# Annus Horribilis

Marko Papic | BCA Research | 21 January 2016

## EXECUTIVE SUMMARY


- Geopolitical headwinds are on the rise.
- Given recent market volatility on the back of Fed tightening and tepid global growth, we recommend that investors make capital preservation a priority.
- Beijing's RMB devaluation is a sign that "Chimerica" is dying, potentially one of the biggest geopolitical events of the decade.
- Chinese piecemeal stimulus is not working – reforms have fallen by the wayside, and investors and depositors are voting with their cash.
- Volatility is still the only clear winner in oil markets.
- Populism is far more pernicious in emerging markets (EM) than in the US and Europe, but anti-establishment forces are here to stay in all regions.


## INTRODUCTION

> "I would tax China coming in, products coming in... let me tell you what the tax should be: The tax should be 45%. That would be a tax that would be an equivalent to some of the kind of, you know, devaluations that they've done."
> – Donald J. Trump, Sr., leading GOP presidential candidate

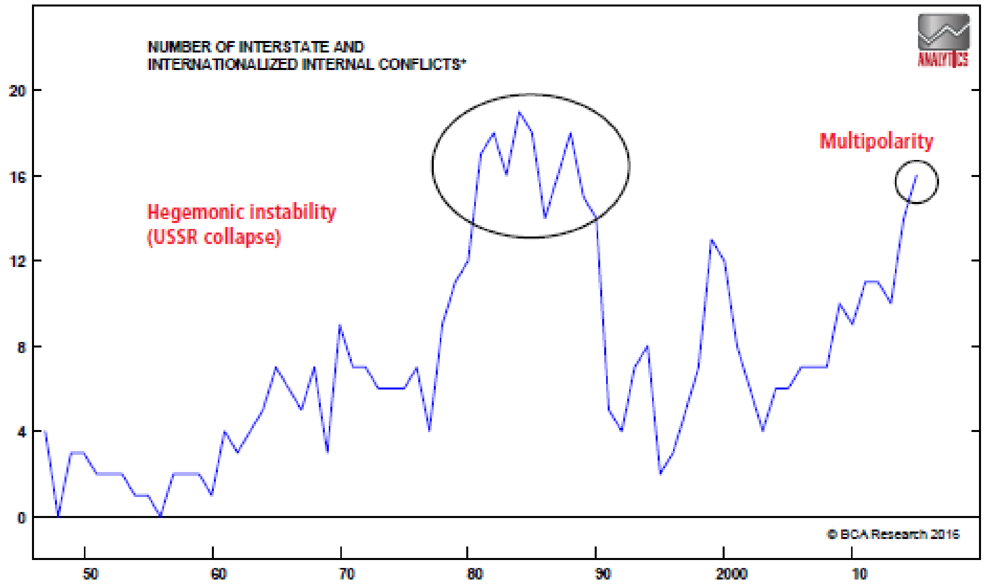
The year 2016 has started poorly for the global economy and horribly for the markets. It is very difficult to find a silver lining, a tailwind of any sort, for one-way long bets in risk assets or the broad economy (but we try below!). A number of negative themes that the *BCA Geopolitical Strategy* has articulated since 2011 are ascendant, whereas the positive ones are either pausing or petering out.

We turned bearish on global risk assets for the first time last August, looked through the dead-cat bounce in the fourth quarter, and we remain pessimists in our 2016 *Strategic Outlook*[1]. Three broad geopolitical themes inspire this pessimism.

### 1. Multipolarity

The last time geopolitical power was as diffuse as it is today was prior to World War II. Before then? World War I. Already, the number of "conflict dyads" – conflict pairings between two sovereign states – is on the rise (Figure 1). What should greatly concern global investors, beyond traditional inter-state conflict, is that a multipolar world is a leaderless one. The world suffers from "hegemonic instability," a phenomenon that defined the 1930s – an ominous sign.

