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Monthly Market Review

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THE GREAT DECOUPLING

Growing mistrust between China and the West; seismic shift in global sourcing trend

According to Albert Einstein, *fear* and *greed* are two of the three great forces that rule the world. Interestingly, both forces were responsible for the huge equity rally in April -- the S&P 500 Index gained 12.7%, and the NASDAQ's 15.4% surge cut the tech-heavy index's YTD loss to just 0.9%. The fear of economic Armageddon drove the Fed into uncharted territory of buying junk bonds in an effort to stabilize the financial system. This move turbocharged the risk-on rally and triggered a fear of missing out (FOMO) among equity investors. By late April, even market leadership had shifted from mega-cap tech stocks to shares of companies with the most credit risk. The widening gap between the collapsing fundamentals and stocks' strong rally seems to reflect elevated optimism (or irrational exuberance) about the pace of post-lockdown recovery. Alternatively, marginal buyers of equities may not care about valuations and fundamentals, instead choosing to trade on catalysts such as the slowing rate of infection, lifting of the lockdowns, progress on therapeutics and vaccines, etc. Regardless of the real drivers behind the rally, it is undeniable that the Fed's monetary largesse and Uncle Sam's generous bailout programs have made greed great again.

Treasury investors did not share this exuberance as U.S. Treasury yields drifted lower. However, the Fed's move into junk territory helped narrow high yield bond spreads. On the commodity side, precious metals continued their march higher while WTI crude oil prices made history by plunging to as low as *negative* $40 per barrel on April 20th. Crude oil traders were literally paying others to take their May futures contracts to avoid taking delivery at a time when excess oil supply has filled up spare storage capacity. Agricultural and cattle prices were mixed as COVID-19 caused supply and demand anomalies. There is growing concern about food shortages in some parts of the world, and China has resumed agricultural imports from the U.S. On the currency front, the greenback mounted a couple of rallies but was largely unchanged for the month.

Lastly, in case you are curious about the other great force that makes up Einstein's trio, it is *stupidity*, as in actually ingesting disinfectant in an attempt to kill the COVID-19 virus. Please, don't try it at home.

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THE JEWEL OF THE ADRIATIC

Near the southern tip of Croatia stands a medieval city with red-tiled roofs and white city walls overlooking the azure of the sparkling Adriatic Sea. Known as the Jewel of the Adriatic, Dubrovnik is a popular tourist destination hosting more than a million visitors each year. These days, the marble paved main street of the old town is eerily quiet and evokes the memory of the city's medieval quarantines.

Dubrovnik was once an independent sovereign state known as the Republic of Ragusa. Founded in 1358 after its maritime arch rival, the Venetians, were driven out, the Republic evolved into one of the most enlightened and wealthiest states of its era. Its official motto was *NONE BENE PRO TOTO LIBERTAS VENDITUR AURO* (Latin for "liberty is not sold for all the gold in the world"), and its flag featured just one word – *LIBERTAS*. It had instituted term limits among top political positions, afforded women much economic freedom, and in 1416, abolished slavery.

The lifeblood of Ragusa was maritime trade. Its commercial fleet of hundreds of ships sailed as far as Egypt, the Levant and Spain, and its diplomats were able to seal free trade deals with powerful states near and far. However, the free flow of people and goods also brought them diseases. As the plague began to spread across Europe in 1377, Dubrovnik became the first state to legislate quarantine – all merchants and sailors from plague-infested regions had to spend a month in quarantine on designated islands away from the city. Over time, the city-state built quarantine centers on these islands and established a Health Office to administer the quarantine provisions.

Due to its small population, Ragusa had to import skilled professionals and even the clergy, mostly from Italy. During the outbreak of the plague, the city-state hired specialized medicus pestis, or plague physicians, who were paid handsomely but had to live in quarantined quarters to evaluate and care for the infected. It was recorded that in 1526, a Venice-trained surgeon named Ivan Mednić was hired as its plague physician on generous terms: for a full year of service, Ivan was paid a salary of 200 ducats and his five sons each received 3 ducats per month *for life*. With his family's residence in the city costing 15 ducats per year at the time, the salary was quite high, but so was the occupational hazard.

In spite of Ivan Mednić's dedicated work, the plague still claimed the lives of more than 20,000 Ragusans, roughly 25% of its population, and paralyzed the city for six months in 1526. However, the city-state managed to overcome the health crisis and continued to prosper. Its eventual decline was triggered by another natural disaster -- a devastating earthquake on April 6,1667 that killed 6,000, including the Rector and half of the Great Council. Three quarters of the public buildings had collapsed, and the port was destroyed by a powerful tsunami.

