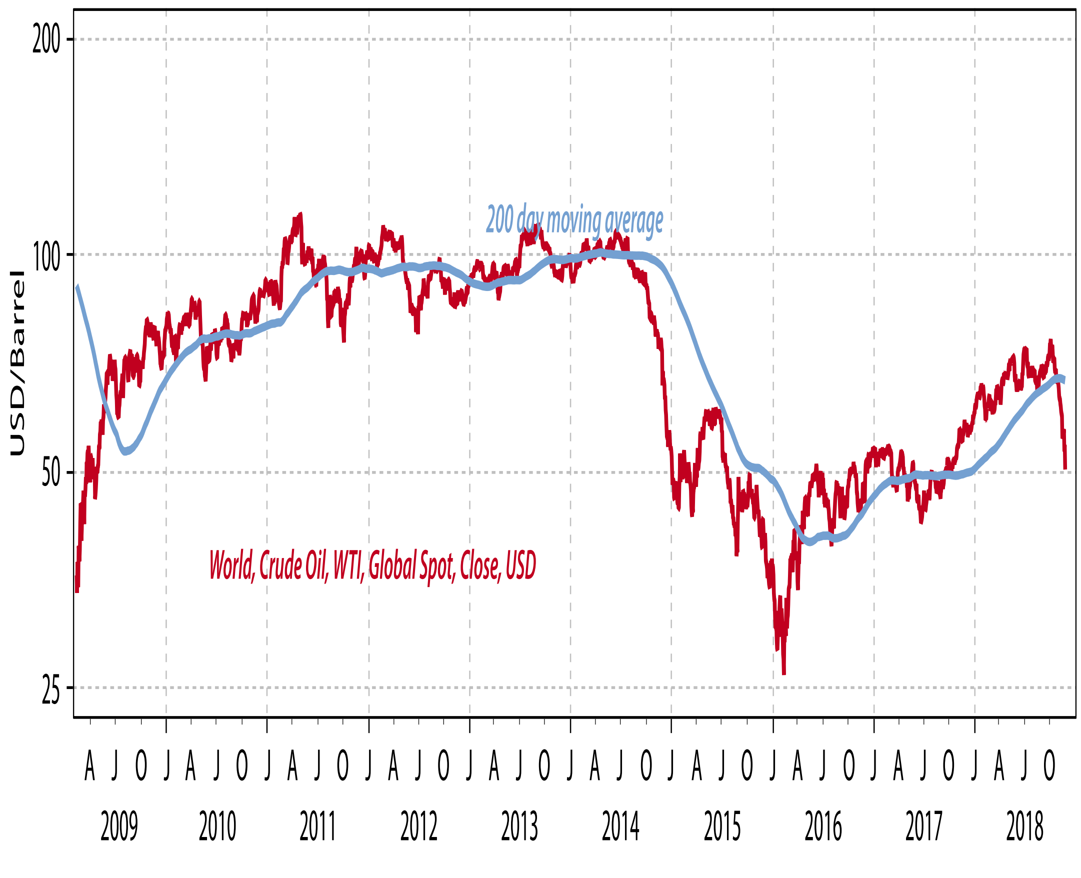
Against

- 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?

Major question: does lower oil mark the end of the liquidity squeeze?

The Drop in Oil Price: -30% in a few weeks



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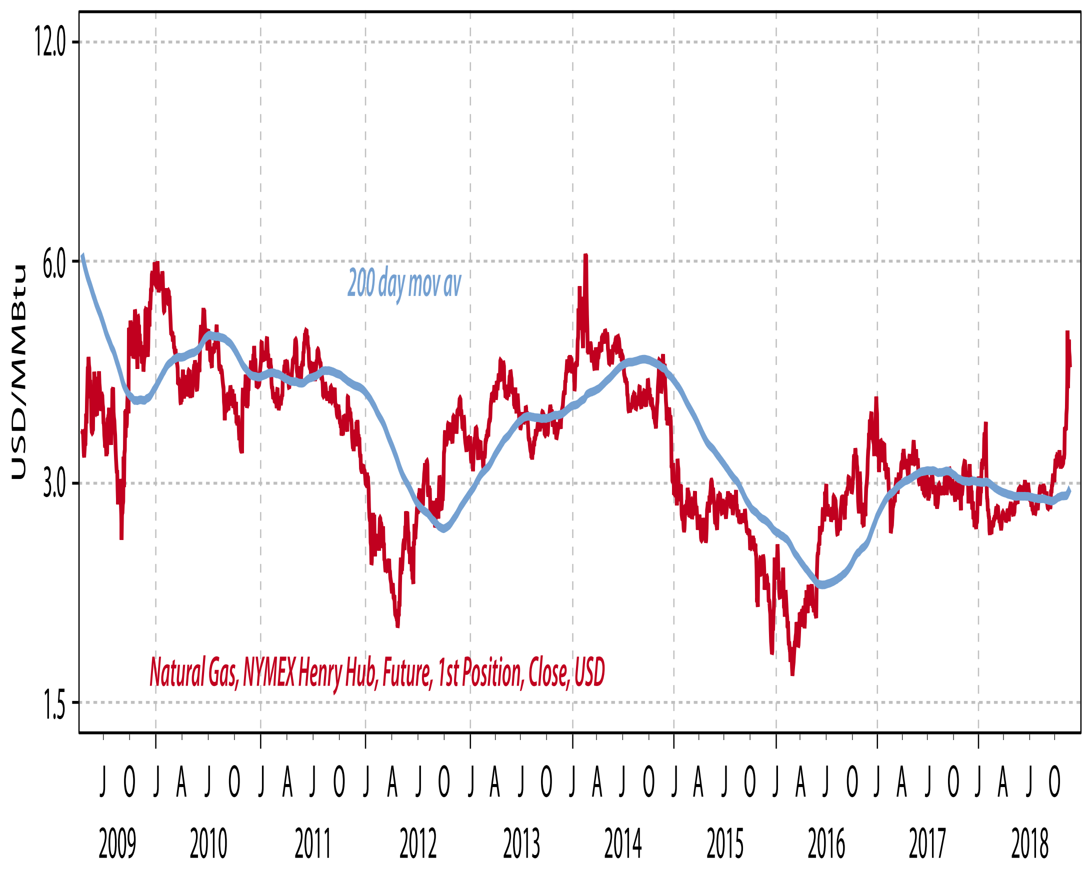
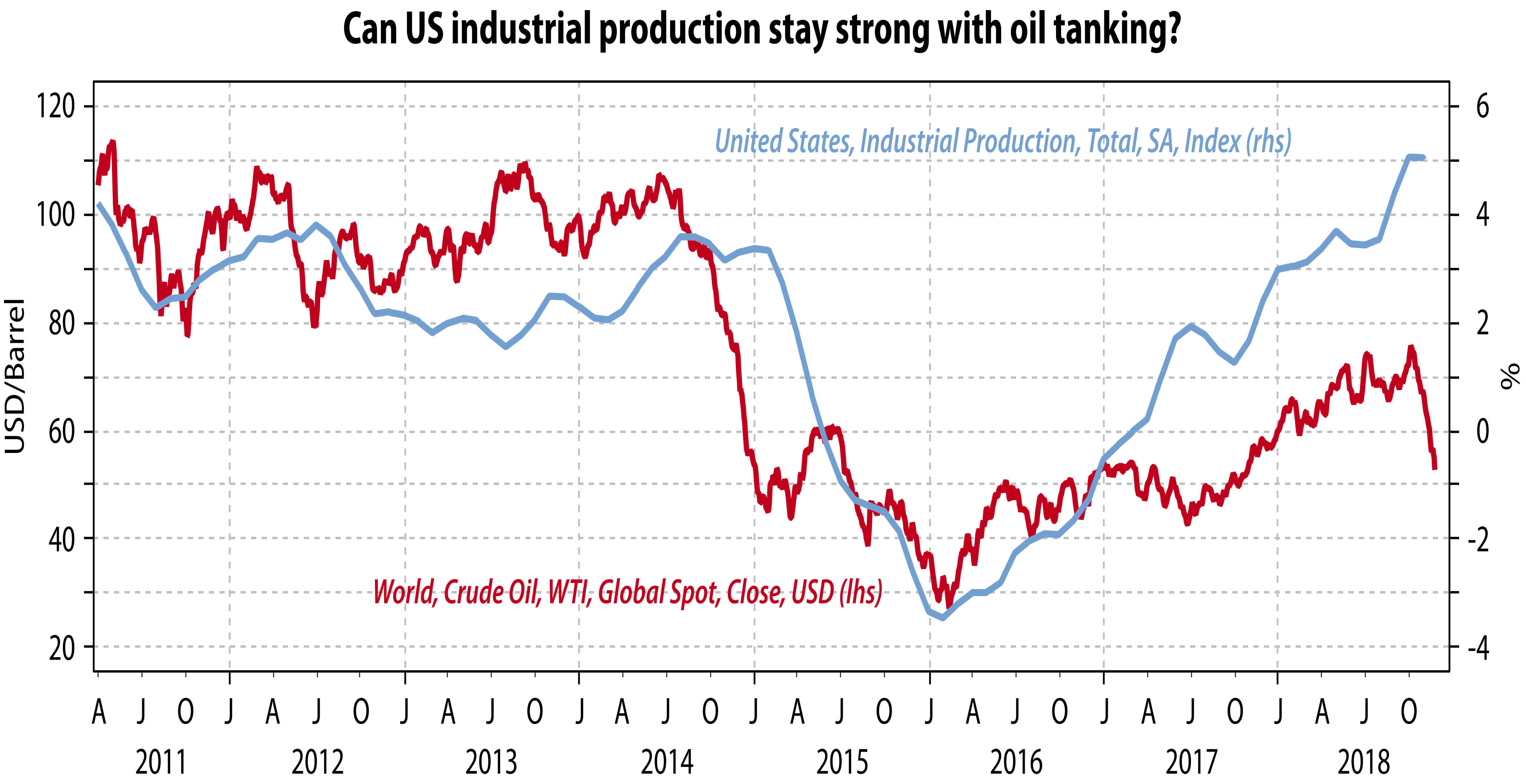
Natural Gas: +60% in a few weeks



Gavekal Data/Macrobond

And if oil drops further, what does that mean for US growth?



