The Navigator

COVENANT CAPITAL

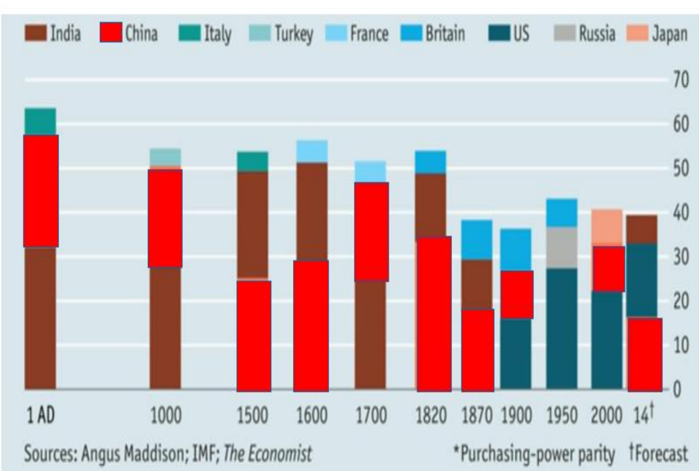
May 2018

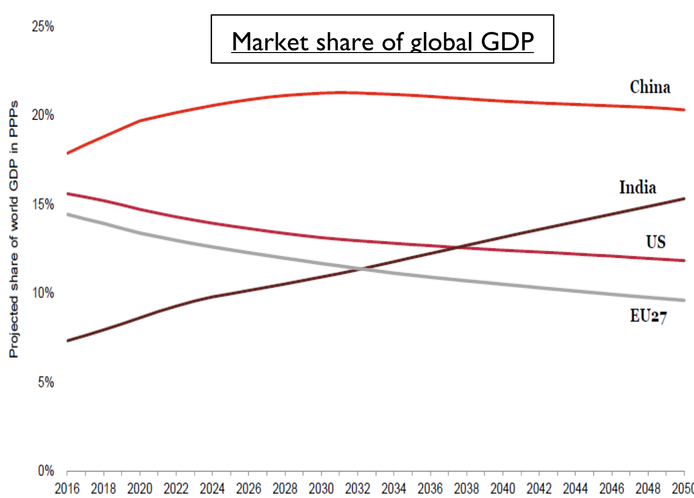
Thucydides Trap

The phrase "Thucydides Trap" was coined by American and Harvard professor of political science, Graham T. Allison, to describe the "natural, inevitable discombobulation that occurs when a rising power threatens to displace a ruling power". The phrase was named after the famous Greek historian and general who documented the Peloponnesian War between the Spartans, the established power, and the Greeks, the rising power. He wrote in 411BC "What made war inevitable was the growth of Athenian power and the fear which this caused in Sparta." Dr Allison contended that out of the 16 episodes since the late 15th century where a dominant order was challenged by an up and coming nation, 12 of them resulted in war between them. While his article "Destined for War" was published in 2015, his thoughts have become even more relevant in recent times as China pits itself against 70 years of US hegemony in the global arena.

The ingredients for such potential confrontation are ominous. We can simply trace back to China's prominence pre-industrial revolution where itself alongside India, constituted the largest chunk of the global economy. In the words of the formidable geopolitical observer, Lee Kuan Yew, "Theirs is a culture 4,000-year-old with 1.3 billion people, with a huge and very talented pool to draw from. How could they not aspire to be number one in Asia, and in time the world?". According to IMF, China has already surpassed the US as the largest economy in the world since 2016 accounting for 18% of global economy. But by 2030, PWC forecast that China's economy will be 60% larger than the US and by 2050, it will account for 20% of the global economy and be 70% larger than the US. The US would be displaced as the 2nd largest economy to third with India surpassing her therefore, restoring these 2 populous nations back to its previous pre-eminence before the turn of this century.

