11-14-2023 Not That 70s Show

Ubiqus
61 Broadway – Suite 1400 – New York, NY 10006
Phone: 212-346-6666 ◆ Fax: 888-412-3655

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MR. MICHAEL CEMBALEST: Good morning everybody, this is Michael Cembalest [phonetic] with the November 2023 I Am The Market podcast. I haven’t done one of these in a little over a month and obviously a lot of things have changed in the world. Mostly, for the worst. And I wanted to share some thoughts with you about some geopolitical questions and answers.

I normally don’t write a lot about geopolitics in the eye in the market. There’s three reasons for that. the first one is debt. There are a lot of troubled places on the planet that all of us are concerned about as human beings. But in my job as an investor the worlds war zones are generally a very small part of the world. They may represent a large share of the worlds population, but they generally represent a very small share of EDP, equity markets, bank lending, portfolio investment, trade, oil, gas, and mineral production, capital formation. And we have a table in the eye on the market that shows a lot of these variables, when you add up all the worlds warzones, civil wars, shooting wars, anarchy and other special cases, they may represent one percent, one and a half percent, half a percent, .2 percent of a lot of these variables.

And so, they don’t have a lot of overlap with the things that effect markets and the things that investors care about. The War on Russia has changed that somewhat. We've had a spike in food and energy prices that is now subsiding. But I wouldn't say that the Russian invasion of Ukraine has been a primary equity market catalyst over the last couple of years.

So point number one is world zone countries generally have a small footprint. Second, if you—if we look at Over the last, let's say, 40 years, the only geopolitical event that ever be, was still the primary driver of equity markets six to nine months later was the Arab Israeli War of 1973. All of the other ones, and we have a table in here of the ones that we've looked at, and there's a few more that we need to put in the table, six to nine months later, whether the markets were higher or lower, they were being driven by the business cycle that had prevailed before that geopolitical conflict erupted.

And the third point to make. Is a couple of years ago, we looked at a whole bunch of indicators. And we looked at whether or not if you knew in advance whether these indicators, whether they were profits or leading indicators like the ISM survey or things like that, would it help you to know in advance what these things we're going to do in terms of being an investor. Of all the indicators we looked at, the least helpful one was a geopolitical risk index.

So for those three reasons, I generally don't spend a ton of time on geopolitics. That said, I did want to walk through, six questions and answers on things, uh, both geopolitics and U.S. politics that intersect with financial markets, and they're questions I get a lot from clients, and so I just wanted to share them with you.

The first question has to do with whether or not the situation in the Middle East is going to lead to a spike in energy prices and a collapse in equities as they did in the 1970s. And the answer is, and I think a lot of this is well known but let me just summarize it for you. U.S. exposure to energy supplies is quite different than it was in the 1970s. We have a chart in here that shows that the U.S. was a very large net energy importer in the 1970s, not as large as the United States was in 2006, before the shale boom.

But the net imports of energy in the United States in the 1970s are pretty high. Now the U.S. is a net energy exporter. It doesn't mean, you know, a lot of energy prices are global and it doesn't mean that the United States is completely immunized from rising prices, but the supply risks and the price impacts are certainly lower than they were in the 1970s.

And there's a chart here in the deck that we didn't put in the Eye of the Market, but if you're watching this podcast, you can see crude oil imports peaked on a net basis at about 10 million barrels a day. They're now three. And in terms of refined petroleum products, they peaked at 4 million barrels a day import. They're now 4 million barrels a day of net exports for the U S. So, obviously those, a lot of these things have changed and made the U.S. less sensitive to these things. More broadly. the oil intensity of GDP growth has fallen by about two thirds or even a little more since 1970.

So, for every unit of GDP, we need a lot less oil than we used to, and I expect those numbers to continue to fall.

And oil demand growth, people forget this, in the early 70s when that 1973 war took place, oil demand globally was growing at eight to 10 percent a year. Now that were, in the world we live in, oil demand growth's growing at zero to two percent a year. Um, and so obviously that's just a much different place in terms of sensitivity to oil embargoes.

There's plenty of spare capacity in OPEC should the Saudis choose to release it. And even if there was some kind of embargo most Middle East oil exports go to China. So it's not even clear geopolitically what an embargo would do for anybody in the Middle East when the U. S., of the remaining imports it's got, comes from places like Canada and Mexico.

There's two caveats that I just want to mention briefly here. One is, and we have a chart that shows the energy spending by the world's largest energy companies, the publicly traded ones has collapsed. Which is all well and good if you believe there's a transition coming, but, so far, fossil fuel consumption has not fallen. So what we have is a sharp decline in capital spending before energy consumption has gone down.

