CROSSBRIDGE CAPITAL

Market Viewpoints

Manish Singh

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> Real knowledge is to know the extent of one's ignorance.
>
> – Confucius

Summary:

The all-important 19th National Congress of the Communist Party of China (CPC) kicked off last week in Beijing. In his bold 3 hour and 23 minute address, President Xi Jinping, outlined the party's priorities for the next five years. If Beijing has its way, China is on a track to becoming an economic power the likes of which we have not seen in a long time. It's not the Japan of the 1980s, it's much larger. It's no surprise then that even the US National Intelligence Council warns that the era of *Pax Americana* is "fast winding down." To the Western eye the ascendant power of Beijing may seem a disruption to the status quo, but to students of world history and China, it is the restoration of a millennia-long equilibrium. China was the biggest economy in the world for most of the past 2,000 years, only to be overtaken by Europe in the 19th Century. The ramifications of this Chinese growth are significant. America will almost certainly come out second best if it doesn't change tack - with Europe a long way behind.

China strides ahead

At a press conference in Washington DC on March 29, 2000, US President Bill Clinton said that granting China Permanent Normal Trade Relations (PNTR), which allowed China to gain entry into the World Trade Organisation (WTO), would be a great deal for America. "We do nothing," Clinton said. "They have to lower tariffs. They open up telecommunications for investment. They allow us to sell cars made in America in China at much lower tariffs. They allow us to put our own distributorships there. They allow us to put our own parts there. We don't have to transfer technology or do joint manufacturing in China anymore. This a hundred-to-nothing deal for America when it comes to the economic consequences."

It didn't quite work out that way.

Former Chinese leader Deng Xiaoping, the architect of China's economic reforms, used to say "Black cat, white cat, what does it matter what colour the cat is, as long as it catches mice?" i.e. it did not matter whether an economic policy was considered to be "capitalist" or "socialist," what really mattered was whether that policy would boost the economy and living standards. So, while some still debate whether China is communist or capitalist, or whether it will collapse, the Chinese cat continues to outpace others in the pursuit of mice (economic growth and world dominance).

If Beijing has its way (and so far, it has), China is on a track to becoming an economic power, the likes of which we have not seen in a long time. I say this due to the size of the purchasing power that its economy will command. It's not the Japan of the 1980s, it's much larger. After cornering the market in manufacturing over a decade ago, China moved into technology and innovation and continues to achieve major success unbeknownst to the average Westerner who has not updated his knowledge of China.

The emergence of large companies such as Huawei, Xiaomi, Tencent, Alibaba and Baidu has paved the way for other local firms to follow. According to figures tallied by KPMG, last year, China received $31billion of venture capital investments, three-quarters of the US total. The sector has tripled in size since 2014 (US venture capital grew by only 20% during that period). According to a recent article in *Wired* magazine, fifteen years ago, China claimed none of the top 500 supercomputers in the world. Today, it not only has more supercomputers than everyone else — including the United States — but its best machine boasts speeds five times faster than the best the US can muster. Additionally in a first, it achieved those speeds with chips made purely in China. Due to China's massive purchasing power, world auto-makers rightly view China as the industry's new center of gravity. According to a report by McKinsey, China makes and sells more light vehicles than any other nation; so many in fact, that in 2016, 40% more cars were sold in China than in all of Europe. This, when, the vehicle penetration in China remains low. Per 1000 people, only 131 people in China have passenger vehicles compared to 850 in the US. There are 609 billionaires in China compared with 552 in America. China is also rapidly becoming a cashless society. The volume of mobile payments shot up almost fourfold last year, to $8.6 trillion, compared with just $112 billion the US. It might take couple of years before the wider world wakes up to Chinese innovation and advancement in technology, but the experts are already well aware of it.

China wants to be the world leader in Artificial Intelligence (AI) by 2030, aiming to surpass its rivals technologically and to build a domestic industry worth almost $150 billion. Anthony Mullen, a director of research at analyst firm Gartner, in an interview with the magazine *The Verge,* said - "Right now, AI is a two-horse race between China and the US and China has all the ingredients it needs to move into first" To build great AI, you need data, and nothing produces data quite like humans. This mean's China's massive 1.4 billion population (including some 730 million internet users) might be its biggest advantage. These citizens produce heaps of useful information which can be mined by the country's tech giants. The adventures of Microsoft chatbots in China and the US make for a good comparison. In China, the company's Xiaoice bot, which is downloadable as an app, has more than 40 million users, with regulars talking to it every night. By comparison, the American version of the bot, named Tay, was famously shut down in a matter of days after Twitter users taught it to be racist.

