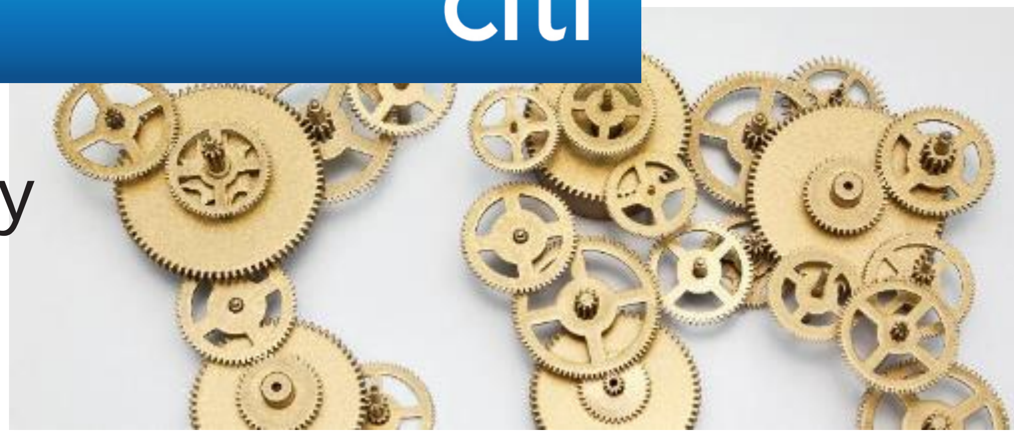
Private Bank



CIO Strategy Bulletin

August 1st, 2020

The G2 World Unfolding Before Us: The US and China Right Now

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An Election Amidst a Pandemic

For decades, the performance of the S&P 500 and levels of unemployment have been used to forecast US Presidential elections. The track record of each model is solid as the S&P 500 and employment have generally moved together (See Figure 1). And yet, as we move towards the November election, we can be certain that one of these indicators will be wrong. With small data sets, like Presidential elections, the risk of following any specific model or polls is real. Just look at 2016.

At the beginning of 2020, the US economy was strong and therefore favorable for the re-election of President Trump. However, the blunt economic impact of Covid-19 and the federal government's controversial and inconsistent health policy responses to the pandemic have flipped the Electoral probabilities for November (See Figure 2).

Figure 1: S&P 500 Performance and Employment Have Parted Ways

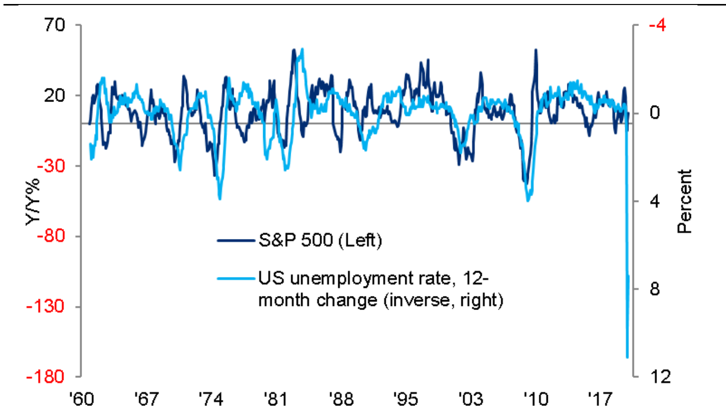
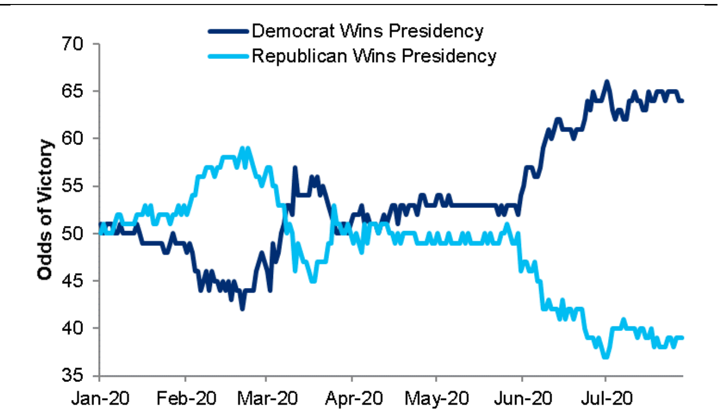


