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# **US vs. Non US Investing. Some Rules to Follow**

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# Presentation outline

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The aim of this presentation is to understand if and when one again should start to invest OUTSIDE of the US, especially in EM

I will deal with these questions in the following way... Investing outside of the US is very much a function of what I call “international liquidity”, which is a by-product of the US dollar being *the* international reserve currency.

This will lead me to assess what a reserve currency is, and how we can monitor whether the US dollar is fulfilling its role.

This, in turn, will force me to deal with three issues:

- The US current account as a source of liquidity for the rest of the world and its impact on assets outside of the US
- The US dollar exchange rate (very loosely related to the US current account deficit) and its impact on markets outside the US
- The behaviour of a line of the US Federal Reserve balance sheet called “central bank reserves deposited at the Fed for the account of foreign central banks”, the movement of which gives a fairly good indication of whether there is a looming shortage of US dollars—always a dangerous situation for financial assets worldwide

I will then try to explain how the Chinese intend to play a role in the world of international liquidity.

## The differences between a reserve currency and an international currency (I)

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The country issuing a reserve currency must, of course, issue a currency which has the characteristics of all other currencies: to be at the same time a standard of value, a reserve of value and a means of exchange.

To become *the* reserve currency, this country would also have to be dominant Militarily (to control sea and air lanes),

Scientifically (to have the best weapons),

Agriculturally (to feed other countries in case of a war),

Culturally (to educate the children of the other countries' elites)

Financially (for bonds to be issued in the country's financial markets by the other countries).

For the time being there is nobody out there who could challenge the US\$.

My contention is that China has no intention whatsoever to challenge the dominant role of the dollar but wants simply to offer the rest of the world in general, and Asia in particular, a substitute to the dollar for international or local trade between countries, a little bit like the deutsche mark in Europe at the beginning of the 1970s.

## The differences between a reserve currency and an international currency (II)

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To achieve such a goal, the requirements are much simpler.

The underlying country must have a strong infrastructure and capital spending industry, and excess savings visible through a large current account surplus as well as a reasonably competent banking system.

This country will then be in a position to offer financing to other countries suffering from a lack of savings (current account deficits).

These countries can buy the capital goods and build the infrastructure that they need with the Chinese financial sector “underwriting” the other countries’ current account deficits, a little bit like the US did at the time of the Marshall Plan.

It should be noted that the Chinese authorities have established quite a few institutions to do what the International Monetary Fund and the World Bank did at that time.

The arrival of a new provider of international liquidity may be a major event with quite a few long term implications, which need to be discussed

# The historical role of the US dollar (I)

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The “imperial privilege” (as described by Jacques Rueff) of the reserve currency is simple.

**The country issuing it has *no* foreign trade constraint.**

Which means that an eventual current account deficit in the US can be paid for simply by sending dollars abroad.

And these dollars automatically become foreign exchange reserves for the countries sporting a surplus. And more often than not these “reserves” are invested in the US government bond market, which implies that the current account deficit finances the budget deficit, or the other way around.

So something very logical happens when the US has a deteriorating current account deficit: the rest of the world has a rising current account surplus.

And since these countries *do* have a foreign trade constraint, the fact that they have at the same time a rising current account surplus and rising foreign exchange reserves means that they will start to follow much less restrictive monetary and fiscal policies and this will lead to the ROIC outside of the US going up a lot, if only to prevent their exchange rates from shooting up...

# The historical role of the US dollar (II)

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And since markets are made at the margin, one can safely say that if the US current account is deteriorating, then the non-US markets should outperform the market in the US—and when the US current account is improving, the reverse will be true

To a certain extent, one could say that it is difficult to have a general bear market outside of the US if the US current account is deteriorating...

The chart on the next slide shows the relationship between the S&P 500 and the WMSCI relative performance at times when the US current account was improving or deteriorating

Our first decision rule will therefore be:

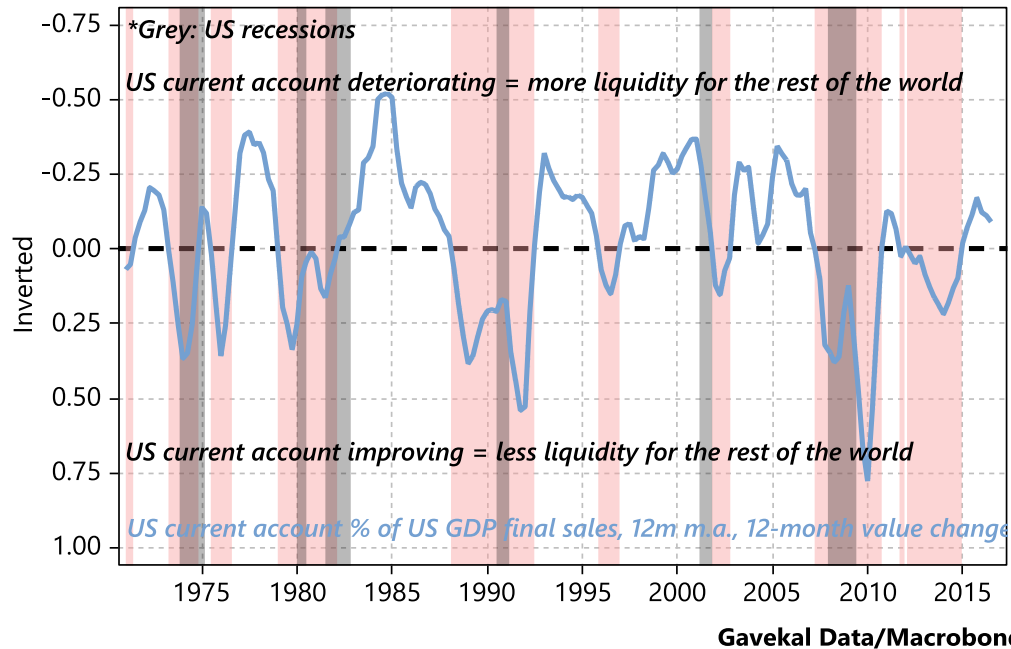
When the US current account is improving, there is very little reason to invest outside of the US, whether in DM or in EM.

And this is what our first graph shows.

# Decision rule #1: US current account and S&P 500 vs WMSCI

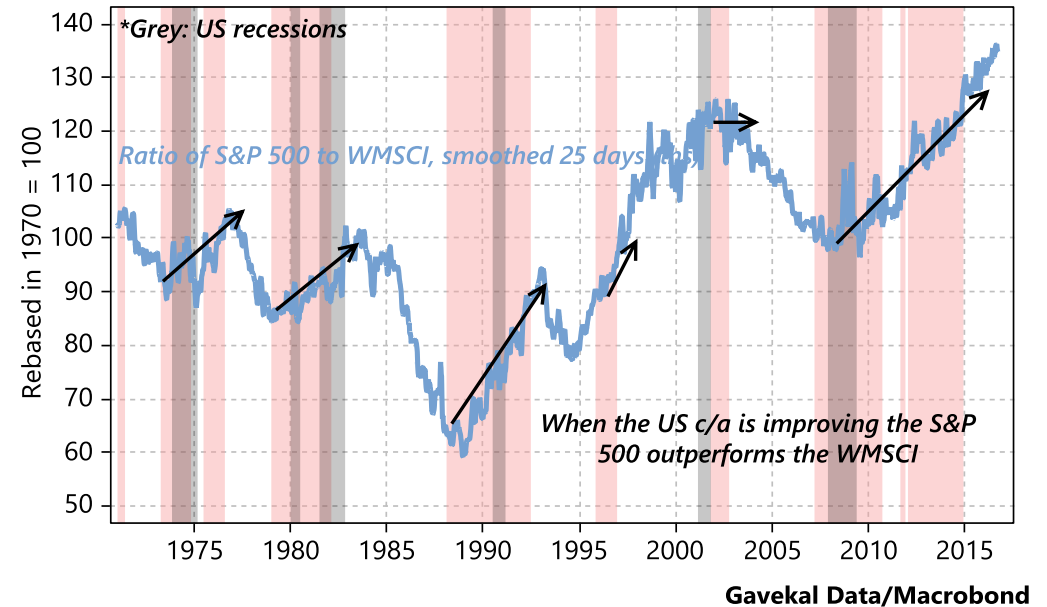
## The US current account as a source of international liquidity

