MONTHLY MARKET REVIEW

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The Silk Road

China's Inevitable Ascendancy; An Alternative to Western Liberalism

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Equities were largely unchanged during April in spite of a strong earnings reporting season. Nearly 80% of S&P 500 companies that have reported March quarter earnings exceeded expectations, and the Index's year-over-year earnings-per-share growth for the quarter was projected to be nearly 25%. Investors, however, were concerned about comments from several industry bellwethers regarding the rising costs of goods sold, which may imply peaking margins for this cycle as well as higher inflationary pressure ahead. Crude oil prices surged on Venezuela's continued production decline along with geopolitical concerns over Syria and the Iranian nuclear deal. The U.S. 10-year Treasury yield surged past 3% at one point, triggering more anxiety for emerging market equities. Higher U.S. Treasury yields also pushed the U.S. Dollar Index above a three-month long trading range to its highest level since early January 2018. The Greenback's surge of late snuffed out precious metals' earlier rally, leaving gold and silver prices largely unchanged for the month. One glaring concern for market watchers was that the U.S. yield curve, the difference between the 10-year and 2-year Treasury yields, has flattened to the lowest levels in more than 10 years. It may portend that the economy is at or past peak growth. The relentless rise in the 2-year Treasury yield, as well as the LIBOR, was bound to have a dampening effect on the economy. Eurozone economic data also came in largely below expectations. It did not help that the Trump Administration's trade policies have also created uncertainties for business decision making and inflation expectations. In short, while the overall corporate earnings backdrop remained supportive, markets may stay range-bound until some of the policy-related uncertainties start to subside.

From Serica with Silk

Silk is one of the most amazing fabrics in the world. It has a soft, smooth, and lustrous texture and is one of the strongest natural

EQUITY MARKETS INDICES[1]	3.31.18 PRICE	4.30.18 PRICE	MTD CHANGE	YTD CHANGE
MSCI All Country World	506	510	0.8%	-0.7%
S&P 500	2641	2648	0.3%	-1.0%
MSCI EAFE	2006	2044	1.9%	-0.3%
Russell 2000®[2]	1529	1542	0.8%	0.4%
NASDAQ	7063	7066	0.0%	2.4%
TOPIX	1716	1777	3.6%	-2.2%
KOSPI	2446	2515	2.8%	1.9%
Emerging Markets	1171	1164	-0.6%	0.5%
FIXED INCOME				
2-Year US Treasury Note	2.27%	2.49%	22	61
10-Year US Treasury Note	2.74%	2.95%	21	55
BarCap US Agg Corp Sprd	1.09%	1.08%	-1	15
BarCap US Corp HY Sprd	3.54%	3.38%	-16	-5
CURRENCIES				
Australian *(AUD/$)*	1.30	1.33	-2.0%	-3.5%
Brazilian Real *(Real)*	3.31	3.51	-5.7%	-5.5%
British Pound *($/GBP)*	1.40	1.38	-1.8%	1.9%
Euro *($/Euro)*	1.23	1.21	-2.0%	0.6%
Japanese Yen *(Yen/$)*	106	109	-2.8%	3.1%
Korean Won *(KRW/$)*	1064	1068	-0.4%	-0.1%
US Dollar Index *(DXY)*	89.97	91.84	-2.0%	0.3%
COMMODITIES				
Gold	1325	1315	-0.7%	0.9%
Oil	64.9	68.6	5.6%	13.5%
Natural Gas, Henry Hub	2.73	2.76	1.1%	-6.4%
Copper *(cents/lb)*	303	305	0.9%	-7.5%
CRB Index	195	202	3.4%	4.2%
Baltic Dry Index	1055	1341	27.1%	-1.8%

source: Bloomberg

The emerging bipartisan consensus in Washington D.C is that the Sino-U.S. relationship is shifting into one of strategic competition.

fibers. It was long believed that silk was first produced in China in the 4th millennium BC, but a recent archaeological discovery in central China dated the earliest silk to 8,500 years ago.

For centuries, China had held a monopoly on silk production and had carefully guarded the trade secret. It was a highly lucrative business that gave rise to the Silk Road, a network of ancient trade routes that connected Chinese goods to as far west as the Mediterranean Sea. Silk was a luxury item adorned by the Romans but it also costed them vast amounts of gold and silver. The Roman Senate tried in vain to prohibit the wearing of silk to curtail this ancient *trade deficit* with China, which the Romans called Serica, the easternmost country known to them. This trade imbalance persisted for hundreds of years and was finally resolved in 522 AD with a bit of intellectual property espionage – the Byzantine emperor Justinian allegedly sent two Nestorian monks to Central Asia to smuggle silkworm eggs hidden in their hollow canes. Using techniques learned from the Persians, the Eastern Roman Empire soon ramped up silk production and dominated the market in the region.

1,500 years later, Western countries are once again complaining of trade deficits with China, and there are also heated accusations of industrial espionage, although the flow of technology is in the reverse direction. History rhymes.

The Modern-Day Silk Road

I recently visited several cities in China, starting with Xian, the starting point of the ancient Silk Road. Xian was the capital for thirteen dynasties, including the great Han and Tang Empires. It is perhaps best known as the burial site for the 2400 year-old terra cotta soldiers. Today, Xian is a bustling metropolis that perfectly showcases the prowess of the Chinese development model. It is strategically positioned at the eastern end of the land corridor of China's ambitious One-Belt-One-Road plan that seeks to transform the ancient Silk Road into an economic and political network. When completed, the ambitious initiative would connect China, Eurasian countries, and Europe by rail, highway, and air, complemented by a maritime route that would link up China, Southeast and South Asia, the Middle East, North Africa, and the Mediterranean Sea. It would be one of the largest infrastructure investments in human history, connecting 68 countries and covering 65% of the world's population and 40% of the global GDP.