Figure 2: Predicted Odds of Republican or Democrat Presidential Victory



Source: Bloomberg and Haver Analytics as of July 27, 2020.
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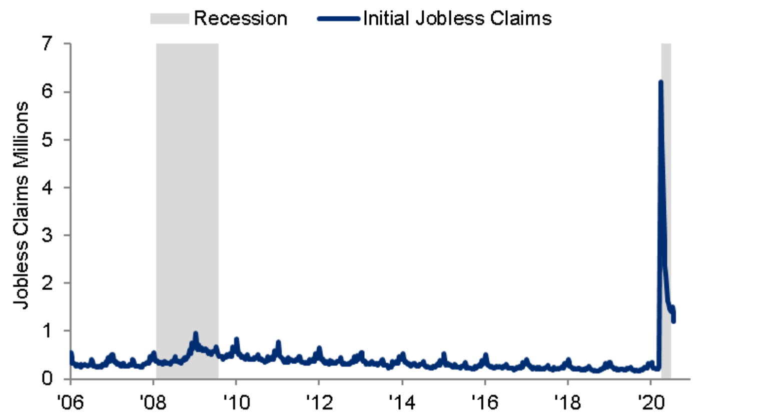
Since the virus first emerged in the United States in January, weekly jobless claims leapt by more than 3000% to as high as 6.9 million. Even this past week's figure of 1.4 million is still double the highest level seen in the 2008 financial crisis (See Figure 3). The unemployment rate, the most commonly referenced indicator, tripled in one-month from 4.4% in March to 14.7% in April, with only a partial recovery through June. With levels of infections at extraordinary rates in much of the US, it is unlikely there will be a dramatic further reduction in unemployment before the election.

Figure 3: Historic Rise in Initial Jobless Claims



Source: Haver Analytics as of July 30, 2020.

Looking at the stock market, one sees a completely different picture. In fact, viewed on the basis of the performance of technology stocks in particular, or the S&P 500 generally, one could argue that the government response to the pandemic has been highly effective. We have written previously that the passage of the CARES Act and the Federal Reserve's full commitment to markets and business provided an initial bridge over a deep chasm. The fact that these actions took place at a time of deep divisions within government could be considered a great success. But polling data suggests the President is receiving little credit for this.

This year, polling currently favors the employment model rather than the stock market model for ascertaining political fortunes. The crucial question is "Are you better off today than you were four years ago?" This depends largely on whether someone is an investor, a small business owner, or an employee of a deeply impacted sector. Investors exposed to a handful of stocks are likely to be very satisfied. "Covid-defensive"[1] companies have been net beneficiaries of the acceleration of favorable business trends, like digitization. But for many furloughed employees, small business owners, or concentrated investors in many industries, it is hard to see how they would not answer the "better off" question negatively (See Figure 4). On Thursday, 2Q GDP was released, showing a 33% annualized economic decline and a correspondingly large increase in the so-called "output gap" (see Figure 5).

Figure 4: Russel 3000, Excluding the 5-Largest Companies and Employment Weighted

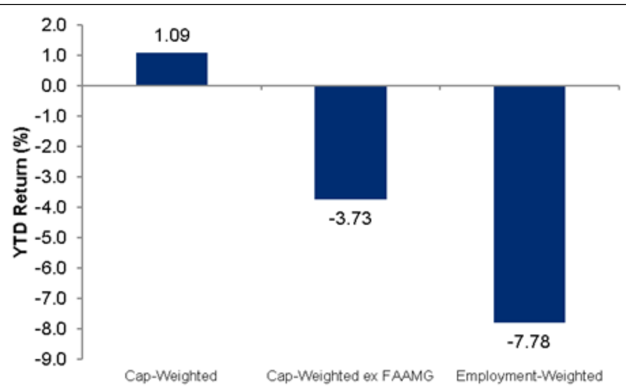
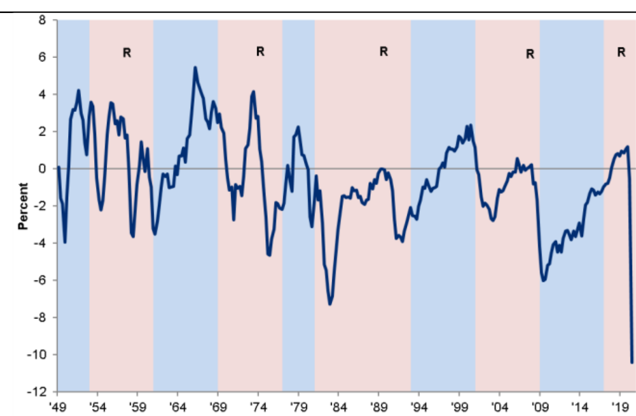


