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MARKET CALLS

Surprises of 2023 Volume 4: Global Allocation, and the China Question

Tuesday, January 24, 2023

Donald Luskin

Europe is done. US bonds will beat stocks (both will do well). China is the last value frontier.

US BONDS BEAT US STOCKS
Probability: **75%**
Consensus: **45%**

US STOCKS BEAT EUROPE STOCKS
Probability: **70%**
Consensus: **70%**

CHINA BEST PERFORMING EQUITY MARKET
Probability: **65%**
Consensus: **10%**

Our global allocation view for 2023 has its roots in what we think was a significant turning point in late 2022. Bear with us while we review the history.

THE ORIGIN STORY In late September, the United Kingdom gilts market was rocked by a panic among pension plans pursuing programmatic liability-driven investment strategies similar to "portfolio insurance" (see "A conversation with Toby Nangle on the financial crisis in the UK" October 26, 2022). This forced the Bank of England to intervene as bond buyers, reversing their quantitative tightening program (see "It's Starting to Feel a Lot Like Brexit" September 28, 2022). The BOE had been the world's first major central bank to lift off from low pandemic-era policy rates, so it may be no coincidence that "something broke" first in the UK, and that this would signal the coming end of the global tightening cycle (see "Or How I Learned To Love September CPI" October 13, 2022).

- Two weeks later, on October 12, Treasury Secretary Janet Yellen warned, after the US market close, that she saw "loss of adequate liquidity" in the long end of the Treasuries market. That, and a worse-than-expected September CPI report, set off a panic the next morning. The S&P 500 futures traded as much as 86 points lower. But then the cash market closed the day 92 points *higher*. Reports the next day explained the miraculous reversal, *which we believe marks the bottom of the 2022 bear market in US stocks*: the Treasury had sent letters to the top US banks querying them as to interest in Treasury's potential buy-back of illiquid issues – that is to say, for Treasury to initiate quantitative easing that would more than offset the Fed's quantitative tightening.
- Then two weeks later, on October 25, Senator Sherrod Brown (D-OH), chair of the Senate Banking Committee – the committee with the advice and consent power on Fed appointees – sent a strong four-page letter to Fed Chair Jerome Powell – urging him to slow

Update to strategic view

US STOCKS, US BONDS, EUROPE STOCKS, CHINA STOCKS: Bear markets in US and European equities bottomed in late 2022, when the gilts crisis in the UK triggered the world's central banks to slow their hiking cycles. The equity risk premium in Europe has made a dramatic more-than-mean-reverting move from very wide to very narrow, which spectacular equity returns, as we predicted. That's over, so there is no case now for European equities. The US equity risk premium has widened somewhat as stocks have rallied and bonds rallied more, as we predicted. We think that will continue in 2023. The only large market with a wide risk premium now is China. While the Taiwan question is a black swan, there is a long list of favorable fundamentals. We are skeptical of the deglobalization narrative, but it could have no near-term effect anyway. Positives include opening up from "Zero Covid," cheap Russian oil, no inflation problem, and a central bank that is easing while all the others have tightened.

[Strategy dashboard]

