The Root Node

By Richard Thies

We feel very fortunate when the calendar-dictated timing of our commentaries happens to sync up with the times when we feel we have something important, or contrarian, to say. This, unfortunately, is not one of those times. We had a strong, out-of-consensus, view that the US economy was set to show signs of weakening and the market was not priced for that outcome (Stop What You're Doing). What we think was an interesting view has become relatively well-appreciated, especially in recent months.

Our unscientific view of the current prevailing narrative is that there is a broad awareness that economic data is starting to weaken, that the US is unlikely to see an imminent recession and that the US remains the best structural story in developed markets, valuations aside. On these consensus views, we do not take major issue. We do think that consensus still does not see how bad leading indicators currently are and we expect growth data to materially disappoint already-lowered expectations in the first quarter. We do also think an inordinate amount of time is spent analyzing minutiae of the US economic story when the major surprise, positively or negatively, this year is likely to come from the rest of the world, namely China. We believe that more than ever, your view on how the Chinese economy evolves this year is central to asset allocation and your view on markets in general. In the decision-tree of investing in 2019, China is the root node. Why do we believe this?

Differences in economic growth expectations between the US and the rest of the world remain the primary driver of the relative performance of US equities relative to the rest of the world. China's impact on non-US growth remains extremely important and is somewhat less important for the delta in US growth. Despite the million other things driving equity prices, the difference in growth expectations between the US and the rest of the world has been a primary driver of equity market returns. (Exhibit 1)

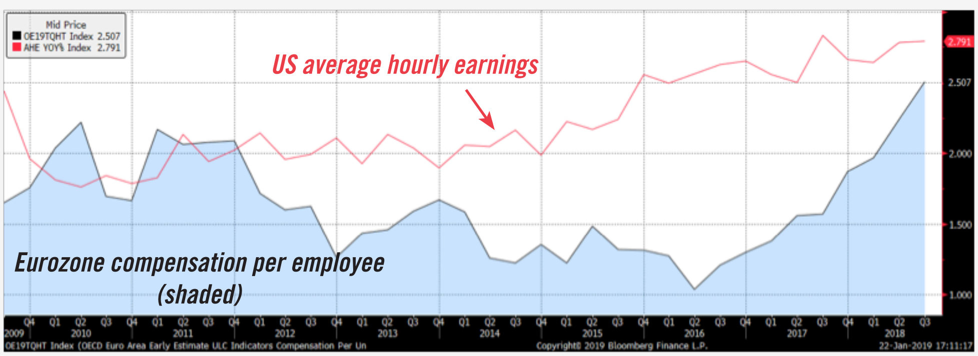
EXHIBIT 1:
In recent years, changes in economic growth expectations relative to those in other countries have been the primary driver of the US' outperformance

Source: Bloomberg

Forecasting the growth differential between a myriad of countries is clearly a difficult task, (given how hard it is to forecast just one country correctly) but we think you can simplify things a bit. First, there were a number of one-offs that supported the US economy last year: tax cuts, a stronger than expected first-half for consumption/housing and a big boost from front-loading of demand ahead of tariff implementation. We see none of those continuing and find it difficult to imagine further unexpected upside surprises. The one we had considered, a bipartisan infrastructure push, seems less likely to us now after watching the shutdown playout. The political incentives on both sides of the aisle are not suited to cooperation on anything. That doesn't look likely to change. On the other side, the country's interest rate-sensitive sectors continue to lose momentum even with rates coming off, the shutdown is likely to make first quarter data look even worse than it already would and there is more pain to come from the tariffs. Estimates based on early-returns suggest the tariffs will increase core goods prices approximately 0.3%, not a great dynamic to add to an already-slowing economy.

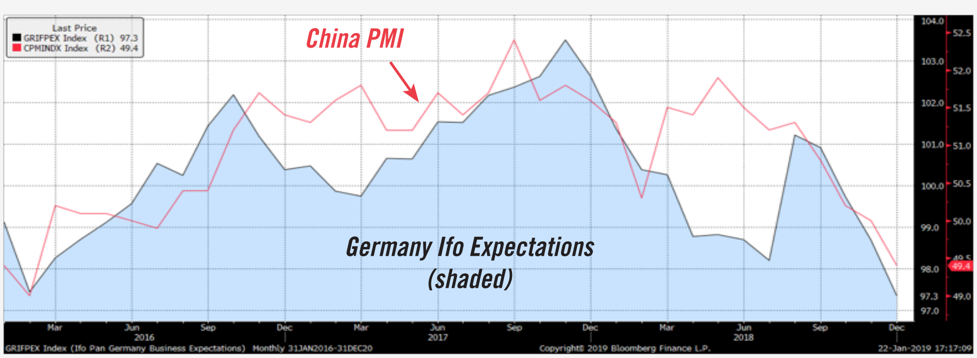
To summarize, we feel comfortable with the assertion that the chances of being surprised to the upside by the American economy are low. The complicating factor is that leading indicators in other geographies don't look much better, in fact, many look even worse. We are not going to specifically discuss the countries that actually have more positive economic outlooks for 2019, but feel compelled to note that they do exist and are mostly concentrated in Latin America and southeast Asia. As it pertains to the other large economies, most are still far more dependent on the Chinese economic cycle than the US is and have recently been more acutely weighed by it. Despite the prevailing negative sentiment toward the Eurozone, its domestic demand data doesn't look wholly different than that of the US, just a bit earlier in the cycle. In fact, wage growth has actually recovered far more impressively in the past two years than it has in the US (Exhibit 2). What Europe does not have going forward is the far higher corporate leverage to the Chinese cycle (Exhibit 3). In short, to believe that the US economy will stop relatively outperforming, the Chinese economy needs to stop deteriorating.