So that sets the stage for outside of recessions, energy prices to remain on the higher side. And then the other thing, which I consider to be a geopolitical malpractice is that the Biden administration ran down the strategic petroleum reserve to its lowest level since 1983 and has absolutely no plan to increase it. And like somebody that forgot to buy insurance for their car, you know, went out for a drive and got into an accident, which is essentially allowing this thing to run down so far and not refilling it. And then you have a geopolitical event. So those are two brief caveats.

But the bottom line is I really don't consider the energy transition risks to the U.S. economy in terms of headline inflation or the eventual pass-through core inflation to be that anywhere comparable to what they were in the 1970s.

The next question was I've described Europe's new global tax system they're trying to impose as a bounty hunting infringement on U.S. sovereignty. And people understandably say, what the heck does that mean, and what does NATO, European defense spending, Russia, and Poland have to do with it? Let me explain.

So the simplest way international tax, international taxation can be an absolute bear to get through. But let me simplify. Let's assume that there's a parent company, a hundred percent in the U.S. that's a hundred percent compliant with U.S. tax rules. It's got two subsidiaries. One in India, one in Germany. Both of those subsidiaries are compliant with their tax rules in India and in Germany, respectively. Even so, these new Pillar 2 rules in Europe would allow the German government to determine that the U.S. parent or its Indian subsidiary didn't pay enough in those jurisdictions. And therefore, the German government would have the right to collect taxes unpaid by subsidiaries in the U.S. and India from the German subsidiary.

This is essentially a bounty hunting arrangement that is aimed directly at the United States because we have different rules about R&D credits and taxation of intangible assets. Europe has a lot less intangible assets, and R&D. And so that's one of the reasons why they're taking aim at it.

I find this somewhat disturbing, because the history, this is essentially a one size fits all tax policy that Europe's trying to impose. Europe's had a lot of trouble with its one size fits all monetary policy. We have a chart in here that shows the Eurozone countries are more than twice as different from each other as the nine U.S. regions are in the United States from themselves.

Europe, the eurozone is even more different in terms of its internal constituents than a theoretical fake union of English-speaking countries from Ireland to the United States to Australia, New Zealand and Canada. You know, the point being, um, Europe has kind of jammed down the ECB concept and on a region that has vast disparities in terms of their. Economic cycles. Now they're trying to adopt a one size fits all tax policy. I don't think it's a good idea. If we look at the history of GDP growth, since the Euro was launched, Europe has grown half as fast as the United States over that time.

And what's even more telling is we have a charter in here that you almost don't believe it. Germany and Italy industrial production used to move in tandem like two doves from the early 80s until the late 90s when the euro was launched. Since then, they have absolutely gone in opposite directions with German industrial production going up and industrial production in countries like Italy plummeting. So this is the opposite of what's supposed to happen when you put a monetary union in place. It's supposed to normalize economic performance across regions, not drive them apart.

So I'm somewhat cynical about the notion that Europe, having essentially failed in its mission, if you look at the things that matter for the euro to work is now trying to impose the same thing in terms of tax policy.

And a lot of these things have to do with sovereignty. And so I'm tempted to say, well, let's expand the discussion on national sovereignty to include spending on defense. And Europe has spent so little on defense, on its own defense, and relying on the U.S. for protection, that NATO actually had to adopt a rule in 2006 requiring member countries to spend at least 2 percent of GDP a year. Most of them are not doing that. And, Europe completely misread Russia and the risks associated with it. And I have a quote in the Eye on the Market that I found fairly terrifying.

Now that we're going to talk about geopolitics, former Russian president Medvedev talked about Poland last week as a historical enemy. And that if there's no hope for reconciliation that Russia should have what he said was a tough attitude regarding its fate. History has more than once delivered a merciless verdict to the presumptuous Poles. And this is real Cold War language coming out of Russia right now as it relates to, you know, Poland, which is really a central member of the Eurozone, and the European vision at this point. And yet still The United States is carrying the vast majority of the responsibility for Europe's defense.

So now that we're keeping tabs of who's paying taxes, let's keep tabs of who's paying for national defense. I have a table in here that shows the European defense, defense spending shortfall by country since different points in time. Depending on how you want to measure it is anywhere from 1.4 to 2 trillion dollars that they've underspent on their own defense or which, in principle, they owe to the United States for their defense.