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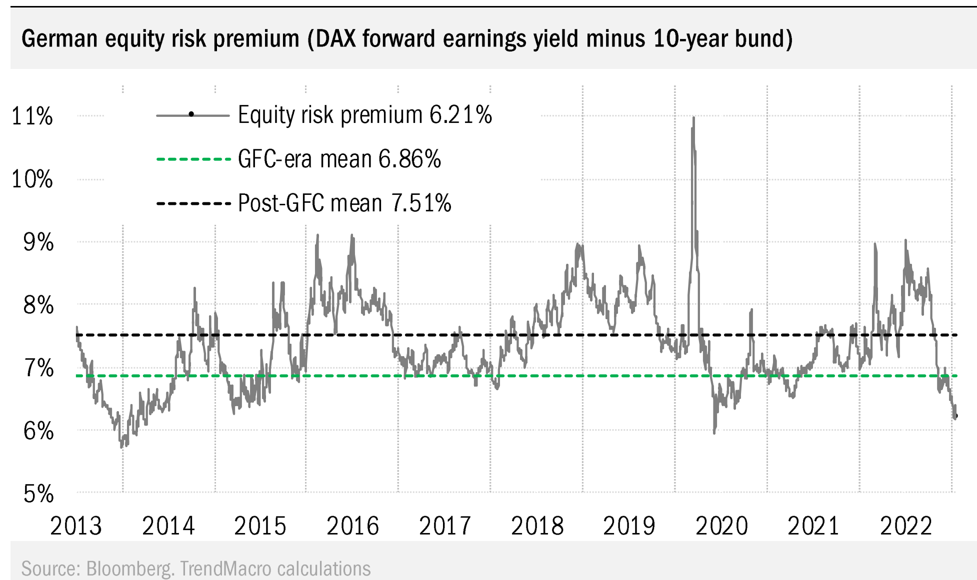
down the pace of rate hikes. This was followed over the coming week by two additional letters signed by 13 other senators and representatives – including Bernie Sanders (D-VT) and Elizabeth Warren (D-MA) – saying the same thing. The very next week the November FOMC announced, effectively, that it would be slowing the pace of rate hikes (see "On the November FOMC" November 2, 2022). With inflation now increasingly clearly rolling over from when we called the top in July (see "Why Inflation Is on the Way Down" July 25, 2022), we are highly confident that the global tightening cycle is over no matter how much nattering to the contrary still emanates from the Fed and other central banks (see "Video: What you're not hearing about the day the market stopped believing the Fed" December 19, 2022).

- We believe that with inflation making it back to the Fed's target by summer, and with financial conditions having already eased significantly since the November FOMC, we will avoid even a soft-landing (see "Recession? No Thanks, We've Already Had One" December 30, 2022).

THE GLOBAL ALLOCATION CALLS As this origin story unfolded late last year, we called the bottom separately for Europe and for the US. Those calls have been correct, and *our calls looking forward have to account for the fact that the recovery from global bear markets last year is already accomplished to some extent*.

- We pointed out in September that our equity risk premium model indicated exception value in European equities – as attractive as any time since the post-GFC euro crisis, with the exception of a few days during the 2020 Covid lockdowns (please see the chart below, using Germany as an example, and again, "It's Starting to Feel a Lot Like Brexit").
- *Technically, this reading implied the strong probability of significant outperformance of local equities versus local bonds*. At the time, with Europe – especially Germany – facing a winter without

German equity risk premium (DAX forward earnings yield minus 10-year bund)



Source: Bloomberg. TrendMacro calculations

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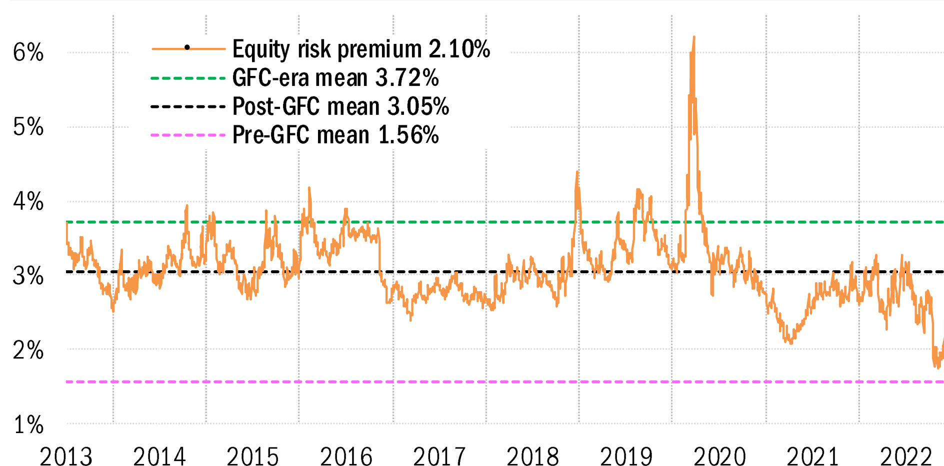
Russian natural gas, this was a most counterintuitive outlook (see "Europe: Winter of Energy Discontent" December 5, 2022). But since our call, German equities rallied 24%, while the total return of 10-year bunds was just 0.4% in euro terms (it makes almost no difference to look at it in dollar terms).

