INVESTMENT NOTES: WEEK OF OCTOBER 14-21, 2018
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Three topics this week:
1. Longer term economic reasons for last week's sell off of 4.1% in the S&P 500.
2. China/USA- underlying currents.
3. US political moves- more to Nikki Haley's resignation than meets the eye.

1. Longer term reasons for last week's sell-off.

Do the high level of asset prices today mirror the trend in house prices ten years ago in the U.S.? Both mis-pricings reflect very low interest rates caused by Federal Reserve policy. During the five-year period before the last downturn, the Fed had decreased the federal-funds rate to as low as 1%. That drove down mortgage interest rates, causing home prices to rise faster than 10% a year. When the Fed raised rates after 2004, the housing price bubble burst within two years. The Siebels Hard Asset fund was started in 2003 in anticipation of the reversion to the mean of housing prices and interest rates and profited from the 30% fall in housing prices that occurred in the correction over three years. Banks that held mortgages and mortgage-backed bonds saw their net worths decline- a total of 140 U.S. banks failed in 2009. The fall in home prices between 2006-2009 cut household wealth by $6 trillion.

Fast forward to today. Although an exact replay won't happen, the stock market slowdown could shrink consumer spending enough to push the economy into recession. Share prices are high today because long term interest rates are extremely low. Real rates are close to zero. The hunt for higher yields drives investors toward equities- thereby driving up share prices.

The 3% yield on 10-year Treasury's is low but twice as high as it was two years ago. Rising inflation and exploding annual federal spending deficits will take ever-higher long-term interest rates to get bond buyers to absorb the debt. As interest rates normalize, equity prices are also likely to return to historic price-to-earnings ratios. If the P/E ratio of the S&P 500 regresses to its historical average, 40% below today's level, $10 trillion of household wealth would be wiped out- resulting in a reduction in spending of about $400 billion or 2% of GNP resulting in a recession.

Most recessions have been short, with less than a year between the start of the downturn and the beginning of the recovery because the Fed responds by cutting the Fed-funds rate. But the Fed will not have enough room to cut substantially if at all. Fiscal stimulus will also be limited as the U.S. fiscal deficit exceeds $1 trillion annually in coming years and the federal debt is predicted to rise from 75% of GDP to 100% by decade's end.

Therefore last week was a hint of what long-term rising interest rates will bring.

2. China/USA- underlying currents.

We wrote about the clause in the NAFTA agreement which essentially allows the US to control trading agreements of other countries . This was mainly targeted toward China. Although major houses are predicting a trade agreement/truce in the trade war between China and the USA before the mid-term election- we don't believe it will happen.

We think that the US is trying to reset the entire US-China relationship. A paper written by former Ambassador Robert Blackwill, Ashley Tellis, a strategic affairs expert and Graham Allison, a Harvard Professor, entitled, “Revising U.S. Grand Strategy Toward China”, has six areas of recommendations: 1. Superior U.S. economic growth compared to China. 2. Implement more effective cyber security policies 3. Embark on high-energy/high level diplomacy 4. Expand Asian trade networks, but exclude China from them 5. Support Indo-Pacific trade and financial partnership 6. Create a Technology Control Framework. There is evidence that the U.S. is following these recommendations- Trump’s lower taxes, deregulation and a push to drive GDP above 3% growth is very different from the previous administration. Trump is also prioritizing making the U.S. energy independent, more competitive global markets and an effort to bring supply chains back to the U.S. in order to revitalize the economy. The amount of money going into cyber security is at a record and will grow- hence we are holding a cyber security UCIT/ETF. There is talk that soon the U.S. will fine one of the big social media companies for a breech in security, finally joining the EU. The U.S. has an aggressive policy toward China in every department- trade tariffs, the Treasury accusing China of currency manipulation and Defense identifying China as a strategic adversary in the National Defense Strategy document. It is not the Administration’s goal to back down to China before the mid-terms. The U.S. has also left TPP and is negotiating trade deals without China across Asia. In addition, the U.S. is trying to create another power bloc to control the Indian Ocean- which can be argued is the most critical ocean in the world as MidEast oil runs to Asia. India and other Asian trading partners are targeted by the U.S. to form special alliances. Lastly, Xi's plan for 2025 and world technology dominance triggered a reaction by the U.S. which highlighted Chinese IP theft, the chip that was planted in major companies and the restriction of key tech exports to China. The Export Control Act of 2018 that was passed by Congress on August 13th targets Chinese IP and allows strong, lengthy prosecution to slow China.

China’s response has been mild so far. However don’t forget that Chinese leaders go to bed every night thinking about how they will control the world in the long run.

3. Nikki Haley’s Resignation.

We believe Nikki Haley’s resignation from the UN is no coincidence. It comes right after the New York Times article alleging that, "Trump Engaged in Suspect Tax Schemes as He Reaped Riches From His Father”. It has been talked about in Republican circles that Trump will not complete his term. This is not due to being impeached by the Democrats over the election, but rather criminal fraud charges being brought concerning his business/tax/financing/money laundering or any combination. The Republicans know that the moderate Republican base has been marginalized and their best bet in the next election is to run a moderate Republican against a far left Democratic candidate. Nikki Haley is the perfect moderate Republican. Combined with Jeff Flake from Arizona (East Coast/West Coast) who is retiring from the Senate, it could be a winning ticket. Democrats will not impeach President Trump- as the case is weak, and it will insure Trump does not get the Republican nomination. Lastly, the Democrats do not want a President Pence who is more right wing in social values than President Trump (and is unelectable on his own). However, the Republican Party must know that the threat of criminal charges as the investigation is taken up by more than an encumbered press, is real and a plan is being formed. Watch this space….