Figure 5: US Output Gap and Presidential Party



Note: FAAMG are the five-largest companies in the Russel 3000, Facebook, Apple, Amazon, Microsoft and Google. Source: Haver and Bloomberg as of July 30, 2020. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

[1] COVID-Cyclicals: Financials, Industrials, Energy, Materials, Real Estate, Consumer Discretionary ex-Amazon
COVID-Defensives: IT, Health Care, Communication Services, Consumer Staples, Utilities, Amazon

Forty Years of Bad Luck?

It has been over 40 years since a recession has started with a Democrat in the Whitehouse. Thus, ironically for investors who tend to view Republicans as friendlier to business, there has been dramatic stock market and economic outperformance under Democratic administrations for the past 70 years (see Figure 6). It appears that most typically, the reins of government are handed to Democrats when the economy happens to be cyclically depressed, and is thus poised for recovery.

Given the small sample size of modern Republican and Democratic presidencies, we would not conclude Presidential elections and policy differences are driving this relationship. Still, we would caution investors against being fearful of a Democratic win.

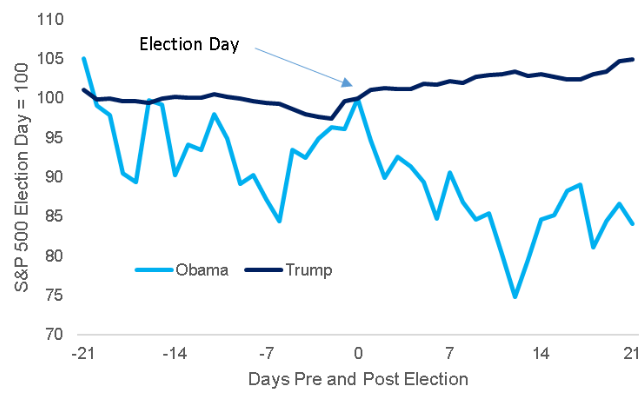
Looking back at 2008 when Barack Obama was first elected, the stock market initially fell on the news of his election (see Figure 7), This initial poor reception was due to fears of higher taxes and other "growth unfriendly" legislation and regulation. Instead, markets enjoyed an historic bull market and years of economic expansion through both Obama's eight years and Trump's first three.

As we showed in Figure 1, unlike past periods, the *broad* US stock market is not depressed in the way the economy is. Still, if former Vice President Biden were elected President, a stock market sell-off would likely present a buying opportunity yet again.

Figure 6: Economic and Market Performance by President

	Annualized Real S&P 500 Total Return (%)	Annualized Real GDP Growth (%)	Party
Truman	9.7	4.7	D
Eisenhower	13.3	2.5	R
Kennedy	9.9	5.3	D
Johnson	7.9	5.1	D
Nixon/Ford	-2.1	2.7	R
Carter	1.3	3.2	D
Reagan	9.4	3.6	R
Bush	11.0	2.2	R
Clinton	14.2	3.8	D
Bush II	-5.3	1.8	R
Obama	11.5	1.9	D
Trump	12.9	-1.1	R
*Trump Result is through 2Q 2020.			
Republican Weighted Average	5.3	2.3	
Democrat Weighted Average	9.9	3.6	

Figure 7: Short Term Market Moves Around Elections Do Not Capture Trend (S&P 500)



Source: Haver Analytics as of July 27, 2020
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A Republican – Democratic Legislative Tightrope

