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THE RACE IS ON

Beijing's ill-timed games; earnings growth racing against valuation contraction

Global financial markets stumbled out of the gate with big risk-off moves due to two issues – expectations of tightening from an increasingly hawkish Fed and a belligerent Russia that threatens to attack Ukraine. Equities had one of the worst January performances on record, and fixed income was hurt by surging U.S. Treasury yields and widening credit spreads.

From the start of 2019, when Chair Powell made a dovish pivot after the late 2018 market tantrum, to the end of 2021, the S&P 500 Index had gone up 90% while its earnings per share gained 28%. Investors theorized that the valuation expansion was justified by falling interest rates – the Index's trailing P/E moved from 15.5x to 23x while the 10-year U.S. Treasury yield dropped from 2.62% to 1.51% during this period. Now, with interest rates rising in the face of four-decade high inflation rates and an imminent cessation of QE, investors have to face valuation contractions. Equity performance comes down to the race between earnings growth and valuation contraction. The former is driven by fundamentals, which are softening but still relatively healthy. The latter is affected by many factors – interest rates, fund flows, sentiment, etc. Valuation contraction is currently in the lead because the Fed, a race-fixer known for providing performance enhancing substances to juice earnings growth and valuation expansion, has its hands tied by high inflation. However, if inflation starts to come in below consensus in the coming months, equities could find firmer footing as investors recalibrate their expectations of the tightening cycle to be less hawkish than currently feared.

President Putin will have to choose between war and peace within a few weeks as Ukraine's thawing snow beginning in March will create a condition call Rasputitsa, or muddy and bad roads, which could bog down Russia's mechanized forces. Based on logic, Putin should favor a diplomatic settlement for which he can claim victory rather than risking a military quagmire and severe sanctions. Such an outcome would likely lead to a relief rally for stocks. However, one cannot rule out a military confrontation as Putin may figure that many European countries will eventually shy away from tough sanctions due to their reliance on Russian natural gas. Sensing that the U.S. may be too preoccupied with Russia, Ukraine, and the Iranian nuclear negotiation, North Korea has launched several missile tests to rattle the cage in hopes of forcing some concessions from U.S. and its allies. For those who are looking for some comic relief coming off a tough month, I heard the suggestion that that one way to foil Russia's attack on Ukraine is to have the U.N. pass a resolution demanding generals and soldiers invading other countries to show their vaccine passports to hall monitors before being allowed to cross the border.

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CHANGING FORTUNES

It was a highly acclaimed international sporting event designed to showcase the prosperity, unity, and ethnic harmony under the socialist banner. It was the culmination of more than a decade of planning and adroit deal-making between a communist country and its capitalist sponsors. It came at a tumultuous time during the Cold War – President Reagan had just called the Soviet Union an "evil empire" the prior year, and General Secretary Yuri Andropov died on the day after the Winter Olympics' opening ceremony, leaving behind a power vacuum. However, for 12 days in February 1984, the city of Sarajevo, in a country then called Yugoslavia, basked in the glory of domestic pride and international goodwill. Locals – Serbs, Croats, Bosnians, Albanians, Macedonians, and others – dressed in their ethnic garbs, sang their national anthem together, and worked side by side in hosting 1,272 athletes from 49 countries and thousands of tourists.

Founded in the 1450s by the Ottoman Empire after its conquest of the region, Sarajevo had thrived with commerce and religious tolerance. By the 17th century, Muslims became the majority among the city's residents as people were incentivized to convert to Islam with privileges such as lower taxes. Sarajevo was made the administrative seat of the Bosnia and Herzegovina (B&H) region in 1850. Following the Russo-Turkish War, a conflict between the Ottoman Empire and the Eastern Orthodox Christians coalition, the region fell under the Austro-Hungarian Empire's de facto rule in 1878. In 1908, Austria-Hungary formally annexed the region, which provoked much socio-political backlash and damaged the empire's relationship with its neighbors such as Russia, Italy, and Serbia. It had also unwittingly planted the seeds of the Great War which occurred six years later.