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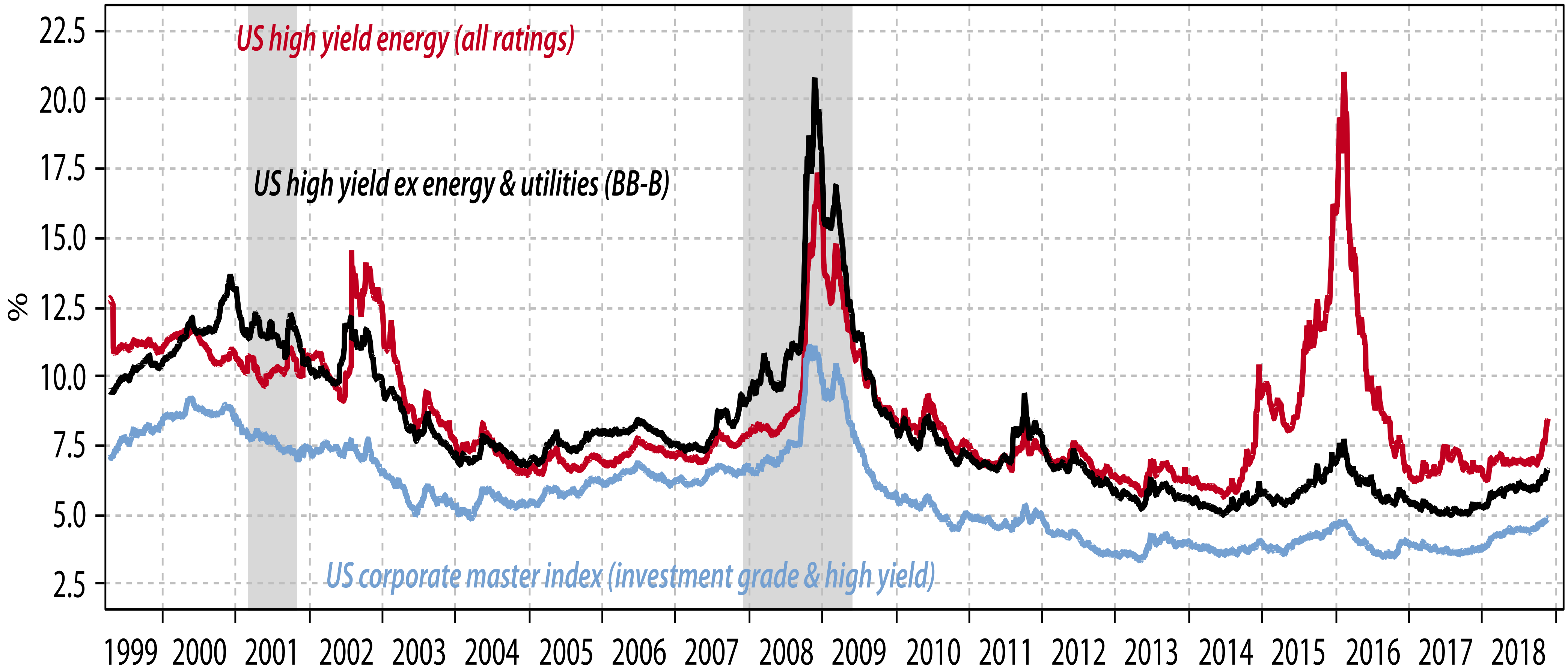
Perhaps more importantly, what would it mean for US spreads?

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

Yield on Merrill Lynch corporate bond indices



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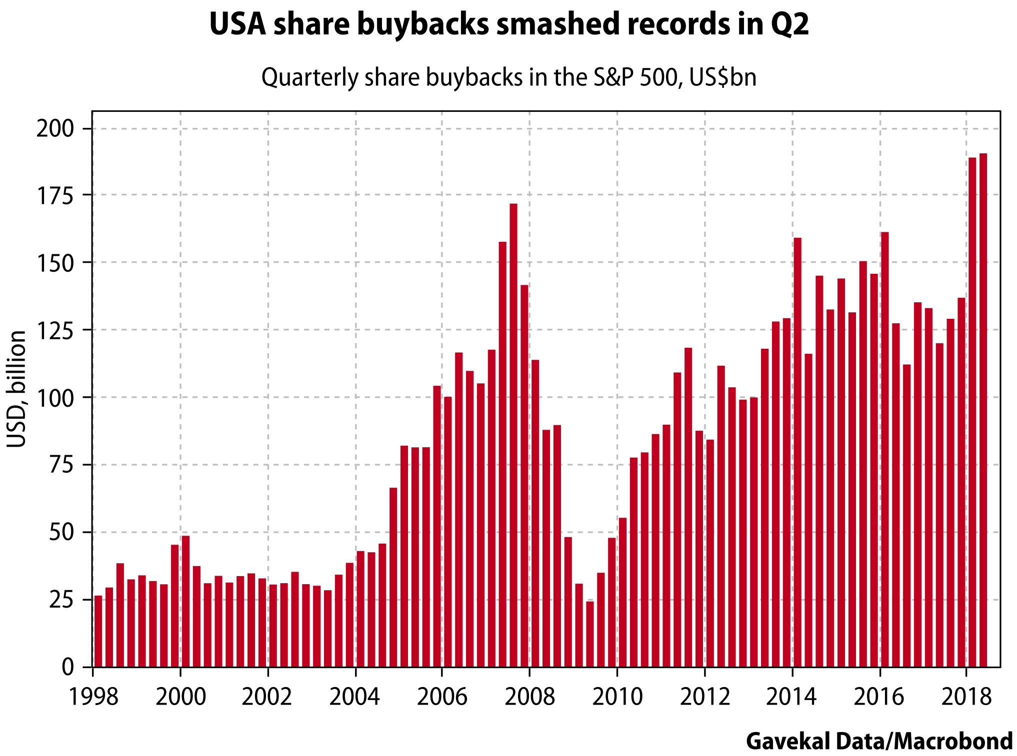
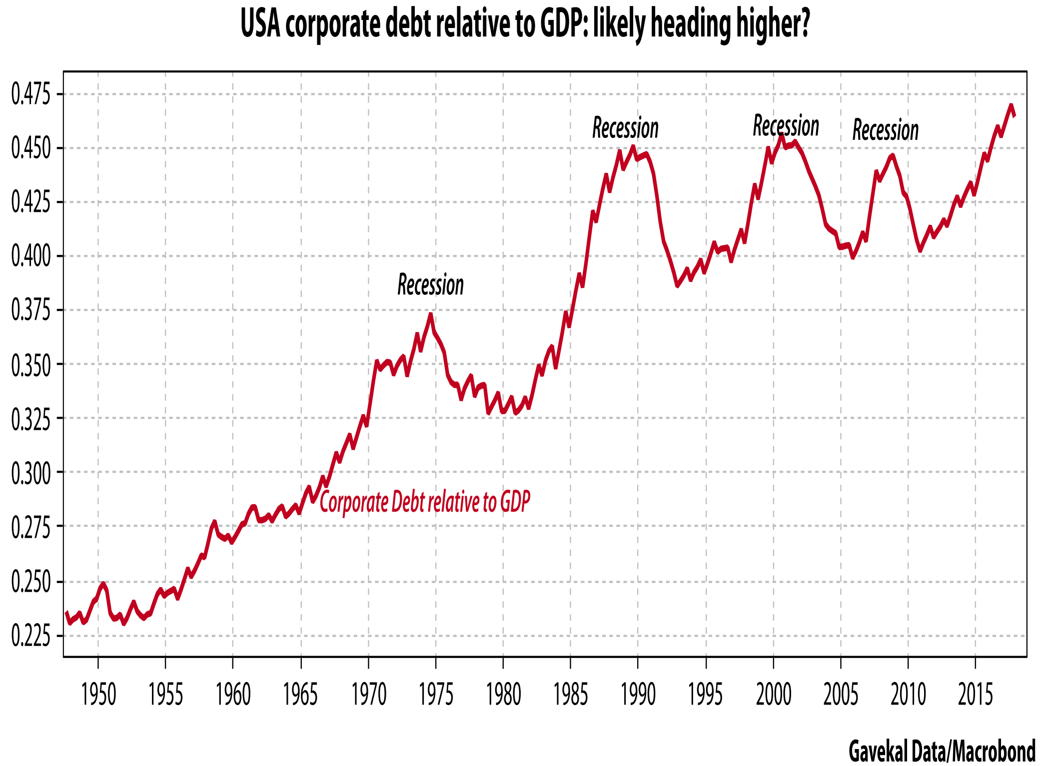
Can corporate balance sheets withstand higher rates?





S&P 500 share buybacks hit a record of US$194bn in Q1 2018, and in Q2 surged to an even more dramatic US$400bn. At current buy-back pace, the equity markets will run out of equities in 17 years!

