

Weekly Commentary 50 – Dec 2022

Heck, it's already the end of 2022...

It's been an eventful year. The only good news about 2022 is that it is coming to an end.

For the final Weekly Commentary of 2022, I will simply make a few points that provides my views on what to expect in the new year.

The world has never been more divided since the end of the Cold War. The world has been divided into three groups – the first being the countries that claim they know what it takes to drive economic growth in their countries, which is unfettered capitalism, and on this belief, they also package it with liberal one-man, one-vote democracy. The second group are the so-called authoritarian countries, inspired by China but not led by it, since China does not want to lead anybody, and this model rejects the histrionics, the mayhem, and the wastefulness of electoral politics, and have so far proven they have a better business model, driving growth at a much higher rate than the competition. And finally, there is the rest, countries that do not want to be involved in the ideological battle between the two blocs above. These were once called non-aligned countries, but now we can call them non-combatants.

There are two unresolved conflicts in the geopolitical situation above. The first is a proxy war between the people who think they are “free” by negligently keeping a blind eye to innumerable social problems in their own societies while teaching others how to run theirs. This group called the collective west have pushed for a war against Russia and when the latter finally took them on, the victims were Ukraine and continental Europe. The conflict is unending, but numerous pundits have said that Russia will not lose this war. Both sides want unconditional surrender from the other side, and so the fight goes on. Let's see if and how it all ends in 2023. Exhaustion, rather than defeat on the battlefield, will be the deciding factor.

The other conflict is the technology war, in which the US, fearful of losing its hegemonic status and become relegated to number 2 in everything except how large a military they have to upkeep to manage that hegemony, has launched a trade war as well as a technology war against China. The trade war has been admitted to be a failure and now the battle is being waged on chips. The Americans have a head start, and it will take a few years to see if there is a final victory on their side. Chances are the Chinese will catch up in no time, and then the US will be behind in everything except remaining a wasted, global military power. But that is useless if that power cannot be exercised against the two peer competitors who have the nuclear weapons that it does not want rained on its cities. It will take another decade to work out who's number 1 and who's number 2, in a non-nuclear competition, and 2023 will show us early signals of an eventual outcome. What is ominous or would be nice to see, depending on which side you are on, is the fact that the Ukrainian war has created the

conditions for Russia and China to get closer to each other, and this will form the basis of a new geopolitical giant in the Eurasia mainland, which maritime powers should fear. For most of us in the rest of the world, who cares?

Then there is the third bloc in the world, the folks who don't want to belong to either camp. This group is not actually sought by the Chinese to become their friends, and more by the Americans who want to build alliances against China. The interesting thing is that because the Chinese are interested in trade and commerce, they build infrastructure everywhere they go to facilitate the transport of goods and raw materials, and by that modus operandi, they make friends wherever the countries like the infrastructure, all done cheaply and effectively. This then poses a threat to the country which aspires to be the leader of the "free world" – the US of A.

At the same time, this third bloc of countries have been forced to use the US dollar as a reserve currency which during the early stages of Ukraine war made them all realised that the country which wants them to use its currency can also confiscate their national reserves like they did with Russia. There is a sense that holding US Dollar reserves is a precarious undertaking and most countries now prefer to de-dollarise, ie do away with relying entirely on the use of the dollar. What is amazing about this trend is that most of these countries used to be buddies with America, and they now want to become members of a newly created BRICs organization, with its own reserve currency, or even something even closer to China, the Shanghai Cooperation Organization, using the Chinese RMB. That is not good for the current financial hegemon – the United States.

This leads to one of the most important influences on the global economy in the new year – the resumption of Chinese growth. It can be summarized this way:

China, the world's largest economy by Purchasing Power Parity, or if the US dollar is no longer the world's reserve currency, has been in lockdown for almost three years as it pursued a COVID-zero policy. Quick lockdowns executed as randomly as the wily virus spread have not only led to a cessation of the rapid economic activity that the world came to expect of China, but they also caused a disruption of global supply chains as the "world's factory" slowed down.