Already on a Purchasing Power Parity (PPP) basis, China's GDP is larger than that of the US, as announced by the IMF in 2014. This, when the GDP per capita of China is still 1/4th that of the US. It's no surprise then that even the US National Intelligence Council warns that the era of *Pax Americana* is "fast winding down." US President Donald Trump talks about coal and steel and tariffs, whilst President Xi Jinping and China concentrate on robots, solar panels, electric vehicles and One Belt One Road (OBOR) - a network of ports, pipelines, railways, industrial parks and ancient maritime lanes that will span 65 countries and open markets that are now beyond the economic reach of Chinese firms. The Chinese are following their path and for the moment it's working. We in the western world are following ours and you can judge for yourself the success of that! The ramifications of this Chinese growth are significant. America will almost certainly come out second best if it doesn't change tack - with Europe a long way behind.

To the Western eye the ascendant power of Beijing may seem a disruption to the status quo, but to students of world history and China, it is the restoration of a millennia-long equilibrium. China was the biggest economy in the world for most of the past 2,000 years, only overtaken by Europe in the 19th Century. When Adam Smith published *The Wealth of Nations* in 1776, he described China as "one of the richest, best cultivated, most industrious, and most populous countries in the world," and "much richer than any part of Europe." According to a study by economist Angus Maddison, China was the world's largest economy in 1820, accounting for an estimated 32.9% of global GDP. However, foreign and civil wars, internal strife, weak and ineffective governments, natural disasters and distortive economic policies caused China's share of global GDP to shrink to 4.9% by 1978. In comparison, the US share of global GDP rose from 1.8% in 1820 to 21.6% by 1978.

The all-important 19th National Congress of the Communist Party of China (CPC) kicked off last week, with the party gathering of 2,300 strong delegates in the Great Hall of the People in Tiananmen Square in Beijing. In his bold 3 hour and 23 minute address, President Xi outlined the party's priorities for the next five years. He said China had stood up, grown rich, and become strong and it now embraced the brilliant prospects of rejuvenation. He foresaw an era where China moved closer to the centre stage and made greater contributions to mankind, whilst regaining the great power status it enjoyed in the 19th Century, with the objective of achieving this by 2049, the 100th anniversary of the founding of the People's Republic of China.

Where to invest?

Speculation is growing that Stanford University professor John Taylor, a long-time adviser to Republican presidents and presidential candidates and a former US Treasury Department official, could be appointed as the next Chair of the US Federal Reserve (Fed). The question on everyone's mind is: How high could interest rates go if John Taylor became Fed Chair?

For that, we have to look at the "Taylor Rule," first spelled out in 1993 to provide guidance for how a central bank should set short-term interest rates to achieve the goal of price stability. For the brainiacs amongst us, here is the formula:

$r = p + .5y + .5(p – 2) + 2$ (the "Taylor rule")

where

r = the federal funds rate; p = the rate of inflation; y = the % deviation of real GDP from a target

Under the Taylor rule, the Federal Funds Rate (FFR) should be at +2.94%. The FFR currently stands at +1.25%. Besides, if the Fed had followed the Taylor rule to set the benchmark over the last decade, the FFR rate should have gone below zero in Q1'2009 and turned positive by Q4'2009. In contrast, the FFR never went below zero but stayed near zero from late 2008 until late 2015, and has risen by 100bps since. It's no surprise then that Taylor has been a vocal critic of the Fed's easy monetary policy. He has criticized the Fed's policy of large-scale purchases of securities, known as Quantitative Easing (QE) and has argued that driving down longer-term bond yields would make lenders less likely to extend credit and hold down economic growth.

The big question then for investors is if John Taylor were to become Fed chair, would he follow his own rule and raise the interest rates to 3%? In my view, that would crash the market. The only thing holding this market up from a cyclical correction is a benign Fed.