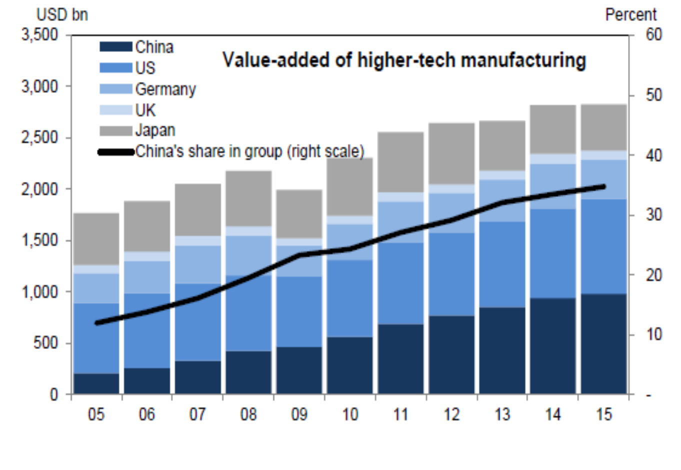
The inevitable restoration of China, and India



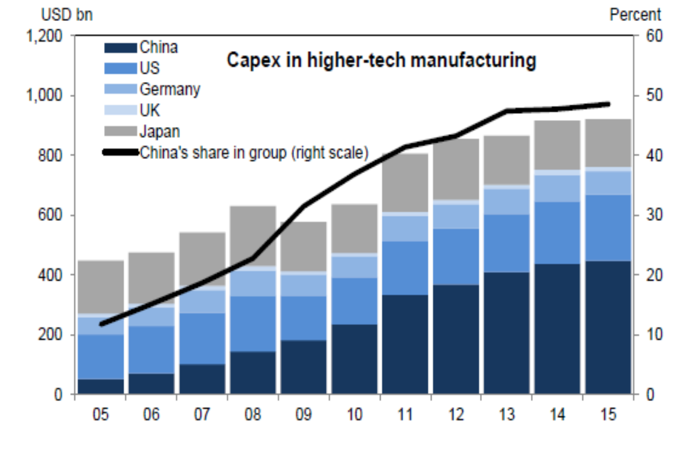


For many of us living in Asia, the meteoric rise is observable but some of us here and many in Western nations still perceive China in the old lens of cheap toys, circumspect quality, and sweatshops. But China today is so far from these misperceptions. China has been the key driver of global growth in high-tech manufacturing since their 2013 clarion call of "Made in China 2025" initiatives where the key tenets were to upgrade their manufacturing value-add, emphasizing innovation, and quality over quantity. According to Goldman Sachs, China rose from a modest 12% in 2005 to a significant 35% by 2015 in terms of total value-added in high-tech manufacturing globally. It also accounted for 70% of the increase. In 2015 alone, they made $450bn of investment in capex for hi-tech manufacturing or the total combined investments made by US, Germany, UK and Japan!

<u>China leading in high value-added manufacturing</u>



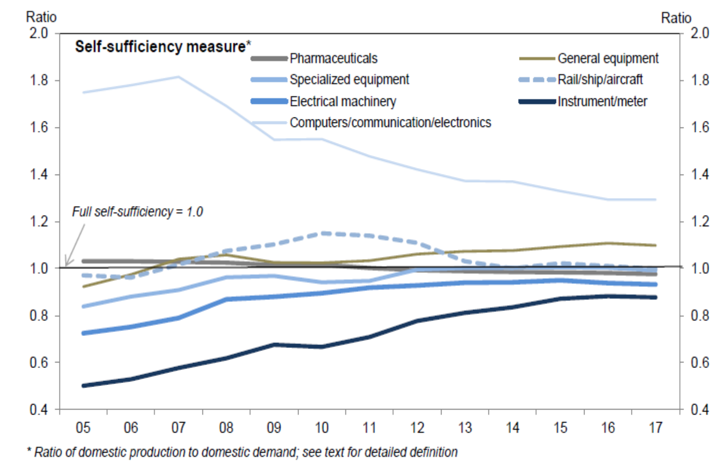
Source: OECD, CEIC, Goldman Sachs Global Investment Research