With China's economy so dominant in global demand, any signs of zero-COVID being loosened has a ferociously large impact on financial markets linked to China's resurgence. If China persists on this cautious path towards reopening the economy, then the world can expect a stronger year ahead for China-facing markets — as long as China does not falter again on another serious COVID exposure.

The hope that China would terminate its COVID-zero policy have already driven currencies in the direction in which they could benefit from Chinese economic growth.

“While rising case numbers and new restrictions pose a threat to near-term growth, signs of a shift in outbreak management have boosted hopes authorities will abandon COVID-zero in Q2 2023,” says Matt Richardson, Senior Client Manager at OFX.

From a health perspective China’s COVID-zero policy has been very effective, with a reported death toll of 5235, compared to 1,112,965 in the United States as at 18 Dec 2022. So much so that, if you ask me, the Chinese public health system had gotten complacent.

From an economic perspective, it has been probably been considered worth the pain, with China’s economy slowing to only 3.9% growth over the past year, compared with its target of 5.5% for 2022. This is unavoidable, when big cities like Shanghai and Beijing and sometimes up to 40% of the country, have been shut down. Unemployment, especially among the young, is also rising. It was a carefully orchestrated trade-off but it cannot be expected to be perfect.

As the world saw, the restrictions finally cause incidents of frustration, and the Chinese government started to pivot on zero COVID rules. In moves that almost seem to come too quickly, testing requirements for activities such as taking public transport were scrapped or scaled back, and the country’s chief health official in charge of the COVID response started to talk in less dramatic terms of the severity of the virus. Signs of the change in outbreak management have boosted hopes the government will abandon COVID-zero within six months. For good.

As a result, the Chinese RMB is gaining strength on the hope of a reopening in the economy. Against the US dollar, the yuan hit its highest level since mid-September on December 5, and then had its best week since 2005 as it climbed 1.6% in the week to Friday, December 2, although US dollar weakness also contributed to the surge.⁴

Besides the currency, the prospect of lockdowns being eased boosted stocks linked to Chinese growth. Top investors have turned bullish on the Chinese economy based on the likelihood of continued reopening. That has driven the benchmark Chinese stockmarket index, the CSI300, to rise nearly 10% in November as nearly US\$8.5 billion flooded into

equities from net inflows of money to buy holdings in mainland Chinese companies which concurrently drove up the value of the Yuan.

China-facing currencies also do well

According to OFX's Richardson, "*hopes that China could move away from its current COVID-zero policy have already benefited currencies correlated with Chinese economic growth.*"

On December 5, for instance, Australia's major mining companies shot up as much as nearly 7% on the prospect of a rise in the price of iron ore, while the Australian dollar hit its highest level since early September. The New Zealand dollar is also performing strongly, up 1.82% against the USD the five days up to December 5. As a significant exporter of agricultural commodities to China, its strength is also strongly correlated to a Chinese reopening.

Reopening will have global benefits.

As the "world's factory", China's lockdowns have had a deeply negative impact on global supply chains, pushing up prices as retailers are forced to carry more stock, or bid higher for limited stock of goods.

The Foxconn factory in Zhengzhou in central China, accounts for 50-60% of global iPhone assembly capacity. The factory's closure in November prompted Apple to warn that there would be longer wait times and fewer shipments of the latest iPhone.⁷ Extrapolate that across China's manufacturing ecosystem, and the global impact of rolling closures gives a hint of how disruptive lockdowns have been.

"A broad reopening of the Chinese economy will offer welcome relief to global supply chains and growth prospects," says Richardson.

As economies continue to feel the pain of stubborn inflation, the reopening of China could help ease global inflationary pressures caused by supply chain issues. Cooling inflation would allow central banks to ease on the aggressive rate hikes that have been implemented to curb consumer spending and bring inflation under control. Changes in relative interest rates between countries will impact the demand for currencies as investors chase higher yields.

