Newsletter

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INDEX House View

The narrative of the expected recession in the US during 2019 has morphed into a softer version, on the basis that consumption and labor market in the US seem to be substantially unscathed from the consequences of the trade war. Notably, the US trade deficit did not improve one bit, ironically the one indicator the US administration wanted to fix.

After one year of tariffs on Chinese goods, we now know the real damage was done by a contraction in global corporate investments and in Chinese exports, but not in global consumption by way of unreasonably augmented prices of imported goods and services. Specifically, global companies re-organized their supply chains and/or postponed major investments in any foreign country – especially China. Investment in the OECD countries slowed from around 4% growth in early 2018, to around 1% growth today. In the US and EU, two thirds of companies are small to medium size, which means that global trade has a very limited impact in a steady state situation – that is, barring a major economic collapse or shock on a global level. When investment is withheld, the next, most elastic and economic way to expand a company's presence in any foreign country is achieved by hiring more personnel, as observed by veteran economist Paul Donovan, with whom a member of our team had the great pleasure to work a decade ago. Therefore, labour figures, especially for the US, remained strong so far.

The question now becomes whether labor markets and consumption expenditure can continue with the same strength in 2020.

In order to answer exactly this question, we thought about a handful of threats to 2020's global trade, investment and growth stability, as follows:

United States

- Trade talks – there is no sign of any resolution coming, but only rumors and opinions leaked by peripheral participants. We remain of the idea that trade disputes will not be solved quickly. This will further depress investments and sustain labour markets in an unnatural way;
- Impeachment of Trump – it might seem there was a quid pro quo in Trump's dealings with Ukraine, but the constant threats, attacks and insults via Twitter make the process much more political than logical, and therefore futile from an investment point of view. Be it as it may, a formal impeachment opens the much worrying question of whether ms. Warren has a real chance to succeed Trump in office. Perhaps naively, we are relieved to see Bloomberg's candidacy, which gives hope against another nationalist inept taking charge of the US;
- Warren's agenda – according to her thinking, the US should allow any foreign company to access US markets only if a series of criteria are satisfied, which includes a clean human rights record, enforcement of religious freedom, compliance with global anti-human trafficking, anti-corruption, anti-carbon emissions and anti-tax avoidance standards, elimination of fossil fuel subsidies and zero suspicious currency interventions. While this is admirable, is sound rather unfeasible since the US themselves have a scatter track record in a number of these departments. This could have the effect to depress trade perhaps more significantly than tariffs on Chinese goods.

Europe

- Germany deciding on 5G network bidding – Chinese company Huawei's role is being fiercely discussed with the CDU, the governing party. Specifically, there has been a strong divide in opinions internally on whether Germany should ban or allow Huawei's participation in the 5G bidding, effectively allowing a major Chinese player to assume a central role in the digital communication spine of Germany. There is much at stake: the US is threatening to cut intelligence cooperation and China will definitely use the EUR 800bn worth of existing trade as a threat to future growth. Being the only serious engine of European economic growth, this decision will have an impact on much of Europe's future growth;
- Brexit – similarly to the US' electoral situation, the alternative to the un-elected Boris Johnson is rather threatening to business, if we do not consider the challenges the EU divorce will already bring on its own. The Labor Party has come up with ingenious but rather communist-inspired rules that a small percentage of company ownership should be distributed to employees. While not unfair, this measure is not exactly owner-friendly. It is also part of the never-ending debate of whom should be retributed the most in the business activity, the owner who put the initial capital to fund the company or the employees who work with and increased the capital;
- France, Italy & Spain – EU budget deficit limits are constantly touched by these three and major European countries. The EU keeps warning them, but current debt levels have become endemic and almost impossible to reduce, since economic growth has been muted for a while now.

China

- Headache in Hong Kong – the Chinese National People's Congress Standing Committee declared last Thursday that "whether the laws of Hong Kong can comply with the Basic Law can only be decided by the NPC Standing Committee, no other authority has the right to make such judgments". This happened less than 2 days after Hong Kong's High Court declared the mask ban implemented last month unconstitutional under the Basic Law. First of all, let's remember that China is ruled by the Communist Party, which is an

oligarchy, and not by the Congress, which is a democratic institution. Second, such direct intervention on Hong Kong's highest judiciary actions and such disregard for Hong Kong's independent judiciary system only confirm that China will never let Hong Kong off the hook. In response, the US Congress has voted favourably on a bill to protect human right in Hong Kong but President Trump has announced it will be vetoed to avoid making trade talks stall. Incidentally, and perhaps a minor event, a Hong Kong national working in the UK consulate came back after some time spent in Chinese detention with some interesting feedback. Having been tortured and threatened, he's now gone into hiding, but it was enough for the UK to formally question their Chinese counterparts on the matter;

- Hong Kong elections – it is no surprise yesterday's Hong Kong elections were overwhelmingly in favour of anti-China candidates. Almost all of the 18 districts are forecasted to turn pro-democracy, with up to 90% of the free seats (almost 100% have been contested) expected to go to the opposition. This is not an unclear message to the Chinese Communist Party, but a rather non-consequential one, since everything that belonged to China will return to China, as Henry Kissinger once said. However, the potential for trouble increases, with unrest expected to continue as the two parties continue to engage;
- Uighurs situation – while a predominantly domestic issue, exactly like the Hong Kong one, the brainwashing and detention of hundreds of thousands of Uighurs is started to attract the attention of Western human rights advocates. The Chinese idea is to maintain law and order in the apparently religiously motivated turbulence, the Uighur idea is to be free to exercise their own religion and life, which is probably quite different from Chinese standards. However we see it, this is another potential front of clash, where we expect the US and UK to start intervening, whether rightfully or not.

Essentially, there are reasons to think the clash of civilizations might be intensifying going into 2020.

How will markets react? As of today, equity markets seem to rely on a done deal between the US and China, something we do not believe is very near. Valuations continue to climb across the board, ever stretching the price paid for decreasing growth and margins. We agree with one observer, Guggenheim Partners, that the S&P500 might reach 3,500 before correcting down, sometimes in the next 18 months. From a fixed income perspective, nothing much has moved in a month, with the only exception of a widening between CCC and B- rated bonds, which is associated with the beginning of a market gyration out of risky assets. Incidentally, the rate of default on first mortgages in the US has increased by 20% YoY in its last reading, much higher than its immediate historical trajectory. These might be random data points, but they do tell a story of change for the worse in specific debt sectors.

We remain observers of the markets and wait for clearer signals to take single line exposure in bonds and equities.

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