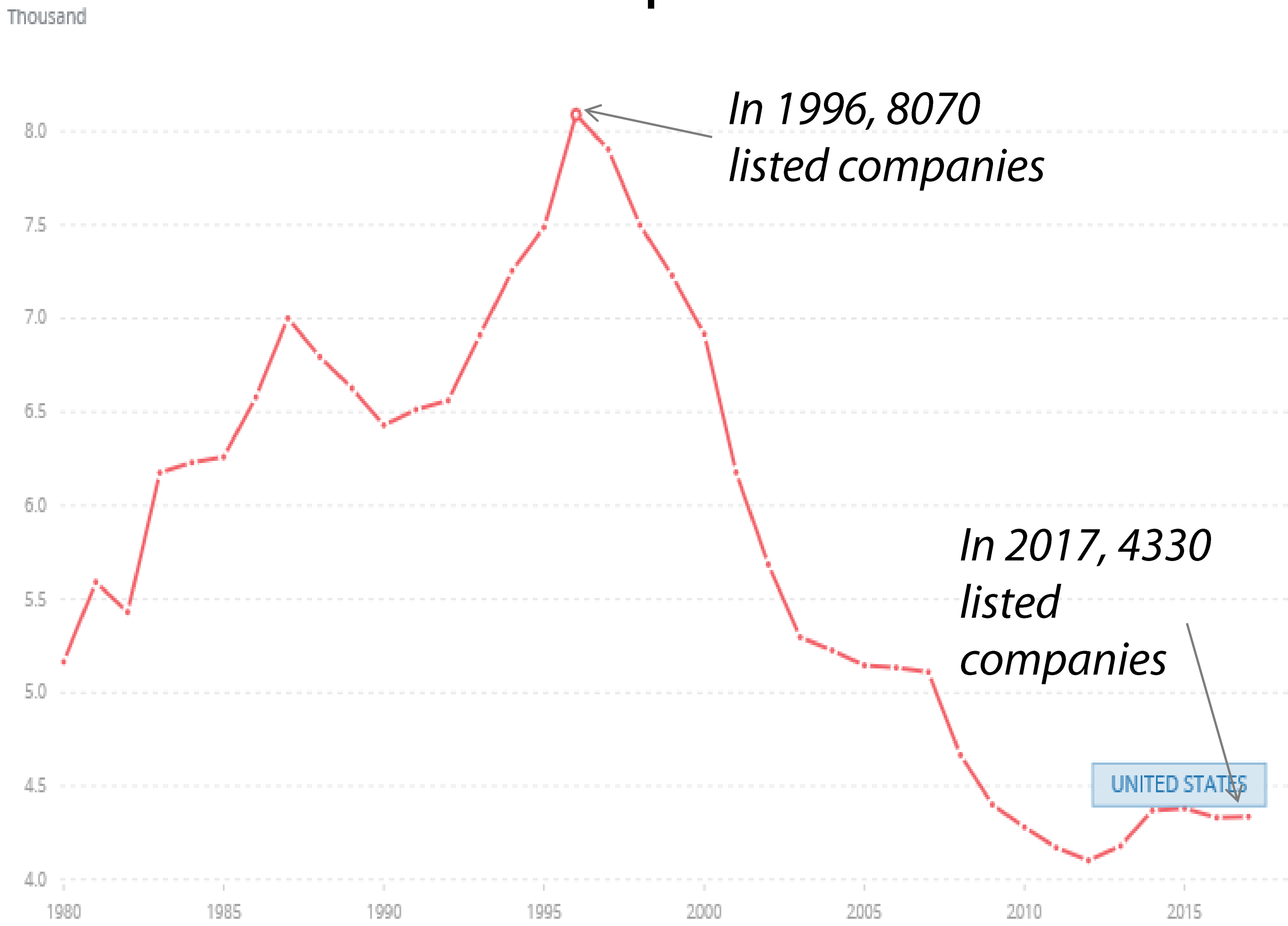
It may be that US equity outperformance simply reflects the steady reduction of equity available to buy. Another indicator: the number of listed firms in the US has shrunk by half since 1996, from 8,070 to 4,330 in 2017.

But there are limits to financial engineering. US corporate debt relative to GDP is already at a levels seen only in recessions. As borrowing costs start to rise, it will be harder for companies to buy back shares.

So far, the spreads on corporate bonds have stayed tight, and there are no danger signals. But once spreads start to rise, equities could be in trouble.

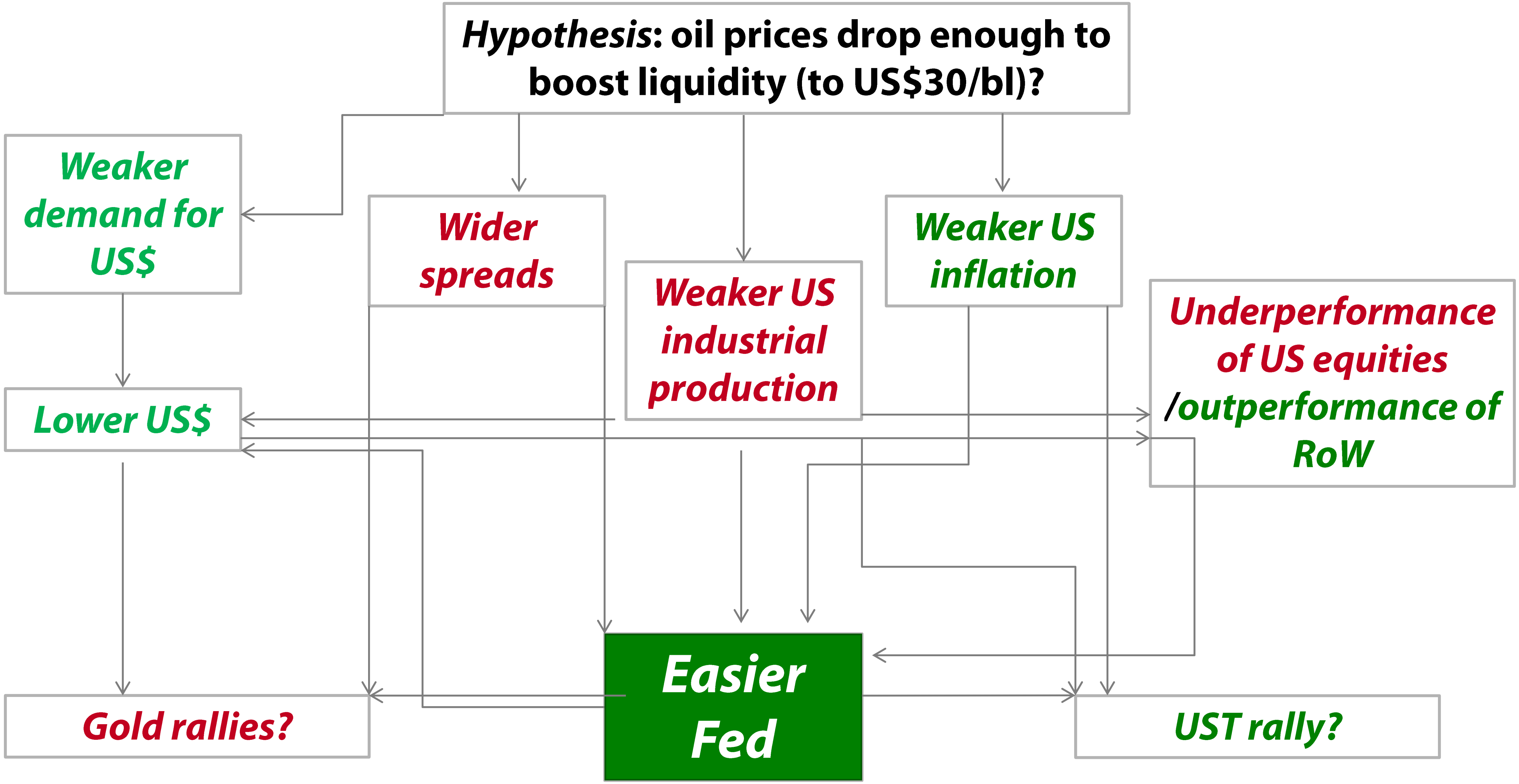
Lots of debt and little equity...

Number of listed companies in the US in thousands



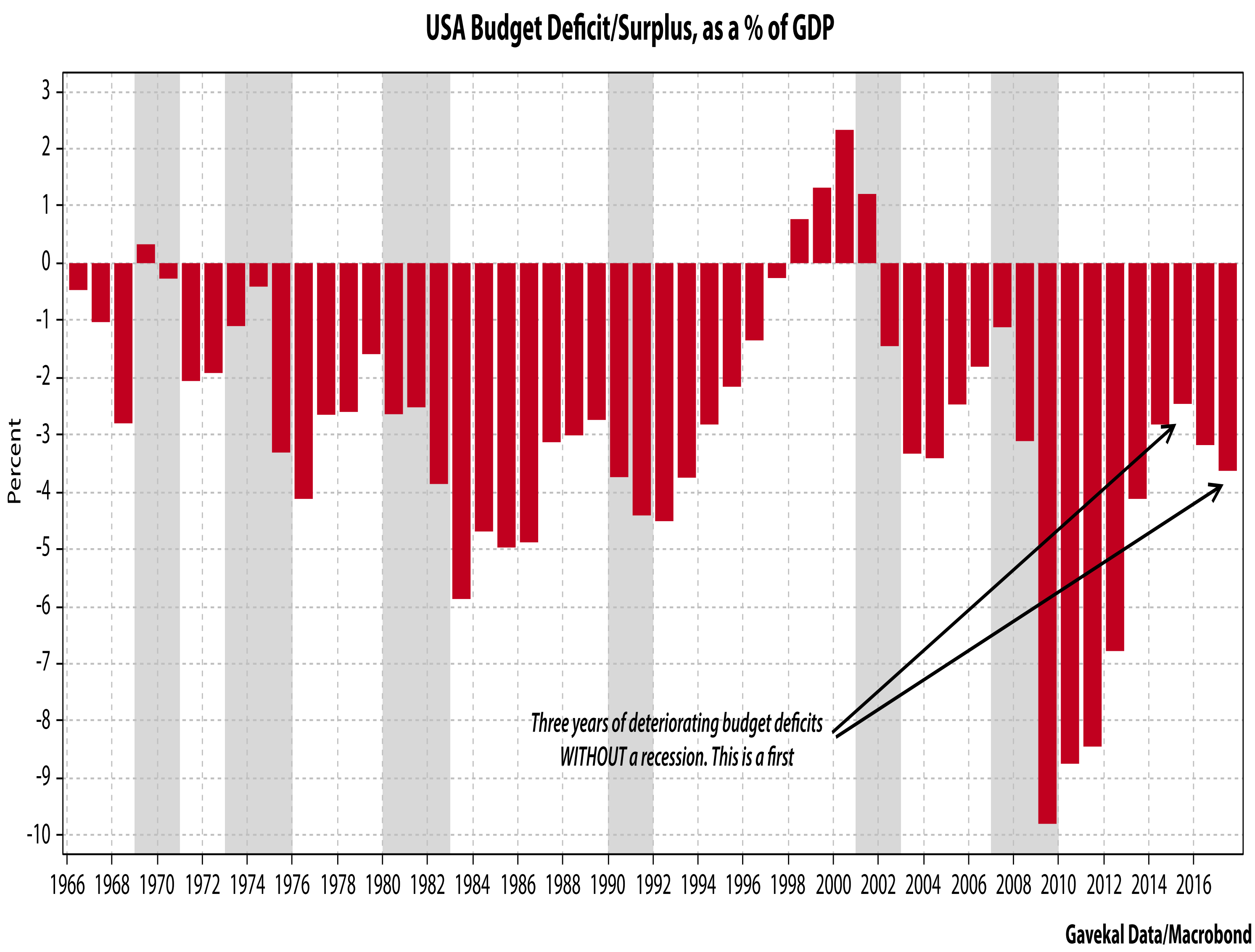
- US stocks are becoming as rare as Siberian tigers. Pretty soon, we will all be invited to charity galas to save listed equity vehicles…
- Maybe the US outperformance is simply linked to the shrinking pool in which investors can deploy an ever expanding capital base?
- We are ten years in a bull market, and still no massive IPO cycle?