EXHIBIT 2:
Wage growth in the Eurozone has seen a much stronger recovery of late than the wage data in the US



Source: Bloomberg

EXHIBIT 3:
There has been almost no difference between European and Chinese industrial cycles of late



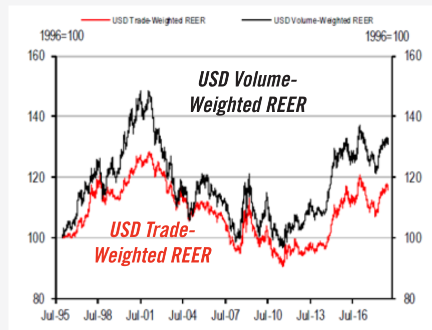
Source: Bloomberg

The dollar is overvalued. As our long-time readers are aware, we view the dollar's direction to still be one of the most important factors for all asset markets. We currently believe that the dollar is overvalued, which is not exactly the same thing as being bearish on it. First, we see the dollar being overvalued on standard traditional metrics, namely the trade volume real effective exchange rate. Similarly, we see EM foreign exchange (FX), the Euro, the Pound, etc all being undervalued. (Exhibit 4) If you don't believe in fancy methods like these, you will see the dollar's increasing overvaluation if you travel the world, as purchasing power has increased dramatically for the greenback. This same phenomenon can also be seen in trade activity; the US's persistently increased trade deficit, in spite of political efforts to contain it, is a symptom of better demand but also shows that the currency is too strong. There are many reasons for the valuation the currency receives but perhaps most notably is the recent idea that 'there is no alternative' to the dollar. With the existential political issues across the Atlantic, and the persistent issues in emerging markets, this is understandable. However, we believe that these narrative explanations are in the price and the risk of that narrative changing over the coming years is high.

If that overvaluation reverses, it will create material relative upside for all non-US assets. The most visible way that this overvaluation would persist is through a further slowdown in Chinese growth as it would likely weigh on ex-US growth more acutely than on US growth. We see relative tightening expectations as being a bigger driver to the dollar than the nominal levels of rate differentials. In our view, it's great that the US dollar is a high-yield currency compared to developed peers but it's the rate of change on relative hiking expectations that matters most. (Exhibit 5) Given that China holds a big piece of the puzzle in terms of whether the US will continue to outperform economically, China holds the key to the dollar as well.

EXHIBIT 4:
The dollar is overvalued on traditional metrics, most other currencies appear cheap

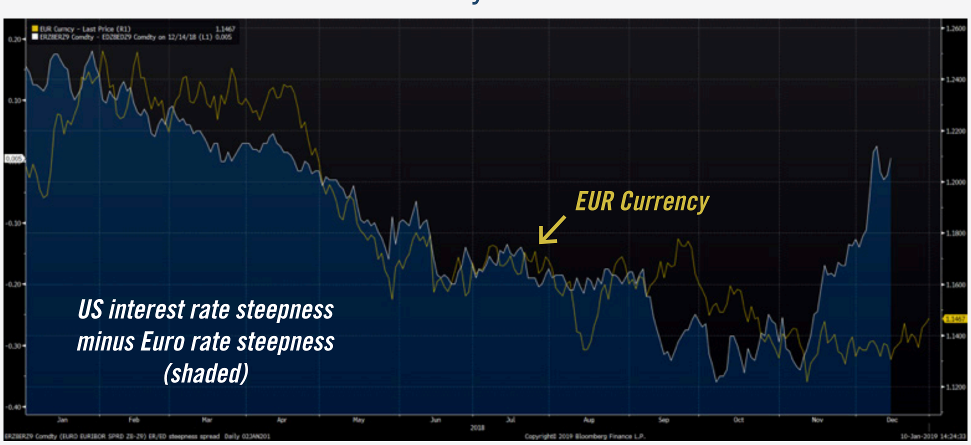
USD REER INDEX



EUR REER INDEX

Source: Bloomberg, HSBC

EXHIBIT 5:
The primary driver of the Euro in the past few years has been the relative steepness of its yield curve compared to that of the US. Given recent movement in US rates, the dollar appears overvalued by this measure.



