



November 2019 Outlook

*Oh, East is East, and West is West, and never the twain shall meet,
Till Earth and Sky stand presently at God's great Judgement seat;
But there is neither East nor West, Border, nor Breed, nor Birth,
When two strong men stand face to face, though they come from the ends of the earth!*

Rudyard Kipling, The Ballad of East and West

We thought we would take a break from economic minutia, Fed speak and stock market gyrations to consider some bigger-picture, longer timeframe matters that have direct bearing on both today's investment universe—and very much on the futures.

Over the last decade the United States, along with the rest of the world, has recovered from one of the most vicious economic convulsions in contemporary history. Having just concluded the 123rd month of this recovery in October, we note how different the conversations surrounding the global economy, global markets and *globalization itself* are today than they were 10 years ago. Perhaps it was the very integrated nature of world economies by 2008 which caused such widely felt pain—history books may reveal this to us in the future. From trans-Atlantic to trans-Pacific we have witnessed increasing strains across various societies resulting in populist revolts. While these strains have emerged coincident with the *overall* wealth-benefits of global financial and economic integration, they are likely symptomatic of where and how these benefits have been accrued within each society. Indeed, Capital Economics, a valued source of macro-economic research to CCR Wealth Management, has been describing and detailing their own long-term “End of Globalization” forecast for much of the last six months—a topic we will likely dive into in the future.

In 2010 we saw the dawning of stress-fractures across the European Union, which began with the Greek debt-crisis. This crisis metastasized into a general distrust of several southern EU members' ability, *and willingness*, to bring balance sheets and fiscal policies in-line with membership obligations. Suddenly, debt levels, borrowing costs and bailouts for the “PIGs” (Portugal, Italy and Greece) became a weekly—even daily focus of financial news. When living

standards plunge, ideology often confronts the existing political *status quo*. Over the years we saw this play out across Europe. “Populism” was said to be afoot in elections in Greece, Italy—and even France. All the while, the European Union itself appeared to be a clumsier model of economic integration than many investors had assumed.

Of course, “populism” was also ascribed to other votes around the world during this period of recovery. Amidst the EU’s juggling of interests between European “*have*” and “*have-not*” states (which, incidentally, coincided with birth of negative interest rates), “Brexit” took the world by storm in a 2016 referendum. A vote put to the people of the United Kingdom on whether to serve the EU with divorce papers was widely expected to fail in a lopsided fashion. Instead, the referendum passed with 51.9% of the vote! Nearly 3 ½ years later, Brexit continues to cause confusion and consternation on both sides of the English Channel and around the world. The UK currently has its third Prime Minister since the referendum—and it has laid bare the strains between the Eurosceptics who were victorious in the referendum, and the Administrative State—understood in democracies as being charged with carrying out the will of the people. CCR Wealth Management has ceased to comment on the latest machinations of the Brexit issue as things have descended into a black hole of parliamentary politics. We would not, however, be surprised if the ultimate resolution to Brexit (whatever that may be) is carried out by yet a fourth PM.

In 2010—still early in this recovery cycle—China surpassed Japan to become the second largest economy in the world. Jim O’Neill, then of Goldman Sachs (and coiner of the “BRIC” acronym, standing for Brazil, Russia, India and China) attributed the world’s emergence from economic Armageddon largely due to the amazing growth and material consumption of the Chinese economy. Raw materials and foreign investment which flooded into China in the previous decade had forged a growing and hungry middle class. Technological advances, usually pioneered in the US, enabled manufacturing supply-lines to splinter into more complex webs. In past Outlooks and videos, CCR Wealth Management has used the Apple iPhone’s component origins to illustrate just one example of this complex picture. China quickly became an epicenter of global manufacturing supply chains, though O’Neill and others saw the future purchasing power of the Chinese citizens as the true economic gem.

Today, the “bloom is off the rose”, as they say.

China stands apart from the rest of the world’s experience with trade and capitalism for two reasons. The first reason, as Kipling depicted, emanates from a significant cultural divide between East and West. The second reason, more sharply defined, is that China is a communist country. The norms of western sensibilities as they pertain to fairness, democracy, human rights—indeed, the idea of *Res Publica* shared among democratic trading partners, are not sensibilities with which the Chinese can be expected to adopt easily.