Given the divergence between the state of the economy and stock market performance, the need for a second Covid-19 relief package is high in advance of the election. Though there was an initial sharp rebound in US economic activity, the fact that the US is still suffering broadly from a high rate of infections in mid-Summer has put a damper on a meaningful continuation of that rebound absent further stimulus. Further, the poor polling data of the President has created rifts among the Senators of his own party, with the conservatives arguing for little further aid and others in swing States looking for a continuation of support for the unemployed. But the Democrats, sensing an advantage given the necessity of their Senate votes, are also at risk if they play these negotiations poorly. They are looking to address four predominant issues, unemployment benefits, aid to small businesses, support for States and municipalities, and schools (especially those that try to re-open). As we have written before, a last minute compromise is more likely than not. The fact that the stock market has priced legislative action in brings immediate pressure to both parties.

Remember, The Margin of Error is Larger Than We Think

Given the large lead in polling and forecast markets between Vice President Biden and President Donald Trump, it presently appears that a Democrat will occupy 1600 Pennsylvania Avenue in January (See Figure 8). However, in the last five elections the winner of the popular vote has only been sworn in as President three times. The Electoral College and the popular vote have contradicted one another only four times in the history of the Republic, two of those times within the last 20 years.

Any model that is focused on national polling, stock markets, employment or any other "country level" variable must contend with the reality of the US's arcane political system that makes a few key States critical for capturing the White House. In Figure 9 we show polling for the 17 states that are most likely to swing the outcome, but caution against overconfidence in any one pole or even via the aggregation of all of them.

Figure 8: Real Clear Politics National Polling Averages

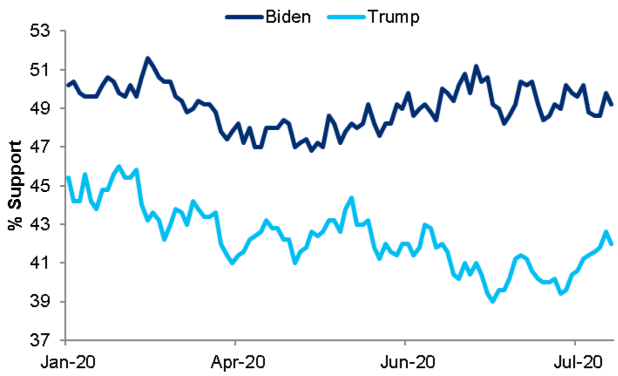


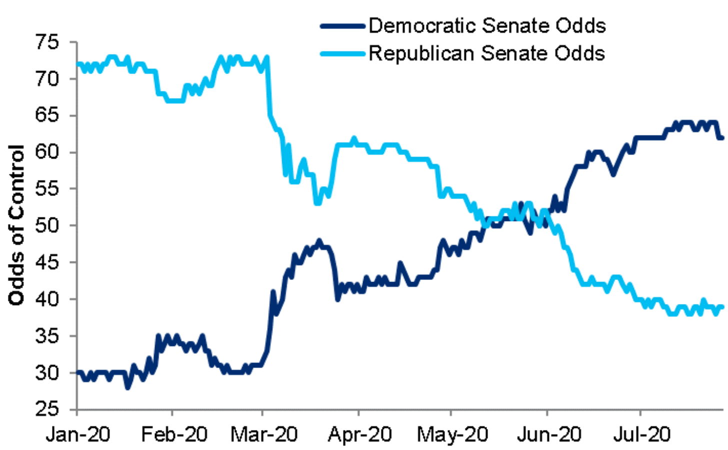
Figure 9: Table of Swing State Polls

		Trump	Biden
		Electoral Votes	
Safe		63	118
Likely		32	51
Leans		20	53
Total		**115**	**222**
Battle Ground States			
	Electoral Votes	Current Polling	
		Trump	**Biden**
Wisconsin	10		+6.4
Michigan	16		+8.4
North Carolina	15		+3.0
Florida	29		+7.8
Pennsylvania	20		+7.4
Michigan	16		+8.4
Arizona	11		+4.0
Minnesota	10		+11.4
Ohio	18		+1.5
Iowa	6	+1.5	
Nevada	6		+4.0
New Hampshire	4		+4.3
Virginia	13		+11.0
Georgia	16	+2.7	
Texas	38	+0.2	
New Mexico	5		+11.0
Missouri	10	+6.4	
Swing State Current		70	173