Source: OECD, CEIC, Goldman Sachs Global Investment Research

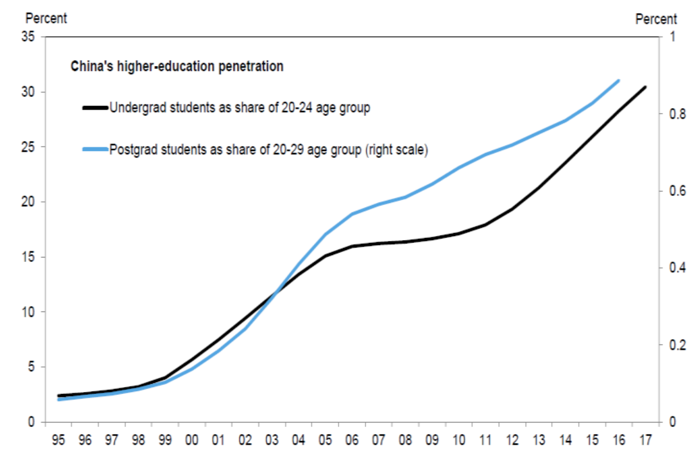
From being reliant on overseas technology or as Americans has accused them as thieves of IP, China has reduced its reliance of import especially in areas of instrument/metering and rail/ship/aircraft parts. Even in areas where they are still lagging foreign manufacturers' such as robotics, China has been able to entice the leaders in this sphere to increase their localisation. ABB, the 4th largest robotics company, established a robot manufacturing plant in Shanghai Kangqiao as early as 2005, and this plant has already become one of its top two robot manufacturing facilities in the world. More than 90% of ABB robots distributed in China have achieved localized content. For the many of our adult readers that still have their inner boys in them, we all would have heard of DJI drones. Founded in 2006, the Shenzhen-based DJI has quickly grown into a global leader in drones controlling over 70% of the global commercial drone market. While there are many more examples to illustrate China's dominance, this author thinks the right chart below demonstrates the most potent source of self-reliance and the concomitant rise in nationalistic pride that can exacerbate tensions between the China and US. 30% of China 20-24 age group are undergraduates and 0.8% of age group 20-29 have post-graduate degrees. That is approximately 38mn of highly educated, confident and well-travelled, conversant in English, deeply nationalistic and possessing high propensity to spend young people. 38mn of tertiary educated, young and proud Chinese is equal to the entire 20-29 age group population of the US or 11% of total US population. They will let not only their opinions be heard, they will demonstrate their displeasure with their wallets.