Shaded pink: US current account improving



## US c/a as a source of international liquidity & ratio of S&P 500 to WMSCI

Shaded pink: US current account improving YoY



When the US c/a is *improving* (shaded pink on the graph), one should *not* invest outside of the US, since this improvement implies a higher ROIC in the US than outside of the US.

The reverse is also true.

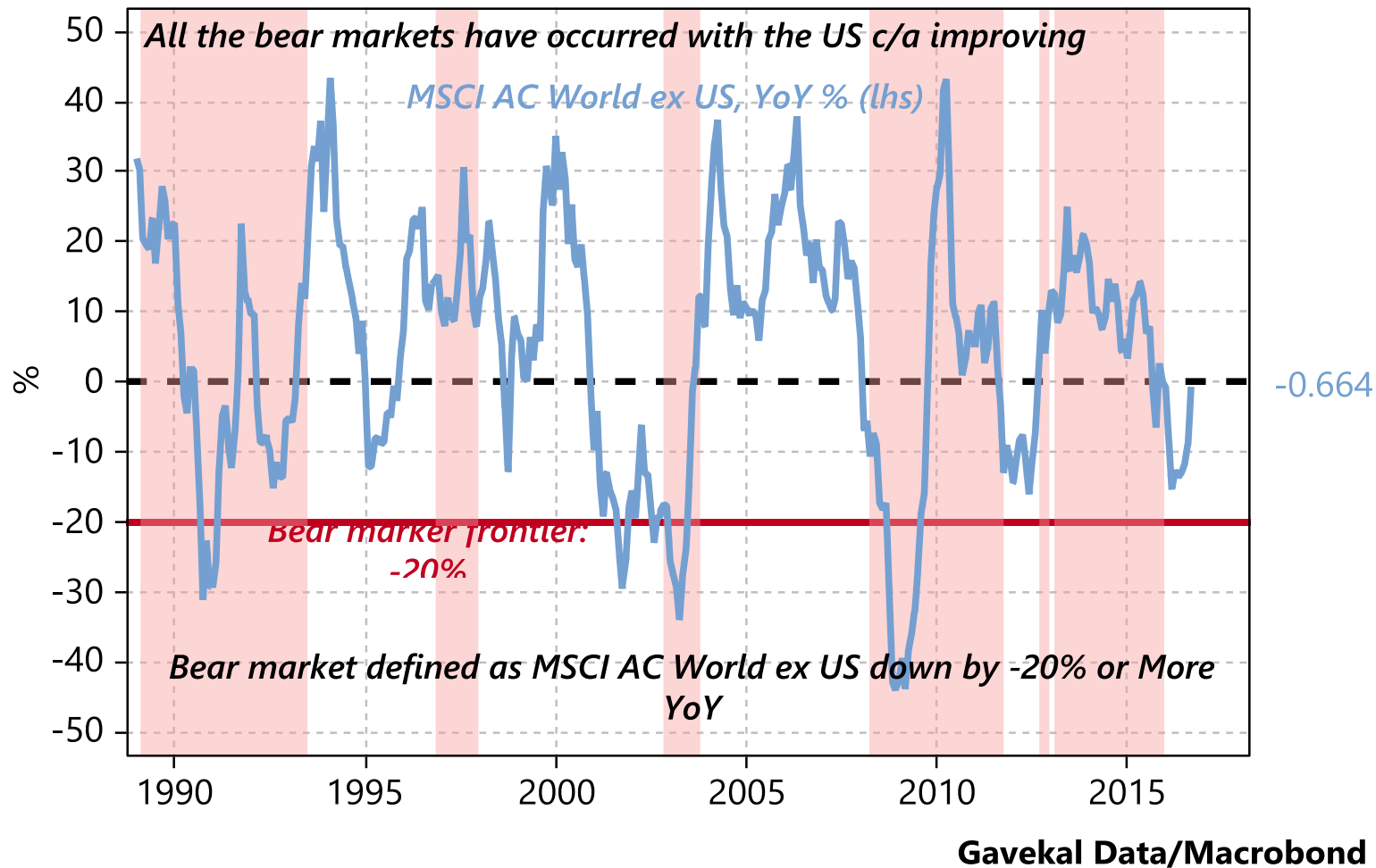
This also implies that most bear markets outside of the US occur when US dollar liquidity is deteriorating, which makes plenty of sense since we have less money and as many fools.

And this is what I am showing in the next chart.

# US current account and bear markets outside of the US

## US current account and stock market indexes

Shaded pink: US current account improving YoY, pushed forward 1 year



Since 1988, we have had three bear markets in the WMSCI ex US: 1992, 2000-2003, and of course 2009.

All these bear markets have taken place with the US going through an "improvement" in its current account.

We are arriving at the end of a negative period since US current account is deteriorating again.

