April 30, 2019

April 2019 Summary Report

Macroeconomic Risks and Geopolitical Dynamics

April 30, 2019

OVERVIEW

In keeping with the Grey G Capital Research framework, this report focuses on short-term macroeconomic dynamics in terms of how they relate to deeper capital market trends. As part of our analysis, these capital market trends are closely correlated with emerging trends in international relations.

Our focus is on how short-term trends fit within a longer-term process of capital market expansion and international integration. We highlight major cyclical challenges that relate not only to what is widely recognized as the current late point in the US economy's business cycle. In addition to market and macroeconomic indicators of this cyclical dynamic, the ability of policymakers to counter cyclical pressures are a central focus of this report.

Following a macroeconomic and capital market overview, we conclude with analysis of geopolitical shifts in April 2019. Similar to our examination of potential "late cycle" market and macroeconomic instabilities, our framework approaches geopolitical trends as part of a possible "late cycle" dynamic in international relations. Related instabilities have the potential for major market and investor implications, and we highlight opportunities and risks.

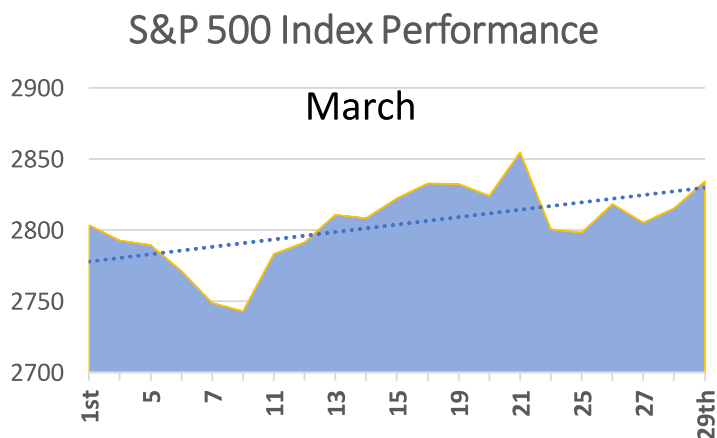
SUMMARY

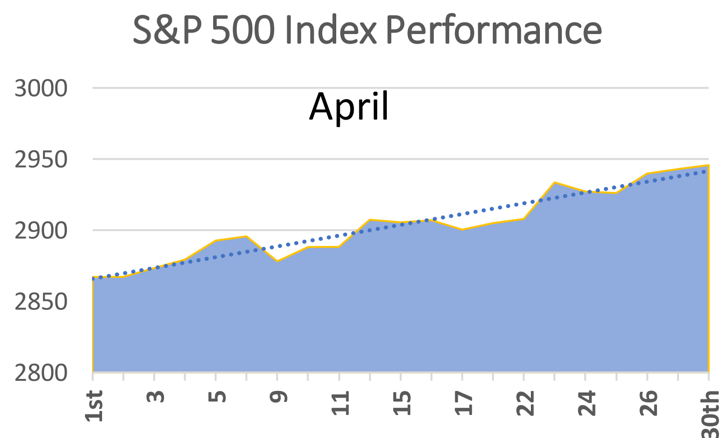
In April, the US macroeconomic situation appeared on its surface to have re-established **a "sweet spot" of equity market all-time highs, robust GDP growth, record low unemployment, yet low inflation**. Grey G Capital Research, however, has identified significant structural weaknesses behind this headline data.