China relying less on imported know-hows



Source: CEIC, Goldman Sachs Global Investment Research

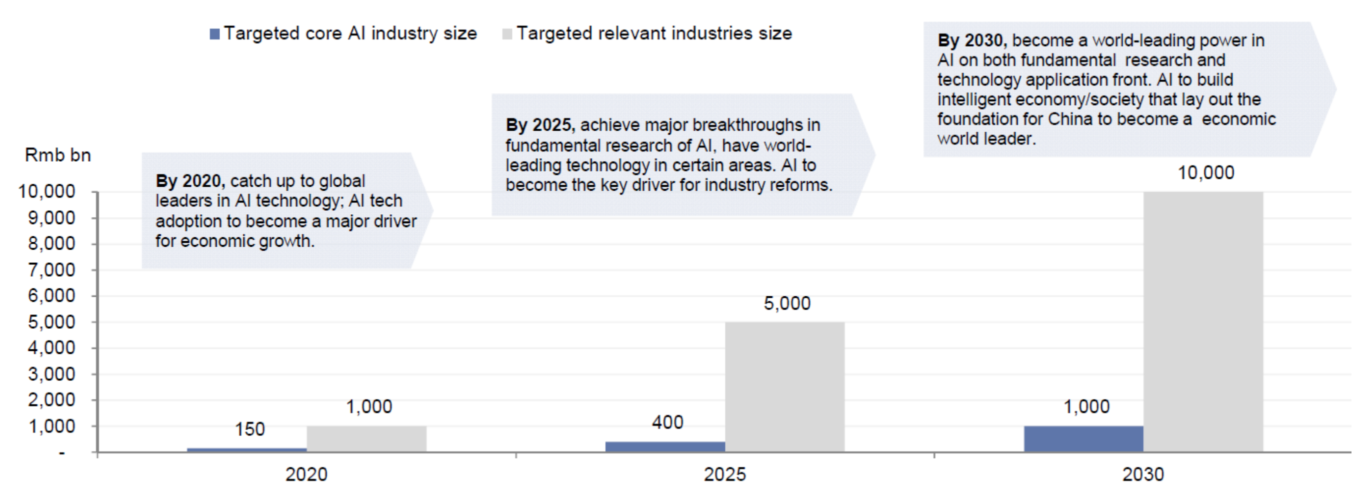
China's large educated populace



Source: CEIC, UN Population Statistics

It is no surprise given the depth and the sheer number of educated population, in the field of deep learning, the apex of Artificial Intelligence, China is leading in the most research paper published (30% more than the US) and cited (15% more) in 2017. It has over 700+ AI-related companies filing over 18k patents in 2016. According to their grandiose plan, China target AI to be Rmb150bn industry and impacting Rmb1trn of industries in 2020, but by 2030 the target is to rise to Rmb1trn and impacting Rmb10trn worth of industries. If their goals are reached, China will surpass the US in the arena of AI.

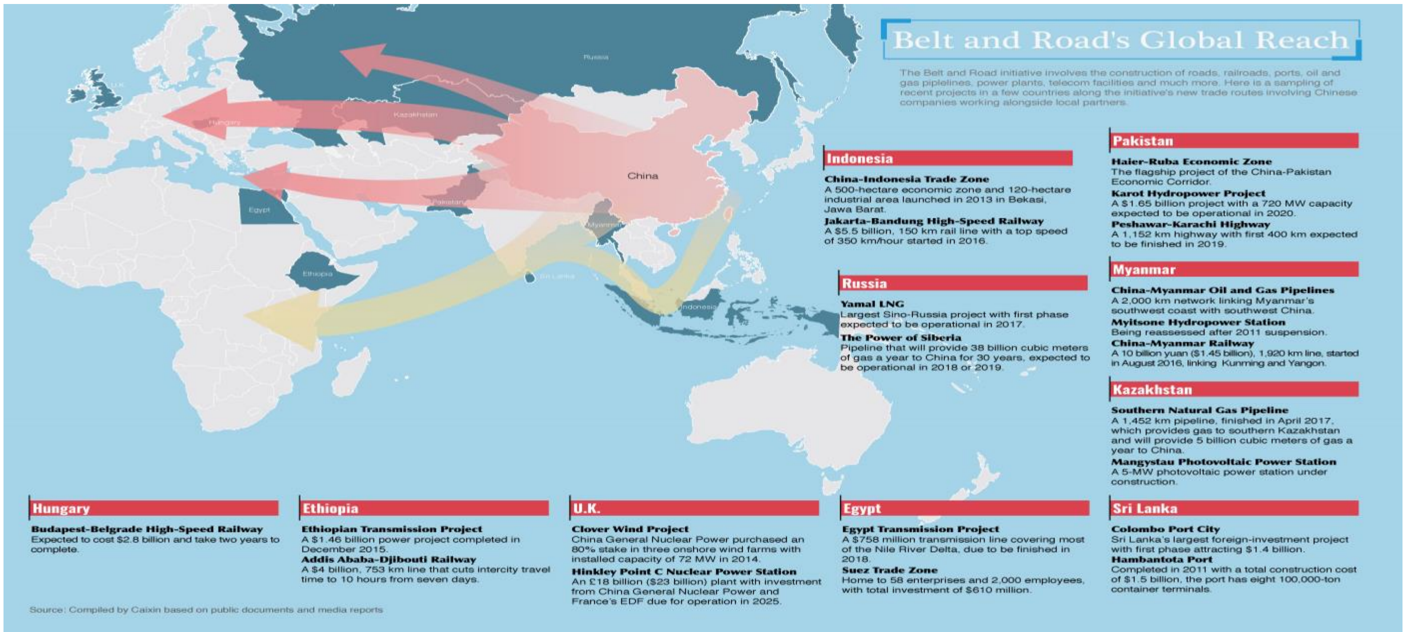
The strategic goals of the national development plan on AI



Source: The State Council.

