

The Biggest Event Of 2020 (By Analogy With 2007) — by Louis Gave

What's the most important event of 2020? Easy, you will answer: the Covid-19 pandemic. Maybe. But will it really look that way in hindsight? Sure, Covid seems pretty momentous today. But years hence, will it really be seen as a key driver of structural change? Or will the most important event of 2020 be regarded as something else entirely?

To see what I mean, consider 2007. If asked at the time “what was the most important event of 2007 for financial markets?” most investors would probably have answered (and many probably still would) with one of the following:

1. February's profit warning from HSBC following record losses on subprime lending.
2. August's decision by BNP to freeze redemptions from three of its money market funds.
3. November's landmark, when oil prices broke above US\$100/bbl for the first time.

At the time, these fore-tremors of the 2008 shock caused much hand-wringing and many sleepless nights. However, with the benefit of hindsight, they pale into insignificance compared with a far more important event that had nothing to do with the financial crisis. In years to come, we might say much the same about 2020. But to see why, it is first necessary to revisit an old Gavekal idea that reserve currencies are like computer operating systems.

At Gavekal, we use Microsoft for two main reasons. First, almost all our clients use Microsoft—and naturally we want to be able to swap files with them seamlessly. Second, almost everyone else in our field uses Microsoft, which means any new team-member we hire will already be proficient in Word, Excel, PowerPoint and all the other products in the Microsoft suite. If we use Microsoft too, he or she will be able to hit the ground running.

For it to make sense for Gavekal to switch from Microsoft to another operating system, the other system would need to be much more than marginally better. It would need to be so good that all our clients, and all our potential employees, would be compelled to make the switch too.

The parallels with the US dollar are obvious. The US dollar is the Microsoft of the trading and reserve currency world. Everyone uses the US dollar because everyone else uses the US dollar. For any currency to replace the US dollar, the new currency would need to be not just marginally better, but many miles better. Today, nothing comes close. Consequently, the US dollar remains the cornerstone on which the global financial architecture is built.

Of course, over the last couple of decades Apple and Google have chipped away at Microsoft's dominance in the world of operating systems. Apple did so initially by focusing on niche markets. If you visit an architect's studio or a web design firm, all the personal computers are likely to be Apple. As Apple focused on capturing certain niches, it pretty much abandoned the big corporate IT system spend to Microsoft. But it completely blindsided Microsoft in another field—which brings me to what in retrospect really was the most important event of 2007: the launch of the iPhone.

With the launch of the iPhone, in a single stroke Apple successfully established iOS, a parallel operating system whose users were not the big corporates that until then had dominated global IT spending. Instead, the users of this new, parallel operating system were middle to high-end Western consumers

(and in time emerging market consumers too). With the iOS launch, Apple demonstrated that to displace a behemoth, you should not take it on at its own game. Instead, you should challenge it on a completely different field of play. Apple left the big corporate IT spend to Microsoft, and instead created a new, parallel operating system—and in the process created a new consumer market that turned out to be at least as big, if not bigger.

Why revisit this well-trodden territory? Because if the US dollar is the Microsoft of the global currency system, there is little doubt that in recent years China has tried to position the renminbi as its Apple. First, China tried to capture “niche” markets that were at best peripheral to the incumbent currency behemoth: financing intra-Asian trade, funding commodity imports into China, and financing infrastructure projects in places such as Myanmar, Sri Lanka and Pakistan where, historically, infrastructure projects have struggled to attract funding. But owning niche markets only gets you so far. If they are all you own, at best you will end up stuck somewhere between an “also ran” a “never was.”

Now, let’s accept that the US dollar has too many embedded advantages (not least, dominance of the SWIFT system) for the renminbi ever to be able to challenge the US currency at its own game. And let’s also assume that Xi Jinping is serious about establishing the renminbi as Asia’s principal trade and reserve currency (and given the threats coming out of Washington that the US could cut China off from the US dollar financial system, Xi should be serious). Then China really doesn’t have much of a choice: it must follow Apple’s example and build a parallel operating system that doesn’t try to compete with the US dollar on its own turf.

This brings me back to the most important event of 2020. If, in retrospect, the launch of the iPhone was the most important event of 2007, then what will go down in investment history as the most important event of 2020? Today, the answer appears obvious: the Covid-19 pandemic. But then, at the time, the start of the subprime bust clearly appeared to be the most important event of 2007. Now we can say it was the iPhone launch. So, in 13 years time, will we look back at Covid as the major driver of structural change that emerged in 2020? Or will we look back at something completely different?

Could it be that we find ourselves looking back at this year’s IPO for China’s Ant Technology Group, together with the drive by the People’s Bank of China to launch a digital renminbi (see Questions On The Digital Renminbi), as the start of a new era? An era when, all of a sudden, consumers and companies across the emerging markets no longer needed to use the US dollar, nor even the SWIFT system, to trade with each other?

Just as Apple did not try to compete with Microsoft for what was seen then as the core tech market—the large corporate IT budget—but instead focused on the high-end consumer, today’s Chinese fintech companies have little interest in grabbing a share of large corporate transfers and becoming big players in the US-dominated SWIFT system. Instead, like Apple, the two Chinese fintech giants Alipay and WeChat Pay are focusing on going directly to the consumer (see the great research on China fintech from our colleagues at Gavekal Fathom China).

And like Apple, they are attempting to establish a new, parallel operating system, by helping Chinese consumers (and increasingly consumers in other emerging markets) with payments and cash transfers (bypassing SWIFT and US control), by providing micro-loans (that are growing like weeds, bypassing the traditional banking system), and by offering savings products (mostly money market funds) and insurance policies (that again completely bypass traditional methods of delivery).

The irony of all this is that if Ant Group and WeChat-owner Tencent are successful in their endeavors, then we will end up in a situation where, while the democratic and federal United States controls the highly-centralized part of the global payments system that focuses on big transfers for large corporates, the deeply authoritarian and centralized China will control a much more diffuse and decentralized part of the global payment system focusing on small payments and consumer needs. It's like Apple versus Microsoft all over again—with the opportunity to buy Apple at 2007 prices.