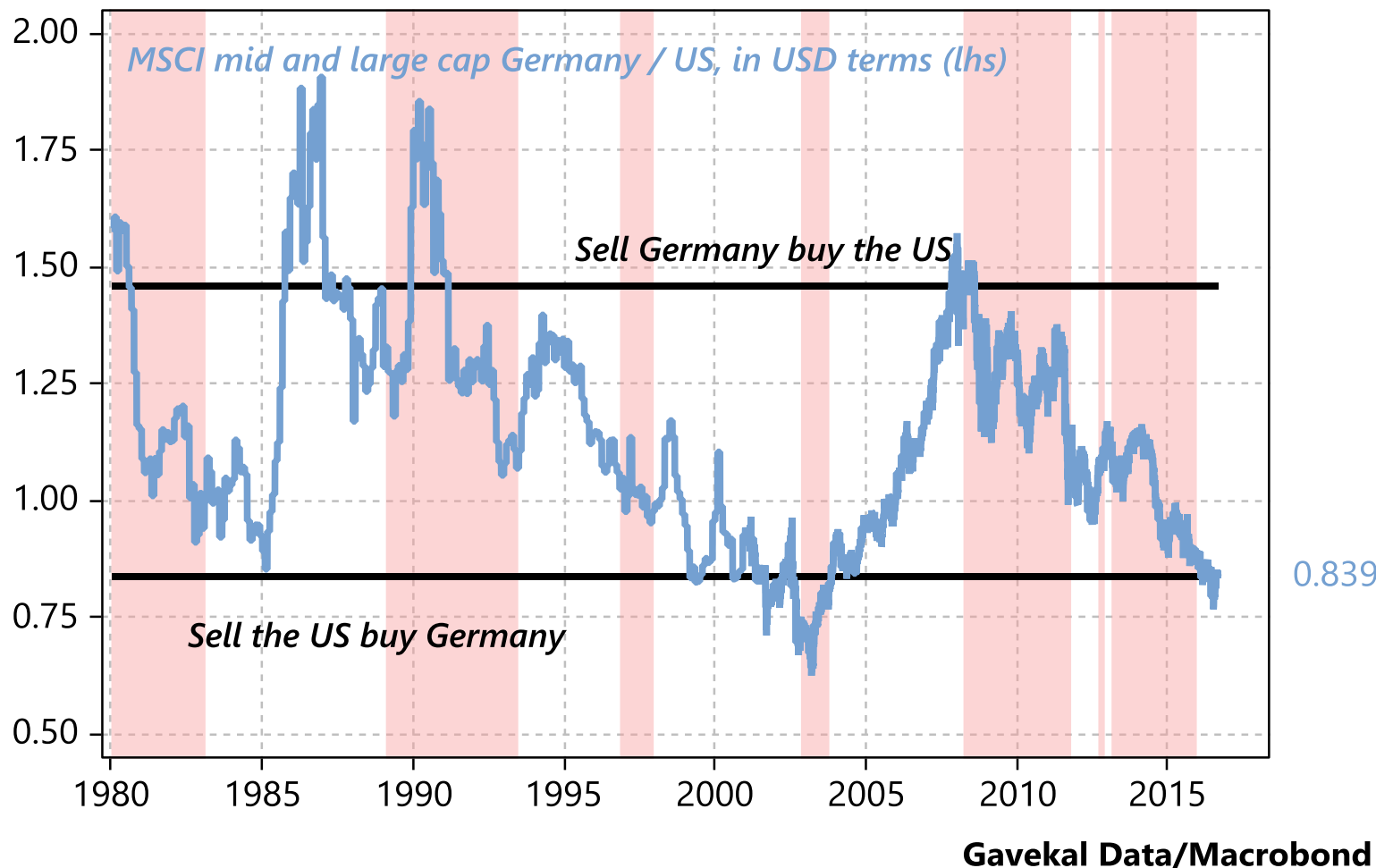
And this is taking place at a time when most markets are significantly undervalued vs the US (see next chart).



# A look at relative valuations

## Decision rule on when to be in German or US shares

Shaded pink: US current account improving YoY, pushed forward 1 year



In an open system, the return on invested capital *has* to be the same between two countries. So the ratio between the total returns in the same currency of two major markets *has* to be the same, and this ratio always returns to the mean.

On a valuation basis, the US stock market is more than one standard deviation overvalued vs the German one.

Logically, the time should have come to sell the US and buy Germany (and most other non-US markets).

Let us now see of the second rule confirms this.

## Moving to the second rule: a falling US dollar exchange rate

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This rule works mainly for emerging markets, and much less so for developed markets outside of the US.

In the emerging markets, quite a lot of the local borrowing takes place in US dollars.

A rising US dollar is thus usually bad news for those who have borrowed, and this leads to a fall in the EM ROIC and from there to a decline in the local stock market.

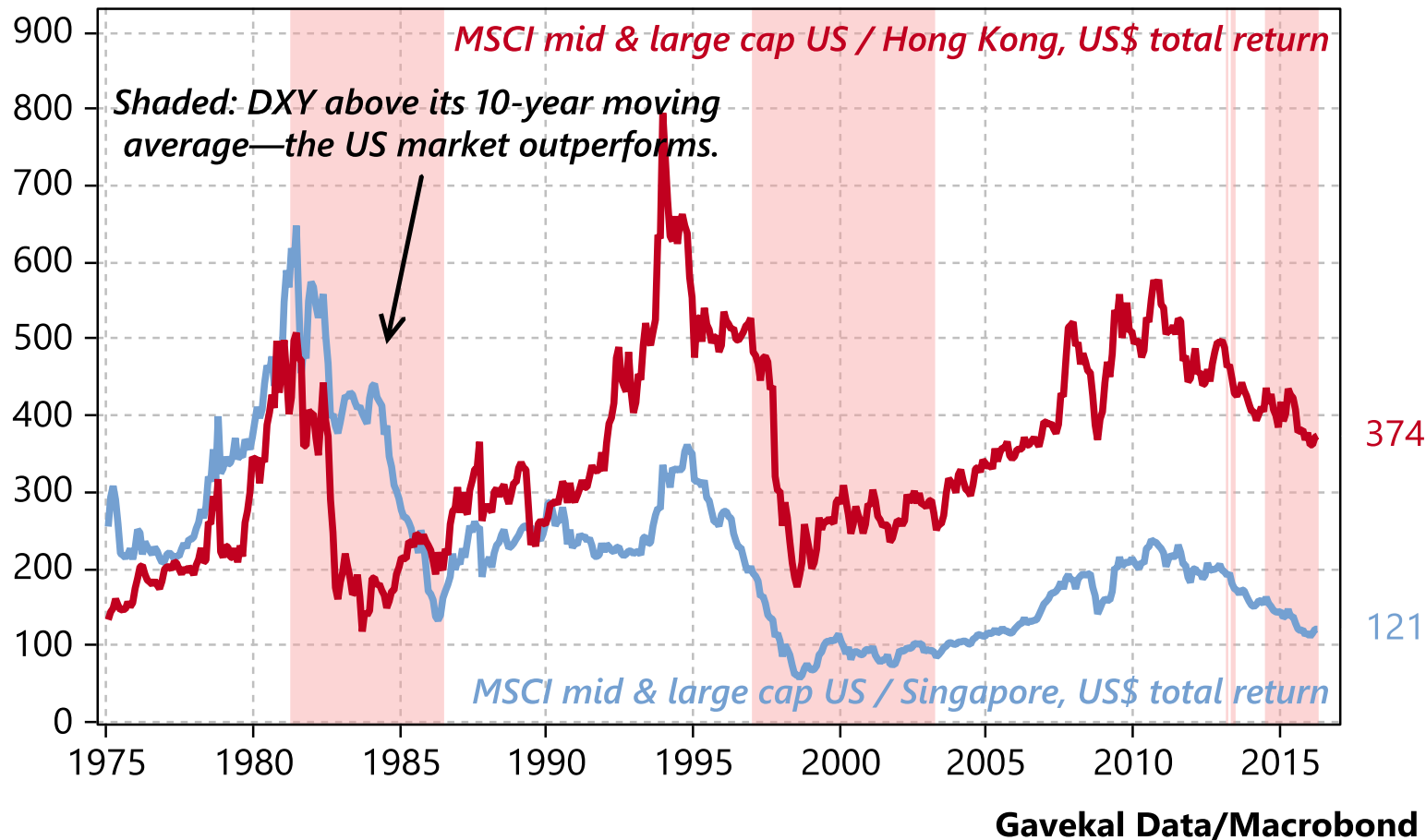
I take as an example the relative performance of the Singapore and Hong Kong markets versus the US market—but the rule works almost everywhere in the EM sphere.

So a falling or at least a stable dollar is more or less required for an investor to move in EM.

# Decision rule #2: a bearish factor for emerging markets

## The US dollar's structural moves and Asian markets vs the US market

Shaded pink: The US dollar is rising structurally



Every time when the US dollar has been rising structurally, (shaded pink on the graph), the US market has solidly outperformed emerging markets

We are still in a “structurally” strong dollar period as defined by the dollar being above its 10 y moving average, but lately the dollar has weakened some.

