A Giant Consumptive Force

By John Mauldin | May 15, 2021

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The SIC was in full swing this week. I am finishing this on Friday morning, a few hours before the start of the last official day and then a "Plus Day" on Tuesday. My mind is swimming with new connections and revelations.

While the live events are mostly over now, your SIC pass gives you full video, downloadable audio, slide presentations and (soon) written transcripts of every session. They are all still quite fresh and relevant, so don't feel like you missed the opportunity. (Note: I've never heard a greater discussion of inflation and/or deflation from so many perspectives. We will go into that in detail in the coming weeks.)

In fact, all this material gives you a chance to customize your experience. You can watch the recorded sessions on your own schedule, in whatever order suits you—though I would urge you if possible to watch in the sequence we presented them. I arranged the agenda as it is for specific reasons. But however you do it, get your pass now.

My next few letters will be reflections on the wide-ranging SIC presentations. I find it takes a little time for all the information to coalesce into conclusions. I'll try to do this thematically, linking together some of the varying thoughts on different topics. Last week I teased you about the China panel, so that seems like a good place to start. We'll review that conversation and then bring in some China comments from later sessions.

Cold War or Not?

I placed our China panel on Day 1 of the conference because, in the big picture, it is one of the more important long-term discussions that we need to have. China's entry into the modern world economy, and especially the WTO in 2001, may be the most significant development of the last half-century. Its sheer size and rapid growth are simply unprecedented in human history. China affects everything.

To unpack the latest China developments, I pulled together Louis Gave, George Friedman, Emily de La Bruyère (remember that name, I promise you are going to hear more from her in the future, and not just from me) and asked Mark Yusko to moderate. Mark has been going to China for decades and was one of the original investors in Alibaba when it was private.

They started with the increasingly common view that the US and China are in a "Cold War." Is that really the best way to describe it?

George, who saw the previous Cold War up close, thinks not. The US, USSR, and their respective allies had large military forces deployed across a fortified border. Both had nuclear weapons at the ready. They occasionally met in not-so-cold proxy battlefields like Vietnam, Central America, and Africa. That Cold War featured very little economic engagement but a fair amount of death, which could easily have been much greater. Today's US-China situation is nothing like the Cold War. We are adversaries in many ways, but also economically interdependent.

What many probably did not pick up on but I knew from my relationship with George was his comment, "It's not a ***War*** if there aren't bullets involved." Let's just say that in a former life in a galaxy far, far away George may have been involved in a proxy war or two where there were real bullets involved. He immigrated from Hungary where there were real bullets involved. War has a different meaning to him and his generation.

Emily picked up on this, framing the relationship as a "long-term peacetime competition." You can use war as a metaphor, but the two countries compete for access to labor, capital, and knowledge. Artificial intelligence and microchips are the weapons of choice. They seek to gain the upper hand by shaping the various mechanisms of international integration: trade agreements, shipping routes, capital markets.

Louis Gave jumped in to note the antagonism that now seems normal is actually a recent development. Just a decade ago people saw a bright future together, contriving words like "Chimerica" to describe a deep and growing codependence. (I believe the term was actually coined by Niall Ferguson, who helped introduce it at a previous SIC along with his new book.)

What changed, in Louis's view, was the 2012 ascent of Xi Jinping. China gained a different kind of leader, one with greater ambitions for China's role in the world. This changed the Western view, and contributed to Donald Trump's rise a few years later. Today challenging China is one of the few points on which Republicans and Democrats largely (though not entirely) agree. Even when they disagree, it is on nuance and not substance.

The US wants to preserve not just its global dominance but also its security and prosperity by depriving China of advantageous technologies that can be used for military purposes. No one really cares about cars or T-shirts, or who assembles phones with products from 30 different countries.

But China has ways to respond. As Emily pointed out, both governments have enormous influence over the other's economy. China is the main supplier of the deflation that has kept interest rates low, enabling US debt and spending. These "asymmetric dependencies" change the rules of competition. Military power, in a world in which neither side actually wants to use it in a kinetic confrontation, is less important than manufacturing, infrastructure, and other economic strengths.

One of those asymmetries is money itself. China is working to level that playing field, and maybe even tilt it.

Digital Yuan

One reason the US dominates the world economy is our "exorbitant privilege" of issuing the world's reserve currency. Most international transactions are settled in US dollars through the US banking system. This gives Washington leverage, or at least influence, over pretty much everything.

