Only the Paranoid Survive

U.S. aims to stall China's 5G supremacy; yield curve inversion raised alarm

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The U.S. equity bull market celebrated its tenth anniversary on March 9th, but the belated birthday greeting from the bond market was "may you live in interesting times." Developed markets sovereign bond yields dropped in unison following the Fed's guidance of a surprisingly dovish roadmap and a slew of softer-than-expected economic data around the globe. The 10-year German Bund yield reverted back to the negative territory and the 10-year U.S. Treasury yield dipped as low as 2.37%. It inverted the 3-month/10-year yield curve for the first time since 2007. U.S. and European corporate bond spreads held up relatively well, but high yield spreads did widen a bit. The soft economic data also weighed on base metal prices, but failed to stop crude oil's upward march. OPEC and Russia have agreed to extend the production cuts to the end of June, and the number of U.S. active oil rigs has continued to decline. The U.S. Dollar Index moved to the upper end of its multi-month trading range and gold prices dipped slightly. In spite of the disappointing economic data of late, U.S. equities still managed to produce another month of gains.

On the political front, Special Counsel Robert Mueller's "no collusion" final report all but ensured that Democrats will not be able to derail Trump from seeking a second term. It may also strengthen his hand in the final stage of the Sino-U.S. trade negotiation where China has reportedly hardened its position of late. Some may have assumed that Trump badly wanted a deal as he was under attack politically and afraid of a stock market decline. Now, a vindicated and reinvigorated Trump may once again roll with his populist and protectionist instincts. President Trump will also have more flexibility in pursuing his goal of improving relations with Russia, although the situation was complicated by Vladimir Putin's provocative move of sending Russian troops and military equipment to Venezuela to prop up the Maduro regime. It will be a test of America's resolve and credibility in its own sphere of influence. Lastly, the March 29th Brexit "Independence Day" came and went, yet the U.K. Parliament was still unable to come to term with a post-EU plan. The choice now is either squeaking by Parliament a soft Brexit deal or face a longer extension. The Brits sure make American politicians look great again.

EQUITY MARKETS INDICES[1]	2/28/19 Price	3/31/19 Price	MTD Change	YTD Change
MSCI All Country World	503	509	1.0%	11.6%
S&P 500	2784	2834	1.8%	13.1%
MSCI EAFE	1874	1875	0.1%	9.0%
Russell 2000®[2]	1576	1540	-2.3%	14.2%
NASDAQ	7533	7729	2.6%	16.5%
TOPIX	1608	1592	-1.0%	6.5%
KOSPI	2195	2141	-2.5%	4.9%
Emerging Markets	1051	1058	0.7%	9.6%
FIXED INCOME				
2-Year US Treasury Note	2.52%	2.26%	-25	-23
10-Year US Treasury Note	2.72%	2.41%	-31	-28
BarCap US Agg Corp Sprd	1.21%	1.19%	-2	-34
BarCap US Corp HY Sprd	3.79%	3.91%	12	-135
CURRENCIES				
Australian *(AUD/$)*	1.41	1.41	0.0%	0.7%
Brazilian Real *(Real)*	3.76	3.92	-4.2%	-1.2%
British Pound *($/GBP)*	1.33	1.30	-1.7%	2.2%
Euro *($/Euro)*	1.14	1.12	-1.3%	-2.2%
Japanese Yen *(Yen/$)*	111.39	110.86	0.5%	-1.1%
Korean Won *(KRW/$)*	1124.44	1135.18	-1.0%	-1.7%
U.S. Dollar Index *(DXY)*	96.16	97.28	1.2%	1.2%
COMMODITIES				
Gold	1313	1292	-1.6%	0.8%
Oil	57.2	60.1	5.1%	32.4%
Natural Gas, Henry Hub	2.81	2.66	-5.3%	-9.5%
Copper *(cents/lb)*	295	294	-0.5%	11.6%
CRB Index	183	184	0.6%	8.2%
Baltic Dry Index	658	689	4.7%	-45.8%

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A RACE AGAINST TIME

In the spring of 1939, exactly 80 years ago, the rarefied world of physics was abuzz with excitement about the discovery of nuclear fission at a German laboratory and the subsequent theoretical proof of nuclear chain reactions. This splitting of a heavy atomic nucleus into smaller, lighter nuclei, a process that also releases a large amount of energy, held enormous potential for power production. However, some physicists also came to appreciate the far-reaching military ramifications.