- In the US, we pointed out in October, on the same day that Senator Brown sent his letter to Powell, that the US equity risk premium was in a diametrically opposite position – it was narrower than at any time for 14 years – below the GFC mean, below the post-GFC mean, and indeed almost as low as the *pre*-GFC mean (please see the chart below, and "Equity Risk Premium: Regime Change Accomplished" October 25, 2022).

US equity risk premium (S&P 500 forward earnings yield minus 30-year Treasury)



Source: Bloomberg. TrendMacro calculations

- *Technically, this reading implied the strong probability of bonds outperforming stocks*. At the time, the panicky consensus was that long-term yields were going to continue to back up as the Fed continued to tighten and force the economy into recession. But we made the call, based on our forecast that the Fed was nearly done, that yields had seen their peak. As they moderated, bonds – that had undergone literally their worst bear market in history – would outperform equities, but that the relief of falling yields would allow equities to perform well at the same time. Indeed, since our call, 7 to 10-year Treasuries have returned 5.9% and 10-year+ Treasuries have returned 12.0% – while the S&P 500 has gained 3.9%.
- By the way, that asset allocation call was two weeks after the day of the panic bottom in the S&P 500 (again, see "Or How I Learned To Love September CPI"), from which the index has now gained 12.1%.
- *Separately*, our September Europe call and our October US call were very successful as to respective performance of stocks and bonds in each region. But *together*, the two calls were very successful as to allocation *between* regions. By the end of the year, European stocks had outperformed US stocks by 7.5% in local currency terms, one of only three times in 15 years – at a time when there was a deep consensus that the Russian invasion of

Ukraine would throw Europe into a recession, while the US would remain a relative safe haven.

NOW, LOOKING FORWARD The equity risk premium in Europe has sharply swung from a post-GFC near-peak in September, when we made our asset allocation call, to a post-GFC near-low today (again please see the chart on page 2). It's mean-reversion (to both the GFC mean and the post-GFC mean) with a vengeance, and beyond.

- *Therefore, there is no case to be made based on the valuation/sentiment dynamics captured in the ERP to think that European equities are especially attractive, nor European bonds unattractive. And all the same fundamental risks stay in place – indeed, one could argue they get worse every day the Ukraine crisis goes unresolved. It's just that now you're not getting paid to take them anymore.*

The US equity risk premium is in a similar position in relation to its GFC and post-GFC means as Europe's is now. However, it got there from the other direction, by widening rather than narrowing. Be that as it may, its move has been relatively small. There's no accomplished mean-reversion to point to. The ERP has neither widened to its post-GFC mean nor narrowed to its pre-GFC mean (again, please see the chart on page 3).

- Our October call therefore remains in place (again, see "Equity Risk Premium: Regime Change Accomplished").
- Stocks are relatively cheap versus this time last year, with the S&P 500 up only 17.3% from its pre-pandemic peak while forward earnings up 29.8%.
- Yes, forward earnings have been coming down. But they've been coming down from extravagantly high levels to still-high-but-not-extravagant levels, with the internal quarter-by-quarter and year-by-year structure of estimates implying strong sequential growth (we'll have more on that in another report soon).
- Meanwhile, bond yields have further to fall as the market more completely takes on board our vision of a one-and-done Fed (see "On the December Jobs Report, and Services PMI" January 6, 2023) and no hard landing (indeed, no soft landing either – no landing at all).
- So while the process we called for in October is well underway, we call for its continuation until further notice this year: *better-than-average performance for stocks and bonds both, with bonds performing best.*

Putting these US and European calls together, we expect US markets to outperform European markets this year.

