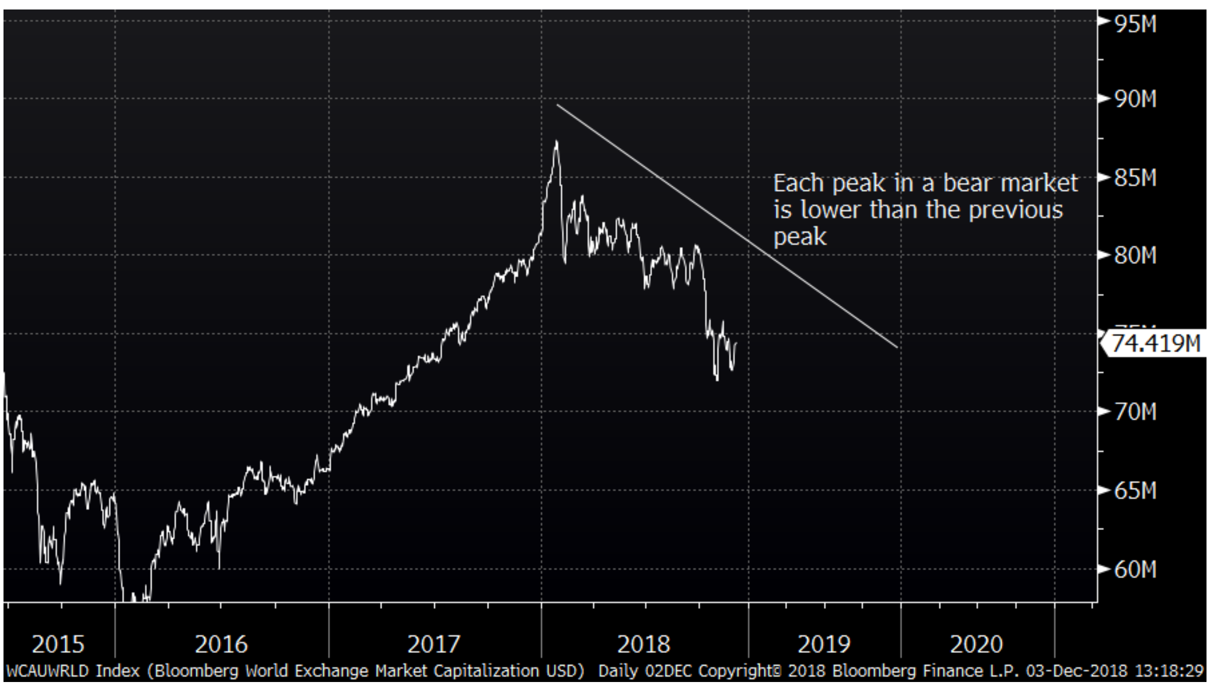
Hutchinson Lilley Investments LLP
robert.hutchinson@hlinv.com

G20 Argentina 2018

Bear market rallies

2018 looks like a bear market for shares; the Bloomberg World Equity Index peaked in January and has trended down since. An important characteristic of bear markets though is that they do not fall in a straight line. There are often meaningful countertrend rallies which can come about both with or without any particular newsflow. These rallies are characterised by each new peak rising to a point which is lower than the previous peak (known as lower highs). The chart below shows this in the case of the world share index.



It would therefore be perfectly possible to have a rally until the end of the year and into the start of next year and still be in a bear market.

