Russell Napier - The Solid Ground Fortnightly - Desolation Row: Which Side Are You On? - 10th October 2018

Praise be to Nero's Neptune, The Titanic sails at dawn

Everybody's shouting, "Which side are you on?!"

Desolation Row: Bob Dylan (1965)

While the world watched the Kavanaugh confirmation drama in Washington DC last week, there was something even more important happening at the other end of Pennsylvania Avenue. In a speech at the Hudson Institute, the Vice President of the United States of America clearly spelled out why his country's disputes with the People's Republic of China go far beyond the realm of trade. If you think US relations with China can return to where they were eighteen months ago, then it is time to think again. The US has China in its sights and even a compromise on trade will not be a sufficient compromise for this administration.

While a bit of sabre rattling ahead of midterm 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. Only by watching this speech can you get a true sense of the belligerence and conviction with which it was delivered. https://www.youtube.com/watch?v=aeVrMniBjSc

For those of you who do not have the 43 minutes needed to watch the speech, the following excerpts provide some indication of the extent to which the United States of America now sees itself in conflict with the People's Republic of China:

The dream of freedom remains distant for the Chinese people. And while Beijing still pays lip service to "reform and opening," Deng Xiaoping's famous policy now rings hollow.

China now spends as much on its military as the rest of Asia combined, and Beijing has prioritized capabilities to erode America' s military advantages on land, at sea, in the air, and in space. China wants nothing less than to push the United States of America from the Western Pacific and attempt to prevent us from coming to the aid of our allies. But they will fail.

America had hoped that economic liberalization would bring China into a greater partnership with us and with the world. Instead, China has chosen economic aggression, which has in turn emboldened its growing military.

As history attests though, a country that oppresses its own people rarely stops there. And Beijing also aims to extend its reach across the wider world.

The American people deserve to know: in response to the strong stand that President Trump has taken, Beijing is pursuing a comprehensive and coordinated campaign to undermine support for the President, our agenda, and our nation's most cherished ideals.

China is also applying this power in more proactive ways than ever before, to exert influence and interfere in the domestic policy and politics of this country.

And worst of all, China has initiated an unprecedented effort to influence American public opinion, the 2018 elections, and the environment leading into the 2020 presidential elections. To put it bluntly, President Trump's leadership is working; and China wants a different American President.

There can be no doubt: China is meddling in America's democracy.

To that end, Beijing has mobilized covert actors, front groups, and propaganda outlets to shift Americans' perception of Chinese policy. As a senior career member of our intelligence community told me just this week, what the Russians are doing pales in comparison to what China is doing across this country. And the American people deserve to know it.

Next month, it will be my privilege to represent the United States in Singapore and Papua New Guinea, at ASEAN and APEC. There we will unveil new measures and programs to support a free and open Indo-Pacific. And, on behalf of the President, I will deliver the message that America's commitment to the Indo-Pacific has never been stronger.

More business leaders are thinking beyond the next quarter, and thinking twice before diving into the Chinese market if it means turning over their intellectual property or abetting Beijing's oppression. But more must follow suit. For example, Google should immediately end development of the "Dragonfly" app that will strengthen Communist Party censorship and compromise the privacy of Chinese customers.

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.

In the new quarterly report (Can China Reflate The World? 3Q 2018) The Solid Ground analyses the prospects for a shift in the Chinese exchange rate regime with initially deflationary impacts but ultimately prolonged inflationary consequences. While investors wrestle with these profound financial problems, there is a growing problem for the nations of Asia - "Which side are you on?" That's also a problem for investors.

Most of the countries of Asia rest under the US defence umbrella. Mike Pence's speech makes it very clear that anyone who benefits from such protection will be expected to take the side of the USA in its multi-faceted disputes with the People's Republic of China. A speech marked by this level of belligerence does not leave room for Asian countries to have one foot in the USA's defence camp and the other in China's economic/financial/monetary camp. That will become clear at the meetings of ASEAN and APEC scheduled for the second and third weeks of November. The Asia that rested under the US defence umbrella, but increasingly orientated its economic policy towards China, is increasingly under political threat. Pence' s speech suggests that such economic alignment will not be acceptable to a USA determined to confront China on so many levels.

