

Market Narratives

A brief unpacking of some popular market narratives...

“The Everything Bubble”

I refuted the concept of an “everything bubble” in [Bubblephobia](#) (4/4/19), so for today just a simple point: How can we be in an “everything bubble” when the S&P 500 has outperformed MSCI EM by 135% over the past decade?

Relative Total Returns: S&P 500 (white) vs MSCI EM (orange)



It can't be an “everything bubble” with one of the assets most sensitive to global liquidity conditions dramatically underperforming.

Chinese Growth is Critical for EM Performance

EM equities are barely above 2007 peaks while the Chinese economy has grown from \$3.5t to \$13.6T (end 2018):

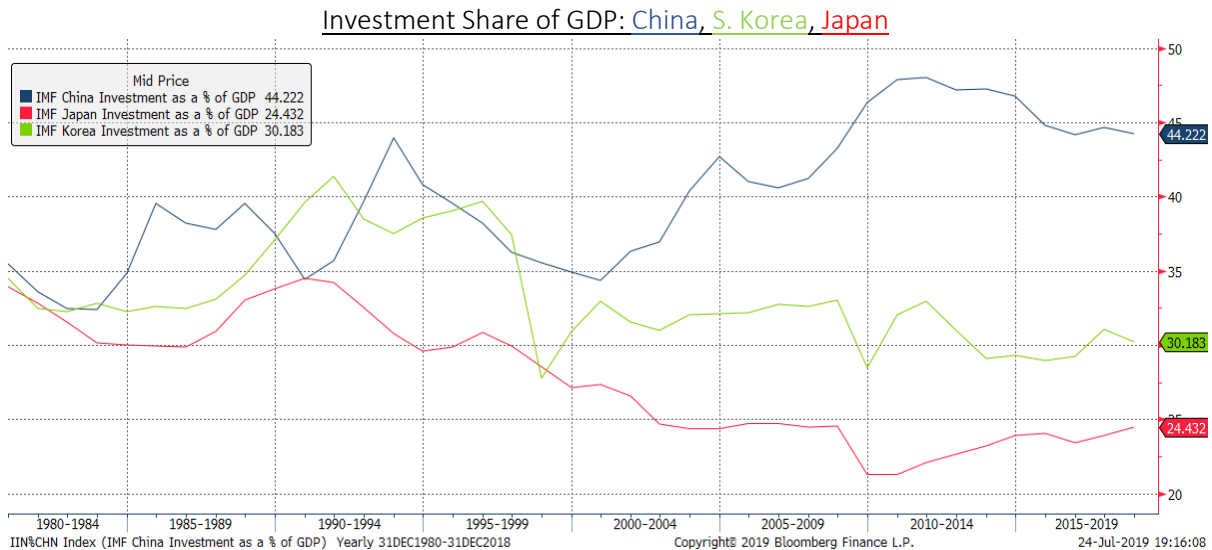
	Total Return Indices			China GDP (\$bn)
	<u>S&P 500</u>	<u>MSCI EM</u>	<u>MSCI China</u>	
2007 peak:	2435.16	463.82	531.80	3550.00
current:	6042.48	494.88	560.52	13608.15
Percent Chg:	148.1%	6.7%	5.4%	283.3%

While the fetid performance of Chinese equities over the past dozen years is a **strong indictment of the quality of China's GDP growth**, the lack of impetus provided to broader EM equity markets **belies the notion that China's GDP growth is driver of global asset markets**.



China is “Rebalancing to Consumption”

The big reason that Chinese GDP growth is less than meets the eye as a global driver is that despite incessant talk of “rebalancing,” the Chinese economy remains dangerously investment-driven:



China’s investment share in GDP substantially exceeds that seen in Korea and Japan as they pursued “investment led growth,” and it has remained elevated for an extended period.

China’s GDP growth is to significant extent driven by the building of proverbial “bridges to nowhere.” Until the Chinese economy dislocates (a la Japan in ’89 and Korea in ’98), the importance of fluctuations in the volume of such activity to global asset markets is grossly overstated.

We’re on the Cusp of a “Global Currency War”

Also, not until China dislocates to some degree. When the RMB breaks through 7.0 to the Dollar all hell will break loose in global markets. But the Chinese presently have no interest in exploding that economic bomb they have strapped to their chest.

In the meantime, all the talk of U.S. Dollar-selling intervention will remain just that – talk – for the simple reason that everyone knows that intervention absent a shift in monetary policy doesn’t work. Furthermore, USD available to the Treasury for intervention purposes via the Exchange Stabilization Fund totals some \$22bn, which they would burn through in about 15 minutes (no exaggeration).

An effective intervention would require an Executive Order declaring a national emergency to mobilize the Fed System Open Market Account for purposes of FX intervention, which would amount to a hijacking of monetary policy by the Chief Executive. This may end up on the agenda in a Trump second term under Fed Chair Shelton, but it’s a non-starter at present.

Coordinated Global CB Easing Will Send Gold to the Moon

Despite the fact that there is little, from a technical perspective, not to like about the gold chart...



... I don't see the case for a runaway gold rally and favor a return to the range sub-\$1400.

Yes, the ECB and BoJ will likely be reverting to easing measures by various means in coming months. However, as the Japanese experience has shown throughout the years, easing effectively at the zero lower bound is easier said than done.