Those who are convinced that the dollar is from now on going to decline could start moving in EM as the cheap relative valuations especially in Asia offer some downside protection.

# The third rule: rising foreign exchange reserves

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Let us go back to square one: the US current account as a source of *earned* foreign exchange reserves.

These reserves are earned by the private sector and some of the money will be used to buy assets in the US, or for the working capital needs of the underlying companies. But at the end of the day, if those companies have too many dollars, they will sell them to their own central banks, and as a result the foreign exchange reserves of the said central bank will increase over time and some will be deposited at the Fed.

One can be relatively certain that if the central banks outside of the US *have* to sell some of their foreign exchange reserves, they will sell first the ones which are *not* deposited at the Fed, and the last to be sold will be the ones deposited at the Fed. In fact, if they sell the reserves deposited at the Fed, the next stop will be the IMF...

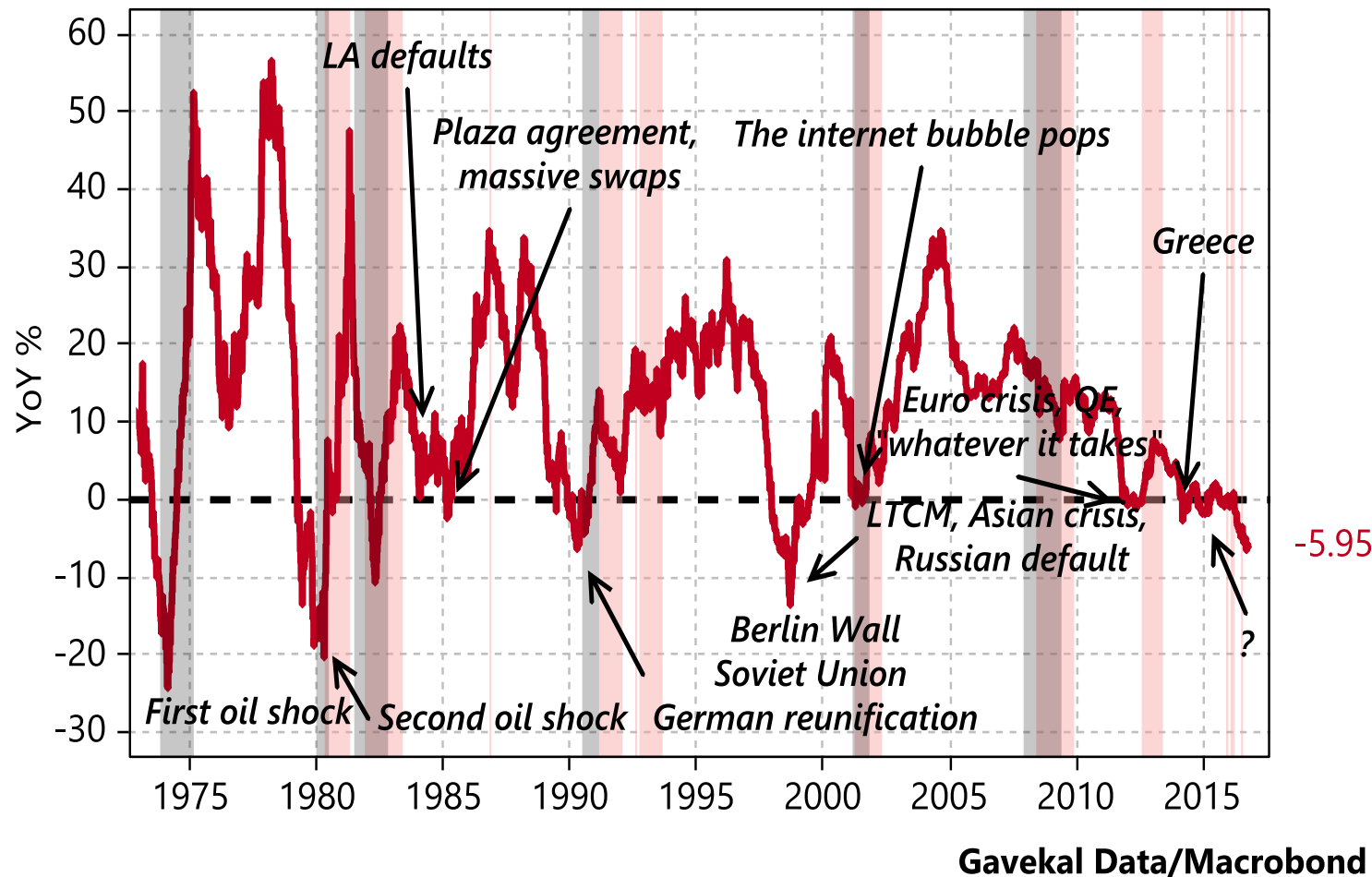
So a year-on-year decline of the reserves deposited at the Fed is usually a sign that somebody big in the system is facing a massive foreign exchange crisis, and this is usually not a very conducive scenario for a bull market to occur.

This is what I show in the next chart.

# Decision rule #3: foreign exchange reserves rising

## Central bank reserves deposited at the Fed by foreign central banks

Pink: OECD recessions (OECD IP negative YoY %) | Grey: US recessions



When the forex reserves deposited at the Fed go down year-on-year, we usually have a financial crisis of some sort. And more often than not the year on year decline is followed by a recession either in the US or in the OECD, defined as a YoY decline of the OECD IP.

We are going through such a decline and for the first time since 2009, the OECD IP has declined Y/o/Y

