

GLEANINGS II - 818
Thursday July 25th, 2019

Quote of the week - “Given the bipartisan, anti-China rhetoric emanating from Washington D.C., Beijing has to conclude that its key relationship has changed. The Nixonian policy of “bringing in China from the cold” has now run its course. From Beijing’s perspective, the US’s new China policy seems to be containment - technologically, economically and geographically. Thus, even when hoping for the best, any forward-thinking Chinese leader must now fear the worst. This means dealing with China’s most glaring weaknesses of which there are three : namely its dependence on overseas supplies of (i) technology/semiconductors ¹, (ii) energy and (iii) U.S. dollars” - Louis-Vincent Gave (*after getting a BA from Duke University & studying Mandarin at Nanjing University he put in time in the French Army & then joined Banque Paribas as a financial analyst. But left there in 1999 to co-found Gavekal Research in London (that has since become a leading purveyor of independent global investment research). Then in 2002, in the belief that Asia would become a more important factor in global economic growth, he moved to Hongkong where he has lived ever since & manages Gavekal’s money management business. Long a “staunch China bull”, he has recently turned more bearish.*

Greek government bonds - For much of this century’s first decade its ten-year ‘benchmark bonds’ traded, like their US counterparts in a respectable 3-6% yield range. But then came the Great Recession &, a little later, the Greek debt crisis, after which their yield ‘spiked’ to close to 40% by early 2012. But YTD it has slipped from about 3% to at last report less < 1%, about half the yield on the UST 10 year benchmark bond - *And with Greece having a Debt to GDP ratio of 176% & the US one of 106%, one can only wonder if buyers of the Greek bonds have lost their financial marbles, or if the market is signaling where UST yields might be headed (especially now that the US bond market may be about to face newly-issued UST paper tsunami).*

Outlook for Hongkong - A recent China Ministry of Defense White Paper, the first in four years & entitled “China’s National Defense in the New Era”, reserves the right to use force to bring Taiwan into the fold with the words “We make no promise to renounce the use of force, and reserve the option of taking all necessary measures” and in the aftermath of its publication Defense Ministry spokesman Wu Qiang said this about the Hongkong situation “Some behaviour of the radical protesters is challenging the authority of the central government and the bottom line of the one country, two systems” & in response to a question if the PLA might get involved in restoring order in Hongkong that “Article 14 of the garrison law has clear stipulations ... and states that the Hongkong government ... can ask the central government for assistance from the PLA’s garrison in the maintenance of public order”, *a clear warning to the young Hongkong agitators.*

Venezuela suffered a massive blackout - On Monday July 22nd two-thirds of the country was without power for much of the day. While government blamed it on a US “electromagnetic’ attack, others attribute it to years of little new investment & insufficient maintenance and, most recently, the ‘brain drain’ associated with so many people having fled abroad. Prior to 2007 the national power company was US-owned & things worked. But then Chavez nationalized it & things started going from bad to worse. And since 2010 power failures have become almost endemic and last March there were so many blackouts that the country had uninterrupted power for only ten days.

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¹ It has just created a US\$30BN fund to promote their domestic production

RECESSION RUMBLES (Thoughts from the Front Lines, John Mauldin)

- Recessions typically do not drop out of solid growth cycles but in times when an economy is at a “vulnerable stage”. And while I still hope we won’t have a recession soon, more of the early warning signals I have depended on in the past are starting to flash signals we may be about to enter a ‘vulnerable stage’. The decade-long recovery from the last recession may have been longer than most, but has also been weaker except in asset (i.e. stock-, & real estate-) prices and since 2009 our real per capita GDP growth has been well down from its 1970-2007 trend rate. Productivity-, real wage-, & GDP growth rates have been tepid compared to their historical averages. Goldman Sachs’ Current Activity Indicator (a proxy for the current GDP growth rate based on 37 US different weekly-, & monthly-, indicators) peaked in early 2018 (about the same time that President Trump started imposing tariffs on imports from China?) & at last report was just 0.8%, down from 4.2% in February 2018. Assuming that Morgan Stanley is correct in postulating that every US\$200BN reduction in the Fed’s balance sheet has the same impact as a 0.25% rate increase, the effect of the Fed’s recent years’ tightening cycle has been significantly greater than commonly appreciated. Earlier this month, the New York Fed’s model signaled the 33% probability of a recession in 2020. And finally, the Cass Freight index that often is a leading indicator of stormy economic weather ahead has this year gone from a + 12.5%-, to a -6.5%-, YoY growth rate, to a level not seen in six years.

And while this week’s budget cum debt ceiling deal may postpone the inevitable, with the benefit of hindsight we may all see at some point down the road that this came at a price.