On the flip side, China's restrictive travel rules have meant that demand for oil has been muted, while decreased factory output has curtailed electricity usage. A reopening may result in upward pressure on prices for energy commodities.

A clear commitment by Beijing to reopening would unleash three years of pent-up demand and supercharge Chinese growth. "

While a Chinese reopening is unlikely to be a bad thing, relaxing restrictions in China could also be a problem. There are concerns about current vaccination coverage and that China's large elderly citizenry may be more susceptible to an outbreak. If China were to lift strict restrictions now, between 160 million and 280 million people could be infected. Fatalities will be far lower, as it is now the Omicron variant that is spreading. The health risk of COVID

is largely over –the virus has evolved away from the dangerous pathogen it was when it first got noticed in Wuhan three years ago.

What the world needs to see is a clear commitment by Beijing to reopening which would unleash three years of pent-up demand and supercharge Chinese growth. It's likely the government would add economic stimulus to lift output from the current 3.9% to the 5% GDP growth target set by the Politburo of the CCP.

That would result in higher prices for commodities, benefiting commodity currencies like the Australian dollar and New Zealand dollar. It would also benefit the Chinese stock market, meaning a currency inflow into China from countries like the US, pushing up the value of the RMB.

At the same time, it will raise global energy prices, which will likely revive US and European inflation, test their central banks' resolve to end interest rates hikes. All told, a surge of growth in China will lead to a stronger US dollar and likely weaker European currencies. As such, it is not improbable that the strong US dollar is in temporary remission, waiting for another bout of inflation due to rising energy prices kicked off by resumption of strong Chinese growth.

The other major impact on the global investment markets is how that the US stock market will turn out. Here is a succinct analysis of the outlook for US equities market, from SeekingAlpha.com.