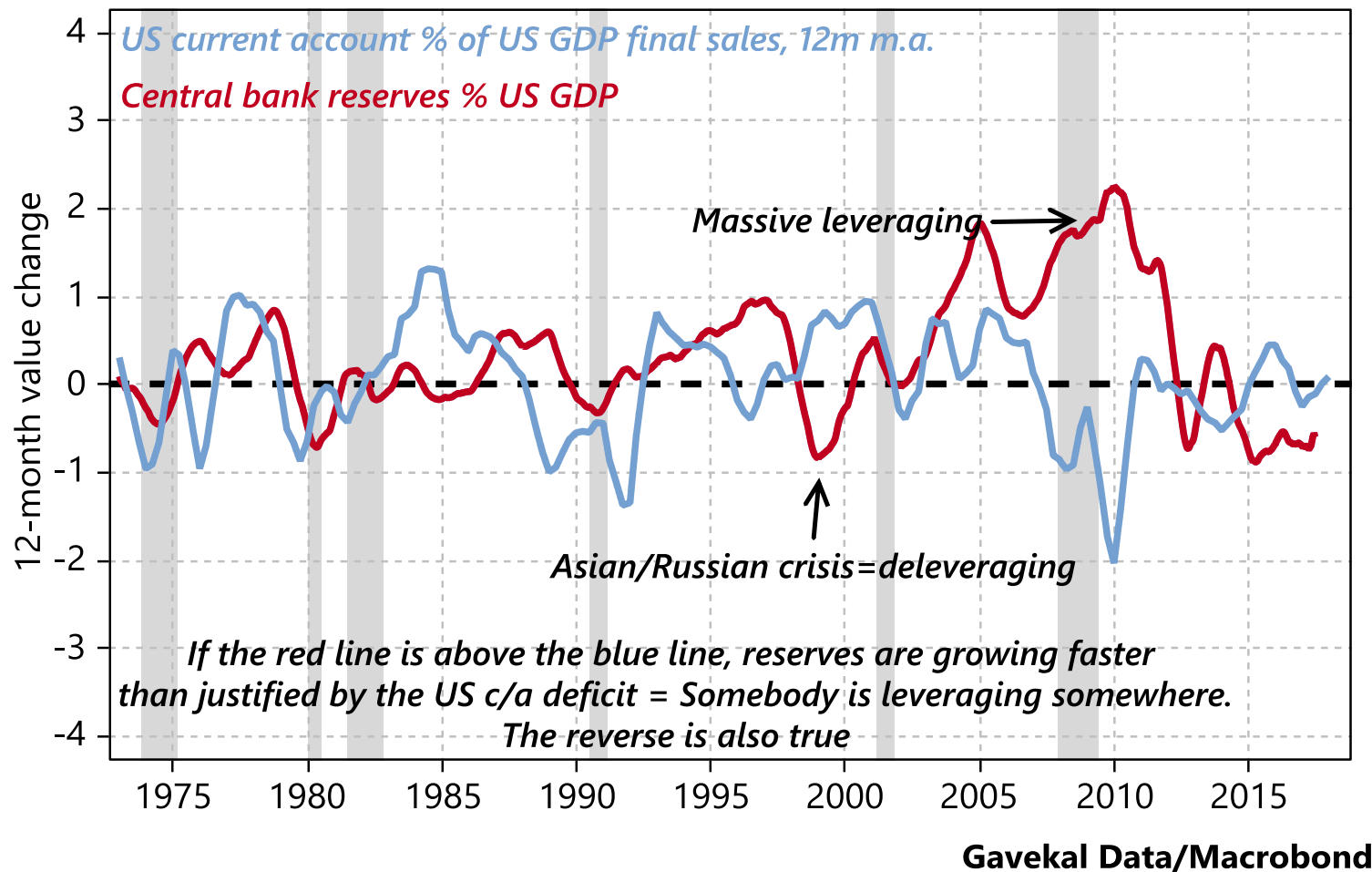
The only catastrophe which was not flagged by this rule in advance was 2009, simply because it originated in the US and not outside.

The question is: why are forex reserves falling ?

# Leveraging and deleveraging

## Central bank reserves and the US current account deficit

Grey: US recessions



If we had no credit creation or credit destruction, and no capital flows out from or into the US, then central bank reserves should be roughly equivalent to the cumulative US current account since the beginning of time.

Of course, they are not, but by looking at the differences between the blue line and the red line one gets an idea of whether the international system is leveraging or deleveraging using the US dollar.

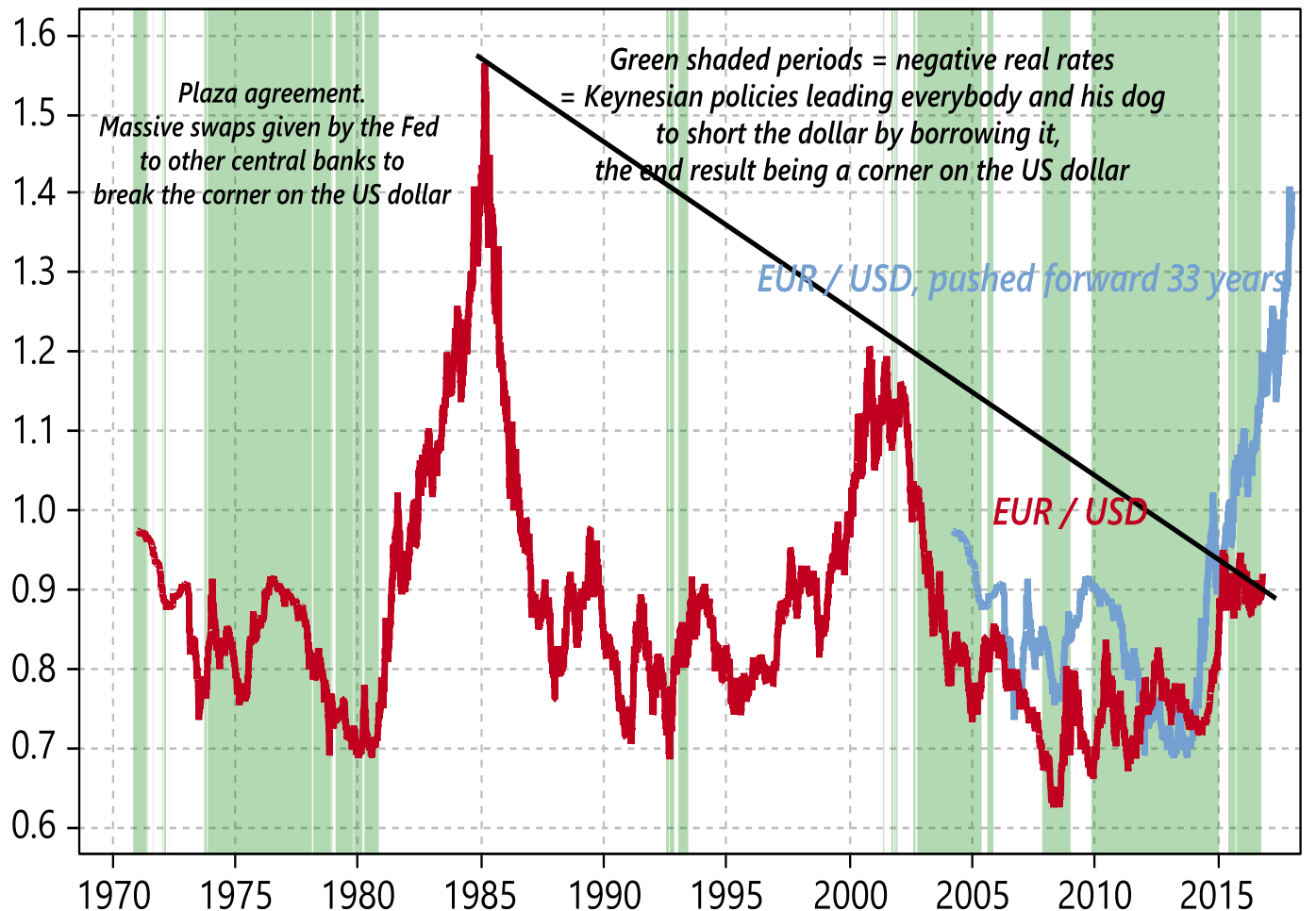
Obviously, we have had a massive leveraging using the US dollar from 2002 to 2014 or so, and we are now witnessing a massive deleveraging

This could create a problem.

# The deflationary tendencies could be exacerbated by a rising dollar...

## Will the same causes produce the same effects?

Shaded green: negative real rate in the US



Gavekal Data/Macrobond

In 1970-80 the Fed followed a policy of negative real rates. The US currency collapsed as everyone borrowed in dollars. Then, in 1982-85, the biggest short covering panic in history unfolded.

Very similar policies were followed from 2002 until today. The BIS estimates that US\$10trn have been borrowed since 2000 and quite a few borrowing entities have no cash-flow in US dollars.

The danger is that the red line could start following the blue line (short covering and corner).

Let us hope that this time is different, but the advice must be to avoid those who have borrowed US dollars but have no means of paying the piper back in the same currency.



# The Chinese cavalry to the rescue? (I)

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Since 1971 and the beginning of floating exchange rates, the main provider of international liquidity has been the US. Every time we had an international liquidity problem, the US cavalry came to the rescue when nobody else could—especially not China.