THE ECONOMY SLOWS TO 2.1% GROWTH IN THE SPRING AS BUSINESSES RETRENCH (Market Watch, Jeffrey Bartesh)

- The Commerce Department on Friday July 26th reported its first reading (of three) of Second Quarter GDP growth; at 2.1% it was well down from its 3.1% final reading of First Quarter growth. While better than the 1.9% expected, the loss of momentum in the business sector, especially among manufacturers & exporters, suggests the possibility that the economy may slow down further in the Second Half even as the Fed appears ready to cut its already low rate at next week’s FOMC meeting (*while a 0.25% may already be ‘in the bag’, would anything bigger than that be a sign of panic?*) There was a difference between consumers & business. Consumer spending was up 4.3%, well up from its lacklustre 1.1% rate in the First Quarter as consumers spent more on vehicles, food & drinks, and clothing, while business fixed investment was down 0.8%, the biggest drop in 3½ years, with that on buildings, plants & drilling rigs down 11% but on equipment by < 1%. Spending on residential housing was off 1.5%, the sixth quarterly decline in succession, while inventories were down by US\$44.3BN (which alone knocked over half a point of the rate of GDP growth). The bigger trade deficit also created some drag on growth as exports were down 5.2% while imports were marginally higher (*and while the bilateral trade deficit with China in the first five months of this year was down about 10% YoY, it was, despite Trump’s tariff grandstanding, just about on a par with that in the first five months of 2017*). Although government spending was up 5.2%, much of that was due to a rebound in federal outlays after last January’s partial government shutdown. The economy seems to have become a row boat with one oar doing most of the work.

Meanwhile the IMF this week cut its global growth forecast by 0.1% from what it had reported in April for each of 2019 & 2020 to 3.2% & 3.5% respectively, commenting that “downside risks had

intensified”, & slashed its forecast of global trade growth in the current year (that is now already half over) by 0.9% to 2.5%.

WHITE HOUSE, CONGRESSIONAL LEADERS REACH BUDGET, DEBT CEILING DEAL
(NBC News, Alex Moe, Frank Thorp V and Dareh Gregorian)

- On Monday July 22nd President Trump and Congressional leaders announced they had struck a budget deal that will suspend the debt ceiling until mid-2021, with the President tweeting that evening, *shortly after Mnuchin had a final conference call with the four senior Congressional leaders to make sure they were all still ‘on board’, “I am pleased to announce that a deal has been struck with Senate Majority Leader Mitch McConnell, Senate Minority Leader Charles Schumer, Speaker of the House Nancy Pelosi and House Minority Leader Kevin McCarthy on a two-year Budget and Debt Ceiling with no poison pills”, calling it (a propos of nothing?) “a real compromise in order to give another big victory to our Great Military and Vets.”* The two-year agreement suspends the debt limit until July 31st, 2021 and ends the automatic spending cuts that otherwise would have kicked in, and increases funding for the opioid epidemic & earmarks another US\$2.5BN for the 2020 Census to help “ensure everyone is counted” (*thereby effectively & formally ending the Trump Administration’s bid for the inclusion of a citizenship question in the census – that never made sense anyway since the law stipulates that everyone, citizen or not, must be counted in order to ensure a fair per capita distribution of all federal moneys to local governments*). It also stipulates there will be no “poison pills” or other new riders on spending legislation unless agreed to by all four Congressional leaders & with the President’s approval.

In other words, the spending ‘sluice gates’ will be wide open during the next 15 months’ pre-election period, fiscal probity be damned, as witnessed by a statement by Sen. Patrick Leahy (D-VT) that he would support the deal, even though he had “serious concerns” about it, since it will “allow us to make new investments in childcare, confronting the opioid epidemic, infrastructure, and American communities. Also importantly, it will raise the debt limit for the next two years² and stave off economic catastrophe.” The deal was put together over the weekend (after five months of fruitless haggling) in some frantic behind the scenes dickering that included no fewer than three conference calls on Sunday involving Treasury Secretary Steven Mnuchin & House Speaker Nancy Pelosi. And while it dismayed GOP fiscal ‘hardliners’, incl. the acting White House Chief of Staff Mick Mulvaney (who was a Congressional Tea Party original), the President faced a brick wall. For Mnuchin recently warned that the government could run out of money by early September & prompt a first-ever government debt default, and was scheduled to go to Beijing over the weekend to try & blow new life into the US-China trade negotiations, and traditionally Congress has recessed for the entire month of August (and, God forbid, that should not be interfered with). So the only things the President got out of the deal were that it avoided a possible government shut-down in September & that he retained his ability to move some money around in the Homeland Security-, & Defense-, budgets to help him fund his wall. A (sarcastic) comment by a former senior official was that “The President asked Mnuchin to negotiate a deal ...Mnuchin went to Pelosi asking her ‘How much is it going to cost me to get a debt limit deal past the election ... He doesn’t care about the cost’ ... So now Wall Street is happy ... Defense ... is happy. That’s good enough.” And, while he feeling among those Republicans who supported the deal was that Mnuchin had done a great job, those who didn’t (support it) focused on the fact that it had the

² He is (intentionally?) misstating the facts; for it is not “raised”, but made totally ‘open-ended’.