Lower oil = weaker growth = wider spreads = easier Fed = weaker US$?



4- But can we have easy monetary policy when fiscal policy is out of control?

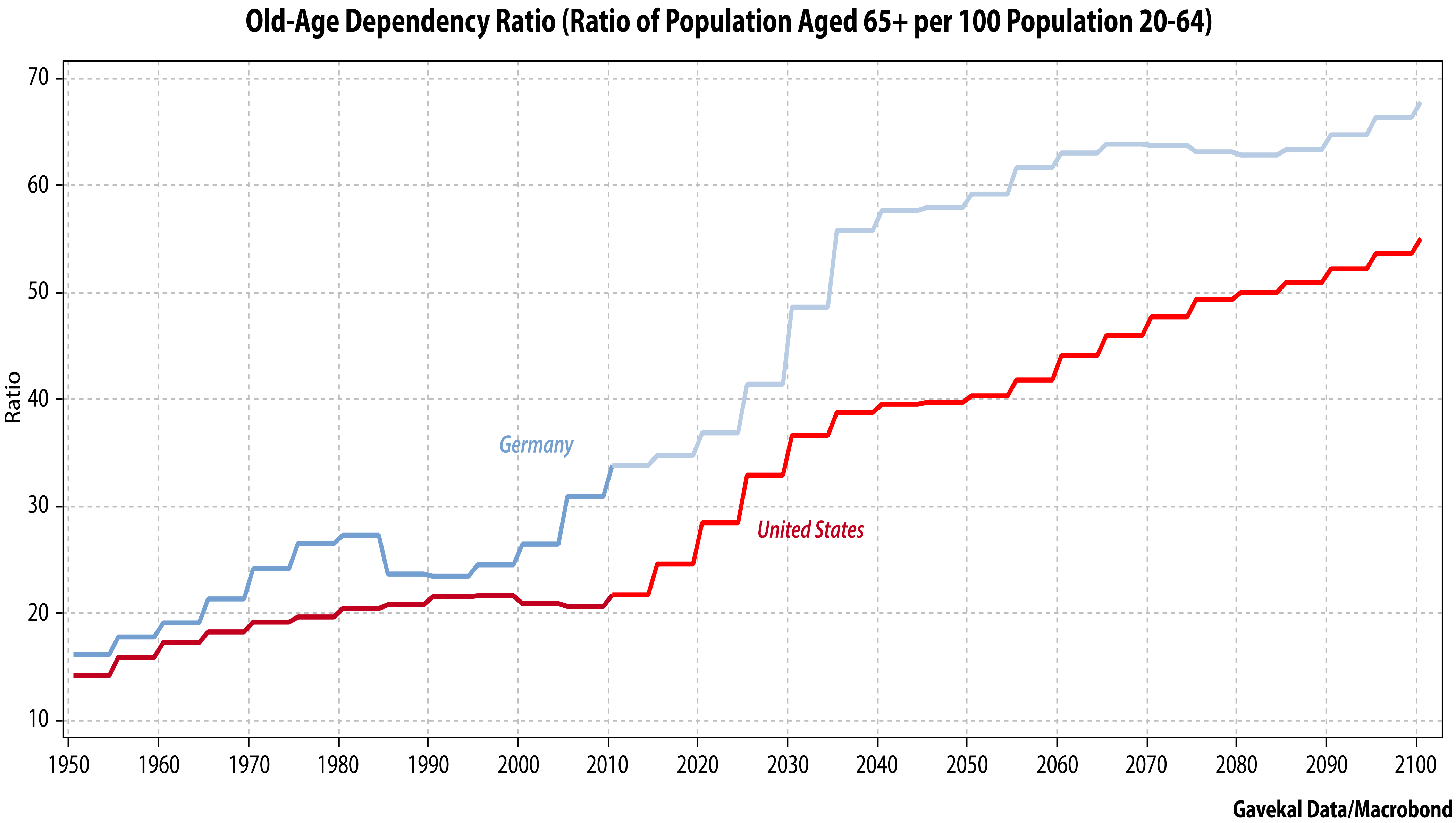
The US budget deficit keeps on expanding in spite of strong growth



- In spite of record high tax receipts, the US budget deficit has once again expanded in 2017.
- Continuous years of budget deficit expansions have NEVER occurred without a recession. **So this is a new development for the US economy**.
- In essence, this tells us that government spending in the US is now growing much faster than government revenues, **even when the economy beats expectations and asset prices make all time record highs**.
- So what happens next? Will the US government:

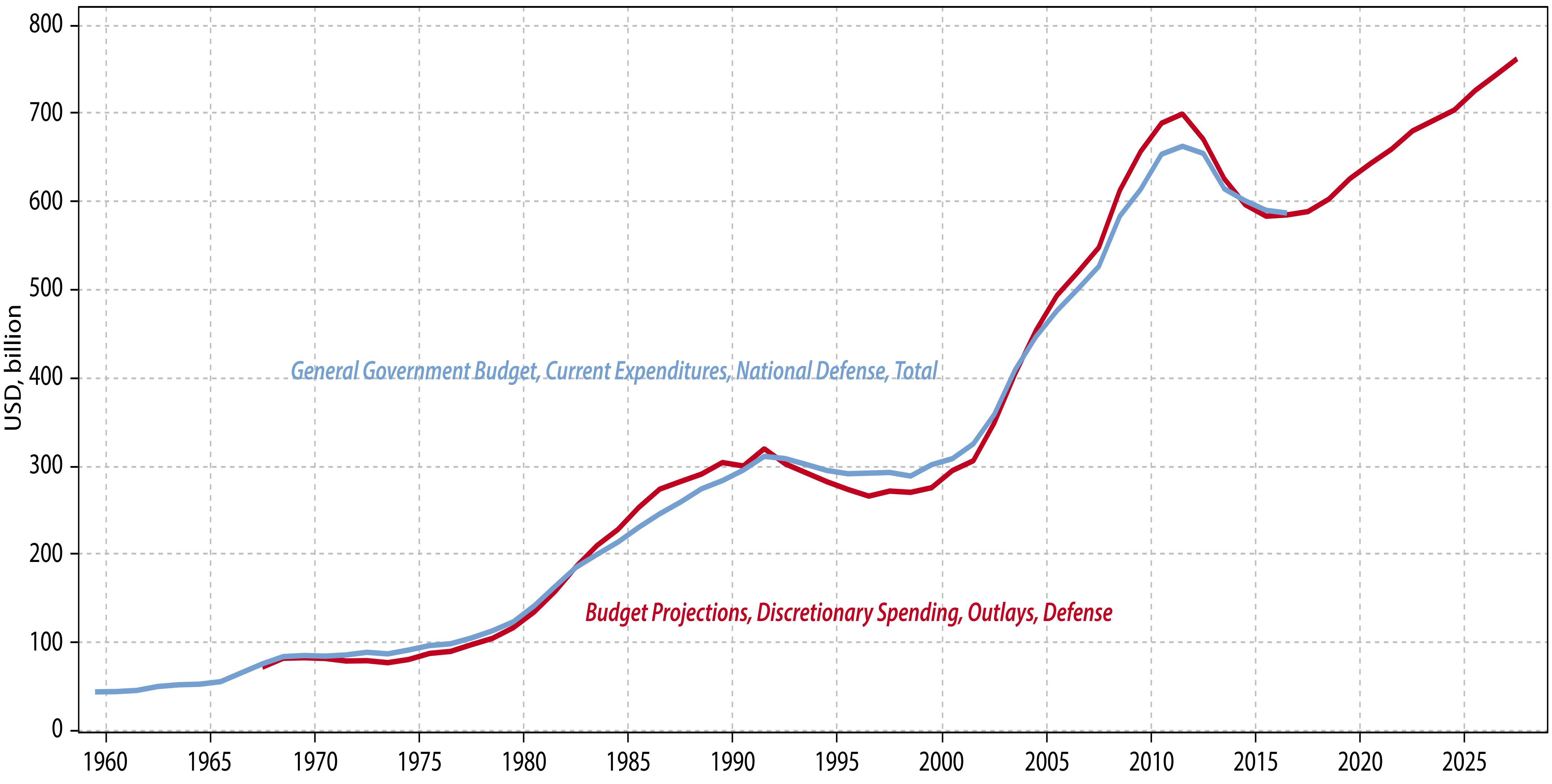
  a) ***shrink spending,***
  b) increase tax revenues or
  c) continue to expand deficits?

