When is a trade war not a trade war? The Cold War “on the other side of the hill”. (13/05/19)

‘…a form of adaptation is thus achieved by narrowing and distorting the environment until one’s conduct appears adequate to it, rather than by altering one’s conduct and enlarging one’s knowledge till one can cope with the larger, real environment.’

K.J.W Craik, The Nature of Explanation

‘All the business of war, and indeed all the business of life, is to endeavor to find out what you don’t know by what you do; that’s what I called “guessing what was on the other side of the hill”.’

The Duke of Wellington

On October 8th 2018 The Solid Ground commented upon Vice-President Mike Pence’s October 5th speech on US China relations - Desolation Row: Which Side Are You On?

While a bit of sabre rattling ahead of mid-term elections is to be expected, this speech, in the opinion of your analyst, changes the world. It changes not just the world of finance and money but, very probably the world of geopolitics……

In the context of this speech trade sanctions are a lever for change in many areas well beyond the issues of trade themselves. It is incredibly difficult to see how the Chinese Communist Party genuflects, or perhaps kowtows, to such major and wide-ranging criticisms of their behavior. To bend to the will of the US administration on these multiple issues is to back away from the political control that is at the heart of the Chinese Communist Party and Xi’s Presidency. For all of us as citizens this raises the prospects of a much more confrontational relationship between Washington DC and Beijing, and for investors it means a whole new monetary order must now be developed. The development of that new monetary order will be as important for investors as the breakdown of the Bretton-Woods agreement was for their predecessors.

Your analyst has been writing about the development of that new monetary order for some time and if you don’t subscribe to The Solid Ground but do subscribe to Grant’s Interest Rate Observer you can watch the video of my presentation on that new system at The Plaza Hotel at The Grant’s Spring Conference on April 9th this year. Sometimes, not often, it’s the change in the structure that matters, not the change in the cycle. What would it profit an investor if he or she has a good grip on the business cycle but then has to live through the collapse and re-building of the global monetary system?

Your analyst is frequently asked if there are any historical parallels with current market conditions. There are no direct historical parallels to where markets are today, but your analyst is constantly struck with the similarities with the late 1960s. Equities were very expensive, the US CAPE rose above 22X by December 1968, but then investors believed that equities would protect their savings from the ravages of inflation and also that what really mattered for future returns was the condition of the US business cycle.
However, it turned out that what mattered was that the Bretton Woods agreement was breaking down, inflation would reach levels never before seen in peacetime and that a geo-political shift produced sustainably higher energy prices. The US business cycle did not peak until December 1969, but by then the CAPE had already declined to 17X and, after the end of the old global monetary order, the decline in valuations continued until equities bottomed at just below 7X CAPE in 1982, having traded as low as 9X CAPE as early as 1974. Sometimes we all know what is 'on the other side of the hill', but we simply want to 'distort the environment' rather than struggling to alter our conduct to cope with it. This is not a trade war, it's a cold war and we need to alter our conduct accordingly.

Such willingness to distort the environment rather than altering conduct also impacts policy makers.

*We endlessly debated options for reform in the Volcker Group. Every member had ample opportunity to express their ideas. The oldest and wisest, George Willis, led the Treasury's international staff. He was the only one of us who held an official position at the time of the 1944 conference in Bretton Woods. He took endless notes at our meetings. When asked to comment on a proposal, he consistently answered in his deep, gravelly voice: “It won’t work.” Exasperated at one meeting, I finally asked, “Okay, George, what will work?” “Nothing” was the even more gruff answer. Well I wasn’t ready to surrender. Instead, I came to feel that sooner or later we would have to suspend our promise to convert dollars into gold as a means to an end: the only way of forcing an adequate exchange-rate realignment and serious reform.*

Paul Volcker, *Keeping At It: The Quest for Sound Money and Good Government* (Public Affairs, October 18)

Many policy makers and investors knew the Bretton Woods system could not be maintained long - before it was not maintained. In China a similar debate has been under way for some years. How long can Chinese monetary policy be ultimately determined by linking the exchange rate to a basket of other currencies dominated by the USD and, through their own currency policies, quasi-USD? The consequence of this policy is that the PBOC balance sheet is now smaller than it was in 2017 and not much bigger than it was in 2014.

With such a key restriction on money creation, the fuel for growth is thus primarily non-bank credit with the inevitable consequence of an ever higher debt-to-GDP ratio: the BIS data is crystal clear that there has been no material de-gearing during China’s so-called de-gearing policy. China is now stuck with a small current-account surplus under attack from US tariffs and, despite portfolio capital inflows triggered by index re-weightings, a capital account in deficit and still no growth in foreign reserves/commercial bank reserves. The current monetary policy, in pursuit of a stable exchange rate and also strong GDP growth and hopefully declining debt-to-GDP, does not work. It will get worse to the extent that US action reduces the size of China’s current account surplus or further worsens the capital account deficit. More bluntly put - how can two adversaries in a Cold War have linked exchange rates?

