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The 21st Century Arms Race

History has been marked by periodic arms races – competitive rapid increases by rival states in peacetime in the quantity or quality of instruments of military power. The most famous was the contest between Germany and Britain to build battle fleets more than a century ago. Others have included the rival naval programmes of Japan and the US to dominate the Pacific, and the hegemonic struggle between the Soviet Union and America to achieve military dominance in the Cold War.

Sometimes these contests led to monstrous armed conflicts – the first and second world wars. Others eased into peaceful resolution.

We now seem to be in the early stages of a new arms race. China and the US are both seeking to dominate the weapons of the modern era – the hardware and software of information technology, which are becoming the keys to superiority in both military capacity and economic power.

America is currently the world leader in both. China is the challenger, determined to match and then overtake the US as the global hegemon. China's economy, says Bank of America strategist Francisco Blanch, is already in size close to the US's in dollar terms, "even bigger" than it in purchasing-power terms.

In terms of conventional military technology, America has a huge lead. It has 20 aircraft carriers, for example; China has two. But the key to future dominance in both military and economic power is going to be an unchallengeable lead in infotech, in design and manufacture of microchips.

China has taken the lead in development in one of its key areas – telecommunications. Its Huawei company is reckoned to be the global leader in 5G, the next generation of network technology that will revolutionize interconnectivity – 20 times faster than the current mainly-used 4G.

Huawei has been targeted by the US because of fears that its equipment will provide backdoor access for the Chinese government to information and operations – including the military secrets – of any country where it is installed. Washington won't allow its 5G system to be used in the US, and has demanded that its allies follow suit. Japan and Australia have agreed. Germany, France and the Netherlands have refused. Britain is equivocating.

Clearly, different countries' security establishments have conflicting views about the risks of allowing Huawei into their stables for fifth-generation systems.

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Refusing to use Huawei's 5G also has economic implications. Doing so amounts to failing to install what's best and cheapest. This issue is particularly challenging for countries already using the company's 4G equipment, because switching to other companies' 5G not compatible with existing 4G infrastructure would be very costly.

Recent developments suggest that American policy is not just about security issues, but part of a broader strategy to prevent a Chinese takeover of the world's fast-developing infotech sectors, including not only telecoms but also artificial intelligence, robotics and internet-of-things.

The US has blocked the sale to Huawei of American technology. This is a serious threat to the Chinese giant as it has great reliance on some critical American components in many of its products. It is the world's largest supplier of telecom networking equipment and the second biggest of smartphones (after Samsung).

Google, whose Android operating system powers about four-fifths of the world's smartphones, has announced that it will cut ties to Huawei, which will no longer have access to updates to its smartphone apps. That will discourage buyers of its phones.

Major American suppliers, including chipset manufacturers Qualcomm, Intel, Qorvo and Texas Instruments, and software firms Oracle and Microsoft, are reported to have suspended sales to Huawei, whose own chip design arm, Hisilicon, has been cut off from critical tools that it needs to function.

America's allies are falling into line. For example Arm, the UK-based but Japanese-controlled world leader in mobile chip design, has stopped licensing its technology to Huawei.

So far China has resisted taking counter-measures to punish American companies, such as banning sales of the rare earths whose supply it dominates, or penalizing Apple, which would be particularly vulnerable. Nearly a fifth of its sales are in China, and it relies heavily on Chinese factories for its production.

If Beijing were to organize a consumer boycott such as it imposed so successfully on South Korean products for political reasons, Apple could lose as much as a third of its worldwide profits. If it implemented supply restrictions, that would force Apple to re-engineer its entire global supply chain. That would be devastating.

Global dominance in six years is the aim

The *FT* reports that the US ban on infotech trade with China could be a problem for Google as its Android system is "central to the smartphone market in China, which is bigger than Europe and the US combined, due to its use by Huawei and other [Chinese] phonemakers include Oppo and Xiaomi."

Chinese president Xi Jinping has spoken openly about his plans for China to gain global dominance in future high technologies in just SIX years' time. Their foundation will be China's capacity to design and manufacture cutting-edge semiconductor chips. $150 billion is being poured into achieving that. However, so far subsidies and tax breaks have only lifted China's self-reliance in low-value chips.

