The US-China Trade War: Global Markets in a Multi-Polar World | David Kotok

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The market goes on climbing, finding toeholds in a wall of worry over trade war folly. But market agents are fraught with uncertainty and Trump Navarro policy is the cause. Add divided government and that uncertainty premium rises. – David Kotok

INTRODUCTION

David R. Kotok cofounded Cumberland Advisors in 1973 and has been its Chief Investment Officer since inception. He holds a B.S. in economics from The Wharton School of the University of Pennsylvania, an M.S. in organizational dynamics from The School of Arts and Sciences at the University of Pennsylvania, and an M.A. in philosophy from the University of Pennsylvania.

Mr. Kotok has served as Program Chairman and currently serves as a Director of the Global Interdependence Center (GIC), www.interdependence.org, whose mission is to encourage the expansion of global dialogue and free trade in order to improve cooperation and understanding among nation states, with the goal of reducing international conflicts and improving worldwide living standards. He has authored or co-authored four books, including the second edition of From Bear to Bull with ETFs and the newest book Adventures in Muniland.

WHY DO I CARE?

The topic I'm most interested in exploring today is the ongoing rift between the Trump administration and the Chinese state. As listeners know, I've devoted three separate episodes to understanding the Chinese political economy, but I've hardly touched on the issue of the trade war. With the G20 set to start next week, financial markets seem to be positioned for continued ossification in trade relations between the two countries.

America's position vis-à-vis Chinese trade practices had only become more accommodative over recent decades, especially after being granted permanent "normal trade relations" status by the U.S. Congress in 2000 and with its entry into the WTO one year later. The perception that America has gotten the bad end of that deal is captured in Trump's "we're getting ripped off by China" phrase. It's hard to argue with him. Even long-time

China advocate and former Chairman & CEO of Goldman Sachs, Henry Paulson, in a recent speech, criticized the middle kingdom for failing to open up its economy, while continuing to benefit from the openness of American trade. The Chinese have perused blatantly mercantilist policies similar to those employed by the United States against Britain in the 19th and early 20th centuries. Similar to Britain, the consensus among Washington's foreign policy community has been one of appeasement and accommodation with the expectation (eventually turning to hope) that in return for Chinese imports, America would manage to export more and more of its liberal, democratic values to China. This has not happened. Instead, the Chinese have used unequal trade relationships to advance their long-term, strategic objectives, including foreign policy goals that have involved pulling other countries closer into Beijing's orbit. They have used their dollar exchange reserves in order to stake a large position in US Treasury securities and supported the theft of technology and intellectual property from American and other Western corporations.

It is my view that the deterioration in US-China relations is not due to the Trump administration, but is rather a result of the country having over-played its hand in its relationship with foreign companies and in its very aggressive tactics in the South China Sea and in cyberspace. That is to say that the Trump administration is the spark that may risk turning a diplomatic war-of-words into a real trade war and maybe even, into a *real* war.

US-CHINA TRADE WAR

1. **Warning Signs** — Because the Trump administration has used US-China trade relations as a rallying cry from what seems like the first day of his primary campaign, it's hard for me to know how and when relations between our two countries began to materially change. How closely have you been following this issue? Is it something that concerned you from the moment that Trump took office or did you think that he was likely to fall in-line with the policies and actions of his predecessor?

> We're a tributary state to China, right? We're the Jamestown to their Great Britain…We're finally engaged in the economic war that they've had against us for the last 25 years. - Steve Bannon

2. **Sticks and Stones** — What are some of the material changes to our trade policies that the Trump administration has enacted? Are we still at a stage where the rhetoric does more damage than the tariffs and barriers? What are some of the best estimates available for what this is costing the US and that it will or could cost them going forward?

> History has shown that confrontation, whether in the form of a cold war, a hot war or a trade war, produces no winners. - Xi Jinping

