A National Security Imperative

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“Dear America, appreciate your allies – after all, you don’t have that many.”
-DONALD TUSK, European Union (EU) Council President on Tuesday

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In March, Evergreen outlined our near- and long-term concern for an escalating trade war in *The Trump Trade Tirade*. Well, ladies and gentlemen, it seems as if the worst ~~has come~~ is coming to fruition.

Last Friday, no more than 48 hours after 4th of July fireworks stopped ringing, duties on $34bn of Chinese goods took effect. China promised to immediately impose retaliatory tariffs on a comparable size of US goods. In a move that some see as mere political posturing, President Trump suggested that the total number could eventually reach to the hundreds of billions – or exceeding the annual value of all Chinese goods exported to the US.

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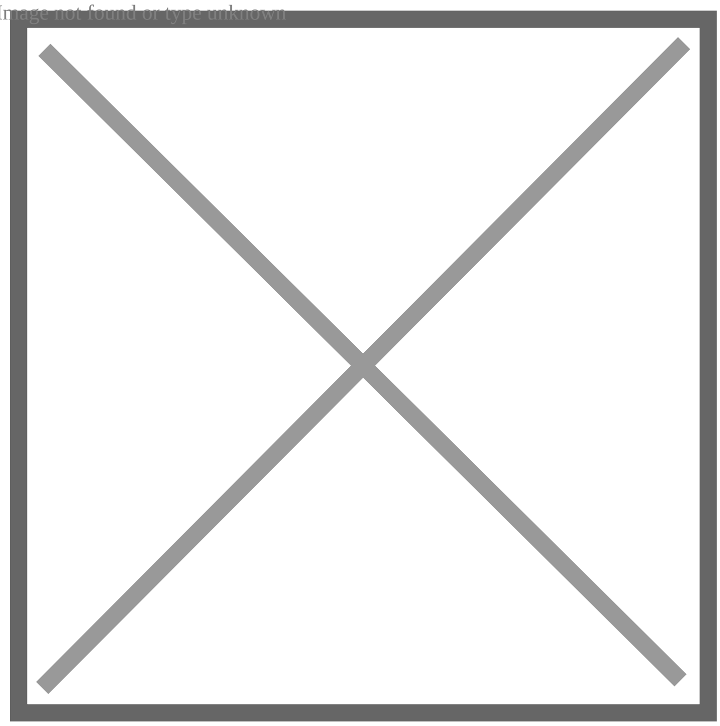

While we feel it’s unlikely Trump’s tariffs will be implemented to the degree shown above, all the back-and-forth and political jockeying is enough to make even the most level-headed individual question their sanity.

For those anticipating the impact of these tariffs will come further down the pipeline (i.e. when the numbers shown above reach the higher end of the spectrum), quantitative and qualitative indicators are already showing signs of weakening confidence in an economy who’s at war with its heavy-hitting trade partner. For example, as the Fed outlined last week, several industry contacts from around the country indicated that the war is already hurting US investment. And those in the good ole’ American heartland and coastal cities alike have already experienced direct business impact.

In this week’s EVA, readers have the opportunity to hear from Louis-Vincent Gave, a man with the unique pedigree of being raised in Europe, educated in the United States and China, and spending many of his working years in Hong Kong. As you will read below, Louis – who has also been dubbed the “Smartest Man in Asia”– has reason to be bearish on the economy and US dollar. Please enjoy hearing from Louis, a good friend and partner of Evergreen Gavekal.

Correction: In last week’s EVA, we stated that later this year the Fed is scheduled to start selling $60 billion of its government bond holdings per month (a $720 billion annualized clip). The correct figure is that the Fed will start selling $50 billion of its government bond holdings per month (a $600 billion annualized clip).

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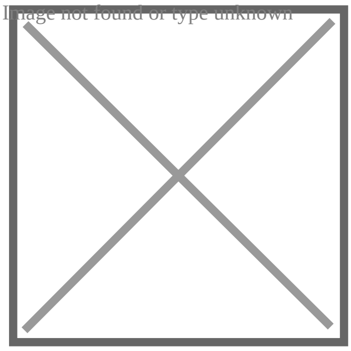

Michael Johnston
Marketing & Communications Manager
To contact Michael, email:
mjohnston@evergreengavekal.com

A NATIONAL SECURITY IMPERATIVE

By Louis-Vincent Gave

Depending on commodity prices, in any given year China spends between US$250bn and US$400bn on imports of the “big five” commodities it needs to continue growing: oil, iron ore, coal, copper and soybeans. Before it can do that, it must first “earn” those US$250-400bn. Only then can it can turn around and buy the stuff the country needs to ensure its long-term growth.