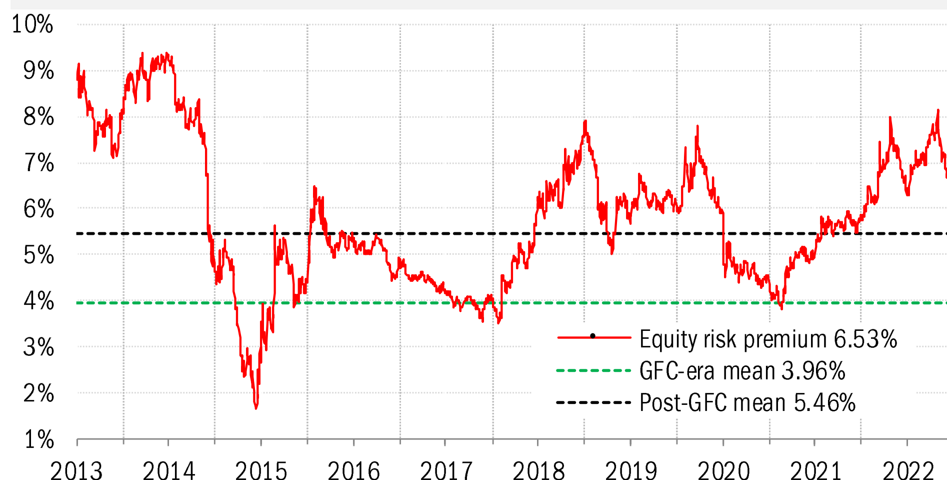
THE CHINA QUESTION In almost every client conversation lately we are asked the same question: *is China now uninvestable?*

- We read into that question the presupposition that for a variety of

reasons it *is* uninvestable: increasingly repressive policy, collapsing housing bubble, Taiwan invasion risk and the possibility of mass Covid infection following the abolition of "Zero Covid" policies. Oh, and it doesn't help that Chinese equities were the worst-performing in the world last year.

- But at the same time we read into that question a hope that the answer is "no" – that China *is not* uninvestable.
- *Far be if from us to support investing in securities in a place where there are no property rights.*
- But that said…
- …for a market that's uninvestable, it looks to us like there are some serious relative advantages coming into 2023. *China is set up to be the best-performing equity market this year.*
- And even if we're wrong about that, you're getting paid the world's most generous equity risk premium to invest anyway. China's wide risk premium is the complete opposite of the narrow ones in the US and Europe (please see the chart below). It's the only large market about which that can be said (see "Data Insights: Global Equity Risk Premia" January 3, 2023). Of course it is, in part, the product of Chinese equities have been last year's worst performers.

China equity risk premium (Shanghai Composite forward earnings yield minus 10-year sovereign)