The One-Belt-One-Road project is transforming Xian into one of China's largest inland ports and logistics centers. The city has also invested heavily in higher education, actively courted businesses, and made it easy for college graduates to gain legal residency. Rapid growth in new residents has created a shortage in housing, driving up Xian's property prices.

In Party They Trust

Unlike the West's free-market economies that have their natural boom-bust cycles, China's central command economy with regional fine-tuning has so far been effective in propping up growth and patching up problems. Remember the infamous "ghost city" of Ordos Kangbashi in Inner Mongolia, about 450 miles north of Xian? It was about a decade ago when foreign media stumbled on the then newly erected district with streets after streets of spanking new but unoccupied buildings. For years, it was used by China doubters as evidence of excessive and wasteful developments. These days, the once empty apartments have been snapped up by buyers and prices have moved up after the local government relocated into the area.

Interestingly, while Xian residents were bursting with optimism, business people I ran into in tier-one cities – Beijing, Shanghai, Guangzhou, and Shenzhen – were less sanguine due to the government's policies to rein in the shadow banking system and to tame the housing bubble. The former was now being felt in the form of tighter credit and rising accounts receivable for some businesses. The latter has led some local governments to implement draconian measures that capped the prices of new apartments substantially below second-hand apartment prices. Furthermore, there was a general feeling that state-owned enterprises now enjoyed even greater advantage over private companies.

President Trump's aggressive moves on trade issues were also a concern, albeit there was the belief that a deal can be made with Trump because he is ultimately a businessman. The Chinese media was full of indignation and the threat of retaliation was loud and clear. The U.S. government's recent action to punish Chinese telecom equipment maker ZTE for the firm's apparent lack of enforcement on the settlement over its violation of the Iranian sanctions has further ratcheted up the tension. Banning U.S. semiconductor firms from selling key components to ZTE for seven years would severely crimp ZTE's business and may even threaten its survival. This development was followed by Chinese telecom equipment giant Huawei's abrupt announcement that it would pull out of the U.S. market. It makes one wonder if China would, as a negotiation ploy, try to make life more difficult for U.S. companies operating in China.

In spite of this general tone of caution, there was widely shared confidence that the Chinese government will be able to support economic growth because failing to do so is not an option. We also suspect the Chinese government would once again take steps to reflate domestic demand should the external trade environment become more challenging. In short, their trust in the government's ability to get things done may have never been higher, and the bureaucracy has indeed become more responsive and effective.

Made in China 2025

In addition to the One-Belt-One-Road plan, China has also embarked on a "Made in China 2025" initiative that aims at growing the domestic content of core materials of Chinese industries to 40% by 2020 and to 70% by 2025. The plan focuses on several industries that the West currently has an edge – semiconductor, pharmaceuticals, medical equipment, artificial intelligence, robotics, electric vehicles, aerospace, etc. The ZTE incident should only harden China's resolve to become self-sufficient in leading edge technologies.

China is already leading the world in some applications. China's dominant mobile phone payment systems – Alipay and WeChat Pay – have become so ubiquitous that some Chinese don't even bother to carry cash or bank cards. Facial recognition and surveillance technologies have become so advanced that fugitives have been identified and apprehended while attending public events like concerts. Some believe that, based on research paper publications, China is already on par or perhaps ahead of the U.S. in artificial intelligence.

A Strategic Competitor

While President Trump has zeroed in on the widening trade deficit with China, there appears to be a growing consensus in the West that there needs to be a reset in its dealing with China. The foremost economic challenge to the West is China's ascendancy in technology, which could pose an existential threat to the West's leadership. The emerging bipartisan consensus in Washington D.C. is that the Sino-U.S. relationship is shifting into one of strategic competition. The competition is not just over trade and military might; it is extending into ideas and values. China's economic ascendancy and sociopolitical stability have given the Chinese much confidence in the superiority of their economic and socio-political model. Some developing and frontier nations may prefer the Chinese model over the West's liberal democracy and market economy. The One-Belt-One-Road initiative is also enabling China to foster closer ties with and exert growing influence over many nations at a time when the U.S. appears to be retrenching from the global stage. However, with the U.S. State Department and the National Security Council now being run by more hawkish leaders, the Trump Administration may take a harder line on China even if a compromise is reached on the trade front. Cross-border mergers and acquisitions as well as technology transfers will be closely scrutinized. There may also be an escalation of tension in the South China Sea and the Taiwan Strait.

While the Sino-U.S. relationship may be entering a period of higher tension, there appears to be a real de-escalation of hostility on the Korean Peninsula. The historic meeting between North Korea's Supreme Leader Kim Jong-un and South Korean President Moon Jae-in may eventually lead to a peace treaty that would finally end the state of war that started 68 years ago in 1950. It should create a more positive backdrop for investments in the region. Interestingly, it was reported that the Chinese city of Dandong on the Yalu River border with North Korea has seen property prices surge as much as 50% in just a few days after that historic meeting.

Lastly, given President Trump's role in pressuring North Korea to the negotiation table, should a peace treaty materialize, we suspect the president's supporters will put a full-court press on the Norwegian Nobel Committee to award the Nobel Peace Prize to Donald Trump. Wouldn't you want to be a fly on the wall during that deliberation?

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