Democrats gleeful, with Sen. Rand Paul (R-KY, the libertarian 'other' Senator from that state) commenting "there's not much conservative about it ... There's stories ... that this is the final nail in the coffin of what used to be the Tea Party movement, That's sad. But may be true" and Sen. Marco Rubio (R-FL) that "it's a lot of spending. It makes it difficult ... It's a tough one to swallow. I get it, no one wants a shutdown and I don't want to see us going over the fiscal cliff, but it's just a lot of spending." But has (vastly?) improved Mnuchin's standing with both President Trump (for how long?) & many lawmakers, and made him one of the most powerful & longest-lasting members of the Trump Cabinet (which should strengthen his hand in Beijing next week).

BOEING SAYS IT COULD HALT PRODUCTION OF 737 MAX AFTER GROUNDING **(The Guardian, Dominic Rushe)**

- Last January Boeing executives reported that the Boeing 737 Max was its fastest-selling plane ever & that it expected to deliver a total of 895 to 905 planes this year (*whereas in May it delivered only 30, less than half the 68-, incl. 8 non-Max 737s, down from 47-, in the year-earlier period. But after two crashes in Indonesia & Ethiopia killing 346 people & prompting a world-wide grounding of the plane, on Wednesday July 24th it reported Second Quarter sales down 35% YoY (& 30% QoQ) to US\$15.8BN & a Second Quarter loss of US\$2.9BN (way down from the US\$2.2BN profit during the year-earlier period), results that were, believe it or not, better than some analysts had expected.* Subsequently CEO Dennis Muilenburg went on record in a conference call as saying that, if the regulators did not do more to lift their ban on the plane flying, production (*that is still proceeding at a 42 unit monthly rate*) could be slowed down if not *altogether* halted. And furthermore that "this a defining moment and we remain focused on our enduring values of safety, quality and integrity in all we do as we work to safely return the 737 Max to service ... During these challenging times teams across our enterprise continue to perform at a high level while delivering on commitments and capturing new opportunities driven by strong long-term fundamentals."

This is once was known as "locking the barn door after the horse has bolted ", for the damage the 737 Max saga has done to Boeing's reputation will be long-lasting. And it takes real brass and/or utter desperation to make such a claim; for after the accidents there was a flurry of former Boeing employees testifying that in its efforts to meet Airbus' new plane type delivery schedule, the Company had, in developing the Max series of planes, thrown all its "enduring safety, quality & integrity" caution to the wind & taken short cuts, that had contributed to, if not actually caused, the two crashes. And now, to make matters still worse for the Company, doubts have emerged that the maiden test flight of its latest new model, the 777, scheduled for next spring may have to be delayed, raising havoc with its plans to start delivering it to airlines in the fall of next year).

DEMOCRATS AND REPUBLICANS CAN'T EVEN AGREE ON THE WEATHER **(Reuters, Gaspani)**

- Years of political squabbling over global warming, incl. disputes over its very existence have grown deep roots among Americans with potentially major implications for the 2020 elections since many Democrat hopefuls will seek support for aggressive proposals for action on climate change. Thus Miranda Garcia, a 38 year-old former journalist, and Democrat resident of Des Moines IA says flooding has been getting worse in a state that has just gone through one of its wettest 12 months on record, while 200 miles away Michael Tilden, a 44 year-old math teacher & Republican resident of Sioux City IA, says "I've noticed essentially the same weather pattern every single year."

- More specifically a recent IPSOS survey confirmed that across the nation Democrats' & Republicans' vastly differed in their perception as to whether the frequency & intensity of extreme weather conditions were much-, or somewhat-, greater than a decade ago :

	Intensity	Intensity	Frequency	Frequency
	Democrats	Republicans	Democrats	Republicans
Droughts	50%	30%	50%	22%
Hurricanes	65%	38%	50%	30%
Severe thunderstorms	65%	42%	62%	42%
Flooding	90%	50%	65%	50%

The difference between Garcia & Tilden may well be in part due to Des Moines' location in a part of the state with above annual rainfall & Sioux City in one where annual rainfall is among the lowest in the state. And it may be worth noting that among Republicans the percentage of climate change deniers in at least some the above is well below Trump's popular support.

CANADA JOINS GLOBAL PACT AGAINST ILLEGAL FISHING (Canadian Press)

- On Saturday July 20th Canada officially became the 62nd member of the now almost a decade-old Port State Measures Agreement that seeks to put a dent in the global US\$23BN annual illegal fishing industry. It had signed on to it when the Agreement was first introduced, but the Harper government didn't get got around to pass the necessary enabling legislation & it took the Liberals another four to get the needed regulations in place. So now vessels arriving in Canadian ports can expect more scrutiny from officials for 'contraband fish'. In this context also Canada recently launched three maritime surveillance satellites to remotely identify & track ships suspected of carrying illegal fish.