It is with tremendous curiosity and trepidation when this author read that the Belt and Road Initiatives (BRI) were written into China's constitution last October. Unlike a strategy or a directive, a written constitution carries the full legitimacy of the country and allows the exercise of the entire arsenal of economic, diplomatic and military tools of the country to achieve and uphold. BRI is a grandiose undertaking that aims to foster greater regional cooperation and economic development across the Eurasian landmass and connect China and Southeast Asia with the northern Indian Ocean littoral, Africa, and the Mediterranean. The official rhetoric is crafted as win-win economic development facilitating trade and infrastructure improvements for these 65 developing countries. However, it can also be interpreted as China's version of US Marshall Plan; a geopolitical and military assertion of China's hegemony in through economic statecraft and in some cases blatant financial handouts. For China to reclaims its preeminence, it needs to secure its borders and its supply routes. It is the very reason why China covets for the return of Taiwan and was decisively displeased with Singapore when it took sides in the South China Sea disputes. Taiwan forms as a natural buffer and naval staging area for China to counteract US presences in Japan and South Korea (incidentally is the deployment of Thaad missiles by the US in Korea in 2016 that resulted in rapid deterioration of Sino-Korean relationship). Much of China energy supplies still come from the Strait of Malacca or as former President Hu Jintao term it as "Malacca Dilemma". A restive Singapore to China therefore, exposes China to the interdiction of foreign navies on their most important supply lines.

The recent establishment of its first overseas military base in Djibouti (Spartly Island excluded since those who unilateral installations) has significantly increased its ability to project its power in Africa and Indian Ocean. Djibouti is strategically located at the southern entrance to the Red Sea on the route to the Suez Canal. Following Djibouti, China established its presence in Sri Lanka acquiring two plots of land in Hambantota and Colombo under the guise of one of their SOE which owns global port assets in places like Nigeria, Togo, Turkey, Hong Kong and Taiwan. It is of scant comfort during the recent height of India-China tension, China sends two of its submarines to dock in the Colombo port. There are also speculations that China is planning to construct a naval and air base near Gwadar, west of Pakistan that can accommodate up to half a million Chinese. Furthermore, with the 1,152 km Perhawar-Karachi Highway in Pakistan slated for completion in a few years' time coupled with their Rmb10bn investment in railway connecting China to Myanmar, fortified by naval and air bases in Pakistan, Sri Lanka and Djibouti and possibly a Tanzania base in future, China would have crafted another supply route into their inlands by passing the Malacca Dilemma.



The US is well informed of China's veiled economic expansion. In fact, as early as 2012 under Obama administration, the US has already declared vociferously its "Asia pivot". Hilary Clinton as US Secretary stated, "Strategically, maintaining peace and security across the Asia-Pacific is increasingly crucial to global progress, whether through defending freedom of navigation in the South China Sea, countering the nuclear proliferation efforts of North Korea, or ensuring transparency in the military activities of the region's key players." Unlike China, US openly stated that their Asia pivot will encompass strengthening bi-lateral defense arrangements and forging new broad-based military presence, advance democracy and human rights alongside advancing its economic interests. It is foolhardy to think President Trump has ratcheted Sino-US relationship, many, this author included, attributed China increasing militancy in part due to Obama's administration outlining a military component and ideological crusade within an economic agenda, ie the recognition that Asia will become the most important center of economic growth and relevancy in the next 50 years which the US must participate. US refusal to participate in the TPP and refusal to join the Asia Infrastructure and Investment Bank at the bequest of China while chiding the UK for participating led to China thinking that American's pivot is nothing more than containment and ideological displacement that can jeopardize its own existence whilst reaping off Asia's economic renaissance. For China, the 1889 Boxer Rebellion wounds still run deep and circumspective of western powers.

Last but not least, the leading actors in this play, President Xi and Trump, share common circumstances and ambitions for their own countries. Both have elevated themselves as unique statesmen and a class above their predecessors. Both have achieved sweeping changes domestically and with populism support, they are emboldened in their pursuits of domestic and international agenda. Both have the common ambition of restoring their own nation to their right stage in the global arena; who will be casualties as one nation seek to realize the "Chinese Dream of the great rejuvenation of the Chinese Nation" and the other wants "To make America great again". Hopefully not Singapore.

