Tech War With China

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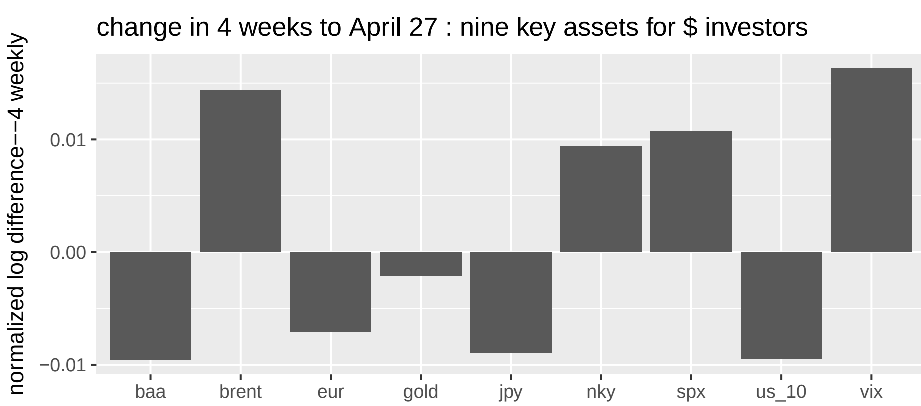
Equities managed a slim recovery, which promoted a drop in expected price volatility in the VIX and favored option sellers.

Government bond yields rose over the month, imposing losses that spilled over into corporate bonds as well. The dollar was weaker against the euro and the yen in a sign of foreign caution on adding to already big US bond holdings.

Oil prices kept rising on the risk of further war in the Middle East. Other commodities rose with US sanctions on steel, aluminum, and certain Russian commodity producers.



In the absence of new news shocks equity investments stabilized. In fact, at month-end, we had the big news of a possible de-nuclearization of Korea. Any further steps toward unification could trigger a global-scale positive shock to spending.

Central banks have long pointed to higher rates during a recovery, and short-dated and risk-free rates have risen in the US. Eventually, as the likelihood of recovery grows, expectations around these rate paths will solidify. Longer-dated and riskier credit yields are then bound to move up in yield, creating substantial losses. That choppy process is just beginning, punctuated by fears that investor's losses will derail the recovery.

These higher rate expectations can be a burden on freshly indebted emerging markets. The trouble starts in China, where deep regulation of finance is underway, but is also visible in jumpy markets elsewhere, including Brazil, Indonesia, India and South Africa.

Can We Really Block China? Fresh trade sanctions culminated in a seven year prohibition on parts sales by Americans to China's telecomm company ZTE. Earlier policies included a block on Qualcomm's takeover by Broadcom, and an ongoing restriction on sales by Huawei of cheap cell phones here. All were described as national security measures, in an argument outlined in a late Obama administration study.[1]

Trade protection is almost always foolish policy because it only serves to transfer income from many domestic consumers to a few domestic producers. It blockades access to the cheapest, and globally most efficient source of goods. Of course, the select few domestic producers of those goods will always be enthusiastic and noisy proponents of the measures.

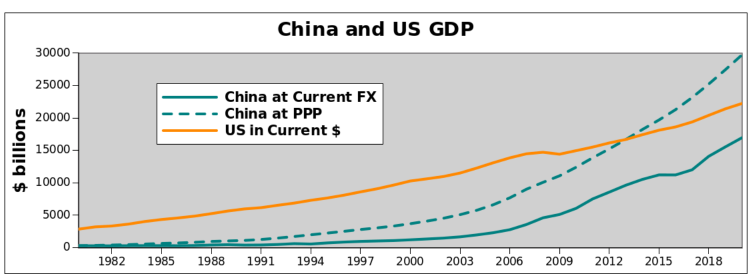
In high technology areas, protection might have some advantages, besides keeping secret one's weapons. If civilian innovations in a rapidly developing area produce transient super-profits, protected for a short time behind information barriers of any kind, then protecting a high-innovation industry can yield a flow of rich returns to society over time.

Against the gains from protection is the great difficulty today of stopping information flows and keeping secrets. The sum of human knowledge is spread through foreign direct investment, trade, and internet information flows. The internet includes, importantly, open software to which the entire human community can contribute and the use of which is absolutely free.[2]

Any US policy of blocking high-tech trade is going to run into other problems. Increasingly, the commercially accessible innovations driven by Moore's Law are giving out. New basic science to will require government spending, in an environment of aggressive ignorance and heedless US fiscal experiments that will restrict public spending capacity for years to come. China, on the other hand, has now grown to the point where it can levy taxes for socially valuable programs, including breaking into several areas at the technological frontier. We will fight any tech war with one hand tied behind our back.

Furthermore, US policy is motivated by an often-repeated claim of theft of intellectual property. Clearly, China is advancing quickly and using modern technology where accessible. Attributing that progress broadly to "theft" is a tricky thing, however. Intellectual property is a social convention designed to reward inventive effort, temporarily. It is best provided by a coherent legal design and, unfortunately, multilateral agreement. Exactly what this administration claims to reject.

In fact, any serious effort to stop China's technological gains now is probably decades too late. Since China now has a real (PPP adjusted) GDP that is larger than that of the US, it has the assured domestic market to support as big an industry as does the US. It could be hard science, but China now has the scientists, the funding, and the big and easily protected domestic market to meet protection with protection in the quest for a share of the tech innovation pie. This kind of protection could be an even bigger loser than in steel, Mr. Trump.



[1] President's Council of Advisers on Science and Technology. (January 2017). *Ensuring Long-Term U.S. Leadership in Semiconductors.* Washington, DC: White House.

[2] International Monetary Fund. (April 2018). Chapter 4. Is Productivity Growth Shared in a Global Economy? *World Economic Outlook: Cyclical Upswing, Structural Change.* Washington, DC.