It took Ragusans 50 years to rebuild the city, but they were unable to restore the prior glory and prosperity. The region's economy and geopolitics were also changing rapidly with the rise of new colonial powers and trade routes. In 1806, Napoleon Bonaparte marched into Dubrovnik, and the Republic of Ragusa was formally abolished and annexed into Napoleon's empire on January 31, 1808.

Equity Markets Indices[1]	3/31/20 Price	4/30/20 Price	MTD Change	YTD Change
MSCI All Country World	442	489	10.6%	-13.5%
S&P 500	2585	2912	12.7%	-9.9%
MSCI EAFE	1560	1658	6.3%	-18.6%
Russell 2000®	1153	1311	13.7%	-21.4%
NASDAQ	7700	8890	15.4%	-0.9%
TOPIX	1403	1464	4.3%	-14.9%
KOSPI	1755	1948	11.0%	-11.4%
Emerging Markets	849	925	9.0%	-17.0%
Fixed Income				
2-Year US Treasury Note	0.25%	0.20%	-5	-137
10-Year US Treasury Note	0.67%	0.64%	-3	-128
BarCap US Agg Corp Sprd	2.72%	2.02%	-70	109
BarCap US Corp HY Sprd	8.80%	7.44%	-136	408
Currencies				
Chinese Renminbi (CNY/$)	7.08	7.06	-0.3%	1.4%
Brazilian Real (Real/$)	5.21	5.49	5.4%	36.1%
British Pound ($/GBP)	1.24	1.26	-1.4%	5.3%
Euro ($/Euro)	1.10	1.10	0.7%	2.4%
Japanese Yen (Yen/$)	107.54	107.18	-0.3%	-1.3%
Korean Won (KRW/$)	1218.55	1218.50	0.0%	5.4%
U.S. Dollar Index (DXY)	99.05	99.02	0.0%	2.7%
Commodities				
Gold	1577	1687	6.9%	11.2%
Oil	20.5	18.8	-8.0%	-69.1%
Natural Gas, Henry Hub	1.64	1.95	18.8%	-11.0%
Copper (cents/lb)	223	235	5.7%	-15.8%
CRB Index	122	117	-3.8%	-36.9%
Baltic Dry Index	626	635	1.4%	-41.7%

AN HONEST DAY'S PAY?

The Republic of Ragusa's generous pay package to their plague physicians demonstrated how it valued its most essential and scarce workers. Presently, the COVID-19 crisis has revealed who our most essential workers are – medical personnel, first responders, people who keep our supermarkets and pharmacies well stocked, warehouse and delivery workers who transform our online clicks into packages at our doors, etc. Many of these workers don't make much more than minimum wages yet have high risk of being infected with COVID-19. For instance, food processing plants have become hotbeds for the virus. At Smithfield Foods' Sioux Falls pork processing plant, more than 800 of its 3,700 workers were infected. Adding insult to injury, these essential workers are making much less than recently laid-off workers. The average hourly wage at a meat processing plant is about $17. Thanks to a generous provision in the 2020 CARES Act, recently laid off workers are getting an *extra* $600 of payment per week (equivalent to $15 an hour in a 40-hour work week) on top of the standard unemployment benefits through July.

Reasonable people can debate whether unemployment benefits should exceed regular pay checks. However, it seems morally wrong that essential workers at high risk of contracting COVID-19 are paid much less than the unemployed. Should they be getting a weekly hazard bonus of $600? Who would foot the bill and how would that impact corporate profitability and inflation? It's no secret that businesses and investors have benefited handsomely from decades of stagnant real wages in the U.S. The surging unemployment rate should continue to put a cap on wage growth. However, with the government now taking an active role in managing the economy and bailing out various industries, businesses will likely face mounting populist pressure to share the wealth, especially if Democrats sweep the elections in November.

THE DEEPENING FAULTLINE

Another catalyst that will likely create upward wage and pricing pressure over time is the deteriorating relationship between China and the West. Just like the 1667 earthquake that marked the beginning of the Republic of Ragusa's decline, COVID-19 is a seismic event that may irrevocably alter the once-symbiotic relationship between China and the West. Prior to the pandemic, some in the West already harbored concerns about China's growing challenge to liberal democracy and the Western-led global order, yet many were afraid to advocate policies that could trigger China's ire as so much commercial interests were at stake. As a case in point, in spite of warnings from the U.S. and their own intelligence agencies about potential security risks, the British and German governments have elected not to ban Huawei's 5G equipment for fear of China's economic reprisals. COVID-19, however, has exposed the deepening fault line between the two sides and will likely accelerate their de-coupling.

