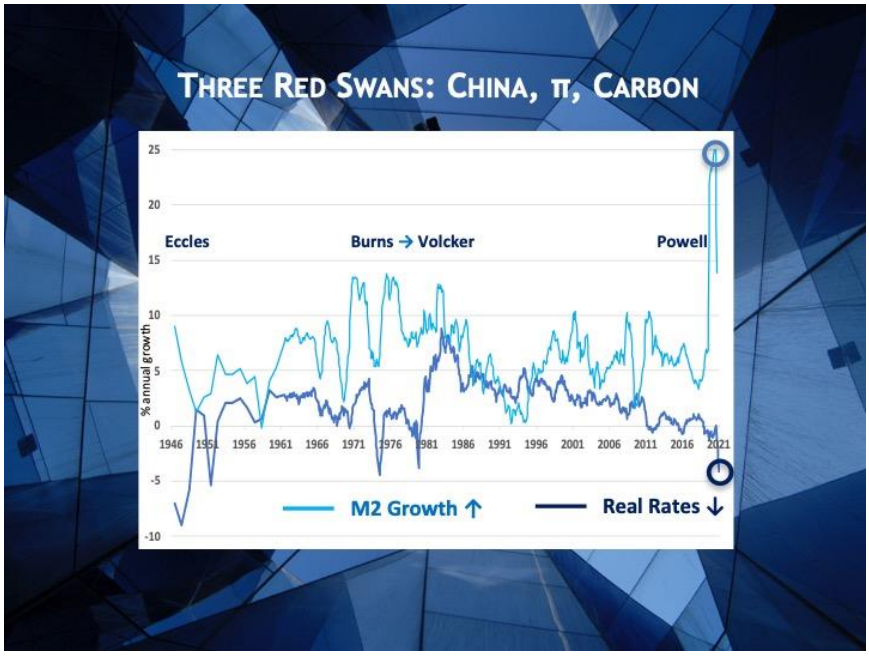


THREE RED SWANS

How do investors manage risks from China, rising inflation, and decarbonization?

> *"Around the corner are lurking serious issues like interest rates, inflation, labor and commodity prices."* *Jeremy Grantham, July 2021*

Investors often prefer to extrapolate momentum into the indefinite future, waiting for yet another dance as in 1929 and in 2000. Some may try to peak around the corner to anticipate what risks we may be awaiting. When regime changes happen, outsized gains can be realized, and risk-mitigation strategies pay off when more investors join. Global-macro investors endeavor to identify high-impact events in the near term with probabilities that are mispriced in the markets. And indeed, three red swans could materialize over the next year: China decoupling, big inflation, and decarbonization.

On China, investors have been piling in and net inflows exceeded $88 bn in 2021Q1, the highest in seven years, while Chinese bonds and A-shares were added to global indices. Given the large stakes in China, many investors are turning a blind eye to the recent regulatory crackdown, calling it just "noise". But what if there is a Chinese strategy behind the madness, and what if that decoupling is evolving deliberately?

On inflation, investors have become complacent, even as we witnessed last year the largest post-war monetary expansion, and even as we today experience negative real interest rates that were last seen in the 1970s. Meanwhile, Chairman Powell is saying that "inflation is likely to be temporary". But what if inflation stays higher for longer than expected, does today's FED have the Volcker muscle to raise rates aggressively?

On carbon pricing, China has started the world's largest emissions trading system, and the EU has expanded its green agenda while carbon prices have doubled this year. Could there be a "big shock" to inflation that could revisit stagflation of the 1970s?

<A> The most dramatic red swan would emerge in case China invaded Taiwan. Markets are not focusing on that risk and appear to be complacent in the wake of the Hong Kong takeover last summer that drew only a weak international response. Investors are focused on a gradual de-coupling of China, as seen in regulatory actions against big tech and US listings of Chinese companies, as well as in Chinese policies to reduce leverage of real estate developers. But could these Chinese actions represent a pre-emptive strategy to an anticipated international response to conflict on Taiwan?

Chinese politicians are known for planning way ahead: they understand the US efforts to re-build alliances and to strengthen the Quad, to contain strategic industries such as 5G through trade sanctions, to gain leverage through the global payment systems and forced de-listings by US exchanges, and to pressurize lenders to reduce exposure to certain industries in China. Each one of these pressure points is already countered through China's policies and new alliances, its Belt and Road initiative, reinforcement of alternative technological supply chains, its development of a digital currency and modern payments systems, and its financial risk mitigation policies.

Chinese political ambitions and policy options on Taiwan are illustrated in the recent Foreign Affairs journal. Beyond doubt, Chinese leaders desire the great rejuvenation with full control over Hong Kong and Taiwan, where the first part was accomplished and the second part is accelerated in time. Chinese military capabilities appear to near completion, and popular support for nationalist Chinese policies has been rising. The perception has been formed that US foreign policies remain non-interventionist, that China has little upside to collaborate with the new US administration, but also faces little downside by forcing new Chinese faits-accomplis regarding Taiwan.