In August 1939, Hungarian physicist Leo Szilard, who had fled Nazi Germany to the U.S., convinced Albert Einstein to sign a letter he wrote to President Roosevelt about the possibility of powerful bombs triggered by nuclear chain reaction in uranium. He also cautioned that Germany had stopped the sale of uranium from the Czechoslovakian mines that it had taken over.

Before the letter was delivered to FDR, Hitler invaded Poland on September 1st and triggered World War II. FDR eventually received the letter on October 11th and authorized the creation of the Advisory Committee on Uranium, the first step in the effort to develop the atomic bomb. The mission gained urgency shortly after the U.S. entered the war in December 1941. Driven by the lurid existential fear that Germany had a head start in the atomic bomb development, the Manhattan Project was given the highest wartime priority. The U.S. even considered kidnapping or assassinating top German physicist Werner Heisenberg. It was a frantic race to build the first nuclear bomb or face annihilation.

Unbeknownst to American policymakers, the German nuclear weapons program had fizzled by mid-1942. The Fuhrer never fully came to appreciate the potential of the atomic bomb. He instead poured resources into missile development, which resulted in the world's first ballistic missile, the V2 rockets that rained on London starting in September 1944. By the time the U.S. detonated the first nuclear bomb in New Mexico at 5:29 am on July 16th, 1945, the Nazis had already surrendered two months earlier. So instead of using the nuclear bomb against Nazi Germany, the Manhattan Project's intended target, two were dropped on Japan in August 1945.

How would history have turned out if the U.S. intelligence had known in 1943 that the German nuclear program was essentially dormant? Would it have slowed the Manhattan Project's progress so that Japan could have surrendered before the nuclear bomb was successfully developed? Would the U.S. have ceded military superiority to the Soviet Union, which detonated its first atomic bomb in August 1949, letting Stalin take over Western Europe unopposed?

THE NEW ARMS RACE

Today, the world's nuclear-armed states collectively possess roughly 15,000 nuclear warheads, enough to destroy the world several times over. However, few are losing sleep over the threat of nuclear annihilation. The U.S. intelligence community instead considers cyberattacks as the top threat to national security. Indeed, the new arms race is over technological superiority – from artificial intelligence to autonomous weapons – and the network is the central nervous system that connects everything. It explains why the U.S. has been pressuring allies to exclude Chinese telecom giant Huawei from building their 5G networks. The 5G mobile networks, at more than 20 times faster than existing networks, will enable the so-called Internet-of-things (IoTs) – robots, autonomous vehicles, sensors, computers, etc. – to exchange vast amount of data in real time. U.S. intelligence warned that Huawei's equipment could contain "back doors" for espionage, and that the software-heavy nature of 5G equipment makes such back doors difficult to detect. China and Huawei, of course, argued that the U.S. has no evidence to back up the allegations and accused the U.S. of being motivated by its own hegemonic pursuit.

This tussle over Huawei could have negative ramifications beyond the Sino-U.S. trade negotiation. It has already created a conundrum for U.S. allies who value their alliance with the U.S. but are afraid of jeopardizing their economic interests with China. As a case in point, German intelligence has sided with the U.S. on the Huawei issue, but the powerful trade association, the Federation of German Industry, warned that a ban on Chinese 5G equipment could prompt China to retaliate. With China having purchased $110 billion of goods and services from Germany in 2018, Germany's export-driven economy can ill afford to incur the ire of their Chinese customers. The indecision has led the U.S. to threaten reduced intelligence sharing with German security agencies if Huawei is allowed to partake in the country's 5G network buildout.

Italy recently rankled its allies by becoming the first G7 country to officially embrace China's belt-and-road initiatives. While the deal did not include 5G technologies, Italy's growing desire for Chinese investments would make it harder to reject Huawei. Therein lies the risk for the U.S. – China will try to sway U.S. allies with economic threats and incentives, and the failure of the U.S. to preserve a unified front among allies will likely hurt America's prestige and create more division. It may eventually prompt the U.S. to use the so-called nuclear option – prohibiting companies from selling critical components to Huawei by finding it guilty of violating the Iranian sanction. Such a move would open the proverbial Pandora's Box and wreak havoc in the telecom industry and global trade.