Sarajevo became the center of international tension in June 1914. Archduke Franz Ferdinand of Austria, the heir-presumptive to the throne, and his wife were assassinated by a young Bosnian Serb while they were visiting the city. The assassination led to the Great War and the eventual disintegration of the Austro-Hungarian Empire. On December 1, 1918, nineteen days after the end of the Great War, the Kingdom of Serbs, Croats, and Slovenes was created, and B&H was incorporated into it with no formal status of its own. The country was renamed the Kingdom of Yugoslavia in 1929.

From the get-go, Yugoslavia's diverse religious and national affiliations have created simmering tensions among its populace. During World War II, the Axis Powers occupied and divided Yugoslavia into several satellite states, some of which went on to conduct brutal ethnic cleansing campaigns. However, the communist-led resistance, headed by Josip Broz Tito, eventually drove out the Axis Powers and reunited the country. In 1945, riding a popular wave as the liberators of the country, Tito's People's Front Party won the general election, deposed the king-in-exile, and renamed the country the Federal People's Republic of Yugoslavia.

Equity Market Indices[1]	12/31/21 Price	1/31/22 Price	MTD Change	YTD Change
MSCI All Country World	755	717	-5.0%	-5.0%
S&P 500	4766	4516	-5.3%	-5.3%
MSCI EAFE	2336	2222	-4.9%	-4.9%
Russell 2000®[2]	2245	2028	-9.7%	-9.7%
NASDAQ	15645	14240	-9.0%	-9.0%
TOPIX	1992	1896	-4.8%	-4.8%
KOSPI	2978	2663	-10.6%	-10.6%
Emerging Markets	1232	1208	-1.9%	-1.9%
Fixed Income				
2-Year US Treasury Note	0.73%	1.18%	45	45
10-Year US Treasury Note	1.51%	1.78%	27	27
BBG US Agg Corp Spread	0.92%	1.06%	14	14
BBG U.S. HY Corp Spread	2.83%	3.42%	59	59
Currencies				
Chinese Renminbi (CNY/$)	6.36	6.36	0.1%	0.1%
Brazilian Real (Real)	5.58	5.31	-4.8%	-4.8%
British Pound ($/GBP)	1.35	1.34	0.6%	0.6%
Euro ($/Euro)	1.14	1.12	1.2%	1.2%
Japanese Yen (Yen/$)	115.08	115.11	0.0%	0.0%
Korean Won (KRW/$)	1188.90	1205.90	1.4%	1.4%
U.S. Dollar Index (DXY)	95.67	96.54	0.9%	0.9%
Commodities				
Gold	1829	1797	-1.8%	-1.8%
Oil	77.0	88.2	14.5%	14.5%
Natural Gas, Henry Hub	3.73	4.87	30.7%	30.7%
Copper (cents/lb)	446	432	-3.1%	-3.1%
CRB Index	232	255	9.8%	9.8%
Baltic Dry Index	2217	1418	-36.0%	-36.0%

Source: Bloomberg

President Tito had leveraged his popularity and cult of personality to improve ethnic relations and to foster a national identity. Under the slogan of "brotherhood and unity", Tito rolled out policies that emphasized the commonalities and interdependency among all ethnic groups. He also pivoted away from Marxist orthodoxies and promoted market reforms which led to rapid economic growth. These policies had resulted in a rise in inter-ethnic marriages and the number of people who identified themselves as Yugoslavians.

Tito did not live long enough to see the pageantry of the Sarajevo Winter Olympics; he died in 1980 at the age of 87. With his passing, the national identity that he had fostered started to fall by the wayside. A faltering economy and widening economic gaps among various republics in the federation further fueled ethnic tension. By the late 1980s, Yugoslavia's communist party, which had adopted a collective leadership model after Tito's death, was rapidly losing power like their fellow communists behind the crumbling "Iron

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Curtain." In 1990, the party was dissolved into leftist political parties in individual republics, and the nation was broken up in 1991, starting with Croatia and Slovenia declaring independence.