We too often take that privilege for granted. Jim Bianco reminded us at the conference and then in his Bloomberg column on Wednesday:

> The history of modern finance has seen several monetary orders, from the gold standard of the 19th century to the current fiat-based era starting in 1971. Each period had its dominant reserve currency, starting with gold and then moving to the British pound and US dollar. The current system is 50 years old, about the average length of previous monetary orders.

The currency privilege is also a vulnerability. US companies import goods from China and pay for them with dollars. China uses those dollars to buy US Treasury securities, helping to keep our rates low. OPEC countries did the same before China's rise.

Beijing would rather not finance Washington's debt, but presently has no choice. Xi's central bankers would like to give the world another currency system—a digital one that may work as well as dollars.

There are real-world reasons in terms of cost and flexibility for considering a digital currency. Almost two years ago I wrote about Facebook's "Libra" plan. Along with a bunch of (non-bank) partners, Facebook envisioned an electronic medium of exchange backed by deposits of "real" currencies. I noted several problems with their plan, which still hasn't launched and was recently renamed Diem.

China has something different in mind. Their digital yuan would be issued and backed by their central bank, the People's Bank of China, giving it instant legitimacy. The SIC China panel thinks this is a major development. Louis Gave noted currencies are kind of like computer operating systems (Windows vs. Mac, for example). People in general, and especially large organizations, don't move from one to the other easily. For change to happen, the alternative must be not just better, but *massively* better. If China wants to displace the dollar as the global reserve currency, it needs to offer more than an alternative. It needs something way better than USD.

(Sidebar: Elon Musk says the same things about cars. He says you can't make a car just a little bit better. You have to make it *obviously superior* to get consumers to take a chance on something new as opposed to a trusted brand. The dollar is currently the trusted brand, which means that the Federal Reserve's stewardship and the probity of Congress in budgets is important in maintaining trust in the dollar's brand. Losing that trust would be highly problematic.)

The Chinese plan is moving slowly. The PBOC has issued small amounts of digital yuan through state-owned banks. Users access it via a smartphone app that lets them make purchases from selected merchants. Chinese consumers are already accustomed to similar non-bank systems like Alipay, so it's not a huge leap.

How this will proceed is unclear. The PBOC may let the digital yuan grow slowly from the bottom up, encouraging merchant and customer usage. But they can move fast if they want. Emily noted that China isn't just big; its government has the ability to dictate standards, leaving businesses and consumers little choice. And not just domestically, but also with some of its trading partners. ***The digital yuan could easily have a billion users a few months after launch.***

Then of course, they have the potential to launch that same platform into many Belt and Road countries. A potentially frictionless currency transaction that is acceptable and transferable to your local currency, and that is easier, especially to those who lack bank accounts. How can this happen, you ask? Go to Africa. One of the primary mechanisms for commercial transaction is the telephone. Many Africans have no bank account, but they have a telephone with a digital equivalent of the bank account. It does have some "friction," in that the company you use charges a transaction fee. Adoption in Africa was still blazingly fast. When you start with a billion users in China it could happen faster than many Westerners think.

All this is happening in a certain context, too. China got where it is today by becoming an export powerhouse—the world's low-cost factory, so to speak. Now it is transitioning to a consumer-driven economy like the US. The vast (and still impoverished, as George pointed out) interior is urbanizing and growing. China is becoming what Mark Yusko called "a giant consumptive force." Instead of "Made in China" we see goods being made *for* China.

The investment aspect of this is that China is a growing part of global benchmarks. MSCI is making some of their global indexes as much as 20% Chinese stocks. That means institutions can't really avoid investing there. Their choices are to be either neutral or overweight, because being underweight in a fast-growing major economy guarantees your performance will lag.

Yesterday in a prep call for our closing panel, I brought up this concept of a Chinese digital currency. Former Dallas Fed president Richard Fisher, who is extremely conversant on the topic, pushed back hard. He pointed out there is an extreme difference between private cryptocurrencies and a Chinese digital currency. In the latter, you are giving the Chinese government 100% access and visibility into your life. You also give them control over the value of your currency. It is the opposite reason for the development of Bitcoin and other cryptocurrencies.

Sclerotic, Fragile, and Dangerous

A few days later I interviewed Ian Bremmer on the geopolitical picture, of which China is a key element. Ian dissented on this China Juggernaut vision (which he had just recently vigorously engaged with on Bill Maher's show).

China is obviously big and doing big things, Ian said, but it's not the US. We don't see Americans or other citizens of the world clamoring to move to China. Some do, yes, but far greater numbers of Chinese are doing all they can to move their assets, their children (and especially their children's education), and themselves to the US or other Western countries.