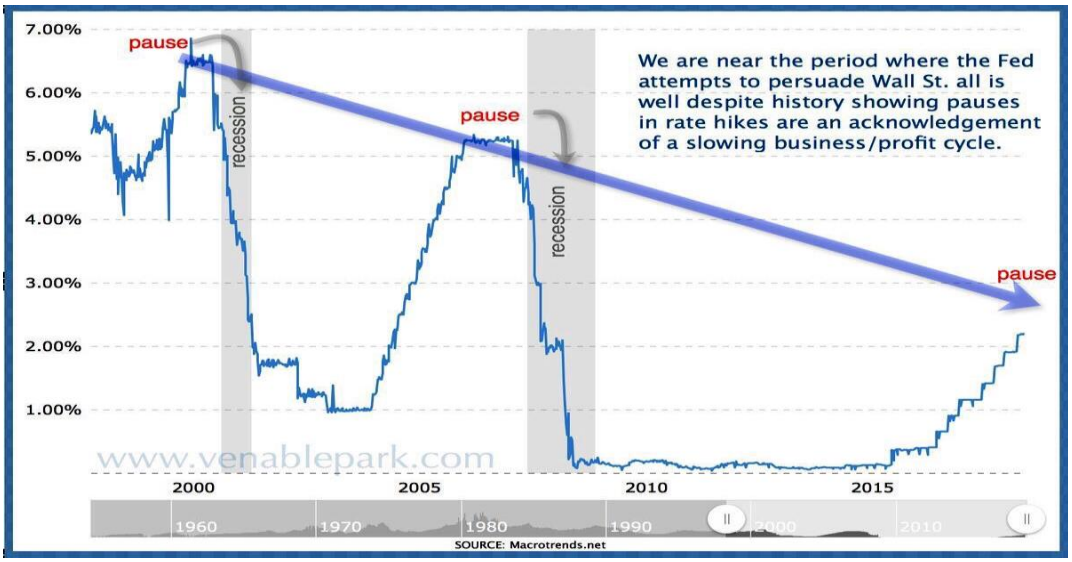
Two short term boosts

As it happens there were 2 pieces of news in November to put a little short term fuel under markets.

1 US Interest rates were not raised in December. It had been expected that they would.

Head of US Federal Reserve Jay Powell did not raise US interest rates. It had been expected that he would make one more raise for 2018 but instead he cited a new script. He said that the interest rates in the US was now *neutral* and that this was appropriate for the current level of economic activity.

Apart from the term neutral being subjective and somewhat meaningless conceptually, this really confirms the view given previously in these reports that the authorities are trapped by their own policies dating back to before the global financial crisis. The worlds' economies are so dependent upon debt that any attempts to restore interest rates to normal risks killing the borrowers and thereby pushing them back into recession (just as Hayek said would happen). Is this the peak for the current cycle? If this now turns out to be the interest rate peak for the cycle it will be the lowest peak rate in history; the latest high will be at a level only about one third the level reached in previous cycles. Historically economic recession has followed when rate hikes have been paused. See chart below which presents a powerful picture even though it may not be useful as a predictive tool as far as precise timing is concerned - even on this analysis the recession can take up to 2 years to arrive.



Fed critics say that the decision to halt rate rises now is not particularly related to their view (whether right or wrong) of the economy but instead simply to the level of the stock market. The fact that it has fallen in 2018 has put them into panic mode. If this is the real reason (and it could well be) then the conclusion to be drawn is that central banks now exist to keep shares high which is a far cry from the founding principle to preserve the integrity of the banking system by being the lender of last resort to ailing banks.

In summary, althought the early ending of interest rate rises was seen in the last days of November as a short term boost to share markets it is actually a sign of a rot in the financial system and is possibly also a medium term warning of recession on the horizon.