B&H seceded from the disintegrating Yugoslavia with Sarajevo as its capital in March 1992. The region was an ethnic powder keg as its main ethnic groups – Bosniaks (Bosnian Muslims, 44% of population), Serbs (31%), and Croats (17%) – had different national identities. A month later, the Bosnian Serbs, who wanted to create an independent Bosnian Serb state of Republika Srpska, laid siege to the city with a force of 13,000 fighters from the surrounding hills. It was the start of the longest siege of a city in modern history – nearly four years, or 1425 days. The pride and the goodwill that had united this city in 1984 turned into despair and hatred. Erstwhile neighbors and friends became enemies and inter-ethnic marriages were broken up. Residents became stoic from deaths and explosions as the city was subjected to daily shelling and sniper attacks. Neighborhoods were ethnically "cleansed" by means of killing, torture, rape, looting, and even forcible relocation at gunpoint. By the time the siege was lifted after the signing of the Dayton Agreement in late 1995, more than 13,000 had been killed and 50,000 were wounded.

The Dayton Agreement created a sovereign state, Bosnia and Herzegovina, with two entities – a mostly Serb-populated Republika Srpska and a Croat-Bosniak-populated Federation of Bosnia and Herzegovina. Sarajevo rose from the ashes of the civil war, but the ethnic tension has lingered beneath the surface. A political crisis has been brewing since last October, a quarter century after the siege of Sarajevo, as the Bosnian Serbs were once again agitating for secession. The times and the actors have changed, but the age-old force of balkanization remains.

FROM PANDA TO WOLF

The Olympics have long been used by host countries to showcase their ascendancy on the world stage. Hitler had sought to demonstrate his Aryan supremacy at the 1936 Berlin Olympics. The 1964 Tokyo Olympics was Japan's coming-out party to showcase its transformation into a peace-loving industrial powerhouse. The Soviet Union's plan to flaunt its proletariat prowess was spoiled by the U.S.-led boycott of the 1980 Moscow Olympics over the regime's invasion of Afghanistan. The Eastern Bloc reciprocated with the Los Angeles Olympics four years later. In 2008, China wowed the world with dazzling extravaganza at the Beijing Olympics, which was used to project its meteoric rise and a harmonious image resonating with the motto "One World One Dream". To the chagrin of the Chinese Communist Party (CCP), the world's attention was quickly pulled away as the Great Financial Crisis (GFC) hit the fan just three weeks after the completion of the games.

The near collapse of the Western financial system and China's success in weathering the GFC convinced Chinese policymakers that the country's unique "socialist-system-with-Chinese-characteristics" was indeed superior. China's international image reached its zenith in the first few years after the GFC, as it sustained rapid economic growth while accumulating a massive amount of foreign exchange reserves that peaked at four trillion U.S. dollars by mid-2014. Most macro-observers were convinced that, given China's rapid growth and its population at four times the size of the U.S., it was just a matter of time before the red dragon would surpass the bald eagle in becoming the world's biggest economy. Foreign companies and investors were all salivating at this huge potential market.

When Xi Jinping became the head of state in 2013, he was so confident of China's inevitable rise to the top that he ditched the longstanding foreign policy philosophy based on Deng Xiaoping's "hide your strength, bide your time" motto. Programs such as "Made in China 2025" and the "Belt & Road Initiative" were rolled out to much fanfare to advance China's self-sufficiency and global influence. On foreign relations, the so-called "panda diplomacy" that sought to earn goodwill was replaced with Xi's hardline "wolf-warrior diplomacy" that demanded respect and submission. In 2015, Xi Jinping personally lobbied the International Olympic Committee for the right to host the 2022 Winter Olympics, and China edged out Kazakhstan by 4 votes, 44 to 40. Scheduled to take place in the final year of Xi's second term, the Beijing Winter Olympics would have been a perfect platform to showcase his great accomplishments and to bolster his bid for a third term.

Much to the surprise of Chinese policymakers, their best laid plans were disrupted by a former reality TV star who shook up the established world order in trade and diplomacy. President Trump lived up to his promise of being unpredictable in dealing with China and went for the jugular in imposing tariffs and export restrictions on critical technologies. China's hardline wolf-warrior diplomacy and no holds barred acquisition of advanced technologies from abroad have also alarmed other Western countries. The goodwill and the sense of common prosperity that Xi's predecessors had created externally were replaced with fear and distrust. Then came the big blow – a pandemic out of Wuhan. The initial cover-up and the subsequent stonewalling of the international community's investigation on the origin of the virus further damaged China's image on the world stage.