Our "moral suasion" with allies may have been further strained by the Trump administration's "cost plus 50" trial balloon, which acting Defense Secretary Patrick Shanahan was quick to shoot down. The plan would have our allies pay for the full cost of U.S. military bases in their countries plus a 50% premium for the privilege of American protection. Our allies may cynically view it as an extortion to force them to underwrite America's global hegemony. Unfortunately, given Trump's isolationist instinct, this saga may not be over and it could even backfire by creating an opening for China and Russia to gain more influence. Indeed, according to the Gallup World Poll, the median approval rating of China's leadership across 134 countries has exceeded that of the U.S., which has plunged to the lowest levels for any of the past three administrations. In the near term, America's falling stature with allies will likely diminish our soft power, and U.S. multinationals could become political pawns subject to more hostile regulation and taxation. In the long run, it could erode the greenback's reserve currency status, which has far reaching impact on America's fiscal sustainability.

THE DREADED INVERSION

The Fed's dovish pivot since the start of 2019 was a major driver for the equity rally. However, it now appears that the Fed may have gone too far on the dovish side. At the conclusion of the March 20th Federal Open Market Committee (FOMC) meeting, the august policymaking body surprised investors by signalling that rate hikes were completely off the table for 2019 and quantitative tightening would be done by September. While Chairman Powell tried to sound upbeat about the "positive outlook" in the U.S., he did acknowledge the mixed data of late, the headwinds in overseas economies, and the muted inflation. Still, with financial conditions having eased, equity markets nearing all-time-highs, and investors already convinced of the Fed's dovish pivot, one can argue that there was really no need for the Fed to be more dovish than expected. Ironically, the move may have raised the fear that the Fed was probably paranoid about something that investors were not aware of.

Financial market's initial reaction was muted. Two days later, however, a slew of weaker-than-expected Manufacturing PMI data raised the specter of a looming recession. The Manufacturing PMI was below 50 (signalling contraction) for both Japan and the Eurozone, with Germany's 44.7 reading being the weakest in six years. The U.S. manufacturing sector was still in expansion, but the 52.5 reading was the lowest since mid-2017. Investors flocked into U.S. Treasuries as a potential safe haven and brought the yield of the 10-year Treasury bond below that of the 3-month T-bill. The falling bond yields then triggered more hedging activities in the derivatives markets to accentuate the yield decline.

There is nothing magical about the yield curve inversion; it reflects investors' collective concern that the Fed has overtightened, and the fundamentals will likely head further south while inflation remains muted. Based on historical patterns, the inversion in the 3-month/10-year Treasury yield curve and the further flattening of 2-year/10-year yield curve signalled that the U.S. expansion has entered the late stage, and a recession may arrive in 12 to 24 months. That said, the script for the future is yet to be written, and nothing is preordained. It is tautological that the latest yield curve inversion will of course be a precursor to the next recession. What it cannot foretell is the lead time to the next recession; it could be weeks, months, or even years. Indeed, the Russian default crisis in the summer of 1998 triggered a brief period of 3-month/10-year yield curve inversion in mid-September. It turned out to be a false positive for the U.S. economy, which continued to expand until the onset of the recession in March 2001.

The current environment appears to be similar to 1998 in that the economic weakness has come from mostly overseas markets. China, the world's second largest economy, has posted three consecutive months of year-on-year decline in merchandise imports. Export-heavy countries such as Germany and South Korea have thereby experienced softness in their manufacturing sectors. We believe Chinese policymakers will likely pump more stimulus into its economy until a sustained reacceleration becomes apparent. It's a good sign that China's Manufacturing PMI for March has climbed above 50. The expected resolution of the Sino-U.S. trade war should help to stabilize business confidence, with the potential roll back of tariffs down the road being an additional stimulus. In short, if China manages to successfully reflate its economy in the second half of this year, the world economy could exit 2019 on a stronger footing than how it started the year. That said, one should not dismiss the warning from the yield curve inversion. China's reflation is not a foregone conclusion, and C-Suite confidence in most geographies has remained in a down trend.

BACK TO THE GRIND

With the Fed having turned more dovish than expected, it is hard to see how the U.S. monetary policy can fuel further equity valuation expansion in the near term. Stock performance will thus depend on the fundamentals. The earnings reporting season in April and May is likely to be a mixed bag as year-on-year appreciation in the greenback and weak international sales could create headwinds for U.S. multinationals. However, Street expectations have already factored in a slight year-on-year earnings decline for the first quarter– the so-called earnings recession. It will be interesting to see if companies have adjusted their capital spending plans and how they have dealt with the rising wage pressure in spite of the soft inflation readings for the broader economy. In the final analysis, we suspect equities could face a period of consolidation and a potential pullback may even be in the cards unless earnings results largely surprise on the upside. That said, we have yet to see sufficient data to suggest that the 10-year old bull market is ready for retirement. Many happy returns, we hope.

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