A particular challenge for Asian countries is how they might respond if the RMB is de-pegged from its basket of currencies, dominated by the USD and its surrogate currencies, and seeks to run a truly independent monetary policy. Should the RMB devalue as it most likely would, at least initially, would the US find it acceptable if Asian countries managed their exchange rates to also devalue with the RMB relative to the USD? To do so would lead the Asian authorities to increasingly accumulate RMB as part of their foreign reserve assets - very directly funding the Chinese government. Indeed, such a shift on a more global basis would create perhaps greater purchases of Chinese government debt than purchases of US government debt on an ongoing basis.

While the USD would continue to dominate the holdings of reserve assets, crucially the so-called 'exorbitant privilege' of having foreign central banks buy newly-created government debt might pass to China. How will the owner of the USD react to such a shift? In particular, will those Asian countries that rely upon the US for their defence be allowed to re-orientate their exchange rate/monetary policy increasingly towards China and away from the USA? Your analyst expects that this issue and many others will be raised at the ASEAN meeting in the second week of November and at APEC the week after. If nothing else, expect the USA to demand more public support from its Asian allies, perhaps even more clear military co-ordination.

The consequences of such demands are negative for Asian equity markets as investors will realise their increasing inability to run low defence spending while also benefiting from China's economic development. This pain comes on top of the ratcheting up of the liquidity pressure from larger US fiscal deficits and a contraction of The Fed's balance sheet. If the RMB is allowed to float, as part of the gathering Chinese reflation, then all emerging markets face an even more painful adjustment. While their economic self-interest is clearly to manage, at least partially, their exchange rate relative to the RMB, their defence interests lie with the USA. How such dual allegiances are managed will be a key driver for financial asset prices in emerging markets for at least the next decade.

You, dear reader, are also likely to fall under the scrutiny of the US administration. The extent to which free capital movement into China will be permitted by the US administration now has to be questioned. Already the administration is persuading US corporations they need to co-operate with the US Government to ensure that US intellectual property is protected and also that US technology is not used for the suppression of freedom in China. It is perfectly reasonable to presume the next step will be that portfolio investors are not expected to invest in Chinese corporations that the US administration deems to be culpable in any of the numerous areas where the US administration is in conflict with the People's Republic of China.

In two weeks visiting clients, your analyst has heard the phrase 'weaponising the dollar' in meeting after meeting. It is clear that it's not just criminals who fear the long arm of the US law reaching across the globe by impacting anyone who transacts or holds a USD. As Stanley Druckenmiller recently said during his excellent interview on RealVision, the US government has found the weaponisation of the USD the way a child might find a water gun. They seem to be having great fun using it, it is having the desired effect and they are looking for new targets. You might be next.

Meanwhile in Washington DC another department of the US government, the Treasury Department, seeks to sell circa US$1trn of US treasury securities per annum. At the same time the US Federal Reserve, also of Washington DC, is now liquidating its securities portfolio at the rate of US30bn per month or US$360bn per annum. The Solid Ground has long argued that this combined sale of treasury securities would have profound impacts in the USA and also offshore (Crowding Out: Higher US Real Rates and Lower Inflation 1Q 2018). In particular, the focus was on the adjustment that these sales of treasuries would have far from US shores:

There is thus a downside for global growth if the funder of the US government is to be the foreign saver, particularly if that saver is removing capital from the exchange rate management regimes. That downside is not just the direct dislocation associated with diverting capital from funding domestic growth but importantly the monetary impact in dampening the growth in local currency, commercial bank reserves and ultimately the supply of broad money supply.

So far it seems like the foreign saver has played a key role in funding the US government with dire consequences for emerging market asset prices. However, did this begin to change last week? In a world where US interest rates are not high enough to attract foreign savers, many of whom live in jurisdictions with either very low rates of interest or growing prospects of material debt defaults, then US interest rates will have to rise to a level high enough to attract US savers. All savers who want to buy US treasuries are faced with only two options: either save more or liquidate other savings assets to fund the purchase of treasuries.