Source: Real Clear Politics as of Jul 27, 2020

There is also substantial talk of a “Senate takeover” by the Democrats. The odds of this have changed from being a long shot to better than even (see Figure 10). But, “better than even” does not mean highly likely. In our view, the Senate election outcome is indeterminate, well within the margin of error, just as it was in 2016 when Donald Trump won election. We also note that even in the case of unified Democrat control of the House, Senate and White House, the Senate filibuster gives a minority party some “stopping power” for legislation absent a nearly impossible 60 vote filibuster-proof majority.

Figure 10: Senate Majority Party Odds



Note: PredictIt is a double auction forecast market that results in probability estimates of political outcomes. Source: PredictIt and Bloomberg as of July 29, 2020.

And Finally…

Many investors presume that a Democratic presidential victory means a roll-back of corporate tax reform and higher levels of regulation. In our view, the condition of the economy in January is likely to be just slightly better than it is today – we had modeled a fourth quarter "Wave 2" of the virus – implying that the highest legislative activity for a new president and Congress may well involve direct fiscal stimulus targeted at putting Americans back to work. Though one can imagine higher marginal tax rates for wealthier individuals and benefits for the poor and underemployed, keeping the US competitive from a tax perspective will also come into play. We also think that rebuilding international alliances, both economic and political, would be a high priority from a new Democratic administration keen on being more competitive relative to China.

China in Conflict

As the world continues to fight the pandemic and the US faces a contentious election, China's international relationships are facing numerous significant headwinds. While China's disputes are likely to unsettle markets over the coming months – suggesting hedges and other tactical moves to improve portfolio resilience – we continue to believe that the long-term growth prospects of Chinese equities remain intact and compelling.

China's Global Conflicts Are Escalating…

Global news and markets are less focused on the US election than they are on events related to China and its relations across the world. Beyond China's tense and devolving relationship with the US, there are escalating political, military and economic clashes between Beijing and many of its largest trading partners.

In a speech given at Nixon's Presidential Library last week, U.S. Secretary of State Mike Pompeo further escalated the U.S.-China conflict by referring to it as a clash between freedom and dictatorship. The speech was preceded by the forced closure of China's consulate in Houston, Texas and China's immediate retaliation with its closure of a small US consulate in Chengdu. Previously, in May 2020, the US imposed new restrictions that severely limit Huawei's access to essential semiconductor technology and the UK followed suit on July 14th with its own decision to ban the purchase of new Huawei equipment.

On July 25th, Australia filed a declaration at the United Nations agreeing with the United States that China's maritime claims around the South China Sea do not comply with international law. Meanwhile, Australia's economic tensions with China continued to escalate after China imposed additional levies on Australian agricultural products. Michael Clifton, who heads the China Matters think tank after serving as head of the Australian Trade and Investment Commission in China for six years, noted recently that China's increasingly assertive international diplomacy made it challenging for even the most moderate of Australian voices to call for sensible engagement with the PRC.

After a battle on its Ladakh border region last month where 20 Indian soldiers were killed in hand to hand combat – there was a 1996 agreement prohibiting the use of guns in that area – India banned 59 popular Chinese apps including TikTok, downloaded an estimated 600 million times, UC Browser, a popular smartphone internet browser, Weibo and WeChat. India then announced last week it would block an additional 250 Chinese apps "engaged in activities… prejudicial to the sovereignty and integrity of India." And, over the coming weeks, it is expected that India will raise import duties on $10 billion of China imports, covering roughly 12% of its China trade.

Ironically, China's more recent actions in the region give credibility to China hawks in the US administration with their broad assertions about "one-sided" business dealings and the dangers of China's role as a provider of technology infrastructure. In short, we believe that China's increasingly assertive foreign and economic policies are polarizing some of their most important trading and international relationships.