**Figure 1: Multipolarity = Geopolitical Uncertainty**
Number of interstate and internationalised internal conflicts*



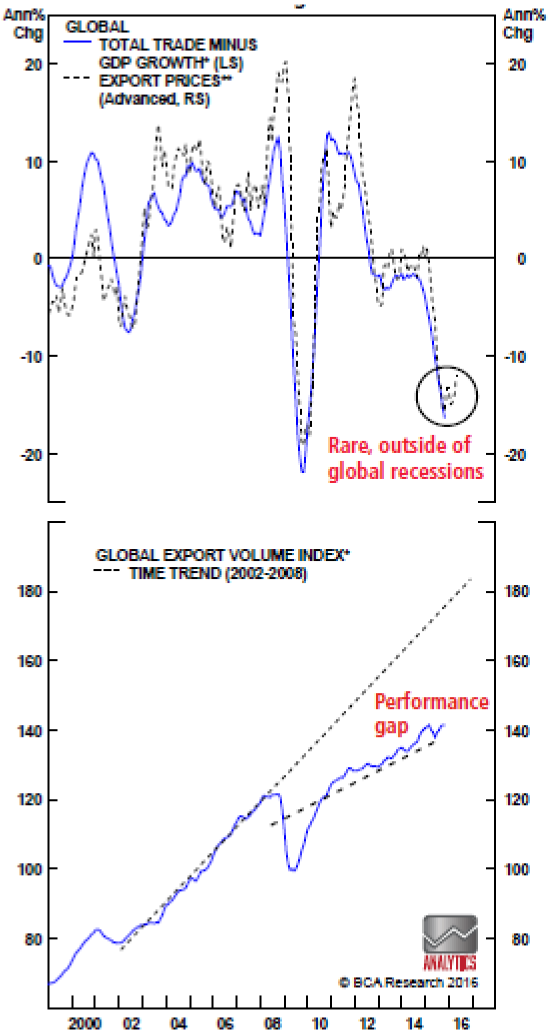

* Defined as the number of conflicts between two types of dyads (pairs); interstate conflict, which involves two states, and the internationalised internal conflict, which involves a state and an organization supported by another state.

Source: Harbom, Lotta, Erik Melander & Peter Wallensteen, (2008) dyadic dimension of armed conflict, 1946-2007. *Journal of Peace Research* 45(5): 697-710.

### 2. Apex of globalisation

In a world where the economic pie is not growing much, everyone strives to protect their own slice. In 2014, *Geopolitical Strategy* speculated that globalisation had reached its apex – a theoretical conclusion that at the time lacked sufficient empirical evidence[2]. Today, the evidence is plentiful (Figure 2). With aggregate demand muted and currency competition becoming a policy of choice, distrust between major economic powers is likely to increase, hurting the chances of major trade agreements in the future.

Figure 2: Global trade is suffering

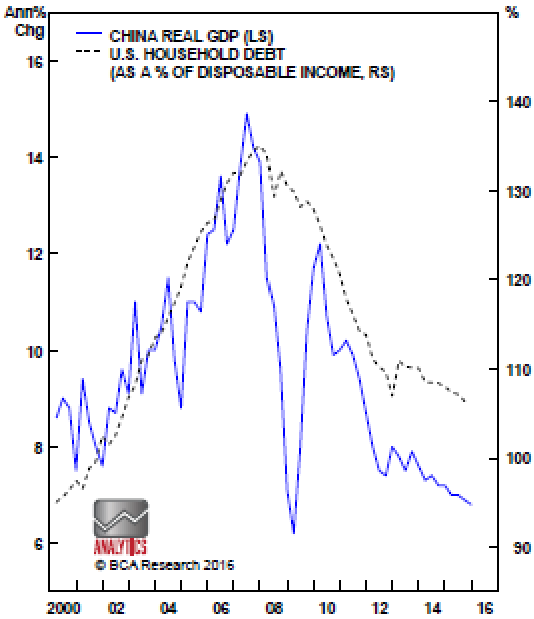



* Total trade minus GDP growth is shown smoothed and advanced by 6 months.
Data Source: IMF

### 3. The end of :Chimerica"[3]

The economic relationship between China and the US is far from over – China overtook Canada last year as America's top trading partner. But their symbiotic relationship, at risk since 2008, probably ended in 2015. With the American consumer unwilling to repeat the credit-fueled consumption orgy of the early 2000s, the Chinese economy finds itself stuck in a rut (Figure 3).