This may well be a sisyphian task. For it is big business. Illegally caught fish account for as much as 40% of the total global catch & make a major contribution to the global oceanic overfishing problem. And the Agreement's 62 member countries are less than one-third of the global total and, worse still, two of the biggest overfishing 'bandits' are China and Russia. That, & climate change, are combining to make oceanic fishing a 'race to the bottom' & a dying industry.

HUAWEI TO BUILD WIRELESS NETWORK ACROSS ARCTIC (Canadian Press)

- Huawei Canada announced it had received federal approval to work with a northern telecom company & an Inuit development company to extend high speed 4G wireless services to 70 communities in the Arctic & Northern Québec with Alykhan Velshi, its Vice President of Corporate Affairs adding that the project was approved under the federal Security Review Program (that is run by the Canadian Security Establishment in conjunction with the Public Safety Department, Global Affairs Canada and other federal departments).

- Meanwhile, the Company (that many, incl. Washington, view as an organ of Chinese military intelligence - which it always denies) is waiting for word from Ottawa on whether it will be allowed to supply equipment for the next generation 5G wireless networks across the country amid pressure from the US not to, and its Chief Financial Officer (& daughter of the Company's founder) remains under house arrest in one of her luxury homes in Vancouver, the centre of a diplomatic battle between Canada & China since her arrest last December on an extradition warrant from Washington that wants her of fraud charges.

Early this year Huawei replaced Apple as the world's second-largest smart phone manufacturer (after South Korea's Samsung). And the concern that it poses national security risks appears to have merit. For its founder, & now Non-Executive Chairman, 74 year-old Ren Zhengfei, was employed by the PLA as a civilian "military technologist" for two decades until he was 'downsized' out of his job' in 1982, after which, a few years later, he founded Huawei on a shoe string. Moreover, a new "National Law" came into force in China last year, Article 7 of which says that "All organizations and citizens shall, in accordance with the law, support, cooperate with, and collaborate in national intelligence work ...". And last, but by no means least, according to the London-based Henry Jackson Society, an neo-conservative foreign policy think tank, an analysis of the CVs of 25,000 (key?) Huawei employees unearthed by Fulbright University Vietnam's Christopher Balding found that many had "worked as agents with China's Ministry of State Security; ... on joint projects with ... the People's Liberation Army; were educated at China's leading military academy; and had been employed by a military unit linked to a cyber attack on US companies."

SOUTH KOREAN JETS FIRED WARNING SHOTS IN CLAIM DISPUTED BY RUSSIA (AP)

- On July 23rd South Korean F-16 fighter jets were said to have fired some 360 rounds of warning shots at three Russian airplanes, two of them Russian-made Tu-95 bombers & the third a Russian made early warning & control (what the Americans call an "AWACS") A-50 aircraft, that invaded its air space on two occasions, once for three minutes & the other for four (in one of them in the company of a couple of Chinese war planes). Moscow denied that any shots had been fired, and the situation is complicated by the fact that all this took place in an "air defence identification zone" over a group of islands in the middle of the Sea of Japan that South Korea controls but Japan claims as its own, that the latter protested to Beijing for having its planes invading "its" airspace & to Seoul for having its planes fire shots in it, and that China protested that air defence identification zones are not territorial space & that hence anybody can fly in it.

Such games of "chicken" sooner or later will end up spawning a serious international incident that could lead to bigger-, & not better-, things. And Moscow getting the Chinese involved is not surprising; for they become 'buddies' that share a desire to pull Uncle Sam's beard.

NORTH KOREA FIRES MISSILES INTO SEA IN APPARENT PRESSURE TACTIC (AP)

- On July 25th it fired two missiles 600 kms into the sea (of Japan) after reaching a height of 50 kms. This was the first such event in two months and came one day after US National Security Adviser John Bolton had left Seoul after having met with South Korean officials & several days after Seoul had confirmed that its army's annual joint exercises with the US Army, that have been a burr under Kim's saddle, will go ahead as planned next month.

There are two explanations for this. One hat it was an attempt by Kim to strengthen his hand in any resumption of the stalled nuclear negotiations that he wants to result in a lessening of

sanctions' pressure on his regime, and the other that it was intended as an expression of his displeasure with the US-South Korean military exercises going ahead (an announcement by Pyongyang the next day made it clear the latter had been its motivation). And while 'not helpful to efforts to ease tensions on the Korean peninsula', there wasn't a peep out of Tokyo since neither missile landed anywhere near its territorial waters, nor violated its airspace.