Reality is US is where Europe was twenty years ago



Unlike Europe, US doesn't want to sacrifice its Army to keep its welfare state…

United States: Actual and Projected Defense Spending



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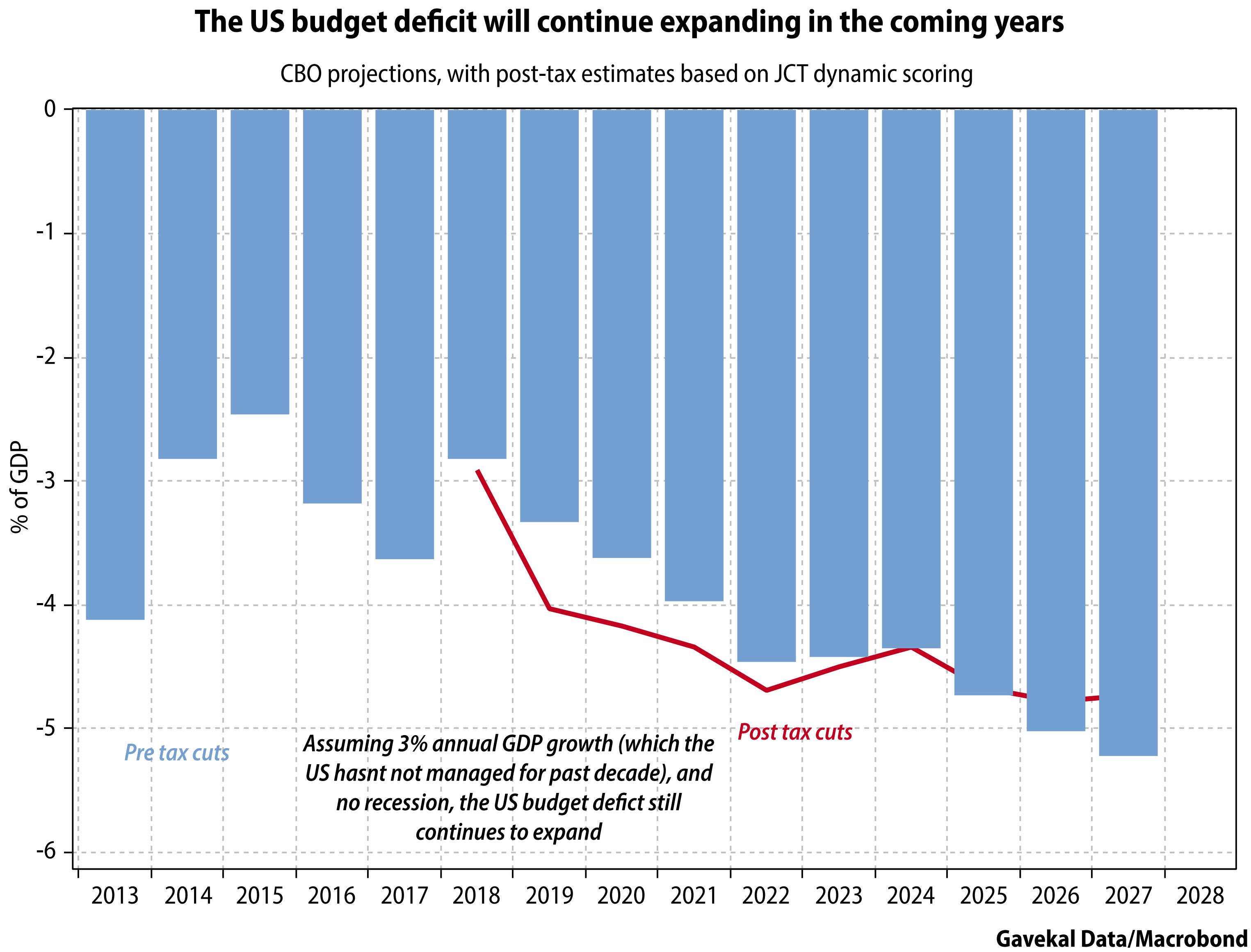
So who will fund the growing US budget deficits?

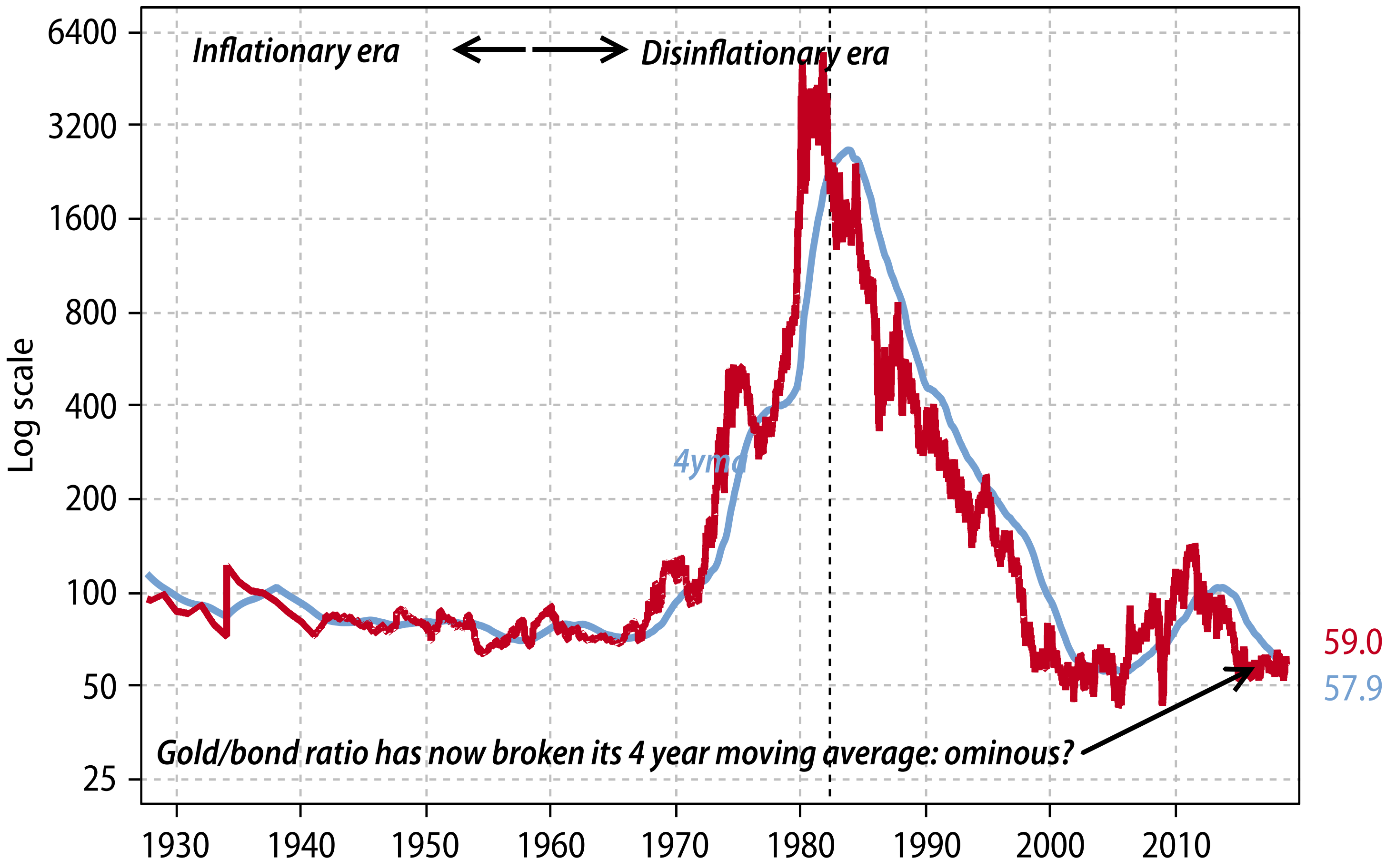


- According to the CBO, on forecasts that do not include a US recession (which would mean that the US would have gone two decades without a recession for the first time), the US budget deficit is scheduled to steadily deteriorate to -5% of GDP.
- Does this mean that the US government will increasingly 'crowd out' private sector investments and suck liquidity out of the system?
- Just this year, the US Treasury will issue US$1.3tr NET worth of US government bonds.

Easy fiscal + easy money would likely = weaker US$?

The gold/bond ratio just broke its critical threshold

Gold price / long-dated treasuries (total return)



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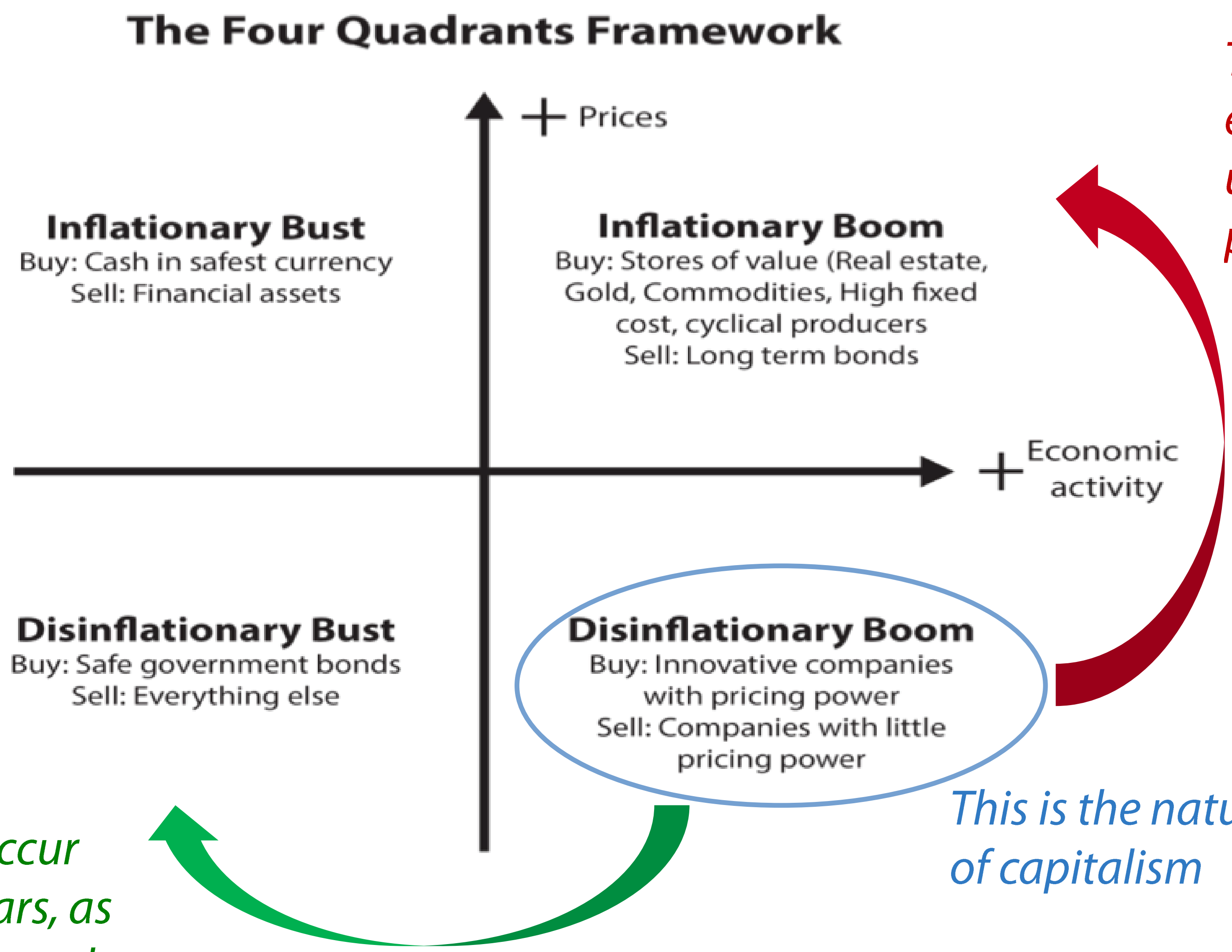
- Gold has no yield, the bond market does. If over a long period (4 years) gold outperforms the total return on bonds, inflation (or inflation expectations) is rising. ***Investors are willing to abandon a nominal return for a speculative capital gain on gold.***
- Once the ratio breaks through its 4yma, it tends to trend in that direction. Today we have just broken the 4 year moving average. **Conclusion: we could be witnessing a structiral shift to inflation.** (See ***A 'Once In A Generation' Shift***.)

