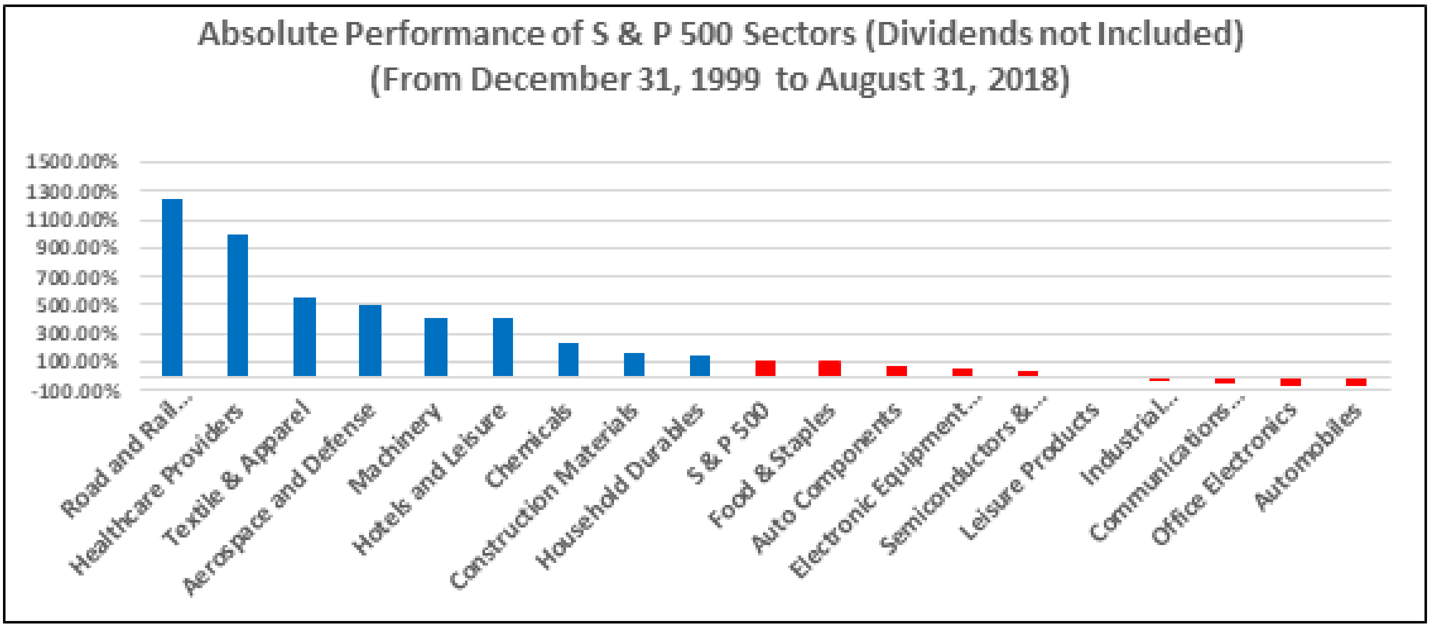
HOW MIGHT THE US-CHINA RIVALRY CHANGE THE INVESTMENT LANDSCAPE

It is tempting to say that the increasingly aggressive rhetoric against China is really for domestic consumption at a time when the US president is headed for an election. Afterall, the US has its share of problems: COVID-19 epidemic, social unrest, and a virus ravaged economy. In a situation like this, bogey men, especially foreign ones, have often proven useful tools of statecraft in rallying the population around the leadership. This, however, may be too benign an interpretation as to what is really behind such bellicosity. In fact, when the US secretary of state starts attacking not China, but the communist party, exhorts the rest of the world to "empower the Chinese people," and describes Chinese President Xi Jinping as a "true believer in a bankrupt totalitarian ideology", then the situation has taken an extremely dangerous turn because the secretary's remarks fall just short of a call for regime change.

The injection of an ideological component into this debate makes it clear that this is a permanent "war" by other means, and it will not go away even if Trump is not re-elected. Therefore, it is time to consider the possibility that irrespective of who wins the election, the world's economic order will change dramatically. But how will this affect us as investors?

Back in July 2018 we analysed the sectoral performances of the S & P 500 and produced the following graph.



Source: Standard and Poor's as reported by Bloomberg.

We were surprised to find that some of the biggest outperformers were such mundane sectors as Road and Rail Transportation, Textile, and others. When we looked at a sampling of the individual companies within the indices, we found that nearly all of them benefitted mightily from globalisation or demand from China or had significant operations in China or had outright out-sourced production in China. Some sectors like Defence and Health benefited from sector-specific fundamentals, but virtually all the outperformers (blue bars) benefited directly from the rise of the Chinese middle class (tourism, discretionary spending, luxury products, restaurant chains, etc.).

What will happen if the US manages to engineer a de-coupling of the world economy? Clearly the sectors that benefited from globalisation would have to adjust their supply chains, but this hardly means that they will re-localise to the US. Therefore, the ills of globalisation (stagnating standard of living in the West and rising inequality) will persist. But things are likely to be considerably worse than the proponents of the de-coupling imagine. In fact, with no large-scale re-localisation, and the world's second biggest economy concentrating on doing business with its Asian neighbours and other non-western countries, the West will be deprived of the fastest growing and most lucrative markets in the world. This will be particularly painful for Europe, which is export-driven, and by extension for the US since it trades with Europe. This raises an interesting question: How will Europe deal with a de-coupling? Will it simply follow the US down the path of de-coupling and stifle its own growth potential, or will it go its own way. The determined resistance to US pressure with regards to Nordstream 2 may be an indication of the way Europe will go.

In summary, we believe that if there is (as there seems to be) an effort to de-couple from China, the following is likely to happen:

- If Europe will go its own way, the Euro will increasingly be seen as an alternative to the dollar as a reserve currency. As a result, the US dollar will gradually lose its lustre as a reserve currency.
- US financial markets will lose their relative attractiveness and money will start flowing out of the US.
- The US economy will underperform Europe's while US inflation will start rising as the dollar weakens.
- There will be no benefits accruing to the US population since any re-localisation will likely increase the use of robots.
- The US sectors that outperformed during the globalisation period will start lagging, but that does not mean that those sectors that lagged during the globalisation period will come to life again because there are now too many entrenched players from Asia whose competitiveness will be difficult to equal.

This is the seventh Newsletter we write since March 2018 about the trade war, which we have analysed from every angle and have always come to the same conclusion: It is simply bad for everyone, and with the world economy ravaged by the COVID-19 pandemic, it is the worst possible moment to ratchet up tensions. Unfortunately, I fear that the worst-case scenario is becoming the most probable one from the moment that ideology has been explicitly injected into the discourse.

FILIPPO SCHIMENTI
CHIEF INVESTMENT OFFICER

PRIVILÈGE MANAGEMENT SA
VIA C. MADERNO 6, CH-6901 LUGANO, +41 91 923 23 30 - HÖSCHGASSE 31, CH-8008 ZÜRICH, +41 43 543 22 50
WWW.PRIVILEGE-MANAGEMENT.COM - INFO@PRIVILEGE-MANAGEMENT.COM