However, there is hope; war is not inevitable. Through the 4 incidents out of 16 of Thucydides Trap that did not end in war between two such nations, Dr Allision provided some clues, some solutions that can help US and China avoid being the 13th such example. A key deterrent to conflict is the paradox of a nuclear war which both countries possesses and recognized a nuclear conflict is equal to mutually assured destruction. Being part of a multi-national institutions such as the UN or trade agreements based on shared goals can embed both nations to a "larger economic, political and security" inter-dependency. Trump's decisions to exit TPP, US exclusion in the AIIB, China's rejection of the International Tribunal Court decision on the sovereignty of the South China Seas are clearly not the right decisions path to take. We hope in the coming months with four-party negotiation on the Korea Peninsula, the bi-lateral trade negotiations and the prospect of the rest of TPP nations accepting US back into the arrangement will alter the course of collision between these two mighty nations.

Asset Allocation Strategy

We view the recent weakness in asset prices as temporary as much were driven by exogenous factors rather than endogenous issues such as weaker growth, run-away inflation and/or dissipating earnings growth prospects. The last four months weakness in risk appetite can be attributed firstly in market re-calibrating their inflation and interest rates view to be in line with Fed (we called it Taper Tantrum redux). This was swiftly followed by concerns of smartphones shipments from likes of Apple and Chinese handset manufacturers. The backlash against Tech giants like social media, Facebook, and e-commerce, Amazon, further hampered risk-taking in the high-flying tech sector. Before the market can settle down to these consecutive umbrages, Trump's instigated trade tension with his key trading partners fueled another round of risk off mentality. We will address some of these issues within the asset classes commentaries. As for trade tensions, we have already expressed our views in March Navigator, Bye, Bye, Miss American Pie and in 2Q18 Investment Outlook: Playbook on inflation. We are of the view it will be re-negotiated, and the eventual impact will be less than the market is fearing.

Fixed Income: Underweight. While we remain underweight Fixed Income, we believe the bulk of rates adjustments by the market have already occurred. As early as September 2017 in The Epitaph of QE and his mates we have commented that the market is significantly mispricing inflation and therefore interest rates risk. We started the year with the view that US10 years will reach 3% to worst case 3.20% by end of the year. We warned at the start of the year market expectation of only one hike in 2018 is grossly misaligned with Fed's intention of three hikes that was well communicated by Fed throughout later part of 2H17. Back in Jan, US10 was trading at 2.38%, a good 62 bps below our year end target. However, with the Taper Tantrum Redux in Feb and a bit more in April, the market has now moved US10 to 3%, in-line with our fair value for the year-end. Further, the market is now pricing 2 more hikes this year similar to Fed and a >50% probability of an early third hike in Jan 2019. Unless a major supply-side induced inflation coming from commodities, which is a probability, we are of the view that the bulk of the beta-induced downward shift in our fixed income portfolio has completed. We believe our selection in preferred securities, EM debt, capital-structures debt, financial and commodities bonds alongside our bell weather core bond fund manager should perform better un the next 1-2 quarters. Our absolute return bond managers' alpha selections should reassert itself as well. We maintained our underweight bar-bell approach but have added some exposures on both ends of the bar. We remind readers not all bonds are created equal. There is still the opportunity to make positive return in fixed income through both carry and capital gains even as rates rise.

Positive returns in fixed income still possible even during rate hikes

Rising rate time period	Change in interest rate	Non-traditional bond	Bank loan	High yield bond	Multi-sector bond	Short-term bond	Inflation-protected bond	Traditional core bonds	Intermediate-government bond	Long-government bond
8/86 - 10/87	+3.31	-	-	1.64	2.31	2.98	-	2.41	1.83	-2.48
9/93 - 11/94	+2.86	-	6.29	0.83	-1.16	-0.16	-1.65	-3.03	-3.93	-7.87
9/98 - 1/00	+2.63	8.48	6.23	5.71	3.33	2.01	1.67	-0.61	-1.36	-6.47
5/03 - 6/07	+2.19	5.31	6.13	8.97	5.94	2.29	2.70	2.94	2.09	1.29
Average	+2.75	6.89	6.22	4.29	2.60	1.78	0.91	0.43	-0.34	-3.88

Source: Blackrock

Equities: Overweight. We fade the concerns of earnings whether it is emanating from smartphones shipments or slower economic growth. Apple in their recent earnings call affirmed its full-year guidance while the granular release of its inventories highlights there isn't a significant build-up in finished good inventory which bodes well to normalized production schedules ahead. After two-quarters of negative shipment growth from Chinese smartphone manufacturers, the latest channels whispers indicate that their revamped price down/ feature-lesser strategies are regaining sell-through momentum.