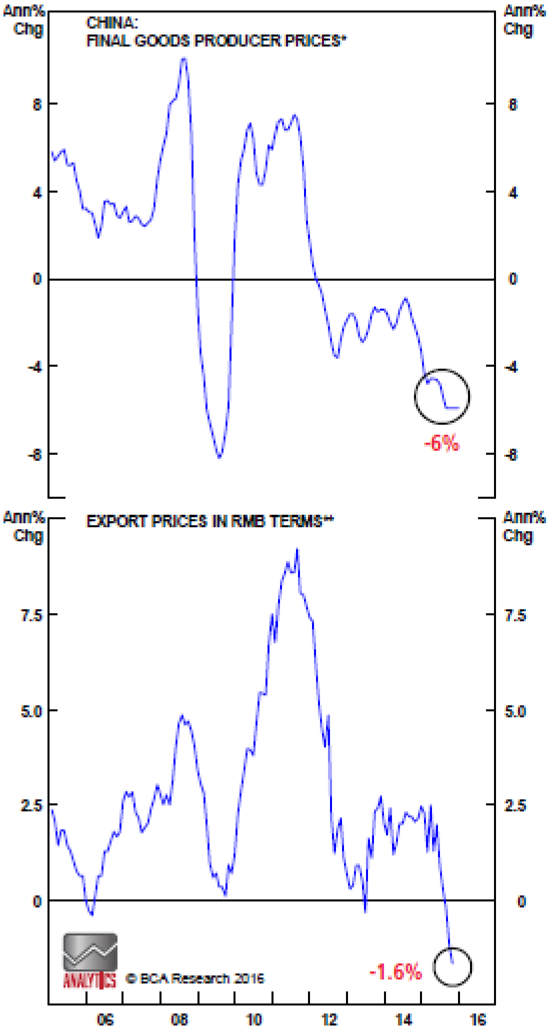
Figure 3: American deleveraging is China's pain




Source: BCA Research

The massive capacity built up on expectations that the "debt supercycle" in the West would drive demand for exports now has to be cleared, which will take time and will add deflationary pressures to an already weak global economy (Figure 4). China is pivoting its economy towards domestic demand and does not want tod ouble-down on its export and investment-led growth model. But it is in fact doing so – it is looking to export deflation both via currency depreciation and by exporting its excess capacity to the rest of the world. Both of these policy decisions will rinforce multipolarity and apex globalisation.

Figure 4: China's main export - deflation




Final goods producer prices - Datastream. Export prices in RMB Terms - Hong Kong re-export price as a proxy.
Data Source: Hong Kong Monthly Digest of Statistics

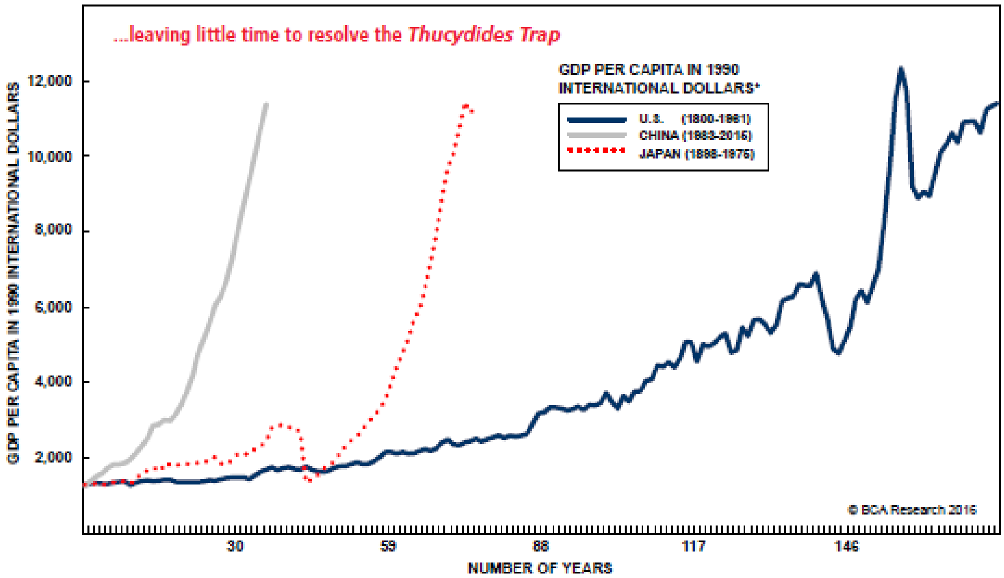
## CHINA'S CURRENCY POLICY

Uniting all three pessimistic themes is Beijing's decision to break the USD peg, perhaps the most important geopolitical consequence of China's slowdown so far. Yes, the RMB divorce from the US dollar is as much a geopolitical event as a financial and economic one. Devaluing the RMB could unleash a massive deflationary wave upon the already battered shores of the global economy - depending of course on its magnitude - but the geopolitical repercussions may be even greater.