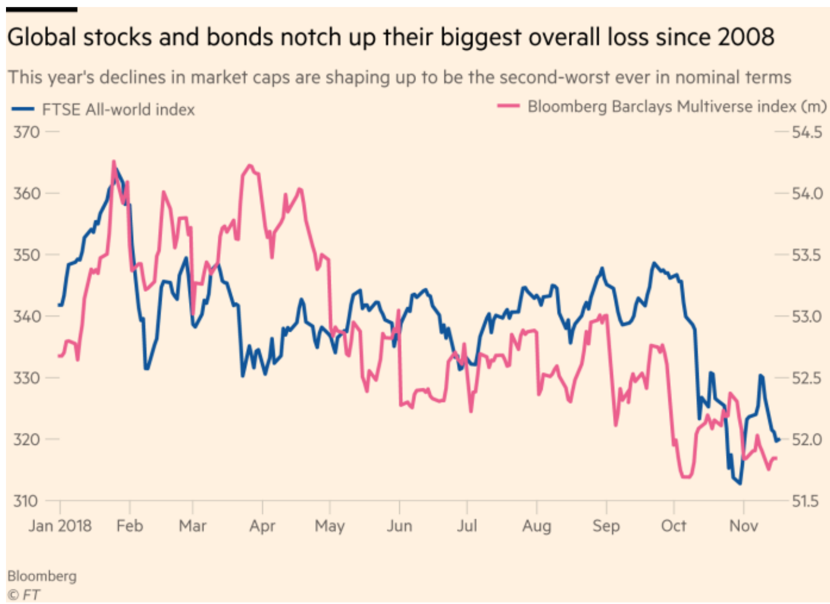
3. **Geopolitical Economics** — The United States has used its position as the preeminent global military power and its status as the leading, free-market economy to bend the international order towards Washington over the arch of post-war history. There seems to be a disconnect between American interests. On the one-hand, it has been in America's interests for the past 70 years to promote economic

liberalization. On the other hand, economic liberalization is increasingly coming at the expense of American empire. How should America's foreign policy establishment try and walk this line between the realities of this new, multi-polar world and the economic expectations formed during the height of Pax Americana in the late 1990's and early 2000's? [1][2]

4. **Risks** — In trying to isolate China, the U.S. risks isolating itself. Companies may look to base themselves in countries that are less hostile to China, instead of the U.S. Such policies could also make the prospects of reconciliation between the two countries all the more difficult. What do you see as the biggest risks associated with current tensions, both short and long-term? Is there a material risk that the United States could alienate companies that need to maintain better relationships with China?
5. **Opportunities** — It seems to me that this wager by the Trump administration could pay off. On the one-hand, current tensions could lead to the resolution of long-standing grievances by US companies against Chinese firms that have worked along-side the state to pilfer intellectual property. On the other-hand, it could help bring some clarity to geopolitical issues that have been brewing for some time, and which could eventual escalate into a hot war. What are some opportunities that could come out of current tensions, which would leave businesses, the economy, and financial markets more optimistic about relations between these two powers in 2019 than they have been in more than ten years?

GLOBAL LIQUIDITY

6. **Contraction** — Financial markets are headed for an unusually bad year, with the overall global bond and equity universe shrinking by a cumulative $5tn since the start of 2018 — the biggest contraction of capital markets since the financial crisis, where global equity markets shrank by more than $18tn. What is your forecast for the end of the year? Do you expect the Fed to continue along its path of tightening into and through its next FOMC meeting at the end of December? [3]



7. **Corporate Bonds** — Financial Credit markets signaled intensifying concern over corporate America's debt pile last week, as a junk bond sell-off deepened and the cost of insuring against defaults rose to its highest level since 2016. Exchange traded funds that track the high-yield bond market sank for a seventh day running. The iShares high-yield bond ETF (HYG) slid to its lowest level since June 2016, chalking up its worst week since February. The cost of protecting against companies defaulting on their debt also soared, with both the investment grade and the high yield credit default swap indices produced by Markit rising to levels last seen at the end of 2016. Corporations have been one of the biggest beneficiaries of the prolonged, low-rate environment, and many of them have come to rely increasingly on the bond market to fund themselves, as banks have been had to exercise more restraint in lending due to regulatory changes post-2008. How vulnerable is the market for corporate debt to the shrinking pool of dollar liquidity? How vulnerable are emerging market

These zero rates and negative rates encourage excess lending and that's of course why we're in such a perilous time right now, because if you just think about how repressed and how depressed interest rates have been for so long, the consequence of that is we have an enormous corporate credit bubble here in the United States, the largest corporate credit as a percentage of GDP ever. – Paul Tudor Jones.

companies, and have investors expressed the appropriate level of concern in your view? What impact do you think an escalating trade war will have on liquidity, particularly for private placements? [4][5]
*** The US corporate bond market has almost doubled in size the past ten years, swelling to more than $9tn from $5.5tn in 2008, while the so-called leveraged loan market, used by riskier borrowers, has more than doubled since 2012 to over $1tn. [6]