Investors needn't worry. The risk of a Taylor Fed raising rates to +3%, in accordance with the Taylor Rule, is almost negligible as Taylor has only one vote and the rest of the Governors will take some persuading given their current views. New York Fed President William Dudley has long argued that rules don't take account of financial conditions, which are a critical driver of the economy's performance. Minneapolis Fed's Neel Kashkari reckoned that following the Taylor rule over recent years would have been a disaster and led to the creation of 2.5 million fewer jobs during the recovery. Several other Fed officials have said in recent months that they won't support another rate increase until they see evidence that inflation is rising toward their +2% target. Taylor could, therefore, have a hard time trying to implement his rule if he were to become Chair.

The main macro theme for some time now has been reflation and the market has been patient waiting for President Trump to deliver on his promises of tax reforms and spending. The passage of the budget resolution in the US was a necessary but relatively easy step, compared to the tough decisions still to come on tax reform. Financial markets have not priced in the delivery of US tax reform this year. Therefore, if we do get it, expect the markets to rally.

Market sentiment towards Japan has been quietly improving for weeks and months. The election result in Japan over the weekend, where Prime Minister Shinzo Abe won a two-thirds majority in the Japanese Diet and became Japan's longest serving Prime Minister, will only extend this optimism. This victory will intensify reforms in Japan, termed *Abenomics*, and deliver positive returns to holders of Japanese equities. *Abenomics* has seen Japan post some of the best growth in decades, while maintaining a very accommodative monetary policy. The other big political development is in Spain where the government of PM Mariano Rajoy decided to seize direct control of Catalonia, with plans to hold regional elections within the next 6 months. I don't see this fight ending anytime soon and as the fight intensifies, Spanish stocks will get hit hard. The contagion, however, is unlikely to spread to broader European or US equities. Catalonia remains a regional Spanish issue. If you have any equity positions in Spain, I would recommend selling them now. I have often believed when it comes to Europe, peace is an illusion. There's far more simmering below the surface than one can tell. The "more EU is a good thing" folks in Brussels are in for a rude awakening. *Brexit*, election results in Germany, Austria, Czech Republic and referendums in Catalonia and Northern Italy, indicate that economic growth and prosperity, and not empire building and forced integration, should be the focus of the European Union.

I still continue to be invested in equities and I am overweight US equities, with sector biases for Financials, Healthcare, and Technology. I have increased the weighting to Japan (DXJ US) but have made no change to an underweight position in Europe and Emerging Markets. My holdings are more in single stocks than Exchange-Traded Funds (ETFs).

I am pleased to share with you that our global equities portfolio (60% US, 20% Europe, 10% Emerging Markets, 6% Japan, and 4% cash) is **up +15.5%** (net of all fees) as of the end of September. Should you need more information on this or our other investment portfolio performance, please feel free to get in touch.

In terms of stocks I like: JP Morgan (JPM US), Bank of America (BAC US), Citi (C US), BNP Paribas (BNP FP), Barclays (BARC LN), VISA (V US), Blackrock (BLK), Allergen (AGN UN), Celgene (CELG UW), Gilead Sciences (GILD US), Apple (AAPL UN), Google (GOOG US), Microsoft (MSFT US), Amazon(AMZN UW), Alibaba (BABA US), Baidu (BIDU US), Salesforce (CRM US), Comcast Corporation (CMCSA), Home Depot (HD UN), CBS Corp (CBS US), Pfizer (PFE US), Estee Lauder (EL US), Glencore (GLEN UN), Rio Tinto (RIO LN), Freeport McMoran (FCX US), Pioneer Natural Resources (PXD), Schlumberger

(SLB US), Danaher Corp (DHR US), JD.com (JD US), WallGreenBoots (WBA US), Delta Airlines (DAL US), Costco (COST US)

Best wishes,

Manish Singh

Manish Singh, CFA

United Kingdom
9 South Street
London W1K 2XA
United Kingdom

Singapore
One Wallich Street
#24-05 Guoco Tower
Singapore 078881

Monaco
Le Park Palace,
Bloc A, 8ème Etage
5, Impasse de la Fontaine
98000 Monaco

Visit our website:
crossbridgecapital.com

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