China's decision to peg the RMB to the USD back in 1994 set the stage for an export-led industrialisation process that was larger and more rapid than any other in human history

(Figure 5). The peg was palatable to Washington in 1994 because America was ascendant economically and geopolitically. The Soviet Union had been defeated, socialism was in retreat, and the "Washington Consensus" had emerged. It was in the interest of the US to bring China into the free-market fold by any means necessary and thus expand the influence of American commercial and financial interests. China was in no way a threat to American hegemony back then – its economy was the size of Spain's, its GDP per capita at the level of Lesotho, and its military expenditure equivalent to that of Brazil. Thirty years later, China is the world's second largest economy, with a GDP per capita of a middle-income economy, and the regional hegemon of East Asia.

Figure 5: China's economic rise has been extraordinarily fast…




* GPD Per Capita in 1990 International Dollars (In Geary-Khamis dollars).

Data Source: Angus Maddison

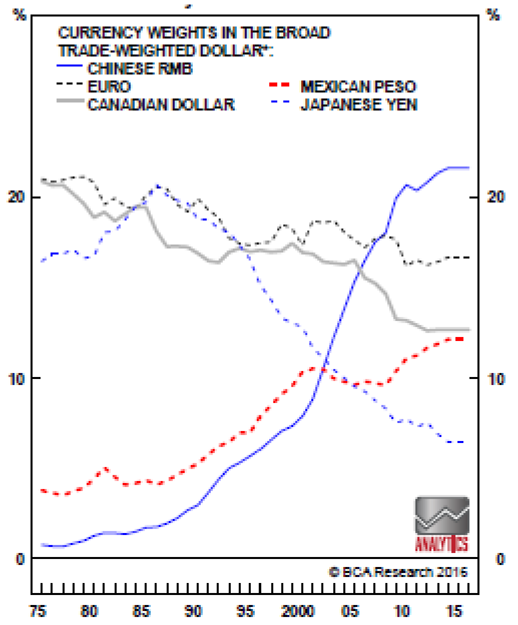
But wait - haven't the US, Europe, and Japan have all been using currency devaluation to export deflation since 2008? Is it not hypocritical to argue that China's devaluation is destabilising, especially when the RMB has only weakened by 6% since August, whereas the euro and the yen are down 18% and 26%, respectively, in the last 24 months?

The answer from G7 capitals will likely be a resounding "no". The US engaged in currency devaluation after a once-in-a-generation financial crisis; Europe due to an existential sovereign debt crisis; and, Japan has been trying to resolve two decades of deflation while dealing with the aftermath of the Fukushima disaster.

China, on the other hand, has come to the end of two decades of unparalleled growth, averaging 10% GDP growth per year. Its growth rate is slowing down to around 6%, a problem that the G7 economies would sell their own mothers to have. And most countries believe this pace of growth has come at the expense of their own manufacturing sectors. As such, it is unlikely that policymakers in the US, Europe, and Japan will accept Chinese devaluation as a necessary evil, least of all in today's context.

We expect further downside to the RMB, a view we have held since November 2014. While the pace of depreciation is difficult to gauge, the direction is perhaps more important. A weaker RMB will put further pressure on the trade-weighted dollar as it has the largest weighting in the broad measure of the TWI, at around 22% (Figure 6).