USD, ECB, & BREXIT

8. **USD —** The US Dollar has spent the past year regaining more than half its losses from 2017. How do you expect the dollar to close-out the year, and how do all of the things we have touched on thus far, including trade relations, interest rate policy, and geopolitics impact your projections? [7] [8]
9. **Europe & the ECB —** The European Central Bank is signaling that it intends to end its €2.5tn quantitative easing programme next month. Mario Draghi, ECB president, made that clear at the bank's monthly meeting in October. Yet the recent eurozone growth numbers were the weakest since 2014. The danger for the ECB is that it will have to start QE up again soon after ending it. How closely are you following what's happening in Europe's economies and how is it impacting your investment decisions? [9]
10. **Oil —** The price of Oil (WTI Crude and Brent) have made steep reversals from what was more than a year of slow but steady gains that sent prices up 70-80 percent above their summer 2017 lows. What accounts for those reversals? How important are geopolitical considerations in what we're seeing? [10]
11. **Brexit —** The Brexit negotiations have been ongoing for what feels like an eternity. The UK government invoked Article 50 of the Treaty on European Union at the end of March 2017, and is due to leave the EU on the 29th of March 2019, when the period for negotiating a withdrawal agreement will end unless an extension is agreed. What has been publicly reported on regarding the negotiations and how does what is happening in the UK inform your larger investment strategy? Most of Europe's exchanges and trading venues, which today consist almost entirely of data farms, are based in Slough, Basildon or locations around the City or Canary Wharf. The City of London also handles a huge chunk of over-the-counter trading and also has a similar dominance in interest rate derivatives, according to data supplied by the Bank for International Settlements. How is the reality of Brexit redrawing the lines of Europe's financial industry/infrastructure? [11] [12]

THE SEVENTIES

12. **A Bygone Era** — I've spent some time recently, contemplating the experience and impact of the 1970's on American society, public policy, and on the mindset of your generation of fund managers and investors. Reading about a particular time in history is only so beneficial. The only way to truly know a time is to have lived it, and even then, the experience is only your own. The second closest thing is to hear the stories of those who experienced it for themselves. I've had the benefit of doing that a bit on the show with some recent guests, most notably Howard Marks and Bill Janeway, and I'd like to continue that with you. As I understand it, you served for several years in the US military as an Army captain stationed in Germany before starting your career on Wall Street in 1970, is that correct? What was banking like then?

13. **Upside-down World** — It's hard for us to imagine today a world where nominal interest rates are multiples of current levels and yet inflation is in the double-digits and unemployment is nearing 10 percent. On top of that, we were in the midst of an energy crisis and a political crisis culminating in the first and only resignation of a sitting president in American history. How did that experience impact you at the time? How did it mold you as an investor? How do lessons learned from the 1970's inform your investing today? Could we see something similar in the coming decade or decades? What could spark it?
14. **Importance of Central Banks** — Central banks have gone from being seen as ultra-secretive, mysterious institutions with the power to make or break monarchs, to being largely irrelevant. How much of what the Fed did to stem the crisis successfully in 2008 was a result of the mystic and reverence that markets still had for the hundred year-old institution? How far are we from the days of Alan Greenspan and this idea that markets would and could always play to the Fed chairman's tune? What role do you expect central banks to play in the next downturn? Is there a disconnect between the market's expectation for what the Fed's "playbook" would be in the event of a major drop in stocks and/or an economic downturn and how this Fed would respond?

'The Pills Are Starting to Work, But I May Be Developing Some Side Effects'

15. **Bond Market** — Yields on UST's have been declining since 1981. The last four decades have been very good for the US government when it has come to borrowing money. What is your outlook for bonds? Are we nearing the end of the great bond bull market? How do you think about "risk-free" in an environment like this, when the risk-free asset of the past forty years are the liabilities of an increasingly difunctionally, highly indebted country?

EXCHANGE TRADED FUNDS

16. **ETF'd** — You have been a proponent of using ETF's as part of one's investment strategy, is that right? Depending on what ETF's you were invested in during the last ten years, you could have done quite well. ETF's have offered investors a great way to participate in the longest bull-market since the end of WWII. The ETF has been a tremendous liquidity provider to equity markets, and it has provided a floor for prices by acting as a consummate, algorithmic "dip-buyer," during this 10-year bull run. Are concerns that these systemic trading strategies could work equally "well" in reverse, and accelerate selling pressure during more violent down-moves? Are investors less educated about what they own and what they hold through these ETF's than they were 20 or 30 years ago, when they were invested primarily in specific stocks?

TECHNOLOGY SECTOR

17. **De-Fanged** — I believe you've said in prior interviews over the summer that you had become progressively underweight tech stocks. What type of exposure did you have to tech and what is your current exposure? What is your outlook for the so-called FANG's?