So as far as I'm concerned, U.S. presidents should not be advocating for these pillar two new tax standards unless all aspects of national sovereignty are on the table. And it's—and the U.S. should consider retaliation against Europe if it moves forward with these new tax rules that are specifically designed to penalize the very firms that result in higher levels of U.S. growth, productivity, and innovation.

So that's the second one. Okay. Third question. How, you know, what do I make of the Trump Biden election? There's certain things I say that I can say, and there's certain things I can't say. I will tell you this. If Trump runs against Biden, it would be the two oldest people running for president, with one exception, since the history of the republic in the United States. Even when adjusting for shorter lifespans in the late 1700s and 1800s and early 1900s.

So we have a chart in here that adjusts everyone's age for prevailing male life expectancy. And this is the second highest race ever other than 1848. And not only that, both Trump and Biden, their average age is beyond expected male life expectancy. So I'm not going to go through all the details, but I thought it was really interesting to walk through what would happen if Trump or Biden or both were forced to withdraw for health reasons. They be, they die, they become incapacitated. They have dementia, who knows?

And you have to, unfortunately, ask these questions a lot of different ways, because does it happen before the ballot eligibility deadline for a given primary? Just before it, so there's no time to get a replacement name on the ballot? What happens if it occurs after the last primary, but before the party convention? What if it happens after the party convention, but before the general election? And what happens if it takes place after the general election, Biden wins but becomes incapacitated either before December 17th, which is the date where all the electors gather in state capitals to vote, or before the January 6th joint session of Congress.

So, there's a guy I work with who's a constitutional lawyer. He helped me do all the research on this. We have a two page summary of all the different rules. I will summarize. Before the party convention, the parties have a lot of flexibility, if they choose to exercise it, to just kind of come in and name replacement candidates. And they can even do that after the last primary, so that the—they're not—the Democratic nominee could be somebody that never ran in a primary and didn't even get vetted at the convention. So up until the convention, there's a lot of flexibility for the party to change nominees. After that, it gets really complicated. And what we do is we walk through in the piece all the different word permutations that would end up with a contingent election in the house. A lot of you that read The Eye on the Market have seen me write about that before.

A contingent election is where every state delegation in the house gets one vote. So California gets one vote for all of its legislators and Alaska gets one vote for its one legislator. And whoever wins the majority of the 50 legislatures becomes president. Right now, 26 to 27 state delegations are controlled by Republicans, but a contingent election would be based on the constituent of the House after the next election.

But, if that balance of power remained the same, the GOP would control the outcome of a contingent election. And I think it's interesting to kind of follow the money here because some of the money that is funding some third-party candidacies and no labels movement and things like that, may be somewhat disingenuous in the reasons why. Not the people necessarily that would run, but the reasons why some of the money is being put up.

In any case, I think it's very—I think it's important for us all to understand the very complex rules around this. In addition, issues around faithless electors, can they switch electoral votes from certain parties? It depends on the state rules. So we have a summary. If you're a glutton for punishment and you want to read about this stuff and understand it, we have that in this week's—in this month's Eye on the Market.

I get asked a lot about. China and Taiwan, again, a topic about which there are certain things I can't say, and there are certain things I can say. I can say this empirically, just looking at information, China has been expressing in a couple of different ways that its geopolitical interests and economic interests are increasingly divergent from the West. So, one chart we have in here shows after Russia invaded Crimea in 2014 the West generally slashed bank lending to Russia. That was more than offset by increased Chinese lending to Russia. And then there's another chart in here that shows, believe it or not, in the year 2000, North Korea still had enough friends in the world that China only represented 25 percent of North Korean trade counterparties.

Now that number—that number has been averaging over 90 percent over the last decade. So China is basically North Korea's main economic sponsor at this point. And so I would describe that as another example of its geopolitical interests being in stark contrast with the U .S. So, that said. Here's what I can say on China and Taiwan, recent polling of Taiwanese citizens shows that about only 11 percent are in favor of reunification, 27 percent for the status quo, and almost 50 percent for independence.

That's a red line for China based on statements that have been made at various levels of the government. So this is potentially a geopolitical flashpoint. CSIS, which is different than SAIS, but is probably the preeminent think tank in the U.S. on defense issues, did an analysis about what would happen if China invaded Taiwan in 2026.

They assumed that three things. Taiwan vigorously defends the mainland against Chinese ground forces, the U.S. immediately gets involved militarily by striking the Chinese fleet, and that the U.S. is permitted by Japan to use its bases for aircraft operations and, and maybe even the Japanese defense forces join in.