Would an easy fiscal/easy money mix mean the end of the deflationary era?



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

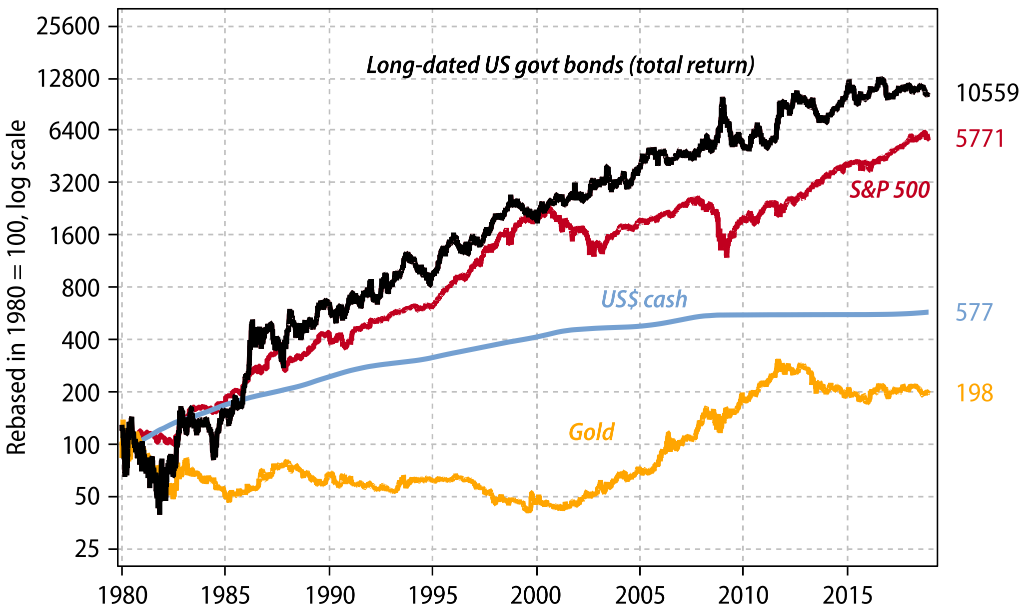
This is the natural state of capitalism

These shifts occur every 7-10 years, as part of the normal business cycle

If so, 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



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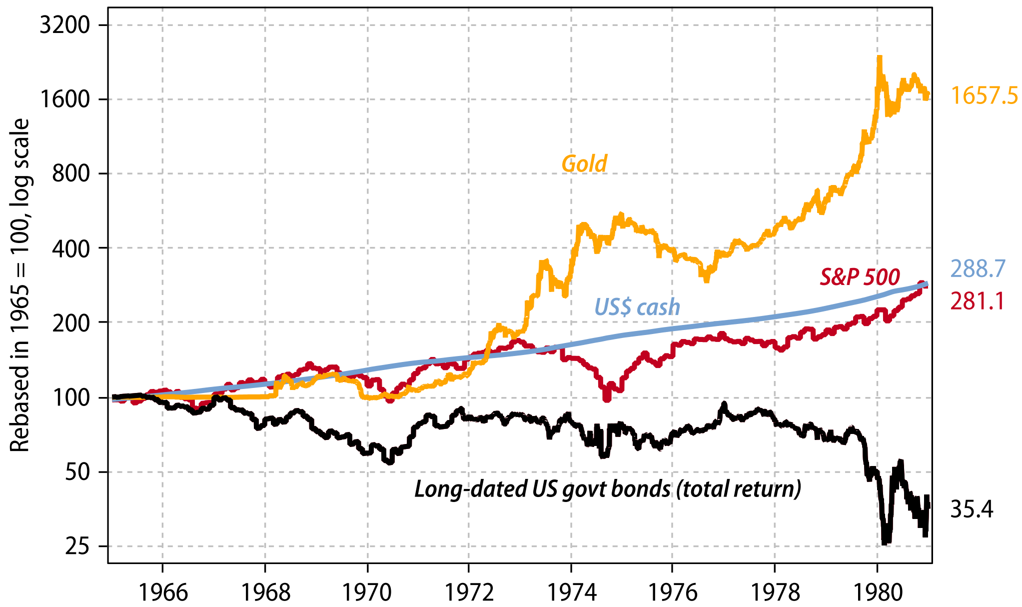
During inflation, the best hedges are cash and gold

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



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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.

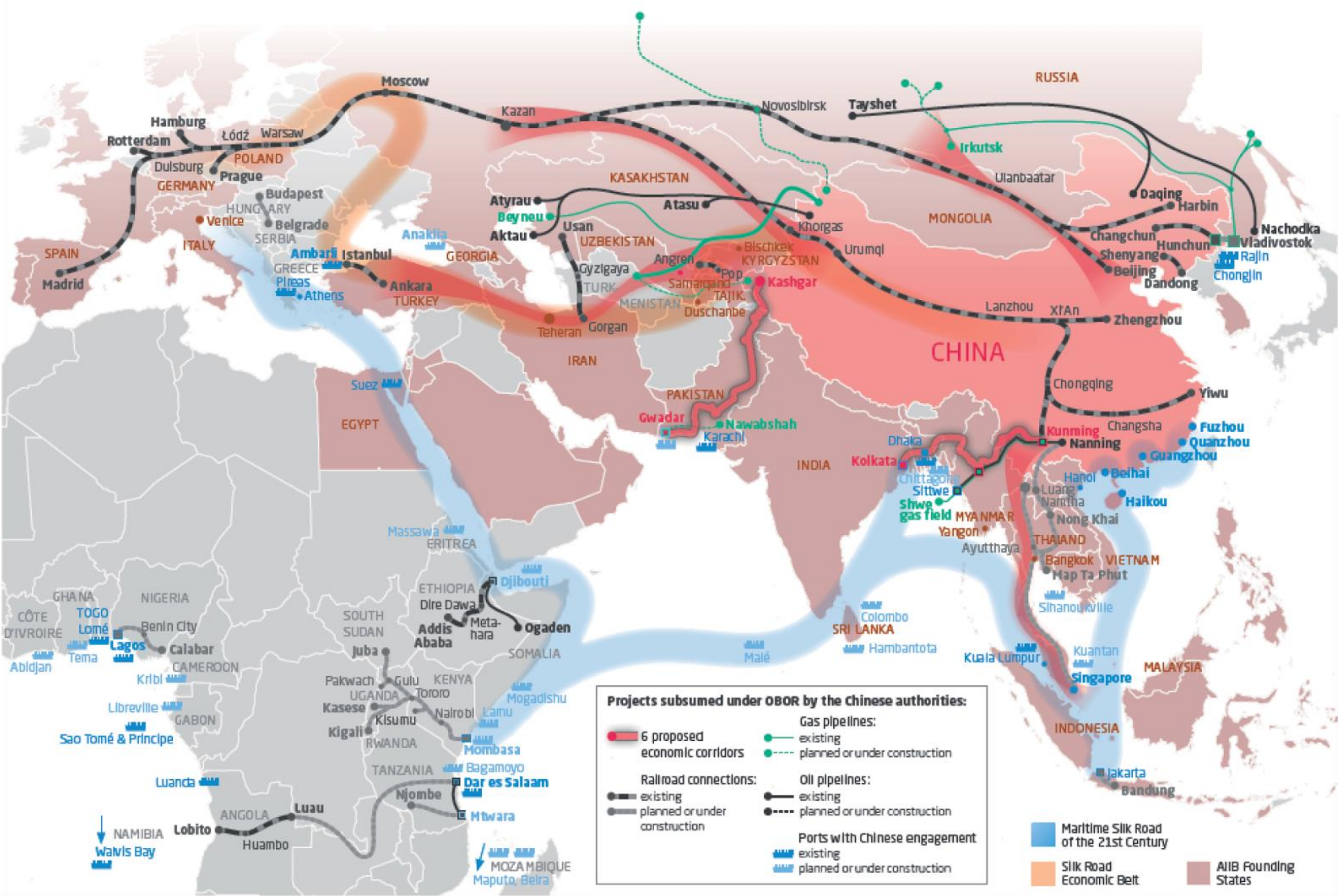
Cash and gold substantially under-performed.

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.

5- An important paradigm shift: the end of Chin-America?

Flashback to 19th People's Congress: step 1 in imperial strategy, OBOR



Source: Mercator Institute for China Studies

Step 2: "Made in China 2025"

- "**Made in China 2025**" is a broad industrial policy with many goals:
  - ✓ Improve manufacturing productivity by better use of IT
  - ✓ Develop capacity/leadership in many tech-intensive sectors (AI, robotics, new-energy vehicles, semiconductors, etc.)
  - ✓ Import substitution: 70% domestic self-sufficiency in "basic core components and important basic materials" by 2025

- "**Made in China 2025**" has some massive funding behind it:
  - ✓ US$232bn spent on R&D in 2016, with nearly 80% by companies
  - ✓ Government venture funds: US$328bn in capital (1/3 for ICs)
  - ✓ Private funds: US$100bn in venture capital; US$1.2trn in private equity

- The Central Commission for Integrated Military and Civilian Development (founded in 2017) raises fears that much Chinese tech development—especially AI—will be turned to military use.