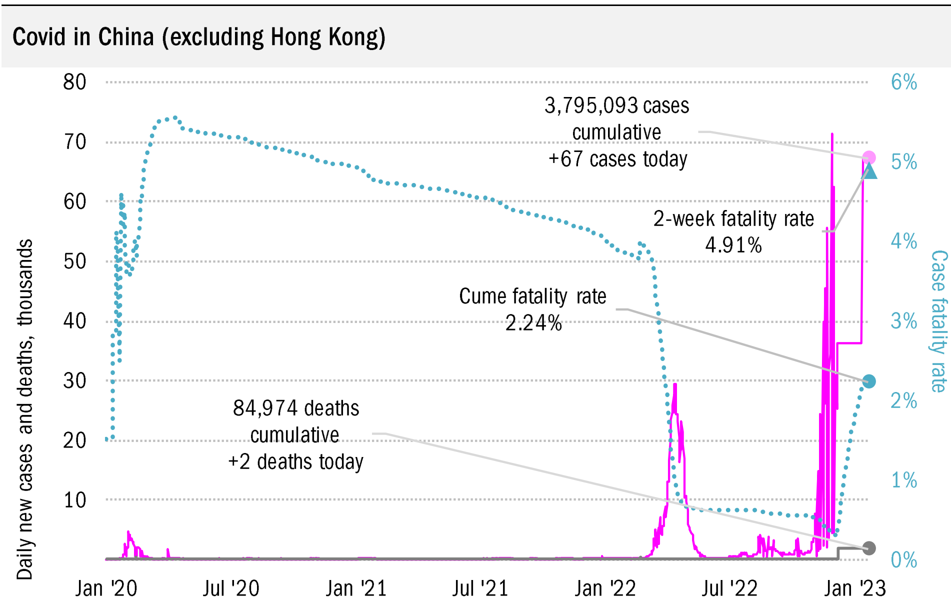


Source: Bloomberg. TrendMacro calculations

- We're not sure we fully buy the often-heard narrative that China is poised for a great growth surge as it emerges from its draconian "Zero Covid" policies of 2022. That's because were not sure we fully buy that last year's lockdowns were really all that draconian (see "The Myth of China's Lockdown" May 26, 2022).
- But they were bad enough to draw widespread social protests last year – although their scope, too, was probably exaggerated. But as we predicted, they precipitated the official end of the "Zero Covid" era not with an embarrassing policy reversal, but with the official downgrade in December of Covid to a risk no more serious than seasonal flu (see "Zero Covid" Protests? Zero Importance" November 29, 2022).
- This is more than a finesse. It's a smart thing to do (Japan did it,

too, last week, without protests to trigger it) – indeed it would have been smart to do everywhere three years ago. But that hasn't prevented the media – the same media that said the "Zero Covid" was destroying the Chinese economy – from saying that the exit from "Zero Covid" would destroy the economy by unleashing a wave of millions of infections and deaths.

- By the official numbers, that wave has indeed come (please see the chart below). But who knows, really? The official numbers in China, where Covid originated after all, have always been suspiciously low. Since the end of "Zero Covid," Chinese authorities have gone from reporting likely fake numbers daily, to reporting monthly, and now weekly (they keep changing their minds). But even granting the numbers are fake, they are meaningful: choosing to reveal this new wave underscores the authorities' conviction in their narrative that Covid doesn't matter any more than the flu (and for what it's worth, from the standpoint of national pride, the official number *still* make China the best-performing nation in the world in terms of share of its population infected or dead – see "Data Insights: Daily Covid-2019 Monitor" January 23, 2023).



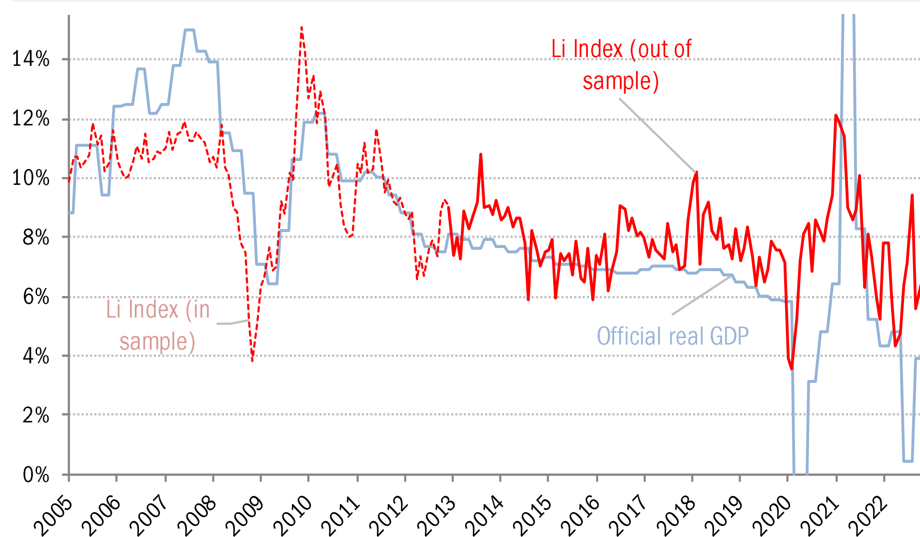
Source: China CDC. TrendMacro calculations