Even with those three assumptions CSIS found that Taiwan could potentially retain its political autonomy, but at an enormous cost to the United States, to Taiwan and to China. And we walked through in this eye on the market, you know, what their different analyses showed in terms of Chinese bombardment of Taiwan's Navy and its air force. Chinese soldiers crossing the straits. But they believe that the Chinese invasion would founder mostly because of U.S. submarines, bombers, and attack aircraft reinforced by Japanese self-defense forces cripple this amphibious fleet.

The bottom line is in this scenario, Taiwan's political autonomy survives, but the U.S. and Japan lose dozens of ships, hundreds of aircraft, thousands of servicemembers, and which would damage the U.S. global position for years, uh, and in just three weeks, the U.S. would suffer about half as many casualties as it did in 20 years of war with Iraq and Afghanistan.

And to be clear, the United States does not have a defense treaty explicitly with Taiwan, and so it's very much conjectured by CSIS that That the U.S. would come to Taiwan's defense. But I thought it was important to kind of understand the latest risk assessment of how a military operation would play out, given 20 years of growing defense spending in China.

Last couple of things and I'll wrap up. The U.S. is eventually going to have to deal with the federal debt, you know, and when? Well, sometime before 2034, let's say. Right now the CBO is projecting that in the early 2030’s, 2033, 2034, entitlements plus interest on the debt will be more than all federal revenue collection. So, there won't be any money left for defense or non-defense discretionary spending unless the country wants to run, you know, enormous deficits, in perpetuity.

And I think before this crossover point hits a combination of the bond markets and the rating agency downgrade threats will force the United States to make some painful adjustments. And what might those look like? I put some of them here. This is stuff that I've been studying for the better part of a decade because, I expect to be retired by when this happens. But just in case I'm not, here are the things that will—that could pop up.

Eliminating or raising the cap on income used to compute social security contributions. Raising the payroll tax means testing of 401K contributions. Either a lifetime or an annual cap. Further limits on itemized deductions like mortgages and charitable contributions. A federal tax on municipal bonds for people that make more than $250,000 a year. Unifying capital gains and income taxes. There are lots of economists out there that talk about the capital gains loophole, quote unquote, because they believe it's a loophole for the rates to even be different.

And then value added taxes, carbon taxes. And then, with respect to wealth tax, there's a lot of constitutional issues. Right now there's a case before the Supreme Court, involving the tax act in 2017 that may have a bearing on whether or not those wealth taxes are constitutional or not.

All the things I just mentioned would be policies to raise revenue. And then policies to reduce entitlement is expending would include means testing of Medicare outlays based on your lifetime income, higher Medicare co pays and deductibles for everybody, caps on Medicaid spending. A lot more government price setting, which just started last year. Remember handful of generic drugs starting in 2030, but that's just the beginning. And then higher Medicare eligibility age, higher social security retirement age, change CPI for social security. So there's, there's lots of levers that the federal government would have to use.

The scary part is they'd have—the debt's gotten so big, they'd have to pick from multiple ones of these two menus and not just a couple. And that's how much would be needed in order to stabilize the debt situation.

The last question is one that I pose to myself, which is, do I have anything else to say on the United States at Thanksgiving? Uh, yes. We have a chart in here and, you know, to be clear, you know, the United States has a lot of political, financial, racial, judicial, and social problems and inequities. That said, there are a lot of people that are very thankful to live in the United States. And I'm saying that empirically. I'm not making a value judgment. I'm saying that empirically because we pulled up this database that you can get from the UN and looked at the entire stock, not the flow, but the entire stock of people that have moved from one place to another place that are still alive.

And so we looked at the ratio by country of people that have gone there. And people that have left there, so migrants divided by immigrants, and the United States has a higher ratio of people that have moved to it than have left it than almost every other country in the world and—and by a very wide margin.

And, so, you know, the United States remains a beacon for people to come to and not leave. And, the other thing that I think is kind of amazing is if people choose to, you don't have to, but if you choose to, once you get to the United States, you can create a completely new American identity and you can decide that you want to support, regardless of your prior background, you want to support American self-interests, American soldiers, American communities, and leave behind historical antagonisms, foreign allegiances, and confine your political litmus test just to issues related to the success of the American experiment.

And I think that that's a kind of an amazing thing that we should be thankful for on Thanksgiving.

Just to two quick follow up items and I'll close, the next Eye on the Market in December will be a review that we do every couple of years on alternative investments, you know, hedge funds, private equity venture. And then the last thing is I want to wish Rachel a happy 30th anniversary and I'm putting this in here to see whether she watches all the way to the end of the podcast. So this will be an interesting test to see if she does that.

Thank you all for listening. And I look forward to talking to you all again soon. Bye.

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