The US administration has re-confirmed its policy of "strategic ambiguity" on Taiwan and also directed the US military to tone down concerns on Taiwan that were voiced earlier this year. Military deterrence has been weakened, especially by threats from Chinese nuclear submarines, and political leverage has been limited to trade and financial pressures from the US and its allies. Trade sanctions, ADR de-listings, and restrictions on payments and investments would likely form the main US response.

How would markets react to the red swan Taiwan? Initially, markets would likely be risk-off with safe-haven currencies advancing. Taiwanese stocks would plummet and Chinese ADR stocks and highly leveraged real-estate developers would suffer heavily. Cyber-vulnerabilities on all sides would likely be exploited. Subsequently, Korean IT, Vietnamese supply chains, and Indian exporters would likely evolve as beneficiaries. Geo-political bloc formation would substantially increase global investment risks.

How would markets react to a Taiwan stalemate? US investors would likely want to exclude China and Taiwan into "non-investable" indices to separate them from other emerging markets. Supply chains would likely be diversified or partially re-shored, and inflation pressures could intensify from rising trade barriers and logistics costs. Shanghai may gradually absorb declining financial services from Hong Kong while Singapore may benefit from relocating expatriates in high-value-added industries.

How could a Taiwan problem be avoided? It could be postponed by more effective military deterrence or through a serious financial or political crisis within China.

<B> A serious red swan would emerge if a dovish FED allowed fiscal dominance. Could monetary policy instruments be instrumentalized by the US Treasury to keep debt financing costs low and to minimize corporate defaults, even if inflation is rising? Could negative real interest rates further inflate leverage and asset bubbles? Could the FED even consider old tools of financial repression such as interest rate ceilings? History does not appear to rhyme with current market forecasts of FED policies.

Today, we witness the fastest GDP growth since 1984 and highest inflation since 1990, with the lowest real interest rates since 1980 and fastest monetary growth since 1943. Apparently, policy makers perceive that they need not take any threat from inflation as seriously, for four main reasons: <i> they believe that the recovery from the 2008 crisis could have been stronger with more stimulus; <ii> they believe that US inflation has not been a problem for 40 years; <iii> they are intrigued by the modern monetary theory and the inability of Japanese policy makers to generate inflation; <iv> they need to balance multiple objectives (employment, equality, ESG) against inflation.

Chairman Powell has orchestrated the most aggressive post-war monetary stimulus and also expanded the monetary toolset in coordination with Congress and Treasury. Federal debt held by federal reserve banks has doubled to 25% of GDP and the total FED balance sheet has doubled to $8 trillion since the start of 2020. Policy makers in the US and in Europe are now warning of fiscal dominance that would arise when politicized central banks use massive asset purchases to monetize fiscal deficits. Otmar Issing, the ECB's first chief economist, recently stated that "fiscal dominance is reality in Europe today" as higher debt servicing costs constrain monetary policy.

Two earlier Republican chairmen of the FED experienced similar encounters with political interference, fiscal dominance, and with financial repression: Marriner Eccles (1934-1948) was a proponent of demand stimulus projects, he instituted strict interest rate ceilings (2.5% on US Treasuries), had to deal with double digit inflation in 1947, and then supported independence with the 1951 Treasury-FED accord. Arthur Burns (1970-1978) was dedicated to support policies of President Nixon, but with best intentions got double-digit inflation despite price controls and negative real interest rates, and a drastic decline in the dollar in a "great failure of macroeconomic policy".

Are there current parallels to the 1970s? Today's real interest rates of minus 4% had previously been realized in 1975 and again in 1979, before Paul Volcker raised interest rates to 20% to control inflation (chart A). Today's record money supply growth of M2 is exceeding the post-war record annual growth from 1976. However, today's budget deficits are four times as large as those observed in the 1970s. Despite independence of the FED, both today and during the 1970s, there is substantial political influence.

How would markets react if inflation is persistently higher than expected? Markets are complacent and investors are driving 10year inflation-protected-treasuries (TIPS) yields into all-time negative lows. But inflation expectations may soon get unanchored when the FED has to taper or eliminate its $120 bn monthly asset purchases. When inflation is rising, does today's FED have the Volcker muscle to aggressively raise rates or does it prefer old repressive Burns/Eccles tools such as interest rate ceilings to limit the fallout in currently exuberant credit markets? Could inflation and rising rates puncture equity market valuations and revisit some experiences of the 1970s?

<C> A third red swan would emerge if carbon taxes led to supply-pull stagflation. Could European policy makers in Brussels and Berlin double or triple carbon prices and impose border adjustment taxes? Could the Chinese new carbon trading scheme find broader global application during the upcoming COP26 event in November? And could higher carbon prices accelerate into "big inflation", as some investors are suggesting?

Most countries have joined the Paris Agreement on climate change and over 110 countries have committed to decarbonize with a net zero goal by 2050. Four clear trends have been revealed in that journey so far: <i> ESG are serious factors that can enhance investment returns; <ii> Fossil fuels are rapidly declining from 80% to 20% of energy consumption; <iii> Carbon taxes are the most powerful tool on that journey with quickly rising carbon prices; and <iv> relative prices, income distribution, growth and global trade will be affected as most industries are racing to innovate and adjust.