“Okay George, what will work?” The clear answer amongst Chinese policy makers has been luring in foreign capital to generate a large external surplus, and thus producing rising foreign reserves, rising commercial bank reserves, growth in broad money and hence robust nominal GDP growth. This analyst, for reasons outlined in the 1Q 2019 Report, believes that George would not be impressed by that answer either. Already the surge in portfolio flows is not resulting in an increase in the net capital account. Other investors in China, whether local savers or foreign direct investors, are running scared of Xi’s increasing authoritarianism, the deterioration in relations between the developed world and China, the increasing restrictions on even foreigners removing their RMB
balances from China, and of course the simple fact that the surge in Chinese wages has reduced the attractiveness of China as a base for production.

As it becomes even clearer that we are entering a Cold War, as history shows a period where not just the flow of goods but the flow of capital can be halted, the prospect of this being the answer to China’s problem gets even smaller. Whoever fulfills the role of George in China’s policy circles will have even greater reason to proclaim “Meiyou” [Nothing] when asked how to sustain a managed currency, strong GDP growth and a likely growing external deficit. Who knows when Chinese policy makers are ready to surrender, but the clearer it is that we are entering a Cold War, the clearer it is that China will have to move to an independent monetary policy. Cold Wars and changes in monetary regimes come along just as Hemmingway warned us bankruptcies come along - ‘gradually and then suddenly’.

It seemed on October 5th 2018 that we had entered a Cold War, though the market then, and even now, prefers to interpret all the sound and fury between the US and China as posturing aimed at doing a deal on trade! Well, at some stage if it sounds like a Cold War and looks like a Cold War maybe it is a Cold War, but for those still in doubt remember that at the end of July the US will have left the Intermediate-range Nuclear Forces treaty with Russia and it will almost certainly start sending missiles to Asia. China engagement is already dead and few, if any, will doubt that this is China containment when US missiles start appearing on China’s borders (for more see The Asian Arms Race and the ‘Weaponization of Finance’ – Hard to Mistake, Harder To Take October 24th 2018). Be assured that elements within the People’s Liberation Army, sure that their lead in short-range missiles in Asia will be challenged as early as August this year, will be urging a proactive move upon Xi Jinping.

Only time will tell whether the Chinese President responds to such urging but history shows that it is in times of military imbalance, but with a balancing force in the process of creation, that some are tempted to act pre-emptively. The breakdown in trade talks between the US and China will be used by hawks in the PLA to recommend that China acts quickly to secure the strategic goals it sees necessary to prevent the success of a China containment policy. This is really, really not about trade and what it is about changes the rest of this century. For those in doubt that this is the direction of travel, I suppose you have to wait a few more months until US missiles start arriving on China’s door-step. In the opinion of this analyst that is to wait far too long.

This is one of those moments when history changes, and for financial markets this move from China engagement to China containment is probably the most important event, political or financial, since the fall of the Berlin Wall. Yes, it is even more important than the Great Financial Crisis (GFC) because China engagement, along with the fall of the Berlin Wall, brought the world thirty years of disinflationary growth. That now cannot be the outlook for the next thirty years. While the GFC produced, albeit with a very long delay, a major political shift away from free-market economics, the shift in the relationship between the West and China is ultimately even more important. It is more important because the negative consequences for asset prices can come very quickly, but crucially they can last much longer as, with the usual uncertainty as to timing, we now begin to enter a world of prolonged and much higher inflation.

Whether initially deflationary or ultimately inflationary, this profound shift ends the long period of disinflation, but it also creates the necessity for much more aggressive financial repression in the developed world. Either deflation brings a surge in debt-to-GDP ratios to even higher new highs or inflation produces the rise in interest rates that will trigger a credit crisis. New action is called for and new action we will get; the ultimate aim being to inflate away debts. Acting to prevent the rise in nominal rates associated with higher inflation, and indeed supporting higher inflation, is the only likely policy response from western democracies to ever higher debt-to-GDP ratios - See Capital Management in an Age of Repression: A Handbook 3Q 2016. (I will be conducting a teach-in on financial repression in London on the morning of May 29th for those interested in attending). So
that’s a Cold War, a new global monetary system and financial repression all now imminent. This would not be a good time to try ‘narrowing and distorting’ the environment until our conduct becomes adequate to it!

At this stage your analyst should pause to make it clear that the near-term outlook remains probably deflationary. While containing China must produce higher inflation in the long-term, as Chinese goods are re-priced following tariffs or banned entirely from key developed-world markets, we are still stuck now with a grossly over-geared global financial system, a particularly over-valued RMB exchange rate at the moment, and a need for a new global monetary system that will not be agreed without considerable rancour.