The Americans are clearly using the current "trade war" to hinder Xi's ambitious plans by demanding that the Chinese cease their theft of intellectual property, and of using their negotiating power to force technology transfers as part of the price of allowing joint ventures to operate in their huge domestic market. 20 per cent of European companies doing business in China, for example, say they are compelled to hand over technology to Chinese partners.

It's unlikely the Americans will succeed in getting the Chinese to play fair. Agreeing to trade-balancing deals would be one thing. Agreeing to stop their massive co-ordinated attack on the heights of leading-edge industries would be something else. It's certain they'll renege on any promises about that they have to give.

Ironically, cutting Chinese access to American components and technology, or merely threatening to do so, is the strongest incentive of all to stimulate Chinese development of high-tech sectors.

Investors have generally taken the view that the ugly contest beween Trump and Xi will be resolved in a "deal" that the American president can claim to be a victory, but Xi can present as a fair agreement. That still seems to be the likely outcome.

As for the arms race… that still has much further to run. It will be a key part of the long-term strategic contest between the hegemon and its fast-growing global challenger.

Sound Money with a 5,000-Year Record

Economic and social conditions favour another bull market in gold – its price is already at or close to highs in other currencies such as the euro and Australian dollar – while technical analysis suggests "conditions for the establishment of the new bull market seem excellent." That's what the well-known Liechtenstein investment company Incrementum says in its latest annual study of the yellow metal.

An important signal was its performance at the end of last year as a good portfolio diversifier. Stock markets plunged, but gold rose 8 per cent for the quarter, while gold mining stocks went up almost 14 per cent.

The metal currently trades around $1,340 an ounce. If it surpasses $1,360/80 – a key chart resistance level – leading to increased interest by institutional investors, a price of $1,800 "seems within reach in the medium term." If things go seriously wrong with the world economy, gold could go as high as $5,000.

Conditions favouring a bull market include:

► The erosion of trust. The global business system based on a complex web of supply chains is starting to break down. Increasingly people no longer trust established institutions or political parties, no longer believe mainstream media. There is crumbling trust in the currency that is the foundation of the global monetary system, the US dollar.

► Recession risks are significantly higher than discounted by the market. "In the event of a downturn, negative interest rates, a new round of QE (quantitative

easing), and the implementation of even more extreme monetary policy ideas (such as MMT) are to be expected."

► The asset traditionally held to offset the risk in equities – bonds – have lost their attraction as portfolio diversifier because of high debt levels, "zombification" of economies (profit margin growth without labour productivity growth, squeezing more earnings through tax arbitrage or balance sheet arbitrage), and very loose monetary policies that have produced ultra-low interest rates.

► In the US the Left wing of the Democratic party is strengthening and increasingly flirting with questionable monetary experiments. "A Democratic victory in next year's presidential election could bring on the perfect storm for the US economic model."

► Political and economic tensions between the US and China are increasing. These and other uncertainties, such as the worsening Iran situation, should support the gold price. Central banks are increasingly preferring to keep their foreign reserves in gold rather than currencies, with the biggest purchases since 1971.

Hungary's central bank has said about gold that it can act "as a major line of defence under extreme market conditions, or in times of structural changes in the international financial system, or deep political crises.

"In addition, gold continues to be one of the safest assets, which can be related to individual properties such as the limited supply of physical precious metal, which is not linked with credit or counterparty risk, given that gold is not a claim on a specific counterparty or country."

No wonder, Incrementum reminds us, that gold has a 5,000-year history as sound money.

Politics Can No Longer Be Ignored by Investors

Until now canny investors have known that they could largely ignore media hysteria about political developments. No longer, says well-known American commentator Mohamed El-Erian. Markets are increasingly sensitive to "politically-induced interference and the weaponization of economic tools."

Yields on US government ten-year bonds have fallen below 2.10 per cent, "bringing the differential with three-month bills – a classic sign of economic trouble ahead – to its widest level since 2007." In Europe German government bonds are trading on yields of a negative 0.20 per cent. (Globally the stock of bonds trading on negative yields has expanded to $11 trillion).