ILL-TIMED GAMES

While China's image may have been tarnished externally, the CCP was able to turn the pandemic into a demonstration of its organizational and operational prowess, especially in the eyes of its populace. Chairman Xi declared war on COVID and promised to make China a zero-COVID safe haven. Through draconian containment measures – strict border controls, aggressive quarantines, and lockdowns – China was largely successful in shielding its population from the virus. The Chinese media has been brimming with pride in contrasting

America's burgeoning death tolls and surging new cases with China's eradication of the virus as proof of the superiority of the CCP's statism over the West's chaotic democracy.

The CCP might have forgotten that China has an adage similar to "Man proposes but God disposes." The Omicron variant emerged ahead of the Winter Olympics in Beijing, an inopportune time for China. The virus' elevated asymptomatic transmissibility among fully vaccinated people and the latency period in PCR tests have been putting more strain on China's border control and event management. China has resorted to creating Olympic "bubbles" to keep athletes, observers, reporters, and workers from the rest of the country, which is already on high COVID-19 alert. In response to localized outbreaks, several major cities have imposed varying degrees of lockdowns, including wholesale relocation of people from "high risk" neighborhoods into quarantine centers. The zero-COVID hysteria has even prompted Hong Kong authorities to cull thousands of hamsters after one pet shop had a COVID-19 outbreak among these furry rodents. These measures are once again disrupting the domestic economy as well as China's exports.

Outside of China, the upcoming Games appeared to have generated more controversy than excitement. The U.S. and several allies have imposed diplomatic boycotts on the Games over the country's human rights issues. Many Western countries have warned their athletes to avoid bringing their cellphones and laptops to the country out of cybersecurity concerns. In short, far from being a celebration of China's rising stature, the Beijing Winter Olympics have turned into a logistical and public relations nightmare.

QUESTIONING THE INEVITABILITY

China's recent diplomatic setbacks and domestic issues with its real estate bubble and pandemic response should prompt analysts to re-examine the popular "Rising East and Fading West" narrative that permeates the academic, policymaking, and investment fields. The prevailing consensus appears to be that China will continue to maintain real GDP growth at around 5% per annum for years, thus enabling it to become the world's largest economy by around 2030. This view of China's inevitable rise is also espoused by the country's leading thinkers. For example, Dr. Lin Yifu, a researcher at Peking University and a former Chief Economist at the World Bank, recently said that he believes China's potential growth is 8% per annum to 2035.

These rosy views of China's growth potential belie the fact that China's working age population has peaked in 2013, and its total population may start to decline within a year or two. The rising wave of defaults among Chinese property developers is a warning that the real estate sector, a pillar of China's growth for the past two decades, can no longer be relied on to juice up the economy. China's engine of innovation may also start to sputter as the West has become more guarded with technology transfers. For years, Chinese industries have capitalized on Western companies' short-sightedness – the transfer of technology to China in exchange for market access and cheap manufacturing. That door appears to be closing as the Biden Administration has continued the tough stance on technology exports that started under President Trump. These headwinds portend a much lower potential growth, and I suspect it will be quite difficult for the Chinese economy to surpass the U.S. economy in size for the foreseeable future.

Despite these structural challenges, Chinese policymakers may still target mid-single digit real GDP growth in the coming years, as it is their strategic goal to overtake the U.S. However, it will likely result in further misallocation of resources and higher indebtedness, structural imbalances, and systemic risk. At some point, economic reality will likely set in such that China would experience either a sharp reset or an extended period of Japan-like stagnation. I suspect it will likely be the latter since China's central planners cannot allow its system to be destabilized by a financial crisis.

BALKANIZATION, AMERICAN STYLE

While China is confronting growing structural problems, the U.S. also has its work cut out. Some observers believe that the U.S. is in worse shape than China in the life cycle of a country's rise and fall. Based on his studies of past empires, veteran hedge fund manager Ray Dalio has developed an "archetypical cycle of internal order and disorder" that pegs an empire's evolution into six stages. The cycle starts with the formation of a new order, which evolves to prosperity and peace, or stage 3, before the inevitable decline into the painful final stage marked by civil wars or revolutions that end in a great reset, or back to stage 1. Dalio observed that China is still on the ascendancy, somewhere between stages 3 and 4, and that the U.S. has already declined into stage 5, where "interclass tensions that go along with worsening financial conditions come to a head."