It is highly unlikely that global growth will accelerate given this combination and, of course, a major Chinese devaluation would create an instant deflationary panic. Subscribers should be fully briefed on what do when this happens. See After The Fall: Asset Allocation After The Float of the RMB, 1Q 2019. Amongst other things, that report looks at the huge political decisions that have to be made quickly by currently largely unaligned countries, should the RMB float.

Do they devalue in-line with the RMB and further screw developed world manufacturers, or do they hang tough and accept that such a devaluation will be dealt with by tariffs, thus protecting their own competitiveness? The 1Q 19 quarterly report looks at each Asian country in turn and forecasts that most of them will actually follow the latter route, dependent as they are upon the US for their defence. If that is correct, the near-term adjustment process would be difficult and for Australia, aligned with the US through the so-called ‘Quad’, particularly difficult as it is harmed by much lower exports to China with limited markets elsewhere for its then glut of commodities. The major decline in commodity prices alone could drive that first deflationary shock as we move to a Cold War.

Of course, the above merely scrapes the surface on the impact that our new Cold War has on financial assets; summing up how the world just changed within the limits of a newsletter is somewhat difficult. Thus, in the next quarterly, I will focus on the impact on the US and in particular on the US treasury market. Deflation is clearly a major positive for this market, but it faces a short-term risk associated with PBOC dumping and a long-term threat from the now much greater prospect of future inflation. There is thus a delicate balance for investors holding Treasuries, and a detailed look at the US Flow of Funds statistics is necessary to assess just how much savings this market can attract, at a time when the PBOC is likely to be a seller and the US Treasury continues to run large deficits. At this stage the only answer is ‘so far so good’.

In scraping the surface of a subject that will dominate investors’ minds for likely several decades, it is possible to end on something of a positive note. Is it much more likely that human beings, at least some human beings, can alter their conduct to cope with the larger real environment than an algorithm? Having just read Ray Dalio’s Principles there is probably a greater prospect than I, at first, thought of algorithms adapting to whole new environments, but in that case it is an algorithm informed by a world-class financial historian. In most circumstances the human being still has the edge in this particular contest. When asked what their databases contain regarding the behavior of financial assets during the last Cold War, the average algo is likely to offer George’s reply - “nothing”. I’m no computer scientist, but I think that’s a 0 without a 1. However, as discussed in the last newsletter ‘Accidents Will Happen…’, even when a human actually knows ‘what’s on the other side of the hill’, there always remains the execution risk in doing something about it:

‘To capture his objective, Gatacre settled for a night march followed by a dawn attack. Not only did he not know the route but he succeeded in forgetting to bring along the one man who did, a certain Captain of intelligence. As a result of the appointment of two ‘guides’ (who knew no more than he did), dawn found him and his army behind the hills he was supposed to be in front of. After some moments of consternation, during which he lost all sense of
direction, the general resolutely faced his army the wrong way with their backs to the enemy. Having recovered from the novel experience of being attacked by an army which appeared to be moving in reverse, the Boers opened fire with such devastating results that within half an hour Gatacre’s force was in full retreat.’

Norman Dixon, On The Psychology of Military Incompetence

Marching orders for investors don’t come in sealed envelopes. For this analyst those marching orders came on October 5th 2018 with Mike Pence’s speech at The Hudson Institute. Today they come very openly in tweets from the US President. It is increasingly clear what is ‘on the other side of the hill’. Are you marching? Where are you marching to? If you aren’t marching, may I beg to suggest that you are engaged in ‘altering the environment until one’s conduct appears adequate to it’. Fall in.
Important Legal and Regulatory Disclosures & Disclaimers

This research is for the use of named recipients only. If you are not the intended recipient, please notify us immediately; please do not copy or disclose its contents to any person or body as this will be unlawful.

Information and opinions contained herein have been compiled or arrived at from sources believed to be reliable, but Orlock Advisors Limited does not accept liability for any loss arising from the use hereof or make any representation as to its accuracy or completeness. Any information to which no source has been attributed should be taken as an estimate by Orlock Advisors Limited. This document is not to be relied upon as such or used in substitution for the exercise of independent judgement.

At Orlock Advisors Limited we are committed to protecting your privacy. Our Privacy Policy explains when and why we collect personal information about people who receive Russell Napier’s written research or contact us; how we use it, the conditions under which we may disclose it to others and how we keep it secure. It also contains information how to make a Subject Access Request.

If you wish to receive a copy of this policy or have any questions regarding it, please send an email to dataprotection@orlockadvisors.co.uk

© 2019 Orlock Advisors Limited

Postal Address: Newbattle House, Newbattle Road, Newbattle, EH22 3LH
Scotland

Registered Address: 6 Logie Mills, Beaverbank Business Park Edinburgh, Lothian EH7 4HG, Scotland

Company Number: SC36220