From the end of the 1980s to three or four years ago, the Chinese policy could be characterized as one of financial repression, which is another way of saying that China was a “taker” of liquidity.

Closed capital account, undervalued exchange rate, massive current account surplus equivalent to excess savings, these excess savings being captured by the government for enormous infrastructure spending...

In such a world, there are no market-based interest rates and exchange rates, and capital spending is directed politically through a technocratic structure.

But, when the ROIC on infrastructure falls below the ROIC on the consumer economy, then the time has come to open up the capital account and move to market determined prices for interest rates and exchange rates.

This implies an enormous loss of power for the techno structure and is thus very often the cause of an acute political crisis, more so because usually this is taking place along with the arrival of excess capacity in the infrastructure industry.



# The Chinese cavalry to the rescue? (II)

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This is where China is today, which leads to the question: is China going to become a provider of liquidity to the rest of the world, especially Asia, from now on?

This is very important since the US obviously has increasing problems being the only provider of liquidity for the rest of the world.

Thus I will try to show that China could alleviate what could be a very dangerous situation which could lead to a continuous decline in world trade if left unaddressed.

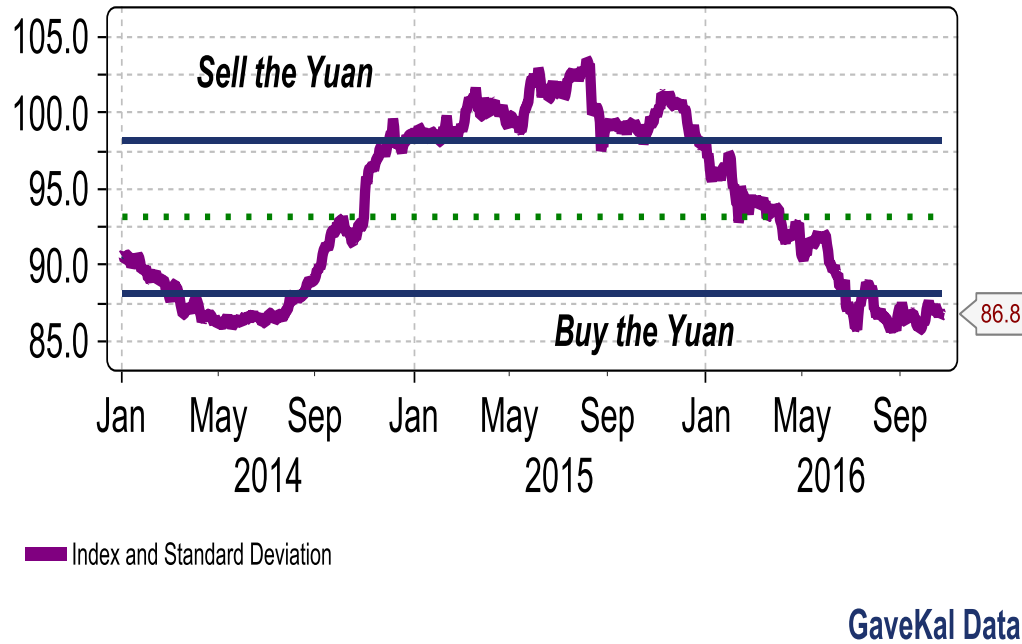
**And this implies that should the Chinese succeed, the next bull market will start in Asia, be centred around a stable renminbi and a rising chinese bond markets, and this combination will lead to a boom in all stock markets in Asia outside of China.**

If China were to become a provider of liquidity rather than a taker of liquidity, then the two markets where we will see it first are the exchange rate of the renminbi and long rates on Chinese bonds.

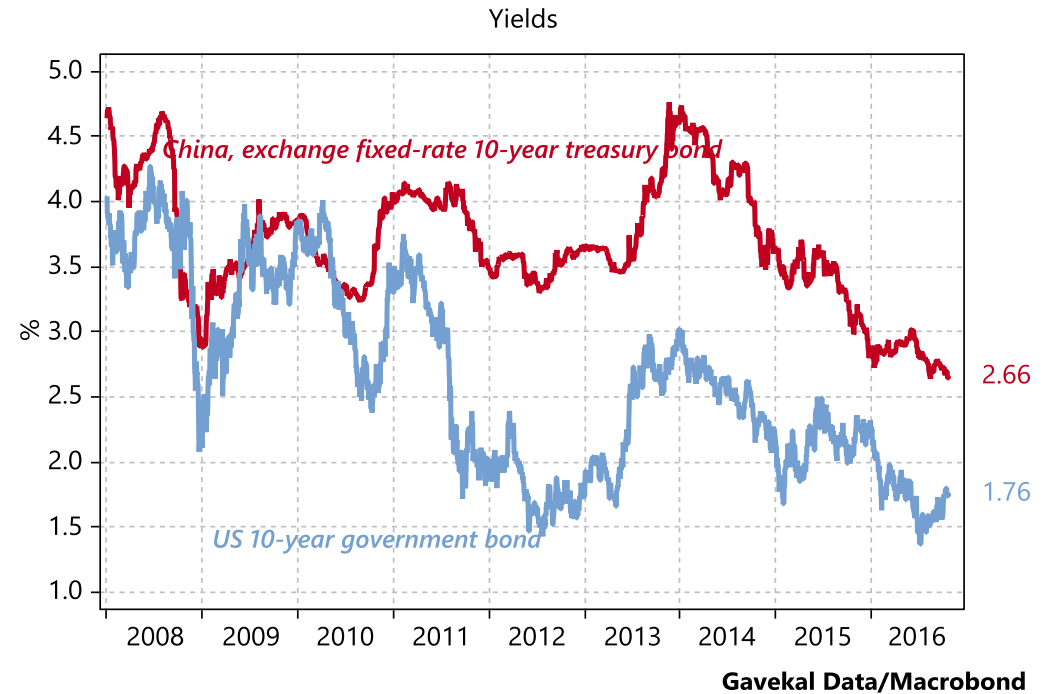
Thus, one should observe the two charts which appear next page. If an Asian bull market is going to start, it will start there.

# The bullish scenario

## Basket for the CNY



## US vs China 10-year government bonds



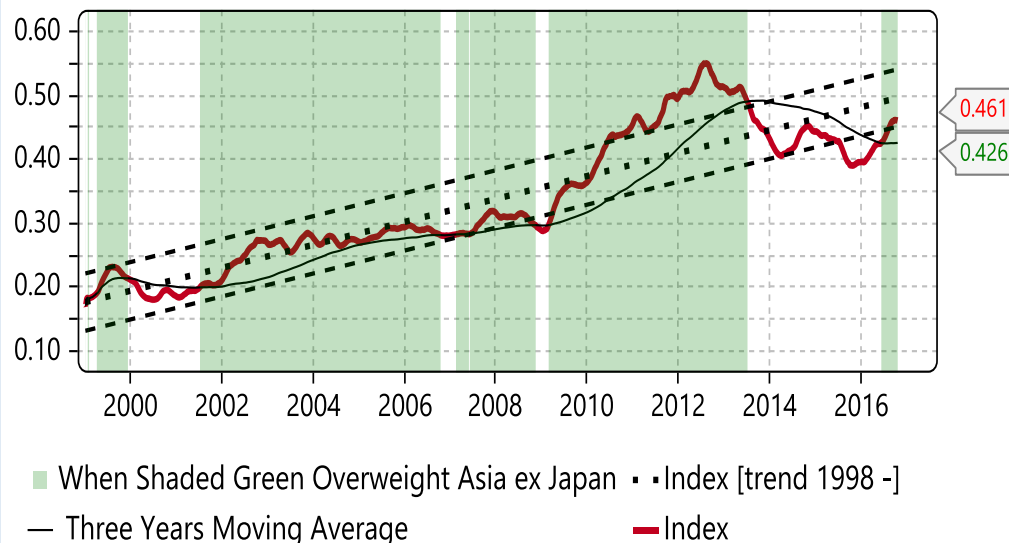
A bullish scenario would require the renminbi to stabilize or go up against its index *and* Chinese long rates to decline at the same time. Apparently, the Chinese currency looks like it is bottoming out and Chinese long HAVE declined . So the bullish scenario for Asia may be falling in place.