This irks the US and now we have the rise in China-USA tensions

- This year's single most important event has been the rise in China-US tensions. Should we conclude that these tensions are:

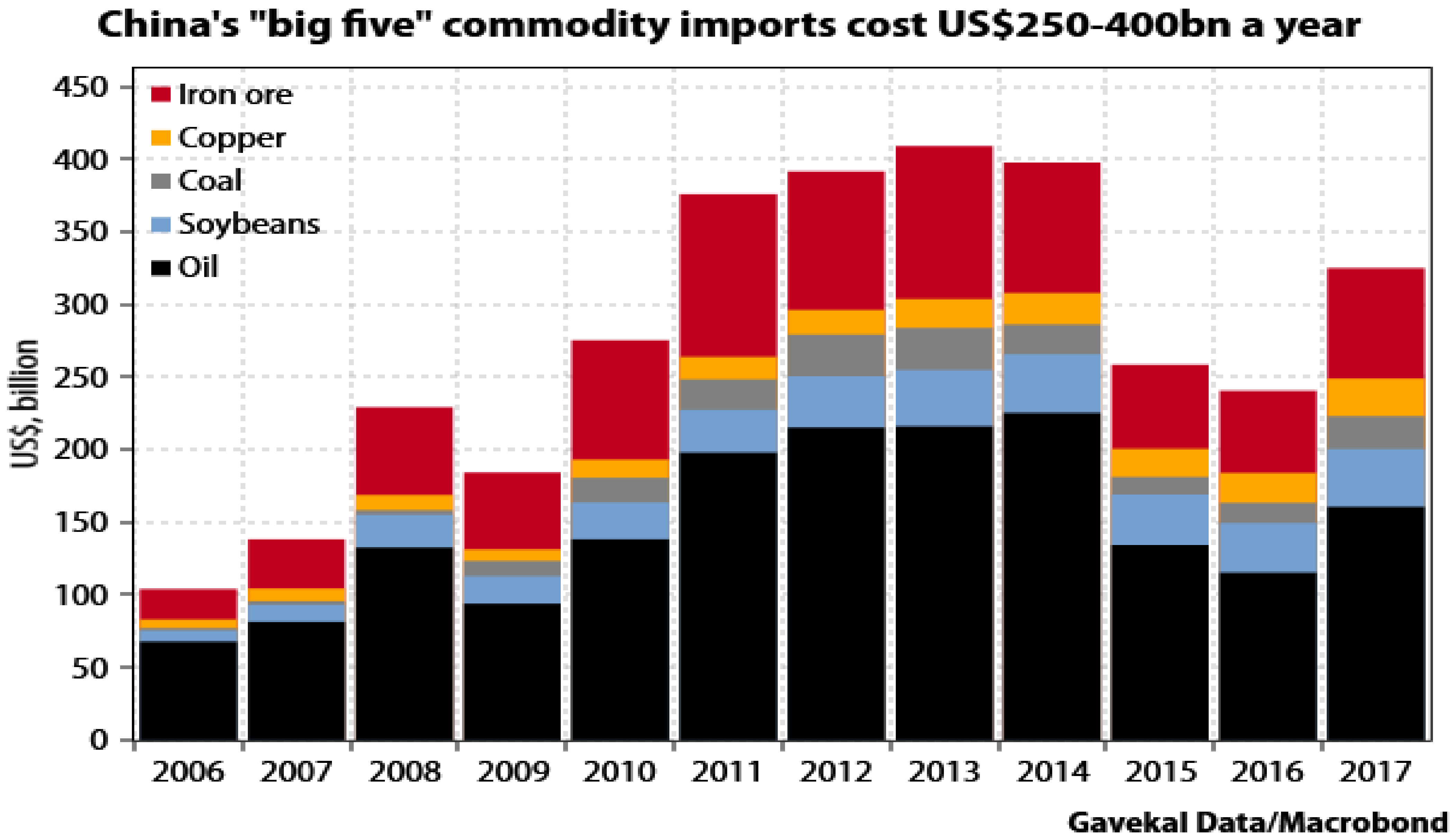
1. A by-product of President Trump's negotiating methods and that soon enough (post G20 meeting), a deal will be struck which brings us back to something approaching the previous status-quo?

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?

What if Xi Jinping has decided that now is the time to strike?

- Given China's imperial ambition, **it is not a question of whether China will need to challenge the US$' reserve status, but a question of when**.
- Xi jinping, and the broader Chinese leadership, most likely know that for China to attempt to de-dollarize Asian trade, and de-dollarize the commodity trade, can not happen without some crisis, and some pain.
- Thus, our assumption was always that, like St Augustine, the Chinese leadership would always look to 'rise to the challenge' at some point far into the future.
- **However, could recent events have convinced the Chinese leadership that, given the growing anti-China sentiment in Washington, the "when" is now?**
- **Or even perhaps that the "when" is now because the US is a 'paper tiger'? Or simply because the US president today is somewhat unpopular at home and abroad?**

Given past year, is China now more, or less, likely to want to de-dollarize fast?



Everyone focuses on the US, assuming that China will be a "taker" of deal

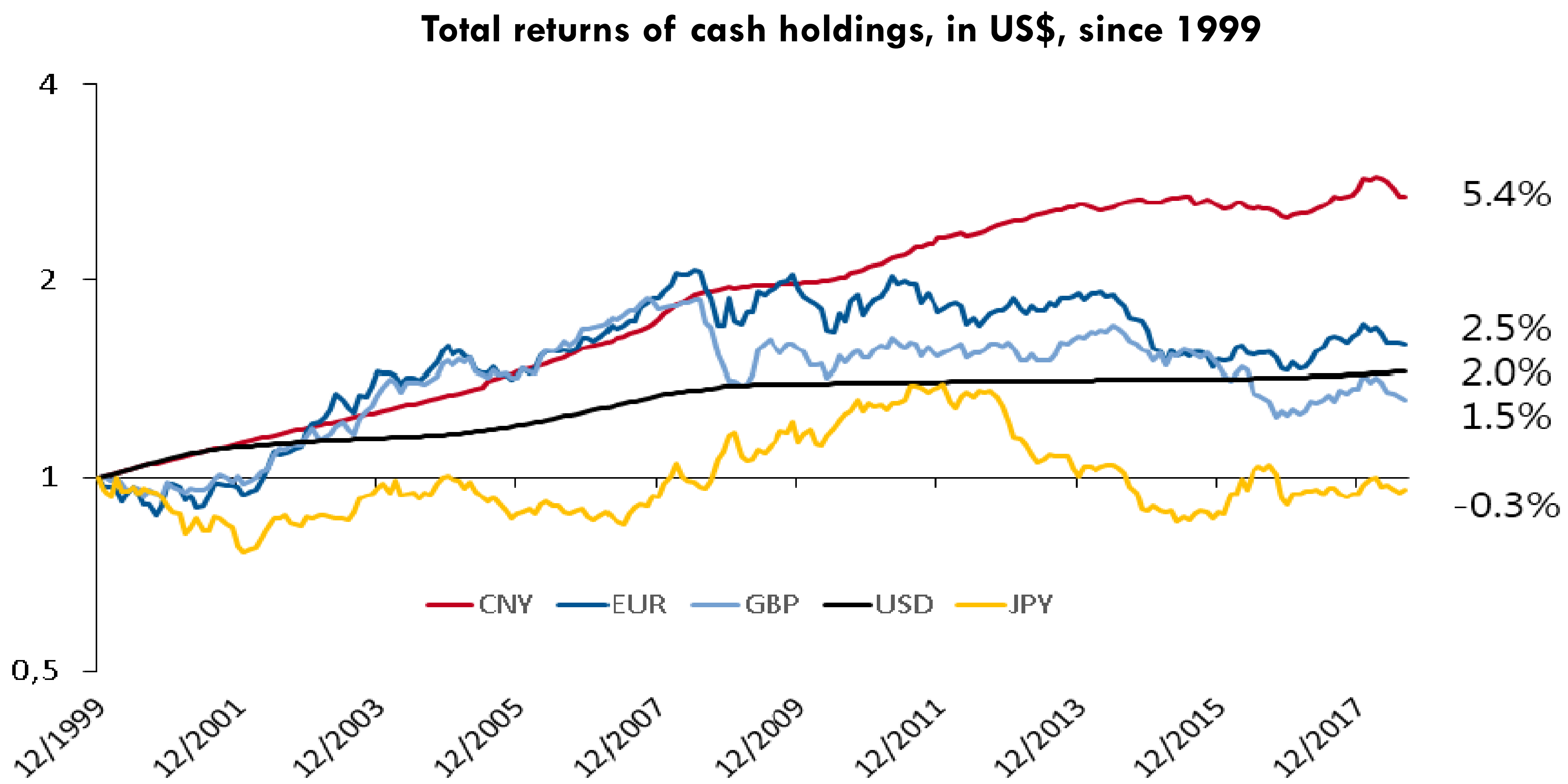
- Following the above quandary, most investors focus on the US to see what the US will do next. **The inherent assumption is that China doesn't have many cards to play.**
- Meanwhile, in China, what have we seen of late?
  1. Tepid responses to US overtures
  2. Massive imprisonment of Uighurs in Xinjiang
  3. Imprisonment of A by-product of Meng Hongwei (Interpol chief), one of a few Chinese officials heading an international organization
  4. Crackdown on churches
  5. Refusal of a HK visa for a Financial Times journalist
- **Maybe China should instead arrest the Minister for Propaganda? Or is China actually looking for bad press?**
- **More importantly, if China now sees itself in a long-term struggle with the US, don't expect China to come to the rescue of global growth as it did it 2008 and 2016.**