China's integration into the global economy over the last twenty-five years, and their emergence as a force to be reckoned with competitively over the last decade has, it seems, culminated with today's stand-off with the US. Yes, it is over trade—but in truth, it is so much more than that. While the last 16 months have been a seemingly never-ending saga of on-again, off-again negotiations, or tit-for-tat tariff threats or impositions, we sense that the two sides, more often than not, are engaged in two different games, with two different objectives, and two different “scoring” systems. It is as if we are on the same field, but we are playing rugby while the Chinese are playing soccer.

To help better understand the thinking, and perhaps the culture behind the Chinese position, the rest of this Outlook is a conversation with CCR Wealth Management's own analyst, **Shiqi (Chloe) Gu**. Chloe was born and raised in Shanghai. She earned her Bachelor of Science at Shanghai University, and her Master of Finance at Clark University. Chloe is also a Chartered Financial Analyst (CFA). We are happy to include her in a discussion to help understand what the “long game” really looks like in the contest between East and West, or more specifically, China and America.

Let's begin:

- **Chloe, does this description of the US and Chinese entanglement over the last year and a half ring true to you?**

It has definitely been a see-saw battle between the US and China. I think it is understandable that no “quick deals” have been reached because of the number—and their far-reaching consequences—of issues being negotiated: Tariffs and trade deficits, market entry for foreign companies (competitors to Chinese companies), technology transfers (forced), industrial policies and government subsidies reformation. Some of the issues could be done immediately—and may soon be, like issues like tariffs, trade deficits and further opening China's financial markets. Others, like technology transfers and intellectual property are more difficult, and could be addressed over time.

So, perhaps a “grand bargain” approach, which was being discussed 6-12 months ago, was never as realistic it seemed. We recall speaking about the China trade issue internally many months ago and my thought was (I'm reluctant to use the word “prediction”) that whatever deal arises—it may look less radically different than what is currently in place. We must note “phase 1”, a term introduced in September, sounds a lot like it is a separation of issues like the ones you mentioned.

- **Chloe, you recently forwarded to me an article—an interview really—from the online version of Swiss magazine Die Weltwoche. The interview was with David Goldman, aka “Spengler”. Mr. Goldman is described as a philosopher, economist, mathematician—among other things. He also was a former investment banker for Bank of America as well as Credit Suisse. He has extensive business experience in China, and under the pseudonym “Spengler”, writes for Forbes and Asia Times. Mr. Goldman points out that this generation of Chinese—presumably he means *your* generation—is the first that does not have to fear hunger. With this source of fragility and hardship behind them, China is turning outward to assert power, and perhaps even dominance.**

In your view, does this sound accurate? If so, do you get a sense that this is a common vision among the Chinese?

My parents were born in the late 1960s. Fortunately, they avoided the two biggest disasters in modern Chinese history: The Great Leap Forward (which caused the Great Chinese Famine), and The Cultural Revolution after The People’s Republic of China was established in 1949. Although they didn’t have to worry too much about the stability of the country and lack of food, in my early memories, they had limited information from outside of the country under the planned economy system. Living was still the major thing they wanted to focus on. (I remember we used grain coupons rather than RMB to buy rice when I was little, so the grain coupon was extremely valuable as only limited amount of grain coupons could be assigned to each household. People could buy televisions and bicycles with grain coupons.)

My generation, so-called millennials (born between 1980 and 1996) have been experiencing the most prosperous period in modern China, along with the loosened policies and fast development of technology. We have better resources to learn about the outside world on the internet, and we get more opportunities to study abroad than my parents’ generation. Life is not just for living for the Chinese millennials. We have dreams, ambitions and life-goals to achieve.