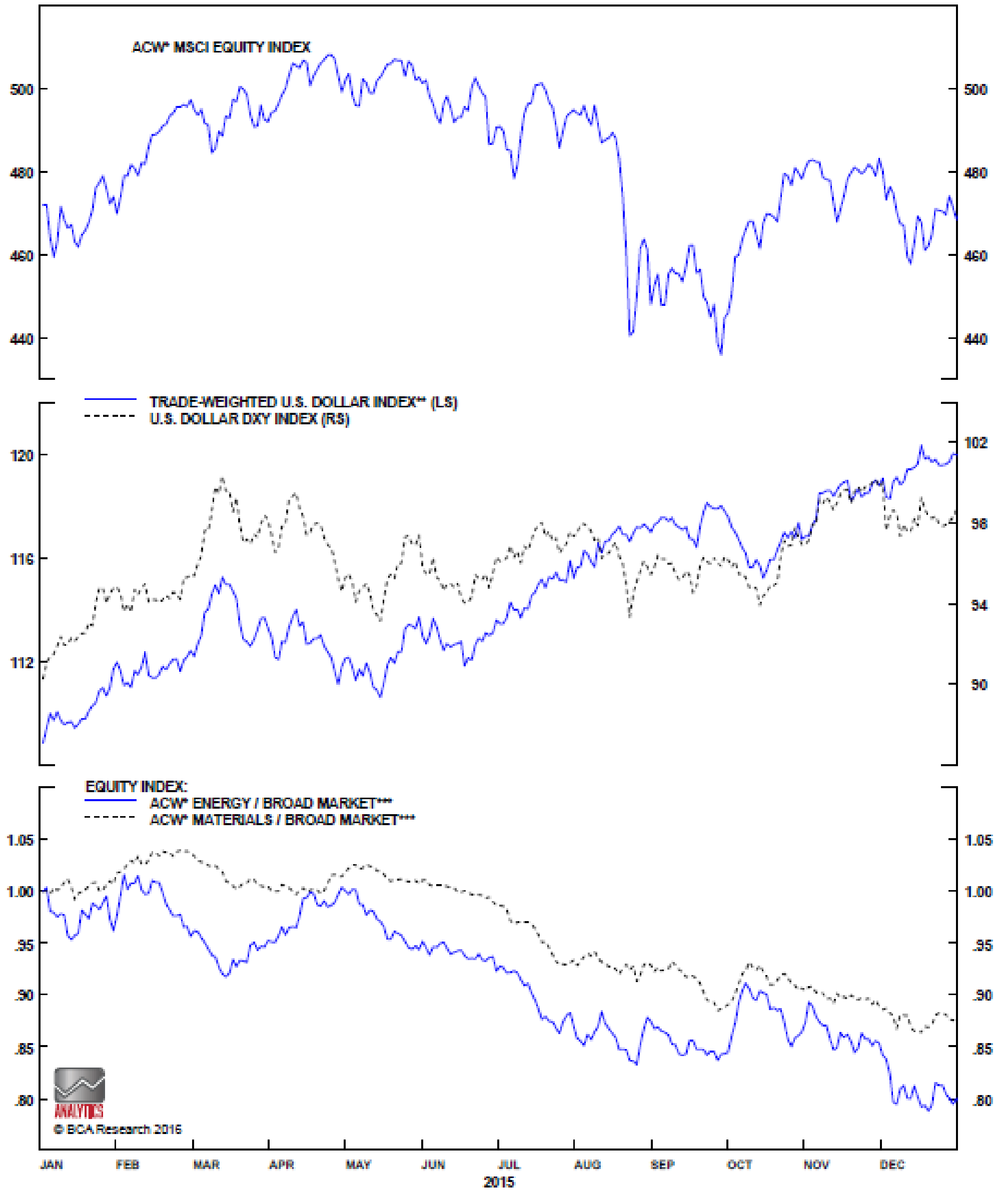
Figure 6: The RMB really matters for the USD




Data Source: Federal Reserve

This should concern investors, as Figure 7 shows that the trade-weighted dollar has recently been negatively correlated with the MSCI All-Country World Index (ACWI) as well as deep cyclical sectors.

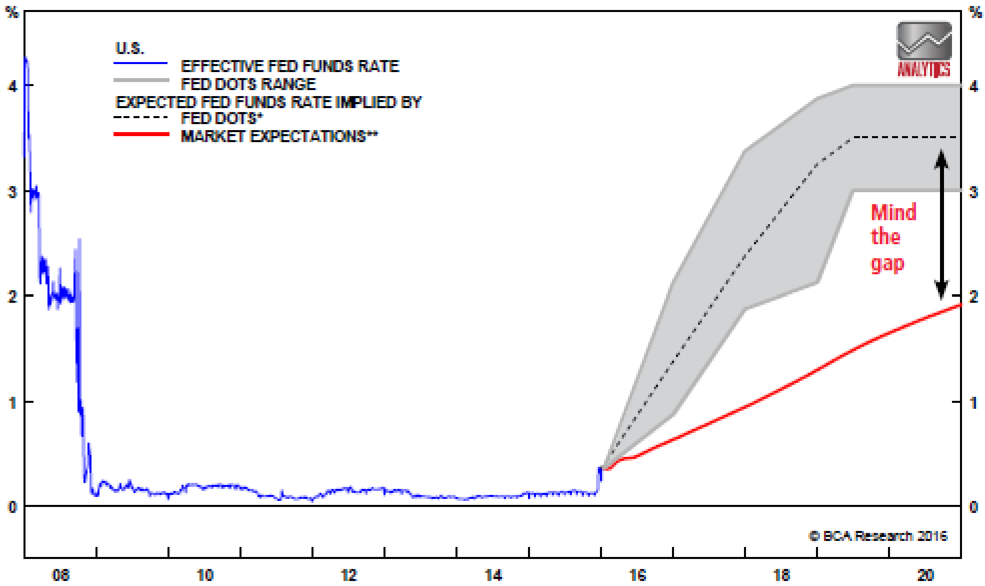
Figure 7: The USD really matters... for a lot of things