To observers in the West, China's lack of transparency in dealing with the outbreak and its "wolf warrior diplomacy" (named after China's 2015 blockbuster film *Wolf Warrior* about a Chinese commando defeating Western mercenaries) to control the narrative have sowed the seeds of mistrust. China's effort to pin the blame for the pandemic on the U.S. is an affront to Americans. To wit, Zhao Lijian, China's foreign ministry spokesman, openly promoted a conspiracy theory by stating on Twitter on March 12th that "*it might have been the U.S. army who brought the epidemic to Wuhan*." Then on April 20th, in response to CNN's question about China's stance on two U.S. lawmakers introducing a bill that would allow Americans to sue China for "misleading WHO and causing the global spread of COVID-19", Mr. Zhao asked if anyone had asked the U.S. to offer compensation for allowing the 2009 H1N1 flu to spread, for causing AIDS, and for triggering the global financial crisis in 2008. (Fact checks: 2009 H1N1 originated in Mexico and AIDS started in Congo, if they matter at all.) Chinese diplomats' combative approach also created firestorms in France, Germany, Sweden, Italy, Australia, Brazil, and even with some of its allies in Africa.

To many in China, their diplomats' wolf warrior attitude is a sign of strength. They dismiss the global outcry over China's pandemic handling as scapegoating and believe the West has been undermining China's rise. Ironically, while the local media has been reporting rising bias and racism against Chinese, Western news outlets have noted growing xenophobia in China. In short, mutual mistrust and recriminations are reaching multi-decade highs, prompting many countries to re-evaluate their reliance on China. British Foreign Secretary Dominic Raab said there could no longer be "business as usual" with China, and Japan's stimulus package earmarked $2.2 billion to assist its manufacturers in shifting production out of China. The shortage of and price gouging in masks and ventilators will compel many countries to pursue local sourcing of products deemed critical to national security. The European Union will likely lead the local sourcing movement as its regulators may seize this opportunity to put in place higher labor and environmental standards.

GRAVE CONSEQUENCES

This decoupling will have far-reaching impact on the global economy, geopolitics, and financial markets. Just as China's role as the world's factory lifted many companies' efficiency and profit margins, the reversal of this decades-long trend will, at the minimum, create higher cost pressure. Various Western governments may further increase the scrutiny of and restrictions on high-tech

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exports to China. Some U.S. lawmakers are considering legislation to ban U.S. public pension funds from investing in Chinese companies. Indeed, on April 21st, the U.S. Securities and Exchange Commission issued a public statement warning about the "significant risks related to investments in China" due to U.S. regulators' inability to access the work of accounting firms in China.

While the proponents of decoupling are focused on China's role as a producer, there will be blowback from China the consumer. China will likely retaliate by boycotting foreign products and services – electronics, automobiles, luxury goods, films, vacation destinations. Real estate prices in major metropolises could take a hit as Chinese investors have been soaking up supplies for many years. Hardliners on both sides may also seize the travel bans to reduce cultural and educational exchanges. The Trump administration has sought visa restrictions on Chinese students studying sciences or engineering in the U.S., and conservatives in China have long viewed Western liberal values as destabilizing and subversive. With students from China having injected roughly $13 billion per year into the U.S. economy, many American colleges will have a sizeable financial hole to plug.

In the final analysis, China may be making a calculated bet that the world is too dependent on it – both as a consumer as well as a producer – to risk material decoupling from the Middle Kingdom. In their eyes, Western political and business leaders lack the fortitude to bear the economic pain of decoupling, since liberal democracies with electoral cycles tend to give in to short-termism and political expediency. China's wolf warrior diplomacy is carefully crafted to forestall any anti-China moves before they gain broader international support. As a case in point, in response to Australian Prime Minister Scott Morrison's call for an international inquiry into the origins of the SARS-CoV-2 virus in Wuhan, Chinese ambassador to Canberra warned that such a move would give Chinese students and tourists second thoughts about Australia as a destination, and would incense Chinese consumers to boycott Australia's agricultural exports like wine and beef. This warning was aimed at not only Australia but also any other countries who may consider supporting Australia's proposal. The long and bumpy road of decoupling will be a test of will and endurance. We, as investors, consumers, taxpayers, and voters, will all be part of this seismic historic shift that will alter the world's geopolitical and economic landscape. May you live in interesting times.

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