Letter n°14

Towards a tripolar world. Where to invest?

« I hold the world for what it is, a stage where everyone must play their part » Shakespeare in The Merchant of Venice

The bipolar American-Soviet world established in 1945 disappeared in 1990 with the dissolution of the Soviet Union. The United States was then in a hegemonic position and, on paper, had all the advantages. A military budget greater than the sum of the other major countries, a quarter of the world's GDP, the international currency, the best research centres, the most prestigious universities, an often copied "American way of life". Nothing was missing and yet this giant was like Baudelaire's Albatross, clumsy and, after some unfortunate, fruitless and costly experiences on the international scene (Afghanistan and Iraq), after an inability to weigh, determine or even simply influence regional conflicts (Ukraine, Syria), the old isolationist tendencies have resurfaced. Discreet under the Obama presidency, the retreat is more brutal under the Trump presidency. "America First", a slogan adopted from Gerald P. Nye, an opponent of Franklin Roosevelt in the 1930s, will have produced the opposite effects of those sought. Trump wanted to crush China and divide Europe in order to break it, he will have provoked the contrary. China is asserting itself more each day and Europe is beginning to mutualise, strengthen coordination and think about emancipation from the United States. So, the world is becoming tripolar.

The Chinese statement:

***"The supreme art of war is to subdue the enemy without fighting."* Sun Tsu**

Trump should have meditated on the lessons of history. Napoleon at the height of his glory, controlled most of Europe, but had not been able to bend the small English island. Deprived of his fleet at Trafalgar, he had not failed to strictly enforce the boycott that should have brought down England; ironically, France emerged demographically and economically weakened from the Napoleonic Wars which led to England becoming the great economic power of the 19th century. We could quote other examples but let us keep only one lesson. Not only did the customs duties imposed on China and the blocking of component sales to Huawei or other groups failed to erase the American trade deficit, $420 billion in 2019 with China alone, it was not even sufficient to absorb it sustainably, but this policy has in fact only fuelled the Chinese determination to prevent the peril. "***You have charged the universe with anguish,***" **Malraux** tells his Chinese hero in "The Temptation of the West". Trump did not want to understand that a trade deficit primarily results from insufficient domestic savings in relation to consumption and investment rates. Imposing customs duties to protect the less than 100,000 jobs in steel, 0.1% of employment, is sacrificing domestic consumers at the expense of producers, amputating the purchasing power of the former and protecting the less competitive of the latter. Internationally, it means exposing oneself to reprisals against the most promising sectors, such as aeronautics when China favours the purchase of Airbus to Boeing. It would have been better for Trump to implement the Trans-Pacific Partnership (TPP) agreement, signed by Obama in 2016 with all the Pacific powers except China, since 45% of world trade was covered.

In response to threats of protectionism, China responded by speeding up the implementation of the Silk Road Initiative, initiated in 2012, which is now open to 120 countries that receive more than $120 billion/year in Chinese investments.

At the risk of being deprived of components, China has sped up the activation of its "China 2025" plan. In addition, it is pursuing its policy of grouping large state-owned enterprises to form international champions. As a result, Chinese companies are now world leaders in many sectors, backed by public capital and financed by state-owned banks that have little concern for their short-term profitability of investments.

While China's development between 1991 and the early 2010's was export-driven and China's share of world exports has increased from 2% to 18%, it is striving to reduce the weight of exports in GDP and promote domestic consumption today because, let's not forget, China's per capita income has increased tenfold in four decades, while it has stagnated in the United States. It is no coincidence that the Caixin Services PMI index has never been so high, although it is true that unemployment, officially at 6%, is probably substantially higher because there are many unemployed among the 280 million unaccounted-for migrants.

The European Renaissance:

"Their rivalries and debates sharpened the intelligences."

Hume's analysis of the divisions between Greek cities applies wonderfully to Europe, explaining its slow progress but also the relevance of its achievements.

The United States, China and Russia will each have pursued similar objectives against Europe, playing on divisions, breaking the EUR and hindering the political affirmation of this economic power but they will have unknowingly worked to strengthen it.

Europe was massively weakened in 2012 by the Greek crisis and that of the peripheral countries, but there was Draghi and his "whatever it takes" attitude. In 2016, Europe faltered again with the British vote in favour of Brexit, an undeniable loss for Europe, but at the same time it is a historic opportunity without which, for example, the Merkel-Macron plan would not have seen the light of day. In several European countries, the Brexit vote had inspired populist parties eager to put an end to the federalist tendencies lent to bureaucrats in Brussels, but it was also an opportunity for a few politicians who were anxious to avert the risk of a break-up.

And, in 2020, when the economic shock caused by the spread of Covid-19 was felt, the capacity for action of the countries was appreciated, as well as the reaction capacity of the European Central Bank, the proposal capacity of the European Commission, and the intervention capacity of the European Investment Bank, which after its EUR 500 billion in aid to SMEs as initially foreseen in the Juncker plan, added EUR 200 billion. Each of these institutions positively surprised the financial markets and we adopted a buy recommendation at an early stage. Admittedly, the health management of this crisis was not without shortcomings, but the social shock absorbers and Europe's strength are playing their parts.

There was no collapse of the EUR but more or less stable against the USD, the traditional refuge currency in case of crisis. The spread of Italian rates against German 10-year rate was at 2.8% at one point, but it quickly receded when operators understood the determination to support Italy and stands at 1.65% as of 6 July.

