Seeing ‘the fifteenth rock’ on October 24th - with Great Power comes Great Competition (21.10.19)

Last week your analyst visited the Ryoani-ji Zen temple in Kyoto. It is most famous for its *kare-sansui* Zen temple garden composed of 15 rocks amongst perfectly raked gravel. From any angle, apart from above, only fourteen of the rocks can be seen at any one time reminding us all that man is not perfect.

Most investors would be delighted to see fourteen out of the fifteen rocks of our investment future and in the modern era the complicating factor is that so many of the rocks, seen but mainly hidden, do not relate to the simple capitalist equation of supply and demand. Many investors prefer to ignore the political rocks on the horizon and below the surface, on the basis that they are ultimately of no consequence to the supply and demand equation and thus the valuation of financial assets. *The Solid Ground* continues to disagree with this form of calculus and believes that a new cold war has broken out between the US and China, and that this fifteenth rock is the most important rock in the garden.

Those still sceptical need to pay attention to the fact that on October 18th the Wilson Center announced that on October 24th Vice President Mike Pence will deliver the inaugural Frederic V Malek Public Service Leadership Lecture at the Conrad Hotel in Washington D.C. According to a press release from the Wilson Center, ‘the topic is expected to be the future of the relationship between the United States and China’. I’ll bet it will. Rocks come in all shapes and sizes these days.

Why should a speech by the US Vice President, delivered at just one week’s notice, be the fifteenth rock for investors? It is important but largely unseen because this is the much anticipated follow-up speech by the Vice President to his full frontal ideological attack on the PRC at the Hudson Institute in October 2018. Just days later your analyst sat on an investment panel with Baron Richards of Herstmonceux, former Chief of the Defence Staff for the UK. When asked what he thought of Pence’s speech he responded, “Oh, the declaration of war.” The audience was primarily family offices and, as they laughed at the answer, Baron Richards was taken aback at the reaction. He clearly did not mean it as a flippant comment! Pence’s follow-up speech was originally scheduled for June 4th 2019, the 30th anniversary of the massacre at Tiananmen Square. The speech was cancelled because it was judged to be too incendiary, given the on-going trade negotiations. Now it is back on.

It is, of course, possible that Mike Pence will conduct a complete **volte-face** from his ‘declaration of war’ of October 2018. While possible it is not likely, so investors should buckle up for some strong words on October 24th. The timing is important. It comes as the US and China struggle even to agree the so-called ‘Part One’ of the trade deal which offers a win for neither side. While most investors continue to see Mike Pence as the ‘bad cop’ as part of the good cop/bad cop routine on China with the President, few if any see the VP’s speech as the herald of a new Cold War. With Elizabeth Warren’s ‘Plan For Economic Patriotism’ now crowding the President’s tough-on-China stance, the temptation for the Trump administration to become even tougher on China, on factors much wider than trade, is becoming very strong. We shall see whether Pence’s October 24th speech is the clarion call that seeks to rally voters to face a newly proclaimed ideological enemy, for which the October 2018 speech set the scene.

If this is largely the same speech that Pence sought to deliver on June 4th, then the timing in late October, just a few weeks before the APEC meeting, is important. It has been very clear from the travel schedule of US Defence officials that the US is seeking agreement with Asian partners to deploy short to medium-range ground-based missiles on their territory. In a trip to Asia, which began the day the US left the INF treaty, Mark Esper, US Secretary of Defense was clear as to the key reason for his visit to Asia:

*Secretary of Defense Mark T. Esper Press Conference August 2nd en route to Australia*

Sec. Esper: *My first trip. And as such, I wanted to make sure that I went to what is*
our priority theatre based on the National Defence Strategy, which says that we are now in an era of great power competition. And our strategic competitors are China and Russia, principally in that order.

Q: Mr Secretary, just on the INF Treaty, just wondered if you could, just maybe, clear up some of the details.....

Sec. Esper: So, the best answer is, sooner rather than later, we want to develop this capability and making sure we can have long-range precision fires, not just for that theatre, but for the theatre we’re deploying to as well, because of the importance of great distances we need to cover, and how important an intermediate conventional weapon would be to the Asia-IndoPACOM theatre.

Q: Mr Secretary, are you considering at any point in the future deploying ground-based, intermediate-range missiles in Asia?

Sec. Esper: Yes. I would like to. But let’s be clear, I’m talking about conventional weapons.

Q: And in terms of timeline, are we talking years?

Sec. Esper: That’s what we’re just discussing. I would prefer months.

Q: And do you have a sense of maybe where?

Sec. Esper: I wouldn’t speculate because all those things depend on our plans. Those are things we—you always discuss with your allies.

Mike Pence’s speech will come just before the US meets all its allies in the Pacific at APEC in the middle of November in Chile. Playing up the scale of the China threat ahead of that meeting could be seen as adding to the pressure on those allies to accept the ground-based intermediate-range missiles that the US wants to deploy in Asia within the ‘months’ stated by Secretary Esper. The so-called ‘Quad’ - the US, India, Australia and Japan - will likely meet separately in Chile and defence will be top of the agenda. The Pence speech could hope to encourage other US allies to get off the fence and choose sides in what Secretary Esper calls the ‘era of great power competition’.

To stress again, this means that Asian countries ultimately no longer get to trade with and invest in both China and the US. They do not get to accept investment from both. The more the ‘era of great power competition’ dawns, then the quicker those countries who seek their defence ultimately from the USA will have to more clearly side with US defence policy and other issues. In the opinion of your analyst, Pence’s speech will set the agenda that increasingly will force allies to declare themselves more clearly as allies. While that has global implications, it has particularly negative implications for Asian economies and growth assets that have benefited heretofore from playing both sides of the table.

So the Pence speech may not just signal the end of any prospect of a material trade deal between the US and China, but also make it clear to investors that Asian equities are more than just collateral damage in the new ‘era of great power competition’. If any of the US’s Asian allies accept US ground-based intermediate weapons, then it is highly unlikely that China will continue to follow its current policy which is widely assumed to be one of waiting Trump out. While he might indeed go away through the ballot box or via impeachment, it is highly unlikely that the China containment policy, best exemplified to China by the current moves to place US intermediate-range, ground-based missiles in Asia, will not go away. The besieged are never as passive as they may look. Alliances are sought, stores laid up and the sally ports readied for possible action. The markets see an active besieger and an inactive besieged and thus are not ready for the action to come.
It was supposed to be Joseph Stiglitz who once remarked, ‘the only perfect hedge is in a Japanese garden.’ Well, I have seen a few of those hedges in the past week and even they are never as perfect as they seem. How do you hedge against the consequences of the ‘era of great power competition’? Subscribers will know that The Solid Ground has many suggestions. However, most obviously, investors must prepare for the full economic and market consequences of a flexible Chinese exchange rate. The very fact that China is prepared to discuss exchange rate stability as part of its trade negotiations suggests to this analyst that those negotiations are not serious.

Few countries, and certainly not one with China’s command economy infrastructure and rapidly rising debt-to-GDP ratio, could offer to so restrict their monetary policy flexibility. The idea that China will continue to link its currency largely to the USD, whether directly or indirectly through the inclusion of other currencies linked to the USD in its basket, in an ‘era of great power competition’ seems fanciful. Pence’s speech on October 24th will likely make it even clearer that this particular form of monetary system is coming to an end and the consequences remain initially very deflationary. In the 4Q Solid Ground the very different longer-term consequences of this change will be made, but between now and then investors need to prepare themselves for a speech on October 24th which for this investor constitutes the 15th rock.
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