DIA, DJI: If History is Any Guide, A Recession In 2023 is Due

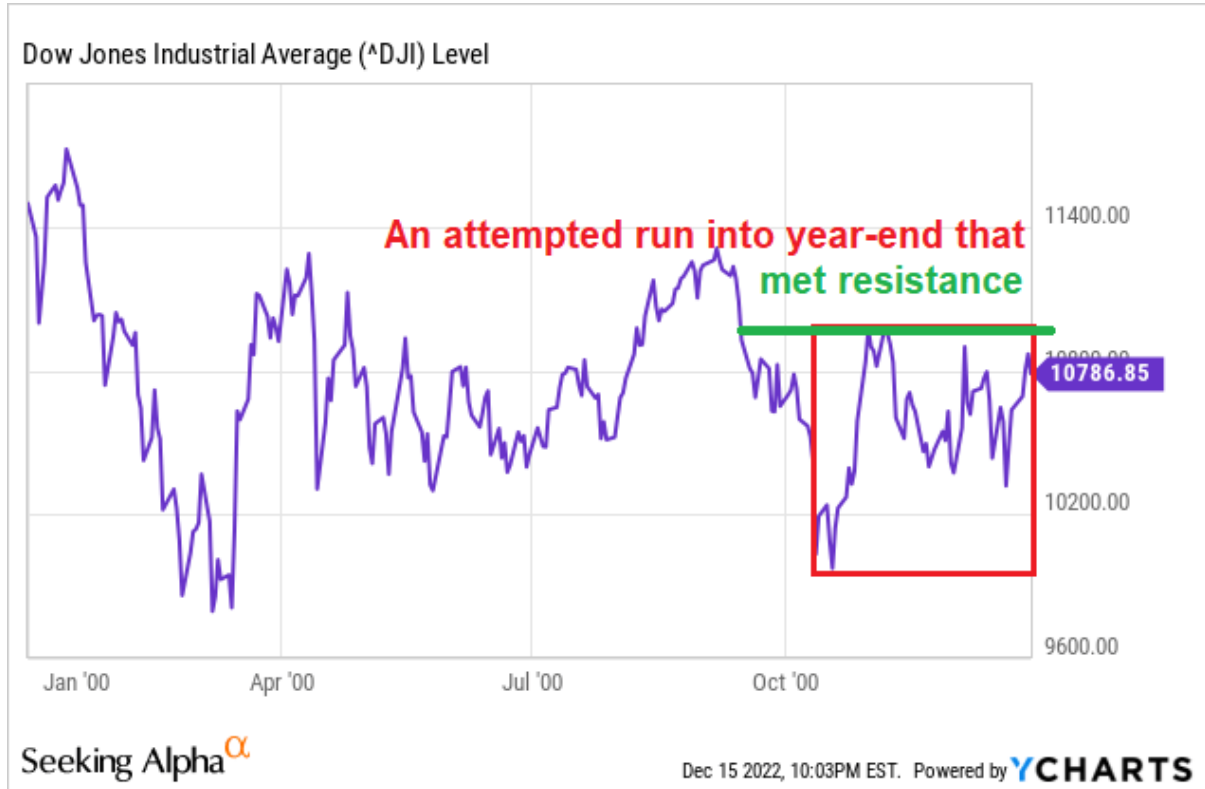
Dec 16, 2022, The Macro Teller

“There's a lot of resemblance between how the Dow Jones Industrial Average behaved back in 4Q/2020 to how it's behaving in 4Q/2022.

- *There's a lot of resemblance between the current cycle to the tech bubble burst of 2000-2002.*
- *With an expected sharp downward revision to earnings, the main indices will have to adjust their valuations down sharply too.*
- *Based on history, there's still plenty of bad action ahead of us before we can start looking for a market bottom.*

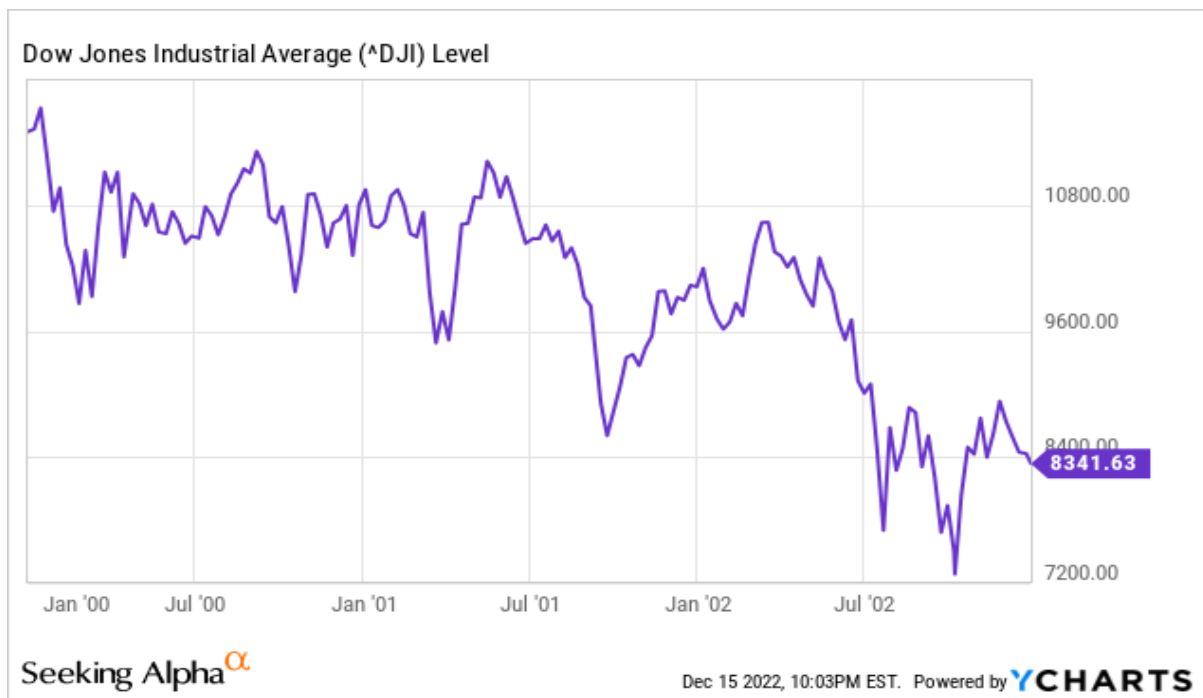
A couple of weeks back, we promised to "share extracts from our weekly reviews." This article, taken from an analysis originally published for Macro Trading Factory's subscribers on Nov. 28, is part of that effort.