A Complicated US Quarter. US consumption, which had surged on immediate recovery costs from the hurricanes, has dropped back. Insurance money has been spent, savings exhausted, and local banks are unwilling to forego mortgage payments any longer. On top of that, gasoline costs were up and floating rate mortgage payments rose. But this should all yield a one-quarter pause in consumption, nothing more. Investment, on which this recovery increasingly depends, was up, but less so than recently.

The complication comes from how the surge in hurricane recovery spending cleared out shelves and sucked in inventories through year-end, which triggered a delayed output kick into the first quarter. It certainly happened: employment over the quarter was up and so were aggregate hours, small business confidence is solid at a high level, and car production schedules have held up better than I thought. The real issue, however, is how consumption and production settle down in mid-year, and I suspect the answer is slower growth around 2-3%.

Even if activity slows, cost have started rising in a way that could persist. Wages are just bumping up on 3% growth, and selected bottlenecks keep turning up. Late in 2017 energy deliveries were disrupted by the hurricanes, since then trucking costs have jumped because of capacity limits in the long-hauling business. And we are coming up on the effects of higher metals and oil prices.

The IMF meetings came and went, and if there was a key point for US policy it was that we have opened up an unnecessary gap in public finances with the new tax law. That gap, incidentally, is supposed to assure stronger 2018 growth but I wonder if the windfall for our rich is actually a very efficient source of consumer spending. Meanwhile the B-team at US Treasury team continues to argue that IMF policy advice should focus on reducing global bilateral trade imbalances, an idea widely discarded in the early modern age.

Europe Catches Cold. Business confidence indicators have definitely turned down in Europe. Partly this may be due to unusually cold weather across a great swath of Northern Europe, but also it may reflect an underlying economic adjustment. As I have been arguing, a global inventory and trade cycle boosted activity through 2017, followed by a likely pause. Just as Europe was the great beneficiary of the trade upturn, it is hurt the most now.

More worrisome than the weather and the global trade cycle, which are temporary, is the possibility that underlying business confidence has being shaken. Armed and aggressive Russian state violence, now in Syria, earlier in the Ukraine and Crimea could raise doubts about the future. Unable to defend itself and riven by assorted populist rivalries, the European experiment seems unable to gather the energy to advance. Is a union based on consensus incapable of further progress toward coherent anti-cyclical policy? Many proposals have been made by President Macron, but few seem likely to be taken up. Who will invest in a problematic Europe?

Given these economic and political disappointments, Draghi at the ECB seems ready to notch back the pace of removing monetary ease. He can point to inflation that keeps drifting down in doing so. Because the process of normalizing policy has such big asset price impacts, he will probably stick to the ECB plan to stop new bond buying after September. But Draghi could hint at a delay the date of the first rate hike, which I had penciled down tentatively for March, 2019. A policy of long-range foretelling of future actions remains where the ECB will respond to changing conditions, if necessary.

China is Slowing, Too. Activity has bounced back from stiff pollution-control measures last year, but not in a very convincing way. By the end of the first quarter, electricity, freight, and value added in industry were all advancing a little more slowly. Surveys seems to show a whisper of weakness in the service sector, too, as M2 growth also slowed. Lastly, fears of a tech-war with the US cannot be comforting to local business. In response, Shanghai equities have been struggling at the 3,000 level and the PBOC released required reserves in a way that was understood to put an end to rate hikes for now. Bond yields came down sharply.

Credit rules are being re-arranged, as promised. First, a national bank risk supervision round is coming up designed to investigate the use of credit card and other consumer debt to get the down-payments for mortgages. Taken together, household debt has become the engine of credit expansion in China, promising to derail the high-savings and high-investment model on which China's long super-expansion has depended. Second, a unified asset management regulator is preparing some stiff and advanced rules to rein in the wild-west financial practices that have prevailed. Probably related were the fraud charges for the Anbang Insurance's chief, Xu. As one official pointed out, paying very high yields far in excess of growth almost certainly conceals a ponzi-scheme of some kind. Indeed.

A sudden blossoming of North-South relations in Korea has emerged. One motive may have been China's shut-off of energy exports to the North, possibly nudged by US trade sanctions on China. Additionally, the collapse of part of Mount Mantap after the last big nuclear test may have wiped out North Korea's immediate potential for any further tests. In any case, North Korea is a great anomaly: in a state of perpetual internal and external war that justifies a savage totalitarian regime on geneological lines. Can such a system survive without enemies? And is Trump really ready to support a hightened domestic terror within North Korea, as the price of nuclear disarmament? It would be a very counter-Reagan development. But nothing less will keep Kim safe on a personal level. Think of all those he has killed.

US trade pressures on China, China's trade pressure on North Korea, and a possible deal to take away nuclear weapons all came together this month. Some of the trade war fears we have faced may have been part of a Trumpian maximum-negotiation demand to put pressure on North Korea, and could fade. Although it is a stretch, a nuclear deal in Korea might possibly open the way to a massive reconstruction of the desperately poor Northern half of the nation.

So we have two main ideas for next month a) political progress in Asia and b) signs of economic slowing across the industrial nations. I remain convinced a pause in our recovery is to be expected as super-charged trade and inventory changes fade away to reveal a lower trend rate of growth. And the Korean news is tentative given that one negotiator, Kim, has a reasonable fear for his own life if he concedes too much.

Amid these side-stories, I still think the big story remains the process of moving the global system back toward normal interest rates. Again, this should be a choppy process with outsized losses among longer-dated assets alternating with modest gains. And it should come by rotation, not with a generalized rush to cash as in 2008.

Most importantly for traders, the rotating sell-off seems to have arrived in emerging markets, starting with China's equity market. Several others seem unusually soft, so hold on.