Source: Bloomberg

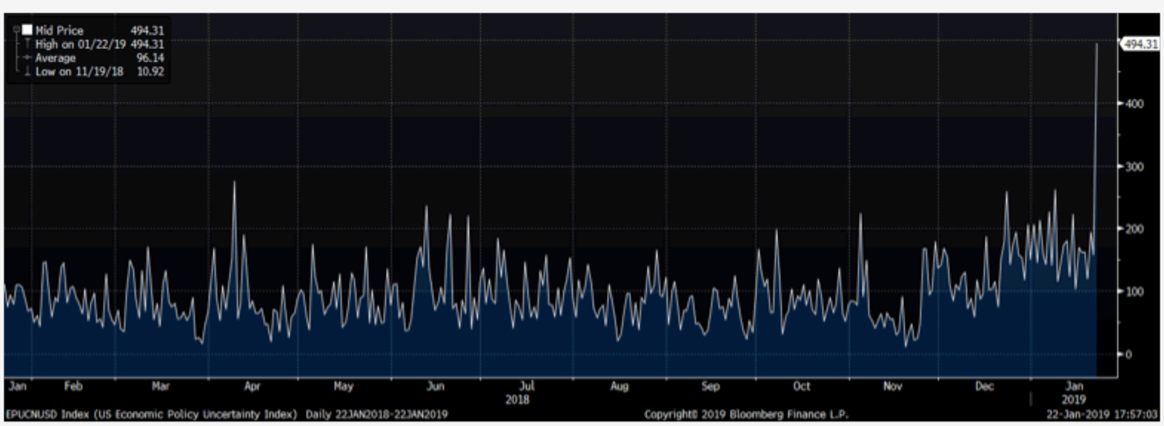
We mentioned that we believe the dollar has been supported by narratives over the past few years. While it's impossible to forecast future narratives, we suggest a few lines of thought that could be instructive. The country with the greatest space for fiscal stimulus and some of the most compelling reasons to employ it, is Germany. If a more lax German fiscal outlook materializes and somewhere other than the US gets a fiscal stimulus for a change, the Euro will be looking very cheap. Similarly, another thing that supports the dollar today is the idea that it will never be replaced as the reserve currency. If more central banks start to diversify assets away from the dollar, as the Central Bank of Russia has just done in massive size, the narrative could start to shift. Finally, US policy uncertainty has never been higher (empirically!). Why should we have such confidence that none of the changes that will certainly materialize, especially as 2020 comes into focus, be dollar negative? (Exhibit 6) All of this is to say that if you are buying the dollar story at this valuation, you better be sure nothing changes.

One final reason we think China holds the key this year is that Chinese consumers remain the key source of end demand growth for most major cyclical industries, industries that are essential for global growth and that are currently seeing material headwinds. To put things in quite simple terms, growth in industries like technology, automotive and consumer cyclicals come either from increasing penetration globally or from innovation. We admit that forecasting innovation is all but impossible (though we are very excited to see what 5G brings us over the next two years). How many of us correctly posited in 2016 that demand from crypto-currency mining firms was going to exacerbate an upcycle in semiconductors to a major degree? As such, penetration stories are much more highly visible and China has provided that growth opportunity to the world over the past several decades, including in the past few years. Contrary to popular conceptions, 80% of Chinese growth has come from consumer-facing industries in the past several years. Unfortunately, we see major industries as becoming saturated. Namely, there is no longer an easy market for high-end smartphone growth no matter how the economy evolves this year. The domestic auto sector is majorly oversupplied and is no longer going to provide a major growth lift to global autos.

China

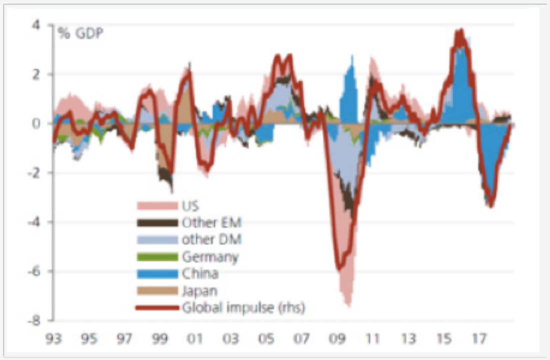
So given we view the Chinese economy to be the root node for predicting almost all the major investment decisions this year, what are we expecting? To be very direct, we see very poor growth results in the first quarter, still-poor growth in the second quarter and potential that things have stabilized by the third quarter which would be the best-case scenario. China remains a highly-credit dependent economy. One of the many ill-effects from the high levels of leverage is that without ample liquidity and credit supply, growth will be bad. Credit has been tightened massively over the past year and it is thus no surprise that growth has slowed materially, aided by external factors like a deteriorating tech cycle and tariff implementation. (Exhibit 7)