At the beginning of the 1950s, and again in 1957, the rapprochement of the six historically divided European countries was largely cemented due to the communist threat. The same is true today. If this old ambition of European defence, first aborted in 1956 with the failure of the European Defence Community (EDC), is resurfacing, it is thanks to Trump's threats about the possible withdrawal of American protection. The "brain death" of NATO evoked by Macron is not an empty word, and Trump's recent intention to withdraw a third of American soldiers from Germany is raising awareness. At the same time, the Germans are irritated by US sanctions to prevent the completion of the 1,200km "Nord Stream 2" gas pipeline in the Baltic, designed to bring Russian gas to Germany in competition with American gas. The Chinese attempt to play the Hungarian, Portuguese and even for a period of time, Italian cards against the EU have failed, and the new European Commission, backed by major states, now wants to speak with one voice with China. The meeting between Europe and China has been postponed and meanwhile, a code of conduct for Chinese investments in Europe is being prepared.

The game between three

In today's $85 trillion global economy, there are three major powers. The United States with a GDP of $22 trillion, the European Union of 27 countries with a GDP of $16 trillion and China with a GDP of $14 trillion. The first has 330 million inhabitants, 4% of the world population, Europe has 450 million and China has 1.4 billion people. In terms of surface area, Europe is the smallest, but it benefits from excellent infrastructure.

With a savings surplus, expressed by a current account surplus of 3% of GDP, compared to the Chinese at +0.6%, far from the 10% recorded in 2007, and America's structural deficit of 2.5% of GDP, Europe has abundant financial capacity if it wants to invest in technologies of the future.

The recovery plan, EUR 750 billion, accepted in principle, probably to be adopted in the summer, is an important milestone. Considering that countries were still torn at the beginning of the year on the adoption of a EU budget 2021-2027 of a maximum of 1.1% of GDP/year, the recovery plan which represents 5% of EU GDP is a happy revolution. Two-thirds of the EUR 750 billion could be the subject of a mutualisation effort, possibly financed by new common taxes, carbon tax at the borders, the new digital GAFA tax, which was inconceivable a few months ago.

Let us bet that in the wake of this, the role of EUR on the international scene will gain in audience, from currently only 23% versus USD to more than 60%. Let us anticipate the implementation of new community policies such as Europe's electric battery industry and stronger digital integration as well as proliferating climate and energy initiatives.

Thanks to Brexit, without which, Europe would have remained nothing more than a large market, a free trade area with neither soul nor manifestation of federated projects. Too bad for the United Kingdom, exposed internally to a break-up, a possible exit of Scotland, or perhaps even a reunification of Ireland in the long term. Too bad for the United Kingdom, as we shall soon see, unable to compensate for the possible loss of access to the large European market, which is the recipient of more than 50% of its exports. A small country of 65 million, with an industry limited to 12% of GDP, very much geared towards exports to Europe, and therefore exposed to customs duties post-Brexit; angers the Japanese with a demand for a similar agreement as that of the EU-Japan, who are threatening to close their car factories; irritates the Americans when discussions are held with Huawei. Within Europe, England was of interest to the United States as a Trojan horse to block any progress. Outside Europe, whether Boris Johnson likes it or not, England has nothing to offer Americans so as to be granted a privileged relationship. With China, the British position on Hong Kong, justified in light of the 1997 agreement, is a factor blocking any privileged economic relationship. There is still the Commonwealth, which only accounts for 13% of its trade, but it is hard to see India and the others developing substantial trade with the former colonial power.

Conclusions

The European market, long in the shadow of the US market, by amplifying the declines and minimizing the rises, should gain in autonomy and began to clearly outperform the US market (8% against 1.8%) in June. The advice to accumulate European assets is justified by the prospect of deeper integration.

The advice to be cautious on the UK market and on the £ is motivated by uncertainty.

The Chinese market remains attractive even though it is at its highest level in the past five years. The country will certainly not be able to count on the expected dynamics of international development, will not be able to acquire technological flagships in the West without authorisation, and will not be able to make spectacular breakthroughs along the Silk Roads because their indebted partners are more cautious. However, it will retain its assets, develop its western regions, create competitive clusters, accelerate its march towards technological independence, and enjoy the high savings rate as well as the massive consumption potential of its 300 million middle class population, a number close to that of its American and European counterparts.

The American financial market, contrary to some concerns, would gain from a victory of Joe Biden, as would the international markets, because multilateralism, which is so necessary for crisis management, could be revived. For those who believed in a capital repatriation from American companies abroad, we will simply note that Trump preferred to forget the subject because the little money repatriated was not used for investment but for the occasional share buybacks. To those who welcomed Trump's aggressive stance towards China, reality shows a contrast with the perceived advantages, with the sustained very high US trade deficit and the fall in US exports to China this year. To those who believed in the reindustrialization of the US and American energy independence, one will object to the weakness of relocations, the ecological damage caused by the exploitation of shale oil, the lack of competitiveness of this industry at $40/barrel. Finally, to those who invoke the beneficial effects of the Trump tax reform, the reduction in corporate tax from 35% to 21%, we will reply that it did not result in the announced increase in the investment rate, just as the tax increases decided by Obama had not caused a recession. On the other hand, corporate tax revenues fell from $360 billion in 2015 to $160 billion in 2018, the current crisis does not allow either candidate to envisage a similar measure tomorrow.

In addition to these three major markets, ***Switzerland***, a centre of monetary stability, industrial competitiveness and financial solidity, and the "Asian tigers" **-** ***Singapore, Taiwan and South Korea*** **-** will be considered as investment targets, thanks to their technological breakthroughs, the strength of their industries, the potential of their middle classes and their export dynamism.

Geneva, July 6th, 2020

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