Worldwide, share markets are falling in response to fears reflecting "growing recognition of messier politics contaminating the economic outlook." In Europe the outcome of elections enhances doubts about governments' ability to implement pro-growth policies. "Stall-speed" growth of less than 1 per cent "is a real and present danger for Europe."

Things do look better in the US, but its prospects are not immune to tensions over trade and disputes such as Mexico's migrant flow policies. "The best that can be

hoped for is a tentative ceasefire amid a growing threat of an all-out global trade war."

El-Erian says "scrappy politics and deteriorating economics" could feed on each other and intensify volatility in investment markets.

There is a growing likelihood that investors face a world where a higher political premium must be priced into the outlook for corporate earnings. A pronounced shift towards separate American and Chinese technology standards, with both countries pushing national champions, resulting in duplication of research efforts, could also hamper economic growth.

Investors face the prospect that companies that have enjoyed the benefits of global supply chains, and squeezing the best out of technological progress, may have to radically alter their business models, says British commentator Michael Mackensie. Hopefully there will be nothing worse than a short-term disruption, that entails a weaker period of earnings growth – and at a time when the business cycle has entered a delicate period, buffeted by rising costs such as employee wages."

Invaders Pour Across the US Border

It's not surprising that US president Donald Trump is being driven to adopt radical measures to stem the flow of migrants flooding in across his country's southern border. More than 144,000 illegally crossed in or were refused entry in May, the most in a single month in at least five years, and nearly three times as many as in the same month last year.

Customs & Border Protection officials said that holding cells are "bursting at the seams" because of overcrowding. "We are in a full-blown emergency, and I cannot say this stronger: The system is broken," said acting CBP Commissioner John Sanders.

Most of the migrants are families, which poses a particular problem for border police. In many cases children don't in fact belong to their claimed parents but are attached to them by traffickers as means to ease the adults' acceptance at the US border. And there aren't enough detention centres certificated to hold families.

In terms of a controversial court ruling, families with children may not be detained for more than 20 days. So many of them are simply released into the community to await processing by immigration courts of their asylum applications. The courts are so backlogged that it can take months, even years, for cases to be decided. And many immigrants just don't show up at court. The system amounts to acceptance of large-scale illegal immigration and discrimination against those who arrival legally.

It has so far proved impossible to change immigration law to make it easier to stem the flood across the southern border because of Democrats' vociferous hostility to any reforms proposed by Trump. For example, they wage an ongoing battle to prevent building a wall along the southern border, even though parts of it were walled years ago… by a Democratic presidency.

"Immigration is a very divisive issue on any country," says Eoin Treacy, "and pushing the onus for action on to Mexico because the US is incapable of having a rational conversation about the subject is a desperate move."

I suspect that in next year's presidential election it's the issue, more than any other, that could deliver victory to Trump.

Investing in Japan

The founders of American private equity specialists KKK now regard Japan as their "highest priority" outside the US. It's "the best value today if you look at value [relative to] price and cost of capital," says Henry Kravis. KKK is looking to buy businesses sold off by Japanese conglomerates like Hitachi, Toshiba and Panasonic that are seeking to jettison non-core subsidiaries.

Jan Pstrokonski, manager of the Samarang Japan Value Fund, which invests in undervalued small- and mid-cap companies, says they're buying some that "would surely be very expensive in the West" but at "ordinary" valuations.

Examples: A sewage consultancy developing drone systems for utilities; a company using growing cashflow from monthly broadband contracts to invest in infotech services such as security cameras; a firm providing accommodation for salarymen on business trips; a logistics specialist controlling major chemical tanker storage sites; a business that's dominant in supply of raw materials for UV-protective cosmetics.

The Japanese currency, the yen, seems likely to continue weakening this year. Japan continues to "print" money on a massive scale to buy bonds and equities. In addition, domestic investors will receive the equivalent of $400 billion from redemption of maturing government bonds.

Leo Lewis reports that the current lack of options for institutional investors to employ this avalanche of money is "striking." Yields on Japanese government bonds are in negative territory for all maturities ranging up to ten years.