- *From an investment standpoint, the end of "Zero Covid" is a win-win. Even if last year's lockdowns were less draconian than advertised, ending them is a growth-enabling move at least to some extent. And as to a post-lockdown case-wave, well, if we (and the Chinese authorities) are right, that Covid is no worse at this point than the seasonal flu, then it really doesn't matter to growth.*
- Speaking of growth, China just reported real gross domestic product growth for 2022 at 3% – a low number by Chinese standards, and certainly well below 2021's 8.1%. Of course it is blamed on "Zero Covid." But what nation didn't have lower growth in 2022 than in 2021? US growth for 2022 will probably be reported

Thursday at something like 1.1%, versus 5.7% in 2021 (and there was no “Zero Covid” here).

- Here, too, we there is reason to be skeptical of the numbers. Indeed, Chinese authorities themselves are skeptical of their own GDP reports. Premier Li Keqiang famously computes his own growth index by looking at rail-freight loadings, electricity consumption and loan growth. The Li Index over the last three years shows the expected drop in the 2020 global Covid lockdowns, and a sharp recovery afterward. But the most recent readings show nothing especially alarming, or even especially different, than anything over the last decade (please see the chart below).

Li Keqiang Index (rail freight loadings, electricity utilization, loan growth)

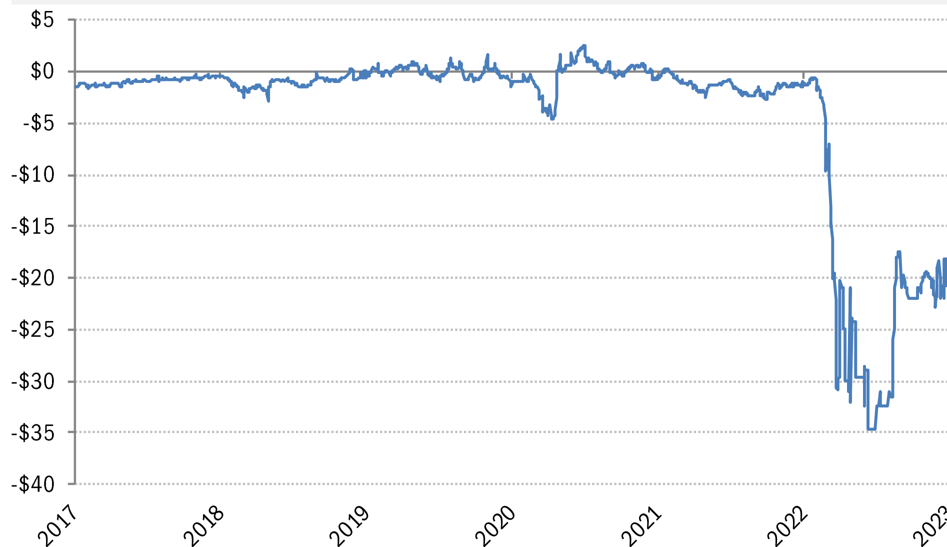


Source: Bloomberg, TrendMacro calculations

- Much was made in the media, at the same time as 2022 GDP was released, of the reported decline in the overall Chinese population by 1 million. This is certainly interesting from a secular standpoint, but it means absolutely nothing for near-term or intermediate-term investment decision-making.
- Actually, it’s not even clear that it makes any difference in a secular framework. What matters for growth is how many people are available to join the urban workforce. While China’s population is graying and shrinking, 45% of it remains rural – a stock of hundreds of millions of persons who could join the urban workforce. Think about it: surely China’s great economic growth story of the last thirty years was never the result of adult population growth – all along it has been a matter of moving people from old farms to new cities.
- At this point in the discussion about China in client conversations, we are almost always asked whether the new post-pandemic trend toward “re-shoring” or “deglobalization” will secularly damage China’s prospects.