There are 400 million millennials like me in China versus 80 million in US. This is a powerful number! It is more than the total population of the US and Canada combined, and 25% of them have bachelor-equivalent or higher degrees. They are willing to contribute themselves to their country. This energetic group is definitely the driving power to the current Chinese economy. However, all Chinese, not just millennials, have been educating themselves over time. They study hard, go to good schools and get decent jobs. Gaokao (standardized college entrance exam) seems to be the only way to achieve success. The Chinese are gaining all this education because we’ve been told it is a big part of doing the right thing. And we’ve been told what the right thing to do is for several generations now. But the definition of “success” in life varies. And in my opinion, many Chinese have been focused on the steps laid out for them rather than thinking about their own personal interests. This is where the statement about Chinese “lack of creativity” is coming from, weakening the power of innovation in Chinese young people.

Here you're talking about Goldman's explanation for the lack of Chinese-grown technological innovation. He points out many if not most of the numerous patents belonging to HUAWEI, for example, were developed by *foreign employees*. Eight Chinese winning the Nobel prize...all of them living in America. Yes?

Exactly.

- **After lengthy negotiations, China was admitted to the World Trade Organization (WTO) in 2001. Admission to the WTO, of course, requires agreement that the country being admitted abides by some specific rules, including those pertaining to Intellectual Property. It is exactly that issue, in fact, which has been a significant roadblock in negotiations between the US and China. Maybe this isn't fair, but I'll ask it anyway: Do the Chinese, as a people, view a written agreement differently than we do in the west? Does it not carry the same weight?**

I must admit that although China was admitted to the WTO in 2001, it could have been more open to foreign investment. Of course, protectionism of local companies and counterfeit/theft of intellectual property have remained issues. China has played loose with the rules for two decades—which are the major disputes on the negotiating table now. In my opinion, the US and China might seal some deals—with conditions. I think China knows it must change its approach to world commerce eventually. However, it is less likely to reach an agreement on other issues in the context of a bi-lateral trade deal with another country. I am talking about things like the reformation of industrial policies. These are internal, “structural” issues and the Chinese will likely insist on dealing with these reforms internally, as they tie-in with the development of the entire economy.

- **Are the US and China enemies? Adversaries? Or Competitors? How do the Chinese view this contest, in your opinion?**

Are the US and China enemies? No, Chinese don't like to make enemies. Confucianism, which is rooted deeply in Chinese culture, says “tit for tat is fair play” (人不犯我我不犯人). Being aggressive goes against the “doctrine of the mean” (Zhongyong). Competitors? GDP-wise, maybe. But we believe Americans lose sight of the difference between our nations from a standard-of-living context. Keep in mind that while China is the second largest economy today, per capita GDP is \$9,608, while in the US it is \$62,602. Also—in terms of technology, and technological advancement, China also has a long way to go. HUAWEI is seen by many as the only great company which can be targeted because it is China's most visible example of technological progress.

So how to explain the relationship with the US and China? In my view, they were trade partners with mutual interests until China became the second largest economy...and the global economy began to run out of steam. China, then, became a target (rather than a threat) because it is not simply the world factory anymore, providing cheap labor for manufacturing. It is also an attractive market with a fast-growing middle class (400 million people). This represents huge buying power! For instance, 18% of Apple's revenue is coming from China as of the end of March. In my view, developed countries (not just the US) have just wanted to harvest the rich benefits from this growth. China has enormous internal issues which need to be solved. I do not see it as a threat to the US now.

David Goldman made that point too. He noted that in 2,000 years or so, China's borders have not changed (apart from claims in the South China Sea). While we are not strategic geo-political analysts, it is important differentiate between current tensions and those of the Cold War with the Soviets. Unlike the Soviets, China has not been intent on spreading a particular ideology throughout the world (funding local communist cells, proxy wars, etc.). Along those lines, the issues surrounding HUAWEI might be an interesting discussion for the future, as 5g dominance has far-reaching strategic implications.

- **My generation, and those before, easily recall that last time the US had such a (how shall we put it?) *rivalry* with a communist country. That, of course, was the Cold War with the Soviet Union. I think that consciously or not—many of us who are of a certain age view China through that prism, where you have a “tyrannical” authoritarian regime over lording a benevolent people who just yearn to be free. How much does this view need to be changed?**

As a native Chinese, I have to say I have a mixed feeling of the current system in China. On one hand, I've been benefiting from the stability and development of the country because of the efficiency of a single-party state. I also have a pride of being a Chinese as it has become the second biggest economy in the world. On the other hand, I'm facing the problem like censorship on social media and limited privacy or freedom of speech. I understand no system is perfect. Democracy has its own issues. What I am most concerned about in current system is the lifetime term of the leader. Lifetime tenure gives the absolute power to a person, which might corrupt eventually.