Last week it seemed that the yield on treasury securities finally got to the level where it is luring savings from other US domestic savings assets, such as equities, and into treasuries. Your analyst expects that this is a temporary problem and that foreign inflows to the US, where the two-year treasury yield is now close to 3.0%, will accelerate in the weeks and months ahead. By watching the USD investors can track whether the capital is indeed arriving and whether the funding holiday of their own government, which US citizens have long enjoyed, returns.

In assessing the attractiveness of the US treasury market, investors have to be very aware of the continued breakdown in the Eurozone. At the weekend Luigi Di Maio, Deputy Prime Minister of Italy, made it very clear that the far left and far right, exploiting the absence of moderate British MEPs in the next European parliamentary elections in May 2019, would gain control of policy making in Europe. They expect to overrule the current incumbents and reverse rules that enforce fiscal discipline across the Euro area. The greatest fear of the Germans will then have come to pass, that the rest of Europe gets to use ‘their’ currency to adopt policies of unfettered fiscal largesse.

This new alliance of the far left and far right comes as the CDU/CSU alliance is pushing back against the Chancellor in refusing to accept her nomination to run the parliamentary party - the first defeat for a Chancellor on such an issue since 1973. The CDU/CSU are being pushed further to the right by the rise of the AfD, appointing a more fiscally conservative candidate to run the parliamentary party, and are in no mood to allow what they see as fiscal transfers from Germany to the rest of Europe. If you see this as a recipe for success then you can buy German Two Year Bunds yielding minus 52bp or you can jump out the risk curve and buy similar maturity Italian bonds yielding 159bp! An alternative would be to buy two year treasuries yielding 286bp.

The far right/far left coalition in the European Parliament that Di Maio confidentially predicts for May 2019 is a prediction for a huge constitutional showdown between the centrists and the sovereignists of Europe. While the world has fixated on the impact of Brexit for the UK, the real impact has been to tip the balance of power in Europe towards a far right/far left coalition whose policies are incompatible with the survival of the Euro. It is a showdown that the Euro is very unlikely to survive and the yield on the two-year treasury is likely to appeal even more to global investors as this drama develops. Last week there was probably a dearth of foreign savers willing to buy US treasuries. We shall see this week whether the rise of the immoderate in Europe will rekindle foreigners' thirst for US treasuries.

To be clear, the US cannot run on other people's savings forever. While the stars are currently aligned to suck in significant capital at still low nominal and real rates, this will not always be the case. In particular the change in US relations with China and the increasingly likely float of the RMB can result in a redirection of reserve asset flows that will pose severe long-term problems for the US economy and in particular its asset prices. However, at this stage those savings are flowing to the US and perhaps having the same impact on the global economy as Barry Eichengreen noted such flows had in 1927 (Golden Fetters: The Gold Standard and the Great Depression 1919-1939), deflating the rest of the world long before the US asset market bubble burst.

Whether we are witnessing a re-run of 1927 or whether it is already 1929 for US asset markets will depend very much upon whether the country can continue to access savings from abroad. If the flow of capital to the US depresses growth outside the US, and thus inflation, it might cap the US yield curve while having little impact on domestic economic growth. A low risk-free rate and a high growth rate are the key ingredients for the 'melt-up' that Jeremy Grantham forecast in January this year and that we witnessed in the US during the Asian economic crisis of the late 1990s. Investors' best chance of assessing the likelihood of this 'melt-up' is by watching treasury yields and the USD exchange rate. A stabilisation of the USD and stable or falling treasury yields would indicate that the foreign savings are arriving and treasury yields can be capped while strong domestic growth continues. Should the USD fall, expect higher treasury yields, a diversion of domestic savings to treasuries, and a weaker US equity market.

Investors have ignored politics in the post-GFC world and for good reason: the political shifts across the globe appear to have had very limited impacts on asset prices. This, however, was a phoney war when, primarily through the slow pace of ballot box change, the new politicians were aligned to confront the status quo. These new politicians have now broken through, particularly in Europe, and they have one goal - to destroy that status quo. Readers of The Solid Ground are not part of the solution to these new political leaders, they are part of the problem. The era when you wondered about political impacts on financial markets will not go away, but now you also have to consider political impacts on you. Politicians are drawing lines in the sand and they know which side you are on. Welcome to Desolation Row.