I suspect that many of us have this nagging feeling that something has gone awry with America. Our prosperity appears to be on borrowed time as the Fed has been indirectly monetizing Uncle Sam's growing debt whose size relative to the GDP has soared to all-time highs. The White House's budget forecast through 2031 does not even have the deficit as a percent of GDP dipping below 4%, a level that Washington used to breach only during times of recession.

Politically, centrists seem to have become extinct and major policy initiatives appear to be driven by ideologues or special interest groups rather than practical problem solvers who can do honest cost-and-benefit analyses. Politicians only pay lip service to fiscal discipline when they are in the minority. Our botched pullout from Afghanistan sent shudders down our allies' spines and emboldened our foes. Socially and culturally, what we used to regard as fringe and immature behaviors on college campuses – cancel culture, intolerance of diverse views,

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and the propensity to be triggered by triviality – have gone mainstream. Meritocracy and the content of one's character don't seem to matter when people are judged through the filtered lens of identity politics. Our cities are plagued with rising crime waves while the opioid epidemic afflicts all communities - urban, suburban, and rural.

This seemingly managed degradation of America is not lost on our enemies. Russian President Putin wryly commented last October that, "We see with bemusement the paralysis unfolding in countries that have grown accustomed to viewing themselves as the flagships of progress." He also observed that, paradoxically, the wokeism in America is akin to what the intolerant and dogmatic Bolsheviks did to Russia in tearing down the traditional political and economic lifestyle, as well as the very notion of morality.

KEEPING AMERICA'S EDGE

According to Ray Dalio, the internal and external strife confronting America – deteriorating finance, internal fighting, and a rising geopolitical challenger – were the exact catalysts that precipitated the decline of past empires. "No empire lasts forever," he cautioned, and he also warned that the U.S. would suffer a humiliating military defeat should we try to defend Taiwan against an attack from China.

Notwithstanding historical precedents, I believe the decline of the U.S. relative to China's rise is not an irreversible path. The one ingredient of success missing in the great empires of yore, with the exception of the United Kingdom, is democracy, which can be a self-correcting mechanism to help right the ship. The malaise of the 1970s prompted the frustrated electorate to send Ronald Reagan, dismissed by the Beltway elites as a lightweight actor and cowboy, to the White House. Reagan wound up reinvigorating America and winning the Cold War. While many still hold Donald Trump in contempt, there is no denying that if he were not elected in 2016, China may still be taking advantage of the U.S. in trade and technology transfers. After all, many in the establishment, especially the business and academic communities, were benefiting handsomely from the so-called symbiotic relationship with China. It was the lower rung members of our society who had firsthand experience of the hollowing out of America that put Trump in office, which led to a wholesale shift in our policies toward China. Today, the hawkish policy stance on China has become a rare consensus in Washington. I suspect there will be a groundswell of support for candidates who champion common sense as well as law and order in the coming elections to reverse some of the self-destructive policies.

As a stark contrast to our democracy, China's authoritarian system, while brutally efficient in decision making and execution, lacks the checks and balances mechanism. As Chairman Xi replaces the Chinese Politburo's collective decision-making model with his increasingly autocratic rule, there is a heightened risk of policy mistakes. For example, the wolf-warrior diplomacy that reflects Xi's toughness is shown to be counterproductive, yet no one in China would dare speak up against it for fear of being seen as disloyal or weak.

Another edge that the U.S. still maintains is in technology leadership, which directly impacts our economic and military competitiveness. While China has done a good job at closing the gap, or even surpassing us in some critical fields (e.g., Artificial Intelligence, 5G), their lack of mastery in advanced semiconductor manufacturing leaves them at a disadvantage. For all intents and purposes, the technology war between the U.S. and China has already begun. America has drawn first blood in seriously damaging Huawei's cellphone business by blocking the company from obtaining critical components as well as foundry service. From China's vantage point, they must be really concerned that the crown jewel of their tech industry can be so easily neutralized.

The tech war requires continued investment in human capital. China has the edge in raw numbers as some have estimated that it produces eight times more STEM graduates than the U.S. each year. However, America still has many of the world's best STEM universities and remains a magnet for talent everywhere. It is incumbent on us to protect our great STEM programs from the far left's assault on meritocracy, and to hold the far right's anti-immigration bias in check so we can attract the best talent from around the world.