Lord Acton is quoted as saying; “Power corrupts, absolute power corrupts absolutely”. But surely this lifetime Presidency must have an asterisk—meaning things must go well for the people.

Part 2 of that question would be to get your thoughts on how a mainland Chinese person might be viewing what has been going on in Hong Kong for much of the year.

I think the tensions in Hong Kong have been building for years—recent protests and violence attributed to Hong Kong’s extradition issues are a symptom. The conflicts between the mainland and Hong Kong are really about resources and democracy. Here’s an extreme example: Thousands of mainland women delivered their babies in Hong Kong in 2011. They occupied all the medical facilities and bought and carried back tons of infant milk powder, which created a dire shortage in Hong Kong. It was seen as scandalous by the Hong Kongers—and so the tensions began.

Personally, I understand the motivations of the protesters, but violence should definitely be avoided. On the surface, Hong Kong people are angry with the central government and mainland people. But from the Chinese perspective, Hong Kong has its own structural issues which contribute to the people’s anger. The economy of Hong Kong has been mainly controlled by five powerful families which dominate real estate, telecommunication, casinos and retail. Real estate prices in Hong Kong are the highest in the world—and the HK government relies on real estate taxes. Young people suffer because they subsist on very little. Most of the money they make gets poured into their tiny homes. As a financial hub in Asia, Hong Kong has also lost growth opportunities to neighboring China as the technology industry has boomed over the last decades. In 2018, Hong Kong’s GDP grew by only 3%, but across the river, Shenzhen’s GDP outpaced Hong Kong’s for the first time in history. Shenzhen is home to many tech companies, including Tencent. Like many other countries—these economic disparities have fueled populism. So in my opinion, Hong Kong’s leadership needs to focus on these structural issues. Having a better life is what people are looking for, no matter in which system.

- **David Goldman says, “You can never be China’s Friend”—in fact that is the title of the interview. What does this mean to you? How does this shape the landscape for coexisting with China economically?**

China, of course, appears to be friendly to the rest of the world because globalization has been selected as the most efficient way to optimize the resources of the globe. David Goldman also mentioned Aristotle’s notion of “political friendship”, saying that China only has interests—no friendships. In China, the notion of true friendships—as it is understood in the West—is reserved for your family. All other relationships are basically strategic. This is true on the world stage too. But I think every country allies with another based on mutual interests, politically and economically.

I am not a philosopher, but I also think China not having close allies is also due to atheism. According to a WING-Gallup International Association poll in 2017, 90% of Chinese are not religious. This could explain why friendship is not considered that “noble” among Chinese.

Thank you for your insights, Chloe.

We are not, of course, privy to the nuts and bolts of trade talks between the Chinese and the Trump administration. We are, however, left to endure the short-term twists and turns of the market based on the media's interpretations. We think a longer view is warranted, however. As Chloe points out, 400 million "millennials" will keep China's economic growth alive *regardless* of the success of "phase 1".

Our conversation with her reinforces the notion that the Chinese people and their government may not be as distinctly at odds as Western sentiment might assume—given the history of failed Communism around the world throughout the last century. Assuming Chloe's ambivalence toward autocratic rule is indicative of the Chinese population as a whole, it rhymes with David Goldman's description of the Chinese Communist Party as "simply another manifestation of the Mandarin administrative cast which has ruled China since it was unified in the third century BC".

The commonality is *ambition*.

Trade issues with China are one of the very few bipartisan issues left in this country. China's ambition and demography fuels an "end justifies the means" philosophy regarding trade, economic and strategic expansion. The West's notion of "fair play" and rules-based trade arrangements will unlikely alter the Chinese approach much in the coming years, in our view. We think closing the per capita gap between Chinese and American citizens will be the key to more harmonious relations. East meets West, in this context, will most likely be a competitive contest for decades to come.

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