This would imply the migration of part of the Asian US dollar debt to a renminbi based debt, and would provide a kind of spare tire for Asia should the dollar tire puncture temporarily, as it did in 2009.

If this analysis is correct, then Asia ex Japan should have started to outperform the rest of the world. Let us look first at the relative performances of the equity markets .

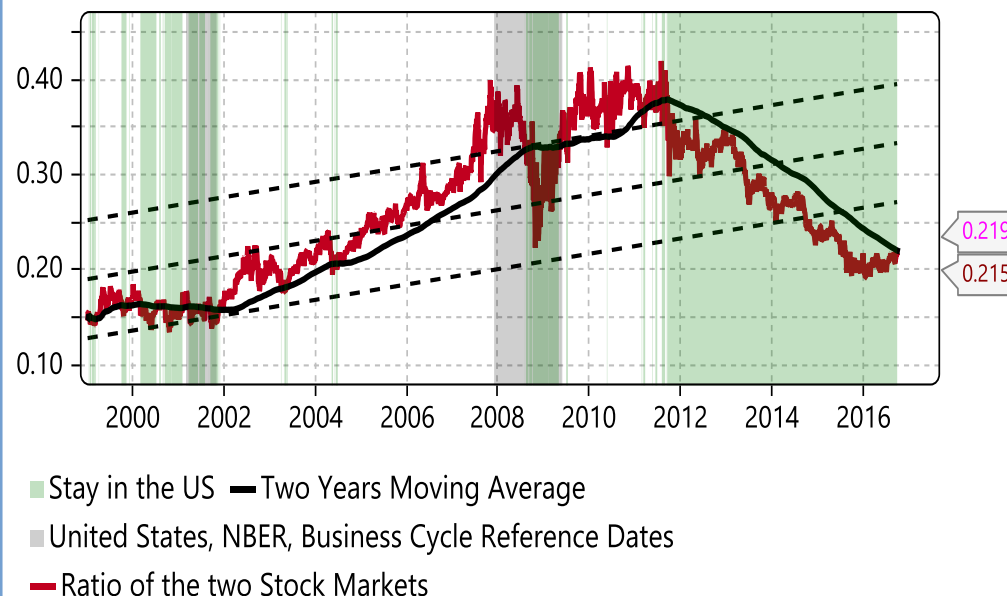
# Relative performance

Equity Indices, "Asia Pacific ex Japan, FTSE World, Index, Close"/"Euro Area, MSCI, Large Cap, Index", Price Return



GaveKal Data - powered by Macrobond

Asia ex Japan vs. the US



GaveKal Data - powered by Macrobond

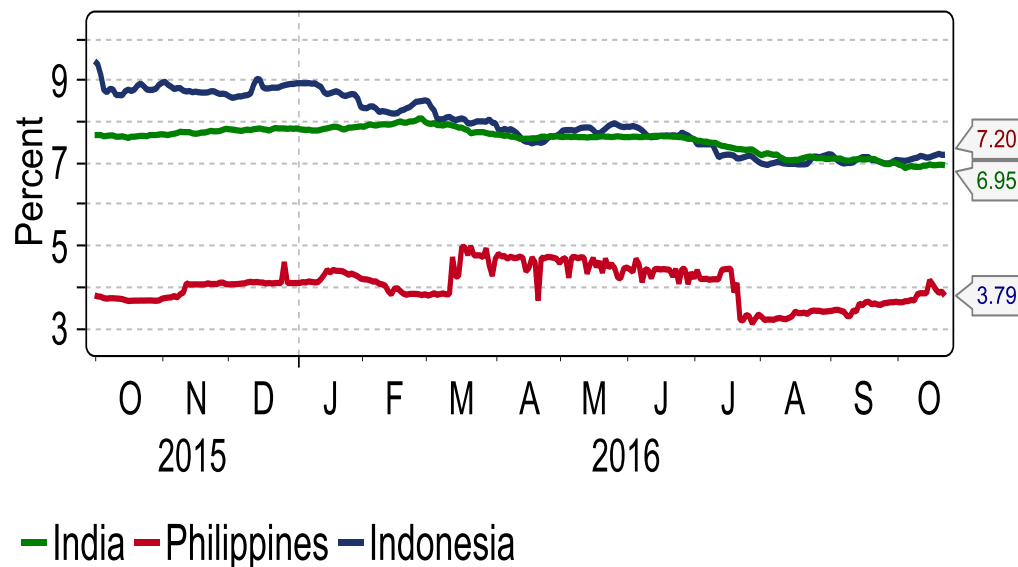
Already , Asia has “broken up” against the Euro area index and has stabilized for the last two years against the US. In fact, on a same currency basis, Asia ex Japan has been the best stock market of the three area we follow separately .

If nothing untidy happens outside of Asia , in Europe and in the US , then perhaps a structural bear market has started in Asia ex Japan.

The question is : what is it that one should own to “hedge” against something untidy happening in either the US or Europe?

# For the Adventurous

## Government Benchmarks, 10 Year, Yield



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## Index of Theoretical zeros in EM Asia Indonesia, India, Philippines