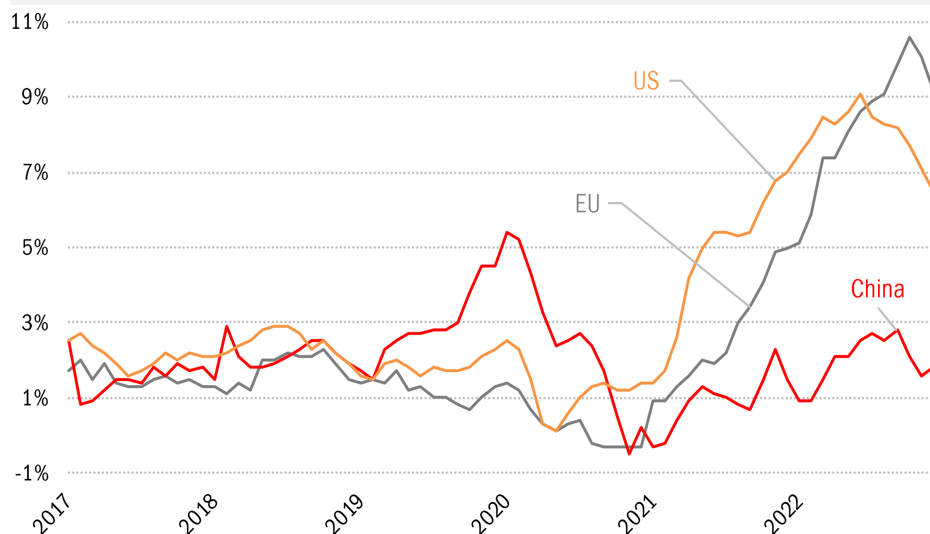
- Our answer is that it already has, in the sense that the great globalization wave that moved so much global manufacturing to China probably crested at least five years ago. So, at the margin, it has not been a force for Chinese growth for some time already.
- But now will it run in reverse? We can see the rationales. China is surely becoming a less friendly place for capital. The disruption of supply chains in the pandemic era taught the world how fragile they are, especially for strategic goods like semiconductors and pharmaceuticals. *But the reality is that it is incredibly expensive and frictional to run globalization in reverse at this point. While no longer as cheap as it was twenty years ago, Chinese labor remains cheaper than Western labor. And most important, the West is not willing to bring back from China the industrial pollution we exported to it twenty years ago when we moved all our factories there.*
- That's a long-term issue anyway. But here and now, and for the foreseeable future, China enjoys a unique growth advantage. As long as the Russian invasion of Ukraine keeps Russian oil a pariah in global markets, *China – the largest economy still willing to buy Russian oil – can buy crude at a $20 per barrel, or about 26%, discount to global benchmarks* (please see the chart below).