America also possesses an unrivaled edge in the form of the U.S. dollar's global reserve currency status (please refer to my report, *Winning By Being Less Bad*, from last August on the geopolitical implications of the reserve currency status). This status has conferred exorbitant privilege on the U.S. – it facilitates the financing of America's burgeon debt at extremely low interest rates and allows the U.S. to unilaterally impose financial sanctions on our foes. To wit, the U.S. is threatening to cut off Russia from the U.S. dollar-based global financial system if it invades Ukraine. While Dalio has written extensively about America's seemingly inevitable decline in the face of a rising China, he did acknowledge that the reserve currency status can stick around for a while.

Given the self-reinforcing feedback loop among the reserve currency status, the economy, and military power, I believe the U.S. still controls its own destiny in maintaining our preeminent geopolitical status for years to come. However, the strategic competition with China will be fraught with internal conflicts of interest and difficult choices as China has built extensive commercial ties with the West. Indeed, some of our companies and allies are the CCP's best lobbyists.

WEIGHT ON POWELL'S SHOULDERS

China realizes that for it to surpass the U.S. as a hegemon, it has to bolster the renminbi's global status while weakening the world's reliance on the greenback. To that end, China has been pursuing a sound money policy while exploring cross-border payments in its digital yuan. Over time, it will likely leverage its

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purchasing power to insist on pricing certain global commodities in yuan. It has also been steadily accumulating gold. Some suspect that, based on China's status as the world's largest gold producer, its official gold holdings are potentially much greater than what has been reported. China's strategy is to leverage its sound money status and economic clout to have a seat at the table in designing a new global currency framework should the U.S. dollar-dominated global financial system run into trouble. Indeed, the Congressional Research Service (CRS) published a report last July about China and Russia's multi-year, multi-pronged de-dollarization efforts. It will be interesting to see how well Russia's de-dollarization efforts will help it circumvent our sanctions should Putin decide to invade Ukraine. The CRS also asked whether Congress should direct the Fed to create a digital currency to maintain the greenback's competitiveness and desirability. On January 20th, the Federal Reserve Board released a discussion paper that examines the pros and cons of a potential U.S. central bank digital currency (CBDC). It is a real big deal as the CBDC can materially alter existing financial and monetary frameworks. However, for now, the attention of investors is focused on the Fed's upcoming tightening cycle.

The much-anticipated Fed tightening cycle has already led to a sharp sell-off in assets from stocks to cryptocurrencies. It has even gotten Chairman Xi's attention as he cautioned at his recent virtual World Economic Forum presentation that there would be serious negative spillovers on global economic and financial stability if major economies slam on the brakes or take a U-turn in their monetary policies. Xi is right to flag this issue, as the Fed, being the de facto central bank to the world, now finds itself in the uncomfortable position of being behind the curve with inflation for the first time in more than three decades. If it moves too aggressively to fight inflation, the economy could become collateral damage. If it lets inflation become entrenched, it could lead to not only socioeconomic problems, but also a debt and currency crisis for the U.S. However, should the Fed manage to stick a soft-landing, Chair Powell will be lionized as a real maestro who shepherded the economy through the pandemic and its aftermath with minimal hiccups.

It is too early to tell how this monetary normalization saga will play out, but based on history, the odds are that the Fed will break something before it's over. The bond market is pricing in a rather compressed economic cycle, and equity investors look confused. In the current environment, investors should focus more on risk management than making risky bets. I would avoid catching the proverbial falling knife with the so-called disruptive innovators and take advantage of the volatility to accumulate quality stocks. Some of the market darlings that had experienced significant valuation expansion over the past few years are at risk of underperforming as the tide of liquidity reverses. On the other hand, some of the laggards of the last decade – e.g., commodities and financials – are poised to do relatively well. In the final analysis, equity market's performance comes down to whether the aggregate earnings growth can outstrip the magnitude of valuation contraction. For example, if the S&P 500 Index's aggregate EPS grows by 8% but its trailing P/E contracts 10% from 23 to 20.7 times, the price return for the Index would be down 2.8%. For now, valuation contraction has the lead due to rising interest rates and the imminent cessation of QE. However, market sentiment can turn on a dime if the Fed winds up being less hawkish than currently feared.

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