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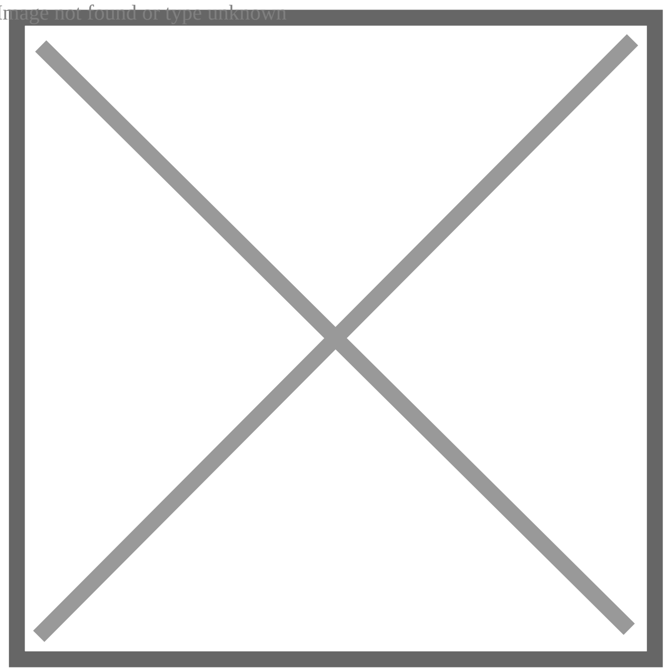

Today, however, the US president is busy signaling that China’s massive trade surplus with the US must drastically shrink, which means that China will no longer be able to earn the US dollars it needs through trade with the US. This leaves China in a quandary: on one hand, it needs a lot of US dollars, on the other, the US president wants to implement policies that prevent China from earning these dollars. What should China do? It has a number of options:

1. **China can choose to ignore all the noise as mere political posturing.** This would be reckless of the Chinese leadership. In essence, it would be akin to embracing hope as a

strategy. And little in the Politburo's recent track record points to hope as a strategy.

2. **China can try and apply pressure on the US to change its rhetoric**, at the risk of making a bad situation worse. This could be done in any number of ways: foot-dragging on corporate mergers (e.g. NXP-Qualcomm), applying pressure on individual US companies (e.g. Micron), trying to team up with other countries and complaining to the WTO (as China is trying to do across Europe, with little success), or perhaps even by signaling that a renminbi* devaluation is possible (since mid-June, the renminbi has weakened steeply, even as other emerging market currencies including the Mexican peso and the Turkish lira have held their own).
3. **China can work to cut back its purchases of commodities.** This would be akin to accepting a much weaker rate of economic growth. Obviously, this would also trigger lower commodity prices. Such a course would be very tough for global growth and emerging markets would be hard hit.
4. **If China can't get access to new US dollars through trade, it would have to get them by selling assets to US investors.** This is a distinct possibility. Clearly China is continuing to open up its bond and equity markets to foreigners. But over time this is not a great strategy for China, as in effect it means selling prized assets at undervalued prices. Why else would foreign investors be interested? In essence, this would be pawning the family jewels.
5. **If the US will no longer allow China to earn the US dollars it needs through trade, China can press ahead with plans to price commodities in renminbi.** It was always in China's national interest to try and switch the pricing of some of its key commodity imports away from the US dollar and into renminbi. After all, why would China want to remain dependent on the ability and willingness of US banks to fund its trade? This simple truth explains why over recent years China has started to internationalize the renminbi and open its domestic bond market to foreign investors. It also explains why in March China launched a renminbi-denominated oil future out of Shanghai.

The only questions remaining are: Will the recent aggressive rhetoric from Washington, and the damage it has inflicted on the WTO's foundations, now push China's "de-dollarization" quest into hyper-drive? Or will China back off to avoid triggering an even angrier response from the US? **In short, does Donald Trump's protectionism now make the internationalization of the renminbi a national security imperative for China?**

Extrapolating from this last point, it becomes clear that the two main questions confronting investors today are:

1. **How destabilizing is Donald Trump's protectionism?** This question elicits a wide array of responses, even in our own little shop. Those of us based in the broader western world tend to dismiss the Trumpian rhetoric as nothing but political posturing which will have minimal consequences for global growth. Those of us based in Asia tend to be a lot more concerned, seeing in the mere threat of protectionism a reason for businesses and policymakers to change the patterns of behavior that have helped to generate so much global prosperity over the last generation.
2. **Assuming US protectionism is for real, is it US dollar bullish or bearish?** Again, this is a question on which we find little internal consensus. For my part, I struggle to see why Washington's decision to give the rest of the world the middle finger at a time when its budget deficits are going through the roof should be bullish for the US dollar. My starting point is that the US has been the keystone of the post-World War II, post-Cold War world order. This is why the post-Cold War order was called the "Washington Consensus". And

> the US reward for being the keystone of the world order was having the world's reserve currency, even if the cost of issuing that reserve currency meant being prepared to run constant current account deficits. Now, if the US is no longer willing to run current account deficits, can we really be sure that the US dollar will retain its role as the world's reserve currency?

In the past, we have frequently compared reserve currencies to computer operating systems: once a majority of users have adopted a given system (Microsoft Windows for PCs, the US dollar for trade and commodity settlement), then it is very hard for any new market participant to displace that system. A wannabe new system can't just be marginally better; it needs to be massively better to replace the incumbent.

By any objective measure, the renminbi is very far from being "massively better" than the US dollar. So, the only way the renminbi can make significant strides towards reserve currency status is if the US itself goes out of its way to undermine the US dollar. Increasingly it feels as if this is exactly what is happening today. Imagine for a second if Microsoft were to come out and say, "We don't want to sell Windows to China anymore", or if Bloomberg were to announce, "From now on, we will no longer sell our terminals to hedge funds". Clearly, the value of these companies would immediately plummet, if only because the "network effect" from which these businesses derive so much of their intrinsic worth would be massively undermined.

Today, the US is effectively saying to the rest of the world, "We don't want to give you US dollars any more". To my surprise, most people view this statement as inherently bullish for the dollar. Their assumption is that people have no choice but to use the US dollar, and that the US trade actions will trigger a massive shortage. However, viewed from Asia, this statement strikes me as particularly bearish for the US dollar. If anything, it will accelerate the move away from the US dollar as the region's sole trade and reserve currency. Once that shift has occurred, reversing it will be almost impossible.

** Note: The renminbi is the official currency of the People's Republic of China.*

OUR CURRENT LIKES AND DISLIKES

No changes this week.

LIKE

- Large-cap growth (during a deeper correction)
- International developed markets (during a deeper correction)
- Cash
- Publicly-traded pipeline partnerships (MLPs) yielding 6%-12% (buy carefully after the recent rally; long-term, however, future returns look highly attractive)
- Gold-mining stocks
- Gold
- Select blue chip oil stocks (as with MLPs, be selective given the magnitude of the recent rally)
- Mexican stocks
- Short euro ETF (due to the euro's weakness of late, refrain from initiating or adding to this short)
- Investment-grade floating rate corporate bonds

- One- to two-year Treasury notes
- Canadian dollar-denominated short-term bonds
- Select European banks
- Short-term investment grade corporate bonds (1-2 year maturities)
- Emerging market bonds in local currency (start a dollar-cost-averaging process and be prepared to buy more on further weakness)
- Bonds denominated in renminbi trading in Hong Kong (dim sum bonds)

NEUTRAL

- Most cyclical resource-based stocks
- Mid-cap growth
- Emerging stock markets; however, a number of Asian developing markets appear undervalued
- Solar Yield Cos
- Large-cap value
- Canadian REITs
- Intermediate-term investment-grade corporate bonds, yielding approximately 4%
- Intermediate municipal bonds with strong credit ratings
- US-based Real Estate Investment Trusts (REITs)

DISLIKE

- Small-cap value
- Mid-cap value
- Small-cap growth
- Lower-rated junk bonds
- Floating-rate bank debt (junk)
- US industrial machinery stocks (such as one that runs like a certain forest animal, and another famous for its yellow-colored equipment)
- Preferred stocks
- Long-term Treasury bonds
- Long-term investment grade corporate bonds
- Intermediate-term Treasury bonds (moving to “dislike” on longer bonds due to recent breakout above 3% on the 10-year T-note)
- BB-rated corporate bonds (i.e., high-quality, high yield; in addition to rising rates, credit spreads look to be widening) * **
- Long-term municipal bonds
- Short yen ETF

** Credit spreads are the difference between non-government bond interest rates and treasury yields.*
*** Due to recent weakness, certain BB issues look attractive.*

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