EXHIBIT 6:
US policy uncertainty is at its highest level of all-time



Source: Bloomberg

EXHIBIT 7:
The worst of China's credit impulse deterioration has passed but is still yet to deliver a positive impulse to the economy

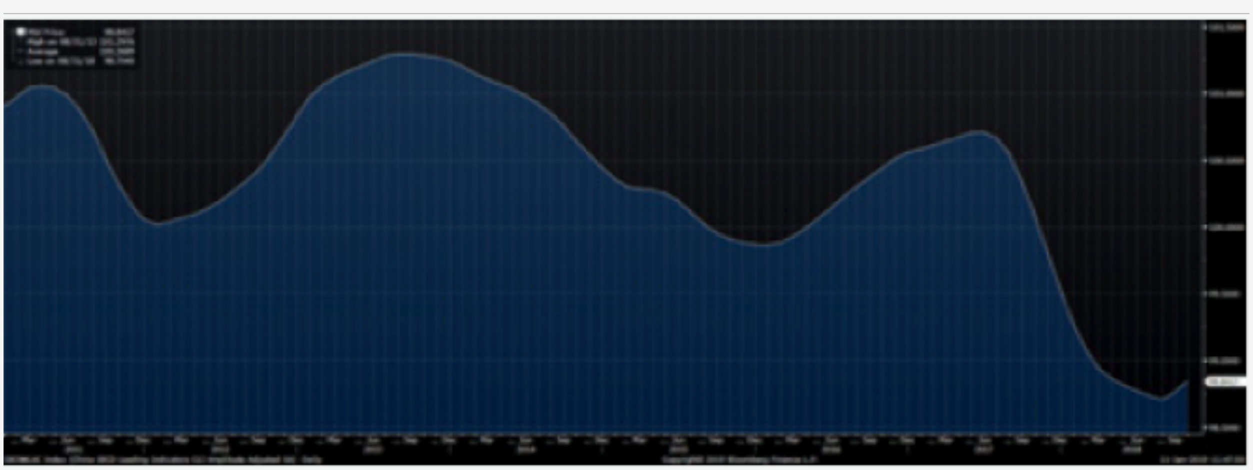


Source: Haver, UBS

We now see the deleveraging effort as having ended, liquidity being supportive but still insufficient credit supply for the economy. This is one of the first times we have witnessed this dynamic. Typically, in a tightening environment, China has tightened up on the money supply and had high domestic interest rates. Currently, the central bank has pushed liquidity much looser but thus far it has not been met with faster credit growth. The reasons for this are twofold, in our view: first, the crackdown on non-bank lending has left a hole in the credit transmission mechanism where things like infrastructure projects have had a much harder time finding funding, especially with commercial banks increasingly focusing on the private sector. Additionally, China's corporates have very low levels of confidence as external demand is weak, internal demand is deteriorating and it is very hard to invest in domestic capacity when you don't know if you can export to the US in three months. Anecdotally, almost every corporate we met on our recent trip to China discussed their ex-China investment plans to skirt potential US issues.

All that to say, the government's traditional credit supply mechanisms haven't been working and they won't start to work until more proactive local government financing schemes are put in place or the property market starts to recover, which is traditionally the fastest means by which easier monetary policy hits the real economy. We see many signs that the government finally gets this issue. Infrastructure investment recovered in the fourth quarter, property sales volumes reacted to policy easing and retail performed better in December than it had the previous six months. We understand the tendency for markets to panic every time China slows but in a mostly-closed system with little external debt, they have the ability to react to weakening data and they unequivocally are right now. As a point of fact, China has among the best looking leading indicators in the Organization for Economic Cooperation and Development (OECD). (Exhibit 8) We are not outright bullish on China but we do believe their efforts will allow for a stabilization in growth by the end of the year. We do not believe that view is priced into asset markets and we think that is the most important view this year.

EXHIBIT 8:
China's long-term leading indicators look surprisingly attractive relative to the rest of the world as a result of the more aggressive credit easing in recent months.



Source: Bloomberg

About the Author

Richard Thies is a portfolio manager. In addition to his portfolio management responsibilities, he provides comprehensive macroeconomic analysis to the firm's investment management and research department, incorporating data releases, market expectations and government actions into forecasts for currencies, interest rates, sectors and market movements. He also conducts in-depth analyses of specific events and potential scenarios at the region, country and sector levels.

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