The broader underpinnings for an overweight in Equities remain. The softer 1Q GDP print in Euro and Japan are stabilizing and we expect 2Q18 global GDP to track consensus full year forecast. Moreover, it has been usual that the 1Q GDP prints are lower than forecast as evidenced in the last 3 years before accelerating in the subsequent quarters. Our nowcasting components such as PMI in April lends support to this view. The all-industry PMI combines data on manufacturing and services and is a proxy for GDP growth. Global all-industry output PMI increased 0.5 points to 53.8 in April, after falling 1.5 pts in March. The bounce back is supported by gains in both manufacturing and services. Critically the sub-component of new orders for both manufacturing and services have increased from March's dip with new orders for services reaching a year-high of 55.5. The employment component of PMI is unchanged and remains at elevated level. At the regional level, the April all-industry PMIs were up in both developed and emerging markets. In DM, the index increased 0.6-pt to 54.6 driven by a 0.7-pt rise in the US to 54.9. The Euro area PMI was roughly stable at 55.1 whereas the PMI jumped 1.8-pt to 53.1 in Japan. The stability in the Euro area PMI is a welcome development following a total decline of 3.7-pts over the prior three months. In the EM, the April composite PMI edged up 0.1-pt to 51.9 lead by China as its PMI improved by 0.4-pt to 52.3.

Latest April Global PMI remains elevated and has improved from March's slight decline

J.P. Morgan global PMI summary

		Dec	Jan	Feb	Mar	Apr
Output	Total	54.3	54.6	54.8	53.3	**53.8**
	Manufacturing	55.5	55.6	54.8	53.4	**53.9**
	Services	53.8	54.1	54.8	53.2	**53.8**
New orders	Total	54.8	55.1	55.3	54.2	**55.0**
	Manufacturing	55.8	55.4	55.0	53.7	**53.9**
	Services	54.4	55.0	55.4	54.4	**55.5**
Employment	Total	52.9	52.9	52.9	52.8	**52.9**
	Manufacturing	53.0	53.0	53.0	52.3	**52.3**
	Services	52.8	52.8	52.9	53.0	**53.1**

Source: J.P.Morgan, Markit

J.P. Morgan global all-industry output PMI

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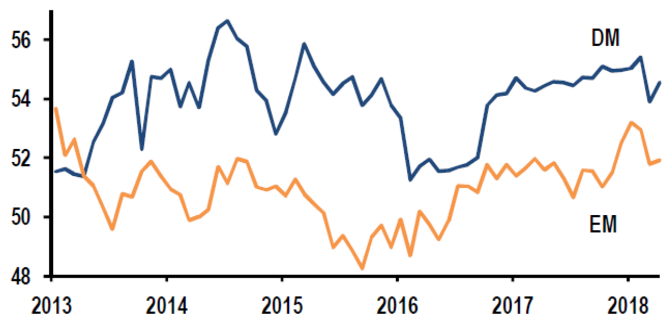
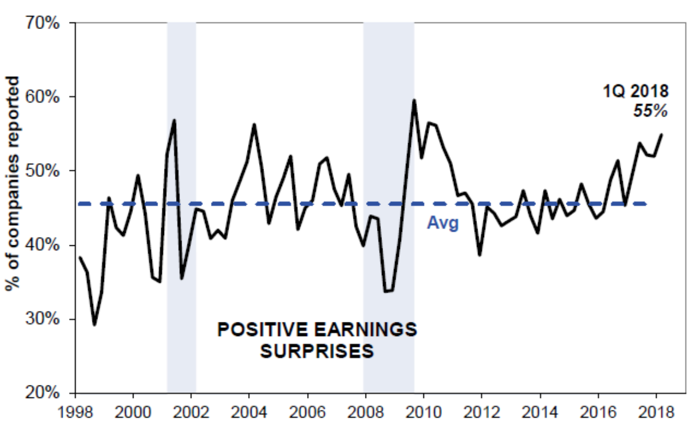