Back in 2000, the Dow Jones Industrial Average Index (*DJI*) had a massive run-up just like it's having right now.



Y-Charts, Author

Shortly after, this is what happened:



Data by [YCharts](#)

This cycle we're witnessing now is very similar to the 2000-2002 technology, media, and telecom ("TMT") bust:

- **Tech/growth wreck in both cycles**

TMT Bust: Tech top in early 2000... Tech wreck... SPX top in Mar 2000... Persistent yield-curve inversion in mid 2000... Recession in Mar 2001

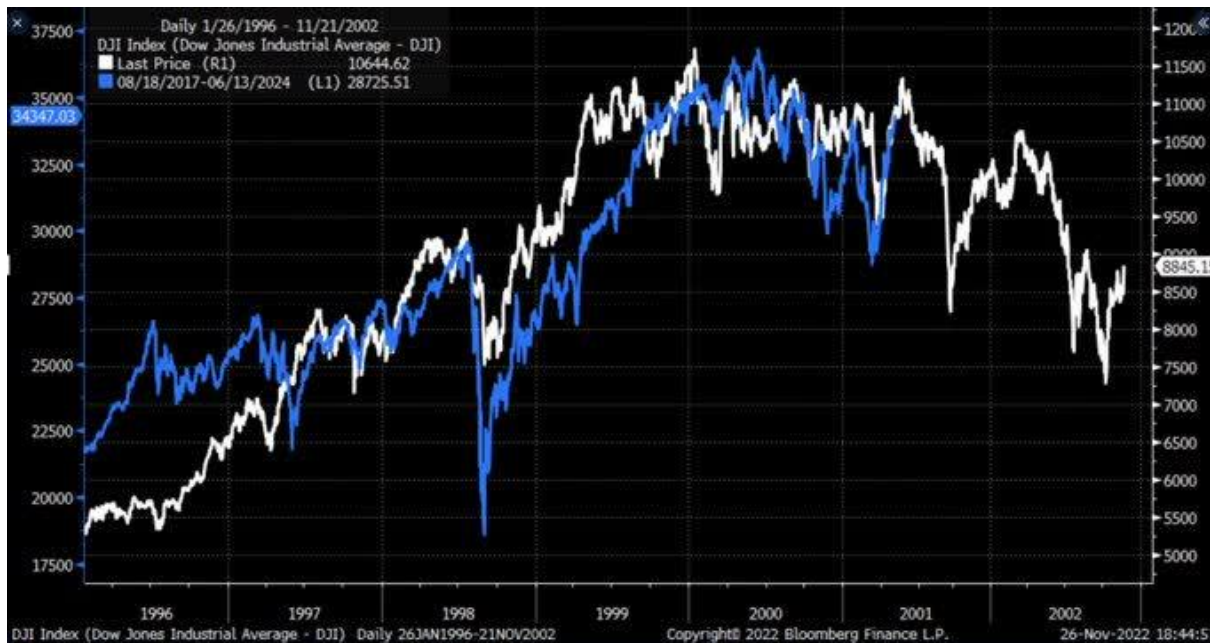
Current cycle: Tech top in late 2021... Tech wreck... SPX top in Jan 2022... Persistent yield-curve inversion in mid 2022... Recession in 2023?