Consequently a "very significant proportion" of the cash avalanche "is going to chase higher-yielding assets overseas, mostly in the US and Europe." That leaves the yen facing downwards pressure from Japanese institutions' capital outflows over the coming months.

Eurozone Will Face an Italian Crisis

Italy's failure to achieve economic growth since it signed up for the Eurozone in 1999 – real GDP per head has averaged only 0.1 per cent a year since then – is the "existential threat" to the euro system, one strengthened by the huge gains made by the ruling League party in the European elections, says Christopher Wood of *Greed & Fear.*

Most Italians support League leader Matteo Salvini in his fight with the European Union's Brussels bureaucracy over fiscal deficits and state aid for Italian banks. He wants to do more to boost economic growth. Brussels opposes measures that would breach EU/Eurozone limits, in particular the 3 per cent of GDP fiscal deficit ceiling set by the 1992 Maastricht agreement.

Wood suggests that following the European elections Salvini is in a stronger position to demand that the Maastricht treaty is reformed. France will probably support Italy. Some Italian economists are arguing that Italy should circumvent Eurozone restrictions by issuing tradeable tiny-denomination government bills that would amount to an alternative currency.

Wood argues that if the constraints on Italy's economic growth imposed by euro membership trigger a political crisis, it would force Germany and Brussels to face the problem of unwinding the Eurozone's bloated Target-2 system. Should Italy abandon the euro and revert to its old national currency, the lira, the huge liabilities of the Italian central bank (now about €480 billion), matched against the huge claims of the Bundesbank and other northern European central banks, would have to be reconciled.

Experts Confirm False Flag Trap in Syria

There are further reports supporting the view that the official story used by the US, UK and France to justify their massive air strikes against Syrian government installations in April last year -- as punishment for its supposed use of poison gas against civilians in Douma -- was false.

At the time I cast doubt on the story. I said there was conflicting evidence. It could be that what happened was a staged event by rebel forces that planted evidence to blame the Assad regime for using chemical weapons. There was already evidence that the rebels themselves used such weapons.

Now a report has been leaked that inspectors of the global agency Organization for the Prohibition of Chemical Weapons have concluded that the story that Assad's helicopters dropped poison gas was scientifically implausible. There is a higher probability that the two cylinders supposedly used to deliver such gases were "manually placed" there.

The American scientist who is a leading expert on false military claims, Theodore Postol, says "the evidence is overwhelming that the gas attacks were staged." In other words, it was a false flag operation. By whom? We don't know. But it seems likely the perpetrators were anti-Assad rebels… with the connivance of American or allied intelligence agencies.

The Donald's War Against Bureaucracy

Mainstream media continue to ignore one of the most important benefits of Trump's unconventional presidency – destruction of a wave of excessive/unnecessary regulation.

The burden of federal red tape inherited by Trump, according to the Competitive Enterprise Institute, was costing almost $2 trillion a year – about $6,000 per American, or about 10 per cent of GDP.

Trump's government has been eliminating two regulations for every new one. And the number of new rules introduced has been the fewest since records began in the 1970s.

The Obama administration imposed more than $100 billion of additional regulatory costs each year, hurting businesses so much that by 2016 – Obama's last year in office – 74 per cent of American manufacturers reported that they were operating in an "unfavourable business climate." After two years under Trump the proportion of discontent fell to 18 per cent.

The unemployment rate is now the lowest in 50 years, employment of traditionally disadvantaged minorities such as Afro-Americans is at record levels, while consumer confidence is at the highest level in almost two decades.

Risks in the US/China Conflict

The trade war: When will it end? Morgan Stanley strategist Michael Zezas says: "Both sides will continue to escalate until clear market or economic weakness pushes them to disengage. This isn't posturing. Meaningful disagreements exist."

At this stage, both sides see escalation as preferable to meeting the other's demands. The conflict is driving down risk-asset values and US bond yields. But a three- to four-month extension of current tariffs could cut economic growth by 20 basic points in China and 30 in America.

A longer period of tension, including fresh tariffs on $300 billion of remaining China exports to the US, would put 100 basic points of global economic growth at risk and push the Fed into several cuts in interest rates.