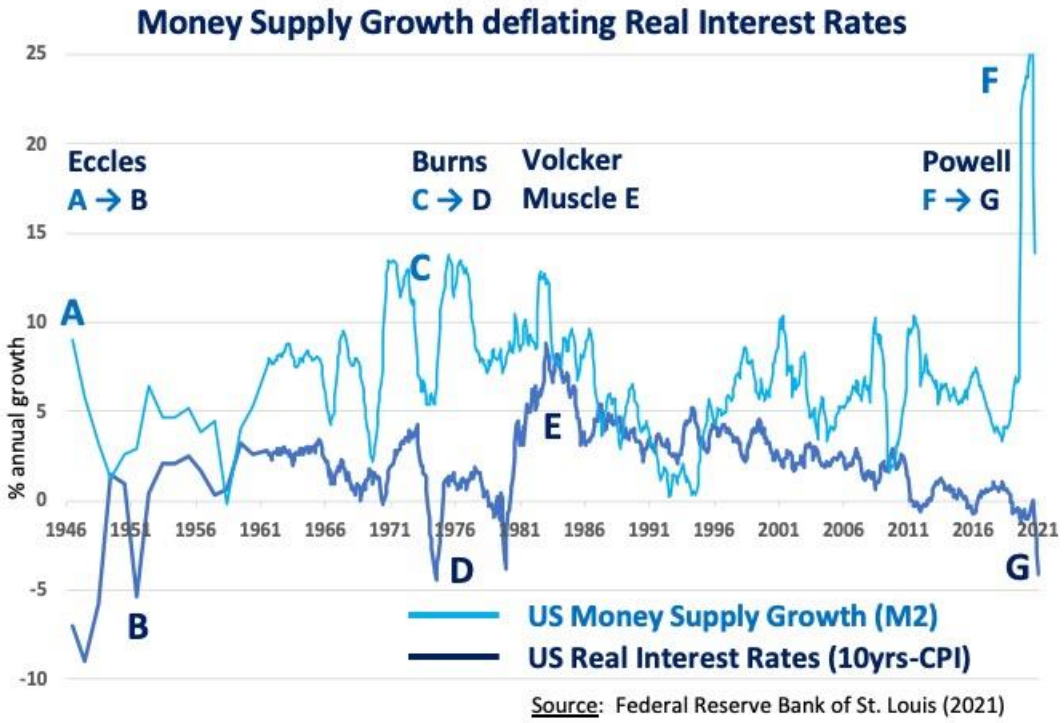
Investment opportunities are provided both by incentives in green infrastructure and disincentives in fossil industries, but they differ enormously across countries: Most energy exporters are adversely affected. Canada and the United States are heavily investing in sustainable industries, but Russia and Saudi Arabia are way behind. The EU is most aggressively promoting decarbonization, as progress has been made in Germany, the UK and the Nordics, but Poland and parts of Eastern Europe are lagging behind. Whereas China is operating the world's largest emissions trading system, India does not yet have any carbon pricing mechanism, although the G20 recently endorsed carbon pricing (78 countries are pricing carbon, 22% of global carbon emissions). Carbon pricing is expanding beyond utilities to industrials, as permits are phased out.

Could there be flashbacks to the stagflation and oil price shocks of the 1970s? The tripling of oil prices during the 1970s, combined with mistakes in monetary policy, have been blamed for high inflation and low growth (stagflation), incl. repercussions across financial markets. Today, a rapid rise of carbon prices could potentially create inflation and supply shocks that can reduce demand and economic growth. However, the substantial increase of EU carbon prices over the past year (€20 to €65 /mt) has not caused inflation mainly because its coverage is still limited. Likewise, China's massive ETS (chart B) needs to be extended and prices need to rise ($8 to $50 /mt) by the end of the decade for emissions to be reduced by one quarter. Tsinghua University estimates that carbon prices need to reach $300 to $350 to achieve carbon neutrality by 2050, and projections for EU carbon prices are around €130 by 2030. Various academic papers project substantial inflation for China and India, but also for the US, from inelastic demand mostly for energy, transport, consumer and industrial goods.

How would markets react to carbon price shocks? Larry Fink, CEO of Blackrock, said there could be a "big shock from inflation" as we "accelerate our green footprint" and do not yet have new technologies, but dynamics matter: a weaker dollar, a strong recovery, trade frictions and rising inflation from massive stimulus could magnify the impact of rising carbon prices but it may be less concerning in an extended pandemic. Elections and politics could lead to spikes in carbon pricing (esp. in the EU and US) that could accelerate the structural bull market in commodities and create a big rift between rising demand for cleaner materials and declining demand for fossil fuels. Local research remains critical to identify effects on firms from regulatory changes. While the market direction looks clear, volatility could be elevated on that journey.

http://www.emleaders.com/pdf/eml-redswans-2021.pdf

Excessive Monetary Stimulus — Chart A



China's Carbon Dominance — Chart B