…Even as its Equity Markets Are Rising

A key driver of China's economic and financial market recovery since Q1 has been its ability to manage and mitigate the impact of the pandemic better than any other major economy, in part due to fewer constraints on personal privacy. China is at the point where restrictions on casinos and other public activities are being eased unlike any other Western economy. And despite increasing geopolitical tensions, Chinese equities have been among the most resilient in the world year-to-date (Figure 11).

We see three key elements supporting Chinese markets:

- A combination of better management of the virus, an equity market increasingly composed of technology, e-commerce and fintech names, and supportive monetary and fiscal actions have all contributed to positive "risk-on" market sentiment, particularly in mainland shares (Figures 12 and 13).
- Increasing retail investor participation – not unlike dynamics seen recently among younger US investors – has also supported China's domestic A-share market even as Hong Kong shares have underperformed.

- Greater dominance of domestic demand in driving China's growth. Two thirds of China's GDP growth came from consumption in the past five years. Companies supplying China's domestic demand have grown increasingly relevant to local and global portfolio managers at the expense of export and fixed investment dependent companies.

Figure 11: Relative regional equity performance

Index	10 Year	5 Year	2 Year	1 Year	YTD
USA	13.7%	11.8%	9.9%	10.3%	2.6%
Europe	5.7%	3.2%	-0.3%	0.6%	-6.7%
EM	3.6%	6.6%	2.0%	5.2%	-2.1%
Gold	5.2%	12.0%	25.8%	36.3%	27.9%
US Bonds	3.9%	4.4%	8.9%	10.0%	7.3%
MSCI China	6.9%	9.6%	7.1%	20.5%	11.5%
Hang Seng	5.4%	4.0%	-3.7%	-9.5%	-10.1%
CSI 300	6.8%	3.2%	14.4%	17.9%	11.9%

Note: 2, 5 and 10 year returns are annualized

Note: MSCI regional indices are used for equity markets and Bloomberg Barclays US aggregate is used for US Bonds. Source: Bloomberg as of July 31, 2020.
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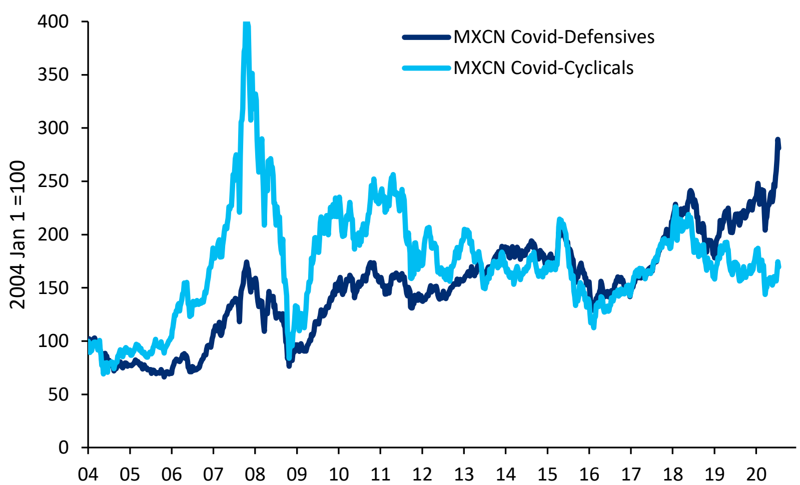
Similar to the US market, many Chinese listed firms have been net beneficiaries from the Covid crisis, while others remain under pressure. For example[2], Tencent's online gaming, Meituan's food delivery, PDD's online retail, Bilibili's online entertainment and Xiaomi's smartphones have received a massive boost in demand as people stayed at home. The biotech industry benefited from the search for medical solutions. Shares of these firms saw 40% to 120% gains YTD. Meanwhile, industries that depended more on people leaving homes languished. As economies eventually open, we continue to expect the cyclical laggards to perform well during recovery.

Figure 12: MSCI China: Covid Cyclicals vs Defensives



Source: Bloomberg as of July 31, 2020.
COVID-Cyclicals: Financials, Industrials, Energy, Materials, Real Estate, Consumer Discretionary
COVID-Defensives: IT, Health Care, Communication Services, Consumer Staples, Utilities
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[2] The equities are shown for illustrative purposes only. It is neither a recommendation to buy nor a solicitation to sell.