* All Country World, in local-currency terms, source MSCI Inc (see copyright declaration). ** Trade-weighted US Dollar Index, source JP Morgan Chase & Co. *** rebased to 2 Jan 2015=1.

BCA's *Global Alpha Sector Strategy* has noted that this relationship is likely to continue in 2016, especially in light of the continued tug of war between the Fed and the market over monetary tightening (Figure 8), tilting risks to the downside and making capital preservation a necessity.[4]

Figure 8: Fed Vs. the market – the main event




* Median midpoint target from the Fed's Summary of Economic Projections (December 2015). ** As discounted in the OIS curve as of 18 January, 2015.

We have long argued that Sino-American geopolitical tensions are the most investment-relevant risk today.[5] Many of our clients have pushed back against this view, noting that the symbiotic economic relationship between Beijing and Washington has acted as a constraint to the emerging "Thucydides Trap".[6]

China's decision to end its dollar-peg policy at the very moment when risks to its currency have moved to the downside significantly accelerates the already decaying symbiosis between the US and China. Clearly, the political rhetoric in the US is sharpening – and Mr. Trump is not alone in this regard (see his quote above). Given that a number of leading indicators suggest that the US economy is not as upbeat as the Fed forecasts, a market correction could create a perfect storm in 2016 that finally causes Beijing and Washington to take off their gloves. We cannot ignore the possibility that economic tensions might spill into the geopolitical theater, whether in China's near seas, breakaway regions like Taiwan, or the Korean peninsula.

## BOTTOM LINE

Our *2016 Strategic Outlook* gives many reasons to be bearish this year, but China remains the chief one, with the broader EM bloodbath a close, and related, second.[7] Further RMB devaluation from current levels – another 10% for example – would signal the real end of Chimerica, an economic symbiosis that constrained geopolitical tensions between America and China for two decades. This is an even bigger consequence than its negative impact on global prices and EM assets.

We continue to recommend our two portfolio hedges - long 30-year Treasurys/short EM equities and our "Doomsday Basket" - in anticipation of a difficult investment environment. We also do not think it is time to bottom-fish EM assets. Stay long DM/short EM equities.

## ENDNOTES

1. Please see *BCA Geopolitical Strategy Strategic Outlook*, "Strategic Outlook 2016: Multipolarity & Markets," dated 9 December 2015, available at gps.bcaresearch.com.

2. Please see *BCA Geopolitical Strategy Monthly Report*, "The Apex Of Globalization - All Downhill From Here," dated 12 November 2014, available at gps.bcaresearch.com.

3. Chimerica was a term first introduced by historian Niall Ferguson and economist Moritz Schularick in 2006, and declared to be on the rocks after the Global Financial Crisis. It describes the process by which China buys American Treasuries in order to sterilise the massive currency reserves it accumulates from its trade surpluses with the US and others. It keeps its currency pegged to the USD and hence its exports remain competitive. Meanwhile, the process of buying Treasuries lowers US interest rates to a level that promotes American consumption of Chinese exports.

4. Please see *BCA Global Alpha Sector Strategy*, "Quarterly Review & Outlook", dated 9 January 2016, available at gss.bcaresearch.com.

5. Please see *BCA Geopolitical Strategy and Global Investment Strategy*, "Sino-American Conflict: More Likely Than You Think," dated 4 October 2013, available at gps.bcaresearch.com.

6. The "Thucydides Trap" refers to a dynamic in which a rising power (China) challenges the status quo developed by the hegemon (US). As the latter looks to contain the former, distrust and uncertainty lead to a vicious cycle that ends in open conflict. From our reading of history, the Thucydides Trap has never been resolved peacefully, although conflict has taken place indirectly, through proxies, as often as directly.

7. Please see *BCA Geopolitical Strategy Client Note*, "All Eyes On China", dated 24 August 2015, available at gps.bcaresearch.com.

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*For more information about BCA's macro research, including the Geopolitical Strategy service, contact Mark Trevena, BCA Research.*

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