Urals crude oil discount to Brent benchmark

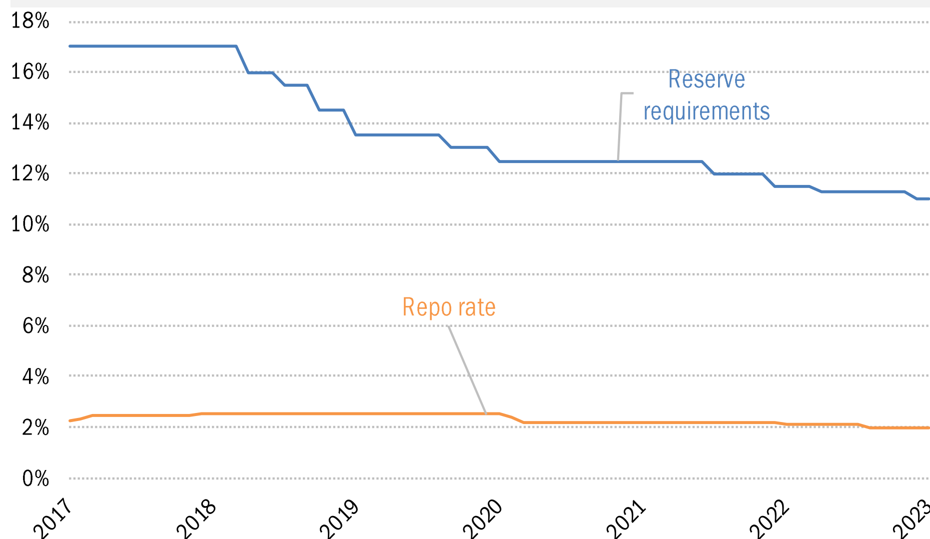


Source: Bloomberg, TrendMacro calculations

- This means that China's economy can fuel growth more cheaply – and more securely. While the US and the West puts themselves at strategic risk by depleting official petroleum reserves, China's can fill its reserves to the brim, and on the cheap.
- Also right here, right now, *unlike the US and Europe, China does not have an inflation problem*, the solution to which entails deliberate slowing of economic growth (please see the chart on the following page).
- As a result, over the last year while Western central banks have been tightening policy, the Peoples' Bank of China has been easing



(please see the chart below). As China cleans up after something of a blow-up last year in its property market, it is essential that the PBOC has scope to keep easing, with no concerns about inflation – and it does.



- Which brings us to two imponderables.
- Under President Xi Jinping, policy has become increasingly unfriendly to capital. We can't disagree with that reality – but for it to affect Chinese markets in the near-term, it would have to get worse to make a difference. For what it's worth, at Davos last week, Chinese officials promised it won't get worse. For what it's worth.
- And that leaves the Taiwan question.
- We don't want to hold ourselves out as one of those self-styled

gurus who pontificate on geopolitical matters. No one knows what the future holds on this issue.

- But one has to have a view, and we have ours.
- We agree with our friend Michael Auslin at the Hoover Institution that *last year's elevated state of both rhetoric and demonstrations of force are, more than anything else, a useful safety valve*, allowing the regime to look strong without actually taking any risk (see "Video: A Conversation with Michael Auslin on potential post-Pelosi post-Ukraine Chinese invasion of Taiwan" September 7, 2022).
- And after Russia's invasion of Ukraine, which we can be sure President Vladimir Putin thought would conclude successfully for him in a matter of weeks, the risks of such ventures are likely all too evident to China.
- But it remains a risk for investors, either way. It's a risk to a lot more than the question of investing in Chinese equities.
- But that's what equity risk premia are for. Chinese equities are offering a rich one – and, not insignificantly – at the same time as other major equity markets are offering poor ones. And abstracting from a potential black swan in Taiwan, the fundamentals we've enumerated for China make that global disparity all the more seductive.

Bottom line

Bear markets in US and European equities bottomed in late 2022, when the gilts crisis in the UK triggered the world's central banks to slow their hiking cycles. The equity risk premium in Europe has made a dramatic more-than-mean-reverting move from very wide to very narrow, which spectacular equity returns, as we predicted. That's over, so there is no case now for European equities. The US equity risk premium has widened somewhat as stocks have rallied and bonds rallied more, as we predicted. We think that will continue in 2023. The only large market with a wide risk premium now is China. While the Taiwan question is a black swan, there is a long list of favorable fundamentals. We are skeptical of the deglobalization narrative, but it could have no near-term effect anyway. Positives include opening up from "Zero Covid," cheap Russian oil, no inflation problem, and a central bank that is easing while all the others are have tightened.