If the supply and demand for real investment capital is clearing at a deeply negative rate, investment must be incentivized by means other than interest rate reductions. Such measures are political in nature and simply not on the agenda in either Europe nor Japan. I am skeptical that either the ECB or BoJ will get much traction in the form of significantly easier liquidity conditions and significantly lower currencies.

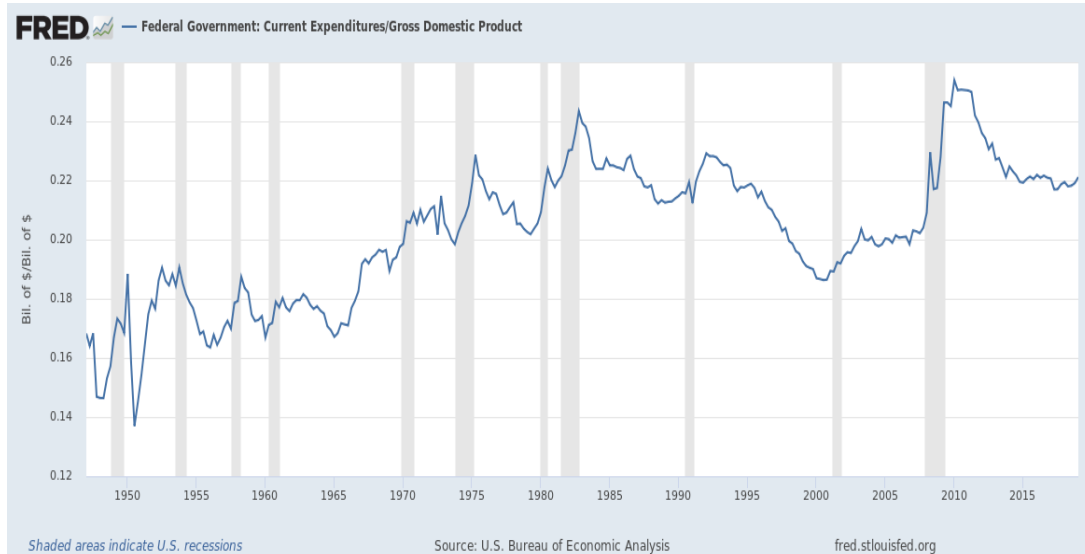
As for the Fed, as I laid out last week ([The Fed Shackled at Neutral](#), 7/17/19), I'm looking for only one or two 25bp rate cuts to get policy back to a neutral setting. Barring a descent into recession that necessitates a far deeper easing of monetary policy, a risk I discount, reversion to a neutral rate setting should be consistent with a return of gold to its well-established range around the 10-year moving average at \$1330.

U.S. Fiscal Policy is Out of Control

While headlines screamed that the freshly agreed [Federal Budget Would Raise Spending by \\$320bn](#), less emphasized was the fact that **the \$320 increase was from the existing budget caps** resulting from the 2011 Budget Control Act (aka the "sequester"). The actual increase in discretionary spending will be \$50bn to \$1.37T, an increase of 3.8% - likely a touch less than the economy's nominal growth rate. Meh.

Government spending as percentage of GDP at 22% is smack dab at the 40-year average. While that is too big for my liking, Washington has finite political bandwidth and the White House has limited political

capital and a sprawling agenda. This is not a political hill worth dying on.



Trump's is "Sacrificing National Security" for Soybean Purchases

Senator Tom Cotton (R., Ark), one of President Trump's closest confidants in the Senate and co-sponsor of a bill to require Congressional approval of any export licenses granted to Huawei, provided important color on the evolving "Huawei for Ag" deal in an [interview with CNBC yesterday](#):

CNBC Moderator Becky Quick:

Watching from the sidelines it's been a little bit confusing, to be told that Huawei is so dangerous, but then to see it kind of get thrown into play in terms of the trade talks. It seems to be the central piece between the China – U.S. trade talks at this point. What do you think of that?

(ed. note: no Becky, not that confusing really: [Osaka G20 – Trump Captures Another Piece](#), 6/30/19)

Senator Cotton:

Well I know that Xi Jinping wants it to be a central part of the trade talks but I would not allow Huawei to get any reprieve from our 'denied Entity list' the at Commerce Department or to let American Companies deal with them in their fifth generation wireless business.

Now Huawei has other lines of business, most notably, second-rate, inexpensive, hand-held phones that are mostly distributed throughout the developing world. Those are not really a threat to America's security or prosperity or privacy. It's the fifth generation wireless network that is a threat because information technology and fifth generation wireless networks are so essential not just to our economy but through the way the American military and our allies will wage war in the future.

Cotton has been touted as a possible Defense Secretary in a second Trump term. It's extremely unlikely that he is out of step with Administration objectives on this issue.

This was the deal all along: survival of Huawei's handset business for a return to Chinese purchases of U.S. Agricultural products. This is a great deal politically for President Trump and frankly, I'm surprised China is going for it.

As I wrote on Monday ([The Frog Stays in the Pot](#), 6/22/19), China's acceptance of the deal is borne of some combination of intense economic vulnerability and a risky bet that 2021 will bring a less adversarial occupant to the White House. From the latter perspective, the evolution of U.S. electoral polling could have bearing on China's approach to the trade war in coming months.