GaveKal Data

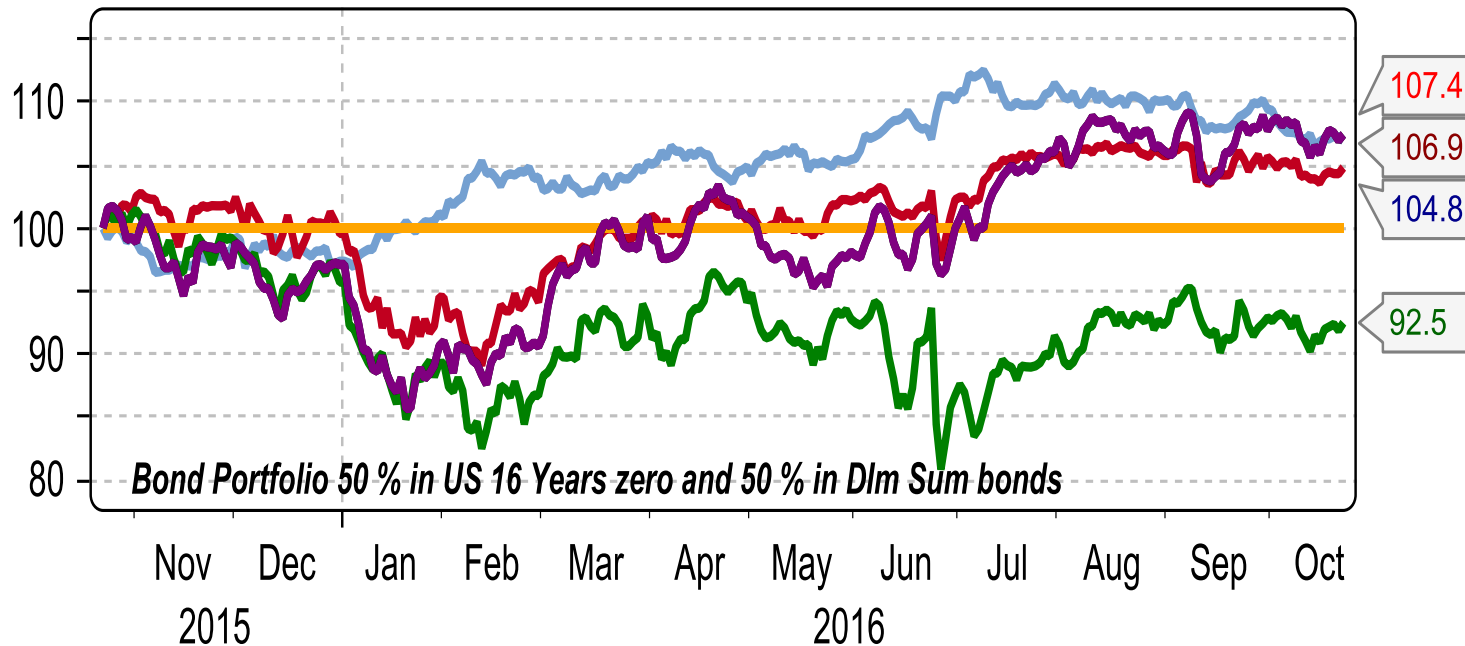
For those who really need income, building a bond portfolio using the Philippine , the Indian and the Indonesian market could make a lot of sense

The average yield will be around 5 % and in the last twelve months an index of 10 years durations would have returned 14 %, for a total return of close to 20 %

This is the kind of returns which are not available anywhere in the OECD , except by going down massively on the quality of the bonds that one is buying

# The best portfolio over the last year

## Bond Portfolio versus different stock markets indices over the last year



— Asia Pacific ex Japan, FTSE, World, Close — Asia Pacific ex Japan, Equity Indices  
— Euro Area, MSCI, Mid & Large Cap — United States, S&P, 500, Close  
— Index 25 Dim Sum 75 US Long Bond

GaveKal Data

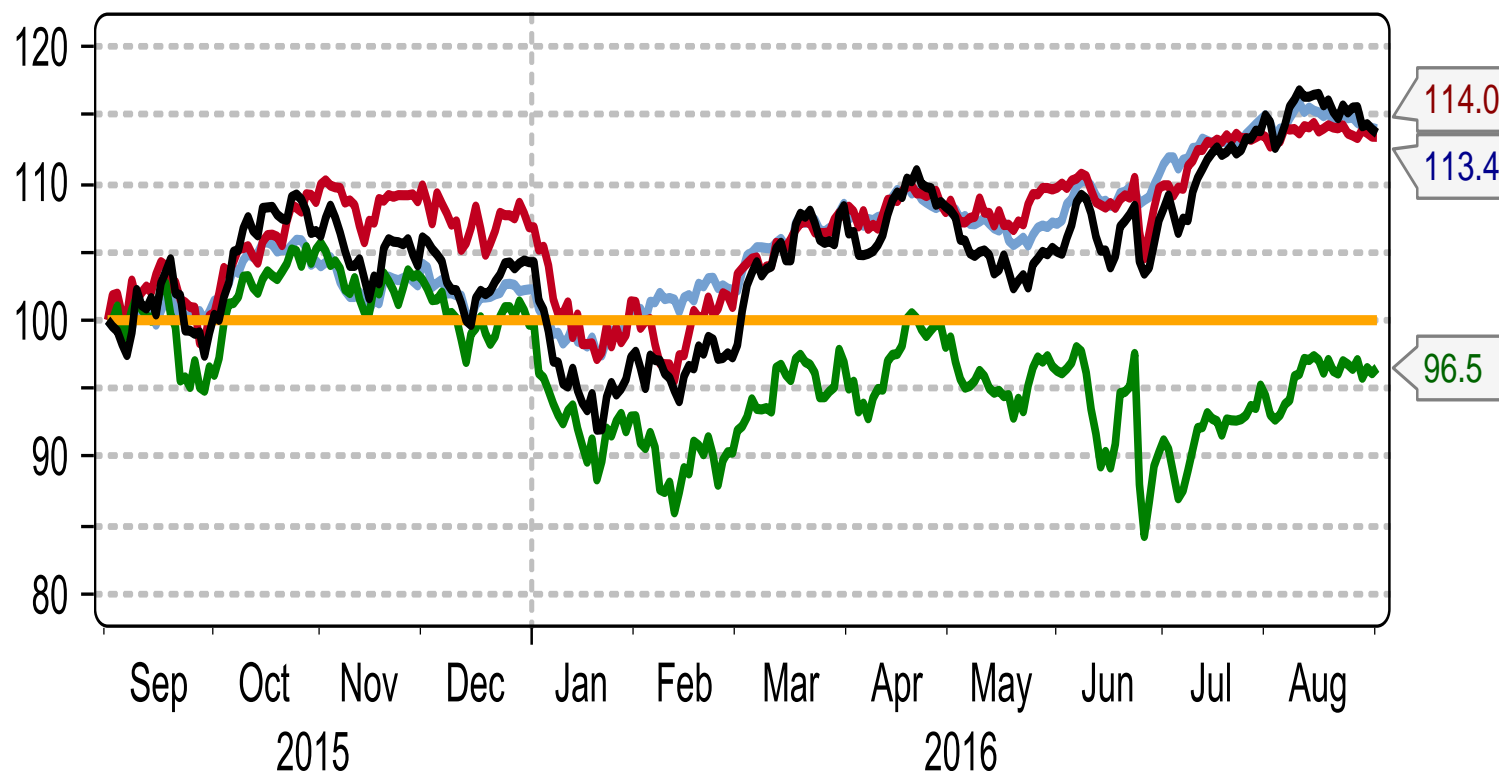
The two most hated assets over the last 12 or 18 months must have been the US long bond and the Dim Sum bond market in Hong Kong.

Not very surprisingly, a portfolio invested 25% in short dated Dim Sum bonds and 75% in US long bonds would have outperformed most stock markets in the world, with the Asian shares ex Japan being second.

This bond portfolio should be the one to own if we were to enter into a deflation or depression. And if we are not, it should continue to do OK.

# The Recommended Portfolio

## Portfolio 50 % Bonds 50 % Asia ex Japan Stock Market



— Asia Pacific ex Japan, Equity Indices — Euro Area, MSCI, Mid & Large Cap  
— United States, S&P, 500, Close — Index25 Dim Sum 75 US Long Bond, 100 Asia Ex Japan rebalanced daily

GaveKal Data

The Asia ex Japan stock market index has outperformed the Euro area stock market index by close to 20 % over the last 12 months, and has had a very similar performance to the SP500. So, given the fact that the US market is much more expansive than the Asian ones, then may be the all weather portfolio should be 50 % in Asia ex Japan equity markets, and 50 % in fixed income<sup>1/2</sup> in US long dated bonds and 1/2 in Dim Sum bonds. Such a portfolio would have done reasonably well over the last 12 months., and should an accident occur somewhere in the world it should resist.

# Contact and disclaimer

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## Thank you!

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