Hong Kong's markets lagged A-shares mainly for two reasons. First, the HK market had a greater weight in traditional industries that belonged to the Covid-cyclicals like financials, retail and commercial real estate. These not only had to deal with Covid impact, they also suffered from investors' worries about HK's future. Second, even though HK benefited from Fed easing and relocation of American Depository Receipts (ADRs), the credit boom and the capital market reforms that lifted retail participation in the A-share market were largely absent from HK.

Figure 13: Hong Kong vs. Mainland Chinese Shares

Source: Bloomberg as of July 31, 2020.
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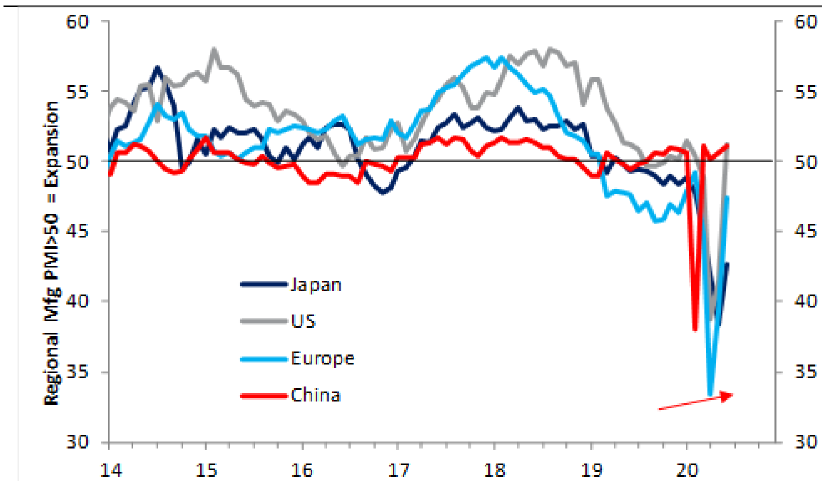
Further, as PMI data indicate, one could argue that China's domestic consumer market and large trade relationships with pan-Asian countries continues to provide it with sizeable, accelerating economic growth opportunities absent military conflicts with the West. (See Figure 14).

Figure 14: China PMIs lead the rest of the world



Source: Haver as of July 31, 2020.

In technology, where US and global competitors have unusual momentum given the positive impacts of COVID on the utilization of all things digital, Chinese tech companies have provided solid investment returns following selloffs related to the trade war and policy tightening in 2018 (see Figure 15). This is in spite of the US succeeding in rallying previously reluctant allies to its side in the "cold war" against Huawei. Even as the US has made a convincing case that Huawei's 5G and superchip ambitions must be thwarted, Chinese enterprises that parallel those in the US are thriving without access to most Western markets.

Figure 15: US and Chinese Tech Performance

Source: Bloomberg as of July 31, 2020.
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The US has escalated its policy objections and objectives across major issues including Hong Kong, Taiwan, ballistic missiles research, intellectual property, market access, journalistic freedom, foreign direct investment, visa access, cultural exchanges and human rights. Yet, China's equity market has been surprisingly resilient in the face of these major issues and the geopolitical tensions highlighted herein, many of its own making. It is, therefore, not clear that the market cares as much about non-trade related matters. We only saw immediate and significant declines in Chinese equities in 2018 and 2019 as Trump escalated the trade war. (Figure 16).

Figure 16: MSCI China relative performance around key US-China conflicts

Source: Bloomberg as of July 31, 2020.
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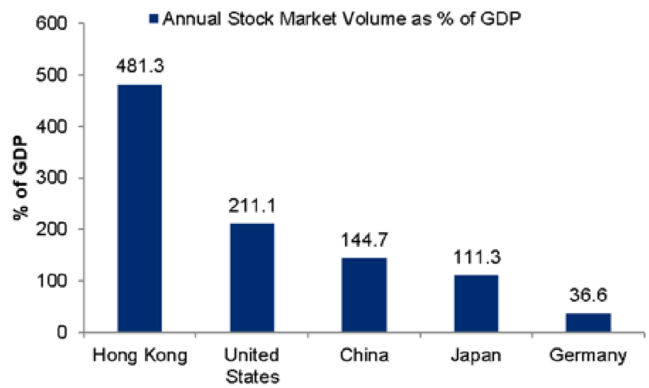
Given fresh investor memories of "boom-bust" market dynamics in China (and emerging market equities more broadly), the recent run-up in mainland shares has deterred some investors from seeking to add exposure to China at current levels. Worries about escalating tensions with the US exacerbate the potential for short-term volatility. We viewed 2018 and 2019 risk off periods as buying opportunities, as bouts of US-China tensions tend to swing like a pendulum.