2 G20 is a talking shop but the trade war with China was given 3 month moratorium.

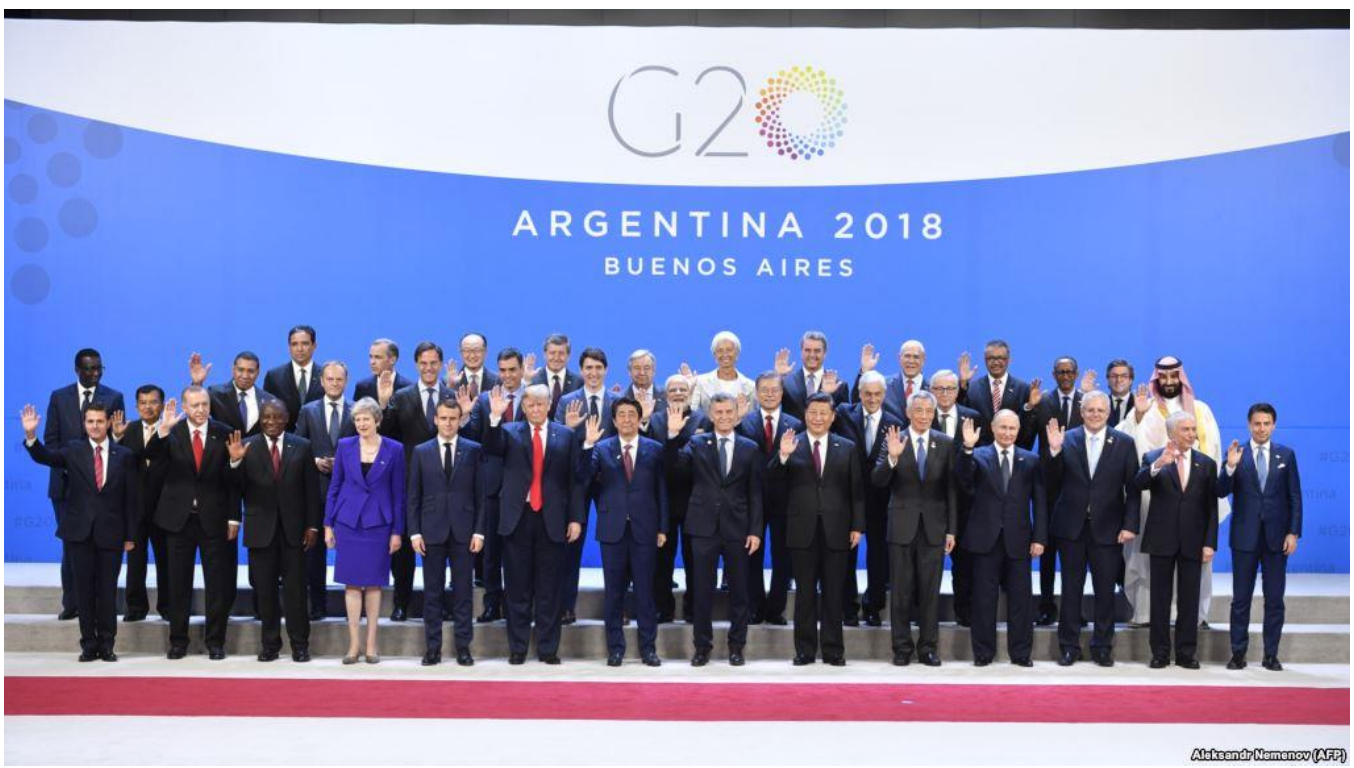


Photo op. – A chance for all these people to appear strong while also appearing to be getting along).

Usually such gatherings of politicians are little more than a photo opportunity and so I tend to have little to say about them in these monthly reports. Not least because less and less of substance comes out them. Following previous G20 meetings communiques agreed upon were subsequently torn up making the whole procedure appear to have been a waste of time. So this time around there were barely any communiques and really tricky issues such as Ukraine, Saudi Arabia and arms build ups in the South China Sea (see below) were left out altogether.

There was, however, one outcome which caught the headlines and which lifted markets for a day or so, although it did come with a catch. The meeting brought about a 3 month moratorium in the US - China trade war. Trump and President Xi Jinping agreed to keep tariffs at 10 percent from January and to talk about removing other tarifs. China vowed to increase imports from America. Trump had been threatening to levy import duties on billions of dollars of Chinese goods which would have jeopardised global growth. The catch in the moratorium was that if they didn't make progress in talks about structural reforms within 90 days, the U.S. would go ahead with import duties at a punitive rate of 25 percent. Matters to be thrashed out before the 90 days are up include so far insurmountable issues such copyright theft/intellectual property, cyber crime and market access for US firms. The odds of finding resolution in all of these within 3 months are not high, so the short term lifting of trade war threats doesn't seem to remove the problem in the longer term. Or just maybe it does?

Trump critics say that he *folded* to Xi by granting this moratorium but I think it is part of his strategy of unpredictability. It has been said that you should not project yourself as a strong leader if you want to get things done in the geopolitical arena; you merely encourage your adversary to be even stronger. Such a tit-for-tat approach makes good sense from a game theory perspective since faces are saved in front of home audiences on both sides; but it is not a particularly effective approach in terms of seeing tangible results for you. A more effective leadership approach is to come across as mysterious, crazy and unpredictable since there is no effective counter strategy available to your opponent. This was described in Thomas Schelling's definitive text on game theory in the political context of deterrence. The Strategy of Conflict was written in 1960 and was used as a manual for higher ranking military officials in navigating the cold war.

Trump seems to incorporate craziness and unpredictability in his armoury. He has an unusual negotiating style (among politicians of developed countries) involving high risk threats which get bad press but which he subsequently reverses. So far these have yielded some good results, most clearly in the case of North Korea. (Less so in the case of Mexico). One moment he was threatening to go to war with NK and the next Kim Jong Un was his friend, agreeing to denuclearise presumably in exchange for US economic support. Perhaps this is also his approach with China, and could be one of the factors behind his trade row?