- **Relative outperformance of old economy (value) in both cycles**

TMT bust: Old economy outperformed-then tanked during the recession... Energy stocks kept rallying and topped out almost a year later in 2001 before declining ~50%

Current cycle: Old economy has outperformed... Energy ([XLE](#)) has rallied for nearly a year post-SPX peak.

- **DJIA strength in both cycles**



Bloomberg

Over the past 70 years, all SPX recessionary bear-markets ended only after the initial rate cut by the Fed, and in most instances SPX continued to decline even after the first rate cut.

During the 1980 recession, SPX didn't decline by more than 20% (bear-market), but the TTM P/E ratio back then was 7x! = way more starting point than the one we're at now.

Forward P/E at bear market lows since 2000:

- 2000-2002: 14x
- 2007-2009: 9x
- 2011: 11x
- 2018: 14x
- 2020: 13x
- Current: 17.5x* or 23x**.

**Based on \$230 EPS for 2023, which seems completely unrealistic. **Based on \$175 EPS for 2023.*

No matter how you spin this around, SPX multiple is still (you may add extremely) elevated, taking into consideration both past (history) and future (forecasts).



Yardeni Research

But there's more to the story than earnings (as if this is not enough...).

Based on where U.S. 10-Year Real Yield is, SPX multiple should be ~13X.

13x multiple X \$175 EPS = SPX 2275 = ~43.5% decline is "needed"! [Note, however, that we don't view this as a base-case scenario. Moreover, we don't expect this level to be met for various reasons that this is neither the place nor the time to discuss.]



Source: FactSet, Bloomberg, Morgan Stanley Research.

Morgan Stanley

Keep in mind:

- *No bear market caused by monetary tightening ever ended before the Fed started cutting rates.*
- *SPX always declined further after the first rate cut before bottoming out.*

- *The Fed is still raising its base rate (aka Fed Funds Rate)!*

Exhibit 11: Fed historically cut before each market bottom

Federal Funds Rate and prior seven market bottoms (1973-8/22)



Source: Bloomberg, BofA US Equity & Quant Strategy

BofA GLOBAL RESEARCH

BoA

Furthermore, no bear market has ever ended before the associated recession had begun.

No bear market has ever ended before the associated recession had begun



Source: Bloomberg, TS Lombard

TS Lombard

Do the math yourself.

Using Leonard Cohen famous lyrics:

"First we take Manhattan" = 200-DMA and 50-DMA (both about 3% below current DIA level).

"Then we take Berlin" = Lows of 2022 (current support) = Highs of 2019 (functioned as resistance back then).



*Y-Charts, Author
"I am guided"*

And now, so are you."

In short, the US equities is not getting back into the stratosphere it was in at the end of 2021 one year on. You may not want to sell existing holdings but it is still too early to commit to new buying. Compared to US equities, which was the best performing asset class for the last decade or so, MARS will outshine.

To recap on the above, the year 2022 ends poorly - if you are like me, with grandiose hopes for world peace and all that shit. The world is in more trouble than it has ever been for three quarters of a century. Not that we are expecting nuclear war, but short of that, the collective west and Russia will not admit to losing the Ukrainian war which will lead to a restive global economy. All of us are going to suffer from that. As some of us know, leave the world to liberal politicians, and they will mess it up for the rest of us.

With the end of their fight against COVID, successful if you compare fatalities against all other nations - but in the end, those measures were undermined by a need to address the materialistic problems of growth and wealth creation - China will re-emerge as the engine that drives the global economy forward at the expense of some Chinese lives. That is the

best that can be managed in a bad situation. On the other side of the planet, the US is now caught between a fear of inflation and a fear of an economic recession, and that uncertainty will cause this Christmas in the west to be more than a little subdued.

We can't solve these problems over the coming holidays. So let's take a short break, get a little tipsy, and see what happens when we all come back next year.

May I represent all the staff of SAL to wish the directors and shareholders all the very best in 2023.

By:

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Fintech Entrepreneur, Money Manager and Blogger

Un-Influencer in a World full of Hubris