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A View From Asia

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Thucydides' Trap: A phrase coined by Professor Graham Allison of the Harvard Kennedy School describing the dangers when a rising power threatens to displace a ruling power - his book, 'Destined for War: Can America and China Escape Thucydides' Trap?', is worth a read.

"It was the rise of Athens and the fear that this instilled in Sparta that made war inevitable". So said Thucydides, the Greek historian, a couple of millennia ago describing the Peloponnesian Wars. Professor Allison, in his book, looked back over 500 years of history and identified 16 cases in which a major nation's rise disrupted the position of a dominant state. His research found that 12 of those rivalries ended in war. His book suggests that this historical metaphor provides the best lens for illuminating relations between China and America today. He opines that war is not inevitable; instead, "it points us beyond the headlines and regime rhetoric to recognise the tectonic structural stress that Beijing and Washington must master to construct a peaceful relationship."

There are times when it is rewarding to dust off our history books and look for some guidance or answers to vexing questions of the day. It wasn't just the violent sell-off in stock markets that prompted me to read Professor Allison's book. On October 4th, Mike Pence, the US Vice President, gave a speech at the Hudson Institute. It was a direct shot across the bows, which enunciated starkly the Trump administration's strategy to check China, now openly recognised as an economic and geopolitical rival. "We will not relent until our relationship with China is grounded in fairness, reciprocity, and respect for sovereignty," said Mr Pence.

On October 30th, federal prosecutors in the US charged 10 Chinese intelligence officers, accusing them of engaging in a persistent campaign to hack into US aviation companies. The day before, the US imposed a ban on American companies from doing business with a Chinese chipmaker accused by Micron Technologies of stealing technology design secrets.

Past peak globalisation?

This raises a question for us in the investment world: are we past peak globalisation? Is this the start of a splintering of economic and political domains? Open markets, free trade, cross border investment, capital flows and democratisation of credit drove a spectacular rise in global prosperity and economic development in the past three decades. The crisis of 2008/9 and subsequent developments revealed that this spread of prosperity was unequal. In Asia, too, where disparities in incomes and wealth have increased, large sections of society now live much better lives than two or three decades ago.

Just as hope is not an investment strategy, neither is nostalgia. The implications of a shift towards a less globalised, more fragmented economic world are manifold. At the simplest, as several company managements in meetings have outlined, there is a desire to accelerate the shift of manufacturing from China to other countries. Alongside this is the urgency to create a supply-chain logistics capability and improve staff productivity in the other countries. Vietnam, Indonesia, Malaysia and Bangladesh might be beneficiaries. However, it is not just a simple decision to find stocks in those countries. Does this move from China lead to duplication of capacities? It is unlikely that existing capacity in China will completely shut down. Does it lead to inefficiencies from lack of scale, lower margins in general and hence lower returns on capital?

If these trade tensions increase, will some countries impose their own restrictions? China, India and Indonesia have raised tariffs on their domestic industries they consider vulnerable. Taking this to an extreme, do we need to prepare for restrictions on free movement of capital? Is that appropriate in an age of indexation when MSCI and others want to increase the weight of Chinese 'A' shares in indices? Increasingly, data is as valuable if not more so, as oil. Will the prognosis by former Google CEO Eric Schmidt of a split in the internet into two be prescient? Does this mean truncation of globally scalable media, entertainment and service businesses, like Google, Netflix or Starbucks?

Finally, there is the critical area of the reserve currency. Does the US dollar retain that status and for how long? The US has been accused by some of "weaponising" the dollar's status to achieve its objectives – recently China was sanctioned for buying some weapon systems from Russia while India had faced a similar threat; all countries were forced to stop imports of oil from Iran.

There are several imponderables, many of which are policy dependent. This uncertainty, coming at a time of an end to quantitative easing and a rise in interest rates, is a major headwind for equities. How do we react? Do we need to make changes to our approach to finding and owning stocks?

The end of easy money and finding relative certainty

Subject to the caveat that increased uncertainties means higher volatility, there are areas where we have a bit more certainty and confidence. It is very likely that several countries are going to push for import substitution in as many areas as possible. For sure, industries of national security (AI, technology, defence) will be priorities. However, as tariffs rise, entrepreneurs will look to identify opportunities where domestic goods and services will take market share away from imports. Hypothetically, if China were to impose tariffs on athletic shoe imports, several Chinese brands might readily fill in that gap.

Access to cheap credit allowed us to buy goods well in advance of affordability. It is fair to assume that trade tensions are going to result in slower growth and likely lower disposable incomes. It would be more prudent to focus on goods and services representing necessities and staples, where demand is relatively stable and the need for credit is minimal. In the past months, I have added to a few stocks in our portfolio that fall into this category. Another category of companies we are currently looking at is firms who have invested substantially in capex in the past 2-3 years but who have depressed free cash flows at present. As those projects come to fruition, the real cash flow earning power of the business should come through, provided, of course, demand conditions do not deteriorate.

If events do transpire in a way that geopolitics dominates our investment landscape, several aspects of markets will undergo a profound change. Risks that we cannot envisage today will become the norm. It is impossible for me to think of or make a prognosis of what they will be. Suffice to say, one of the big risks we carry resides in the impact on valuation multiples from slower growth and tighter liquidity. We have lived through a period of easy money. As it reverses, this will not only expose the poorly run businesses but also affect the discounting mechanism for better quality ones.