Source: J.P. Morgan

Bulk of earnings season is done, and the incoming results remain supportive to overweight equities. In the US, S&P 500 EPS rose a stellar 23%yoy in this quarter, tracking well above full-year forecast of 21%yoy. 55% of companies reported earnings surprise while 51% of companies reported revenues upside. At 55% better than expected reporting, this marks the highest level since 2Q2010 in terms of companies beating consensus. The sectors in the US that have reported the largest beats are IT (91%), Energy (71%), Materials (78%), Industrials (78%), key sectors that we like and are well positioned in. In Europe, with 70% of companies reported, 58% beat expectations with EPS growth coming in at 10% yoy tracking full year estimate and similarly to US, cyclical and IT are the main beats and are driving the bulk of the Eurozone growth. In Asia, 54% of companies have reported recording 16% yoygrowth and tracking inline with historical norm accounting for 24% of full-year forecast. However, more companies are missing than beating with the latter at 35%, which is below its historical norm. Korea and Taiwan are the main countries where there have been more misses than beats partly due to the elevated expectations in tech at the start of the year for these two countries. As we have mentioned throughout the year and set out 2018 Investment Strategy: Eat, Drink, Man, Woman, earning growth and revision momentum are critical gauges we are monitoring as it is by far the single most important driver of equity price performances; more than inflation and rates. So far, post earnings season, EPS revision momentum remains positive with EPS upgraded higher than the start of the year for the global, US and EM; key markets that we are currently overweight.

US companies highest beat since 2Q2010



Source: FactSet, Bloomberg, and Goldman Sachs Global Investment Research.

Synchronized EPS growth and ERM still positive

	2018e EPS Growth, %		2019e EPS Growth, %	
	Current	Jan '18	Current	Jan '18
MSCI World	14.9%	10.0%	8.8%	9.6%
S&P 500	21.3%	12.3%	9.7%	10.3%
Stoxx 600	7.8%	9.2%	8.3%	8.8%
Euro Stoxx	7.0%	9.4%	9.3%	9.6%
FTSE 100	8.8%	7.0%	5.6%	7.0%
Topix*	3.3%	13.9%	8.9%	8.7%
EM	15.5%	13.1%	10.7%	11.1%

Source: IBES, * for Year Ending March 2018 and March 2019

Commodities: Overweight. We are downgrading our view on oil. While the risk for oil could overshoot pass $80, which is high end of our price forecast, due to geopolitical reasons especially from Iran, the biggest move in oil has already occurred. We are also cognizant of the all-time high in speculative oil futures held by non-commercial which represents 690mn barrels net long. At 690mn net long of oil speculation, this is equivalent to 2% of global outages in oil production or half of Iran's production is shut out from the market. We are quite happy to take profit on our oil related names and re-enter when technical are not so over-bought. We remain positive in our view on copper and are exploring other basic materials like steel and coking coal.

FX: Neutral We remain dollar neutral mid-term and are bearish in the longer term. We believe the recent weeks of strength in the dollar is short-lived. The growth differentials between US and Europe/Japan will be less obvious from hereon. As we have mentioned in the fixed income commentary, as we believe the bulk of the US yield curve move in the long end has already happened for the year, while the Fed Fund futures pricing the short-end is much in-line with Fed's 2018 motives. The recent interest rate differential trade favoring the US$ is largely discounted. The dollar as a risk-off hedge will likely abate as geopolitical issues should ease alongside Korea peninsula talks in June and potential political recess from trade issues should commence in June as well. The longer-term issue with US's twin deficits remains and should bear poorly for US$.

Alternatives Investments: No change with preferences for long/short credit manager and total return FI manager.

Cash: Cash level remains 5 to 15% providing enough dry powder when opportunities arise to deploy.

Featured Picture/Quote:

"Let China sleep; when she wakes, she will shake the world" Napoleon, 1817

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Risk Disclosure