Trump is keen on big show-off gestures as evidenced by his many Trump Towers. When he leaves the US Presidential office he will want to leave a legacy behind and it possible that some measurable victories in his *Make America Great Again* (MAGA) campaign would do the job domestically. Ostensibly his trade fights with Europe and China have been carried out in the MAGA name and even though they are unlikely to do much good economically, (trade wars never do) they sound tough politically.

I am somewhat optimistic that common sense will prevail in the trade war. The US consumer wants cheap consumer goods and the Chinese need to continue to sell them. We hear how the "21st century belongs to China" but in the meantime they need their US exports to keep their growth engine working: otherwise they will have a debt crisis. The Chinese moved from a system of central planning to become full Keynesian converts without ever passing through the Adam Smith phase of prudent economic advancement. What that means is that Chinese growth came at the price of large debt build ups (such as also exist with us) and the problem with debt is that you need to grow to service it. You cannot stand still and survive. (Ask the Greeks).

Trade war v Real war

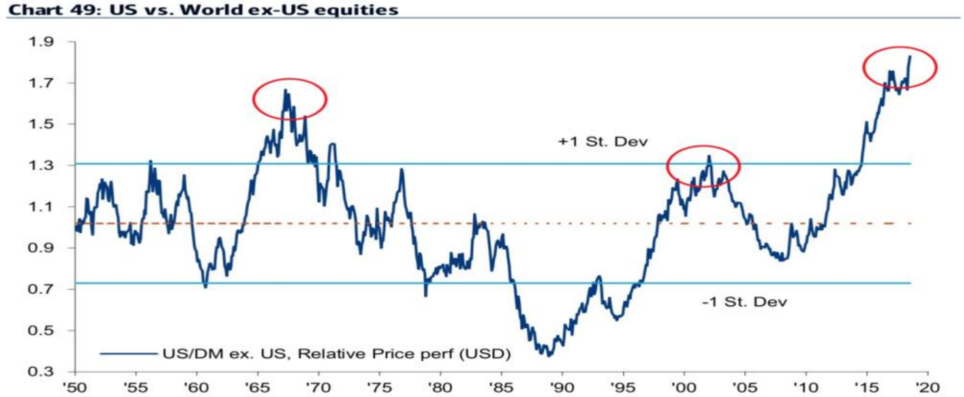
All US presidents seem to surround themselves with identikit hostile hawkish military advisers. This can be the only explanation for why US foreign policy never changes, regardless of what type of president is in office. The war in Afghanistan is now America's longest ever war. The US is building a new base in the Black Sea to rile Russia. And away from the mostly courteous G20 discussions the temperature has been rising in the South China Sea where both the US and China have been flexing their military muscles. In October, US and Chinese naval ships had a game of chicken and came within 45 feet of each other.

So more serious than Trump's threatened trade war with China is the threat of real war, (although admittedly it is hard to imagine that anyone would be so stupid). China says that the S. China Sea belongs to them. The clue is in the name. The US says it doesn't belong to anyone in accordance with the Freedom of the Seas Law which the US championed (about 100 years ago) and which many maritime countries signed up to. But China has never agreed with this law and did not sign up to it. It sees the presence of other navies in what it considers to be its waters as hostile. So under one version of events things could escalte from here and Trump could go down as the president who went to war with China, although I am really not sure that this is what he would want.

But in keeping with his own strategy of unpredictability, and in an act of pure conjecture on my part, there could be a dramatic reversal. In addition to MAGA at home being his domestic legacy, Trump could also seek to leave a grand international and in this context 2 of his big fights so far – Korea and China – might be connected. Trump could seek China's help in bringing about a Korean reunification, possibly in exchange for a favourable trade deal with China after all and economic engagement in the new Korea. This would certainly be a more attractive thing to be remembered for than having a naval battle in the S China Sea. And it would provide a powerful uplift to stock markets – particularly those in Asia.

From a stock market point of view the last decade has belonged to the US. US shares have outperformed those from most other countries as can be seen in the relative performance chart below. Something is going to come along soon and reverse this trend ie the US will surely at some point start to underperform other world equities. Perhaps the catalyst will be a really positive story in Asia?

Chart 49: US vs. World ex-US equities



Monthly data
Source: BofA Merrill Lynch Global Investment Strategy, Global Financial Data