He also noted China hasn't covered itself in glory during this pandemic crisis. The virus emerged there (though exactly how is not yet clear) but the government's initial denials wasted precious time, letting it spread out of control, forcing brutal measures to stop it. Now China's home-grown vaccine is proving far less effective than the Pfizer-BioNTech and Moderna MRNA vaccines. The head of their own CDC admitted their vaccine doesn't work well. Their "vaccine diplomacy" plan isn't working well.

Several important countries—Australia and the Philippines being the latest—are having serious disputes with China. In capitals around the world, leaders may not trust Washington but they trust Beijing even less. Corruption is so entrenched through their entire system that things often just don't work. Buildings fall down because someone took a bribe to use inferior materials. Ian had a lot of data about their construction quality. New buildings in China last half as long as the same buildings built in the US (or the West) because of building codes, materials, and corruption. A lot of their shiny new toys will have to be replaced before the debt which paid for them is recovered.

As Ian says, however, this doesn't mean China can't do amazing things on technology, artificial intelligence, infrastructure, and so on. But their system is more sclerotic, fragile, and vulnerable than the US system—which also has its share of faults. Our political dysfunction is deeply problematic, Ian says. It reduces our ability to promote transparency, democracy, and rule of law. As he put it, the US is one of the *least* functional democracies while China is the *most* functional authoritarian state. That's a problem.

Ian was somewhat less confident than the China panel about China as a military threat. ***This was an important insight for me.*** The US seems clearly superior for now, but only if any armed conflict plays out by the old rules. We have more and better ships, fighter jets, missiles, and so on. But the Chinese may have different ideas. We've seen in numerous cyberattacks how a foreign power can create havoc from afar without firing a shot. Advanced drone technology has overwhelmed conventional airpower in several real-world scenarios.

One of our problems, Ian said, is that US defense planning has been captured by a handful of defense contractors whose profitability depends on selling weapons systems that may not be what we really need. The Chinese are investing in technology for the battlefields of the future. We in the US and the West need to stop fighting the last war. He mentioned a new novel, *2034*, by retired Admiral James Stavridis, in which a China-US conflict unfolds unlike previous wars.

Consider all that in the context of Taiwan, an island Beijing considers a rebellious province, and which is now the world's major source of microchips. Could China take Taiwan by force? Would it? We don't know. But as Ben Hunt (another SIC speaker) says, Taiwan is now Arrakis. That's an allusion to Frank Herbert's *Dune* series, in which a planet called Arrakis is the only source of a drug everyone needs for faster-than-light space travel. It was the single most important planet in the galaxy.

Geopolitically, Taiwan is becoming something like Saudi Arabia: the swing producer of a critical resource, and therefore a place of great interest to leading world powers. But in any event, China is certainly a place of great interest to investors. You really need to hear these full sessions.

How to Deal with Volatility in Your Portfolio

The markets are showing great volatility. The bond market is broken and no longer provides the protection it used to. You have to make sure your investment portfolio is not playing that game. There are other ways to manage your portfolio and your future.

If you would like to find out how you can not only survive but thrive in these times, I suggest you talk to one of the professionals of CMG and find out what's in the Mauldin Investment Kitchen. There are ways to generate cash flow without resorting to a broken bond market. You should be diversifying trading strategies and not stocks. There are opportunities to access the coming technological revolutions in a rifle shot manner.

I am part of a small consortium of firms that have come together to share research and resources to help you with your goals. Click on this link to CMG (where I am the chief economist and co-portfolio manager) and we will send you white papers as well as share with you our approach to preserving and growing your assets. Find out how I am positioned personally. I am very proud of what we are doing and I urge you to see how we approach all the issues that we're dealing with at the SIC.

(Please note, Mauldin Economics is not affiliated with CMG)

New York, Maine, and the Timing of Panels

Sometime in June, I am going to get on a plane and go to New York for some greatly missed meetings with clients and dinners with friends. Then in August I will make my annual fishing trip to Maine with scores of economists and friends. My youngest son Trey (now 26) will be with me. He first went with me when he was 12 years old. What a great father-son tradition.

In just a few hours, Bill White and Richard Fisher will join me and Felix Zulauf for this year's final panel. After yesterday's prep call, I can promise it will be powerful. But in hindsight, it is going to be powerful because of the timing. The same panel in 2014 would have been informative, but have nowhere near the impact because we live in far more interesting times.

It is time to hit the send button. Mark Yusko will open the last conference day in an hour, as he traditionally does. The fastest 50 minutes of the conference. You have a great week and follow me on Twitter.

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