The worst set-up for negotiations: when each party underestimates the other

The US view of China

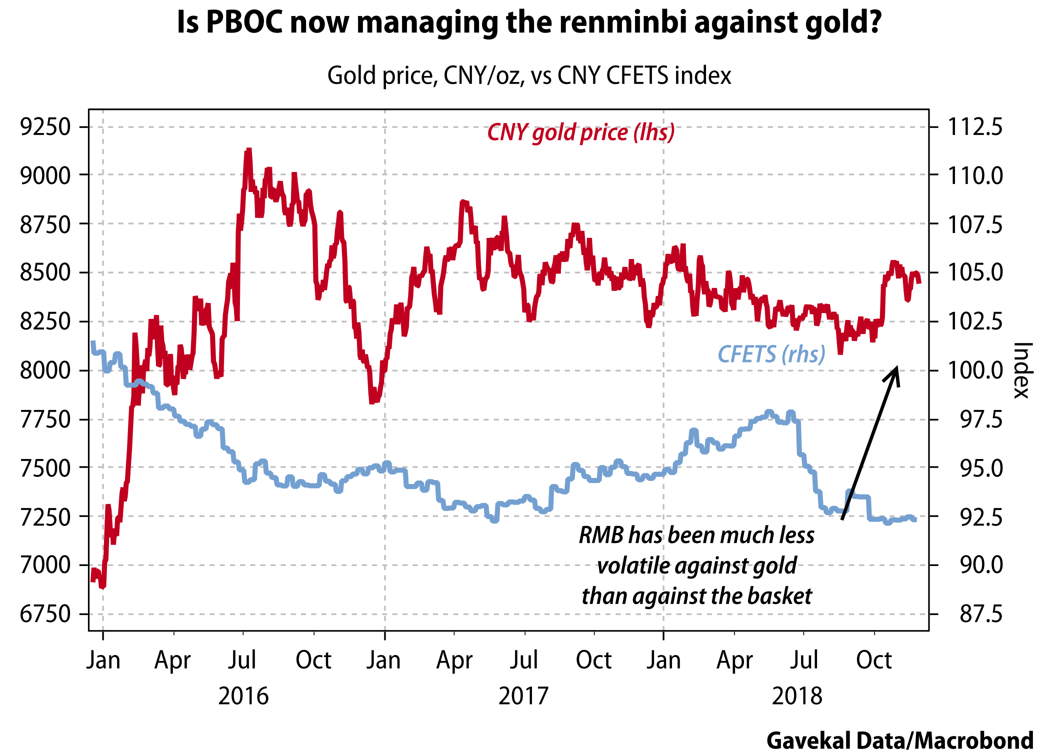
The Beijing view of the US

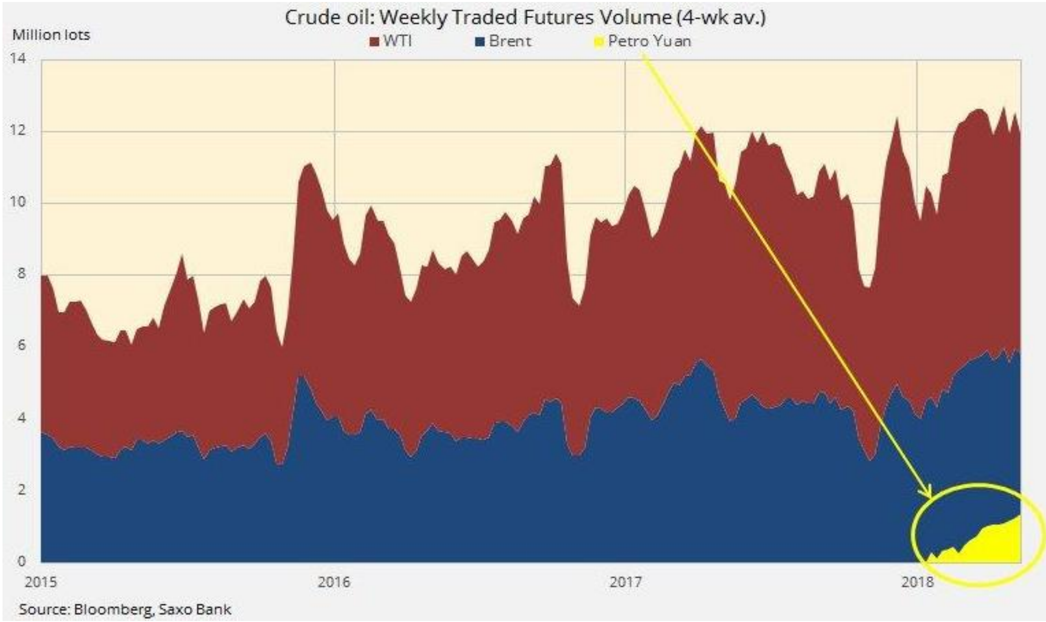
To shift Asian/commodities trade away from US$, RMB needs to be credible



Source: Blomberg data 31/12/1999 to 31/08/2018

Is the RMB managed against basket? Or against gold?





An interesting side note to the RMB: 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 it could be evidence of Beijing's long-term plan of de-dollarizing commodity prices. More evidence: the petro-yuan oil futures contract, which has picked up market share from Brent and WTI.

What's the connection? Swapping the RMB for the dollar in commodities trading carries a risk for Beijing: loss of control over its exchange rate. By linking the RMB 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?**)

RMB bonds remain a hedge against this "China attack" scenario

Evolution of a US$100 invested in 5 year govt bonds in 5 year CGB and UST

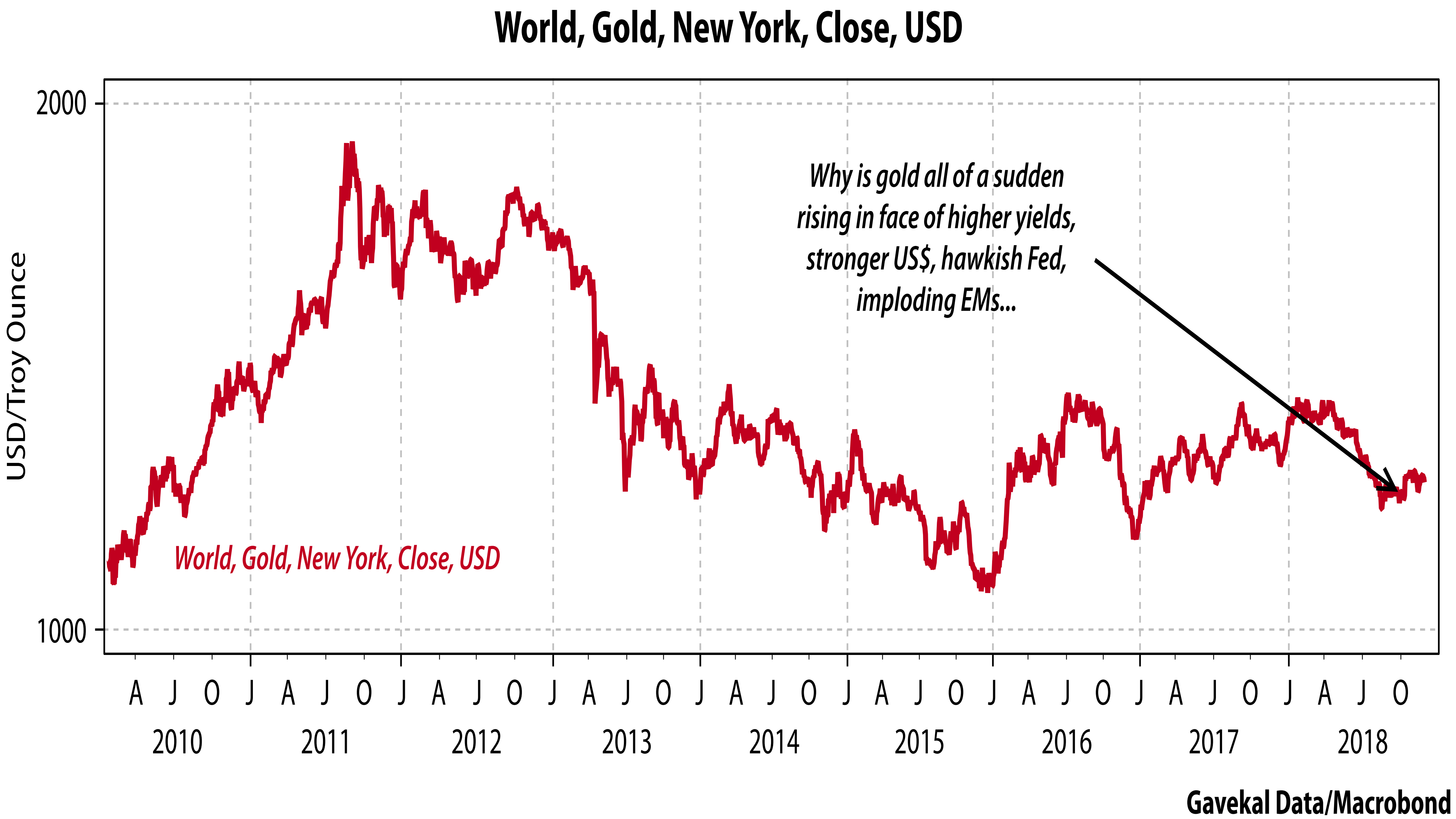
Gavekal Data/Macrobond

- If the pattern of the past five years is maintained, UST should soon start outperforming RMB bonds.
- **Given yield differentials, this can only really happen through a stronger US$. But how will the US$ get stronger when:**

i. A global equity meltdown does nothing to value of US$
ii. Dovish words from ECB and BoJ have no impact
iii. Stronger US growth and US inflation do nothing
iv. Hawkish Fed has no impact?

- **Maybe through a trade war?**

And why is Gold rising?



Gold is likely a decent hedge – but will gold miners be?

Can Gold Miners Start Hedging Anything Aside from Capital Gains?

Gavekal Data/Macrobond

Investment conclusions

Very different portfolio hedges for the different scenarios

	Scenario 1: Liquidity Squeeze	Scenario 2: Economic Downturn	Scenario 3: Paradigm Shift
Cause	- Fed tightening - US budget deficit - Higher oil	- China & EU slowdown - Excess corporate debt - Trade war disruptions	- Chinese ambitions - US weaponizing US$ - Runaway US deficits
For	- Shrinking CB reserves - Growing tensions - Bank underperformance	- OECD LI rolling over - US housing rolling over - Defensive sectors outperforming	- UST/Gold behaviour - Fed hawkishness - Managers feeling lost & miserable
Against	- Spreads remain tight - US$ not so strong - UST weakness - Gold behaviour	- Data weaker but OK - Absolute levels of interest rates not so high - UST not rallying	- "different this time" - Who can replace US$ when every one else stinks?
Impact	***If we are in a liquidity squeeze, markets will likely suffer until either Fed or China eases***	***If global economy is slowing, position portfolio for an easier Fed very soon***	***Continue de-risking portfolio. Gold and RMB bonds may be only hedges***

Contact and disclaimer

Thank you!

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