Investors generally, Zezas warns, "under-appreciate the downside impact of such scenarios."

Asia Shows the Way

The Asian development model, pioneered by Japan and copied by China, South Korea and Taiwan, "treats capital-intensive industry as infrastructure," says American economist and commentator David P Goldman. "It supports chip foundries with public funds the way we Americans subsidize airports or sports arenas."

The result is that virtually all the high-tech products invented in America are now manufactured in Asia. Liquid crystal displays, light-emitting diodes, semiconductor lasers and solid-state sensors are produced almost exclusively in Asia. America's share of semiconductor manufacturing fell from 25 per cent in 2011 to less than 10 per cent in 2018.

But, Goldman warns: "Silicon is to the weapons of the 21st century what steel was to the 19th century. A country that cannot produce its own integrated circuits cannot defend itself."

Tailpieces

Investing in Brexit: Christopher Wood (previously with CLSA, now with the American investment bank Jefferies) says British assets now offer a good risk/reward trade, "particularly for those investors taking advantage of a cheap sterling."

The outcome of the ongoing Westminster political soap opera, he predicts, will probably be either a referendum offer two contrasting options – a no deal or no Brexit at all – or Britain will simply crash out of the European Union on October 31.

“The first option will offer resolution, whichever way the vote goes, which is what markets want. The second will be nothing like the disaster predicted by the establishment, and will create a real bargain-buying opportunity for investors.”

Batteries: China has strong reasons to promote electric vehicles as it imports so much oil. Electricity is or can be largely generated using domestic resources such as coal.

The key to achieving domination for EVs is the aggressive move into manufacture of batteries by Chinese companies such as CATL (three giga-factories approach completion) and BYD.

This could lead to a major fall in prices, not only in China but worldwide. That’s what happened with solar cells when China set out to capture that market. The result was a lot of cheap capacity for generating solar power was installed, but share values plunged as margins evaporated.

Greenhouse gases: Slowly but surely, oil and gas companies are starting to look like cigarette firms (which have experienced an avalanche of anti-smoking legislation), but their defensive strategies such as carbon capture and storage projects are likely to be stymied by customers’ opposition to being asked to pay “premium prices for old-fashioned fossil fuels,” Paul Philips argues in *the FT*.

The answer isn’t renewable energy, which require back-up energy sources. Instead, “it will be interesting to see which oil and gas company has the guts to enter the nuclear power business first.”

Dividends: They grew almost 8 per cent to $263 billion in the first quarter, according to the Janus Henderson Global Dividend Index.

Payments broke all-time records in the US, Canada and eight other countries, but rose strongest in the Asia-Pacific ex-Japan region, where they expanded almost 15 per cent. Pharmaceuticals were the largest-paying sector, thanks to companies such as Novartis and Roche.

Wall Street: American shares have probably entered a poor risk/reward period because earnings growth over the next years is going to be “very low” and companies are fully valued, says investment bank Morgan Stanley.

The economy is slowing, as can be seen in the year-on-year growth rate, companies are experiencing negative operating leverage as costs rise, and there is an inventory build and capex bubble to work through. Trade tensions are a catalyst for higher risk premiums.

India: The Trump administration has terminated its designation as a developing nation that allowed its exporters to ship 2,000 products into the US duty-free. It’s retaliation for India’s increasingly protectionist policies impacting foreign companies’ freedom to operate in the country in sectors such as e-commerce, medical devices and dairy products.

Junk bonds: The *Wall Street Journal* reports that many large private equity firms are issuing them out of the English Channel island of Guernsey to avoid scrutiny of the financial condition of their companies. Guernsey falls outside the European Union's Market Abuse Regulation. Among the dark practices it was designed to prevent is selective disclosure of information to some investors, but not others.

A winning strategy: Higher-momentum stocks – those bought because they have been rising, as different from those bought for other reasons such as cheapness – have outperformed the US market by an average of nearly seven percentage points a year over the past decade, according to Style Analytics.

Wise words: *Socialists want socialism for everyone else, but capitalism for themselves, while capitalists want capitalism for everyone else, but socialism for themselves.* Llewellyn Rockwell.

Martin

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