Two Reasons Why China Acted on HK Now

The first reason why China chose 2020 to become more aggressive in its relationship with Hong Kong is Hong Kong's strategic importance to global markets. Hong Kong is a remarkably vibrant player in global capital markets. It has the largest market capitalization relative to its economy (See Figure 17) and also has impressive trading volumes relative to its GDP and relative to China as a whole (See Figure 18). Therefore, having more control over HK can be seen as providing China with greater access to foreign capital looking past its current global tensions.

Figure 17: Market Cap as % of GDP

Figure 18: Trading Volume as % of GDP



Source: Bloomberg as of July 31, 2020

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Contrary to how many in the West view this issue, China sees the implementation of the national security law as a means to preserve larger elements of the China/HK' "two systems" framework. The alternatives to a more forceful intervention or allowing for more anti-China elements to control the HK government could have further accelerated the end of "two systems." Despite the new law, HK's political, economic and legal systems remain quite different from those of the Mainland.

That said, there is alarm due to the disqualification of 12 candidates previously running in the Legislative Council elections now postponed for a year due to Covid-19. This decision was based on the Legislative Council Ordinance that states candidates must swear allegiance to both HK and the People's Republic of China and to uphold the Basic Law. The disqualified candidates had petitioned foreign governments to sanction HK and openly denied China's sovereignty over HK. There remain a cadre of pan-democratic candidates in the running. Obviously, these decisions do not appease Western democratic governments who see the rights of Hong Kong's residents being abrogated.

The G-2 World Is Upon Us

As we wrote last year, the rapid rise of a G-2 world is fully upon us. The US and China are going to compete more actively, openly and fiercely in global economic, political and military spheres regardless of who wins the 2020 presidential elections. In fact, one could argue that a Biden win would create even greater competition with China as his administration is much more likely to re-engage with European allies, Japan, Australia and others to create common goals and standards for trade, technology, climate and health policies. These may bring more pressure to bear on China, with possible conflicts or compromises in response. Thus, China may have more reasons to negotiate more actively with the West or may accelerate a "G2 strategy" where there are literally two Internets and two different technology platforms that overlap in only selected markets globally.

Ironically for portfolios, G2 may be a "good investment outcome" providing meaningful opportunities for diversification of risk. We have written before of Asia itself as an [unstoppable trend]. And so Asia and China deserve a meaningful allocation to global portfolios. While Asia's growth outpaces the world, the correlations presented below indicate that an allocation to Chinese assets make portfolios more resilient. As the global economy reorients business and supply chains across two distinct centers of gravity, strategic exposure to both poles will grow more important for diversified, global investors in the years to come.

Figure 19: 10-Year Correlations across regional equities, bonds, and gold

	MSCI US	MSCI Europe	MSCI EM	Gold	US Bonds	Hong Kong	China A-Share
MSCI US	**1.00**	0.79	0.70	0.11	-0.07	0.56	0.29
MSCI Europe	0.79	**1.00**	0.71	0.02	-0.12	0.61	0.27
MSCI EM	0.70	0.71	**1.00**	0.24	0.04	0.88	0.43
Gold	0.11	0.02	0.24	**1.00**	0.37	0.15	0.09
US Bonds	-0.07	-0.12	0.04	0.37	**1.00**	-0.06	-0.03
Hong Kong	0.56	0.61	0.88	0.15	-0.06	**1.00**	0.52
China A-Share	0.29	0.27	0.43	0.09	-0.03	0.52	**1.00**

Source: Bloomberg as of July 31, 2020.

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