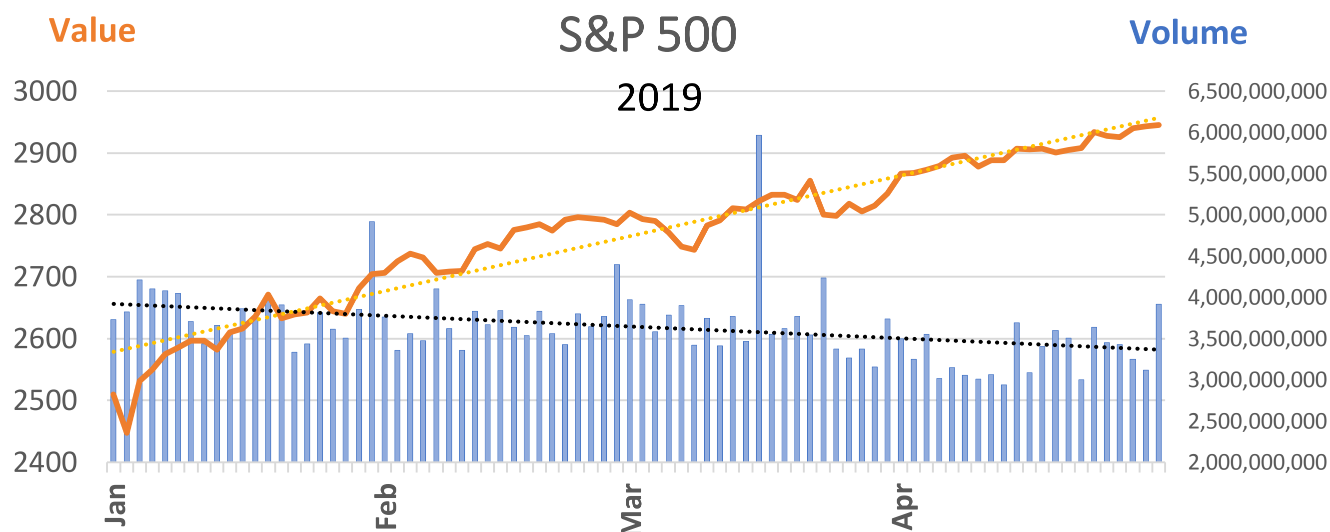
These underlying weaknesses in short-term market and macroeconomic trends are of particular concern given the development of what we view as longer-term market and macroeconomic imbalances. While our bias is not inherently bearish, a critical focus of Grey G Capital Research reports is the consideration of major downside scenario risks and probabilities.

US capital markets advanced steadily in April, following a positive trajectory similar to the trend established in March but with significantly less volatility. Despite this April drop in volatility, it is worth noting that the upward trend in US equity markets which began in January 2019 has recently been characterized by a decrease in overall trading volume. This technical indicator of waning positive market momentum - even as the market has established unprecedented index highs - **represents a potential signal of a reversal in market sentiment.**

Waning momentum in the market's rally may seem unsurprising given the extraordinary strength of market gains in the first quarter of 2019. This technical momentum shift merits special attention, though, given some **weaknesses in underlying macroeconomic fundamentals per April data**. Our analysis of longer-term capital market and geopolitical cycles also indicates latent negative pressures beyond what would be indicated by recent strong headline numbers.







Significant Potential for Stimulus

On a positive note, **April data indicated there remains significant potential for policymakers to reinforce short-to-medium term economic growth** via both government spending and monetary policy. News of a bipartisan agreement-in-principle on April 30th between President Trump and Congressional leaders to spend $2 trillion on infrastructure investment highlighted this potential. Detailed analysis of April GDP data also indicates that **federal non-defense spending is a major untapped possible contributor to GDP growth**.

Low inflation data released in April has reinforced the potential for further monetary stimulus. **Persistent low inflation is conducive to a sustained low-interest-rate environment but should also be seen as indicative of strong deflationary pressures in the US economy.** These pressures pose a significant underlying challenge to sustained US economic growth, and hint at the scale of the challenge the US economy and policymakers may face.

Monetary Policy Constraints

The ability of monetary policy to adequately respond to these pressures could face serious constraints. With the Fed funds rate currently targeted at a maximum of 2.5%, there is little room to cut rates - particularly when compared to the level of interest rate reductions that have been required to respond to previous recessions.

Dollar strength has also been a key contributor to low inflation, suppressing increases in the cost of imported goods even as US tariff levels have risen. **Should expectations of US rate reductions accelerate and lead to significant flows of capital out of dollar-denominated assets, inflation data may appear less benign.**

This dynamic has thus far not emerged, but other geopolitical-related dynamics may prove to have a limiting effect on Fed policy and pose significant macroeconomic challenges. **Geopolitical tensions remained relatively muted in April but**

evolved during the month in a way that is a strong indicator of looming instability.

Evolution of the Venezuela and Russia Dynamic

Of particular importance is the push on April 30 by the Venezuelan opposition to engineer a popular and military uprising. While the outcome of this evolution is unclear and appears unlikely to immediately affect Venezuelan oil production in a significant way, **the possibility for the Venezuelan situation to lead to deterioration of US relations with Russia is a critical focus of Grey G Capital Research**.

We see a significant potential for oil markets to be cumulatively impacted short-to-medium term by a combination of Venezuelan conflict, supply issues related to Iran, and geopolitical tensions with Russia. Though currently low probability, we identify **a tail end risk of geopolitical tension with Russia spilling into the oil market**, potentially even impacting US inflation and Fed interest rate flexibility.

Northeast Asia Geopolitical Deterioration

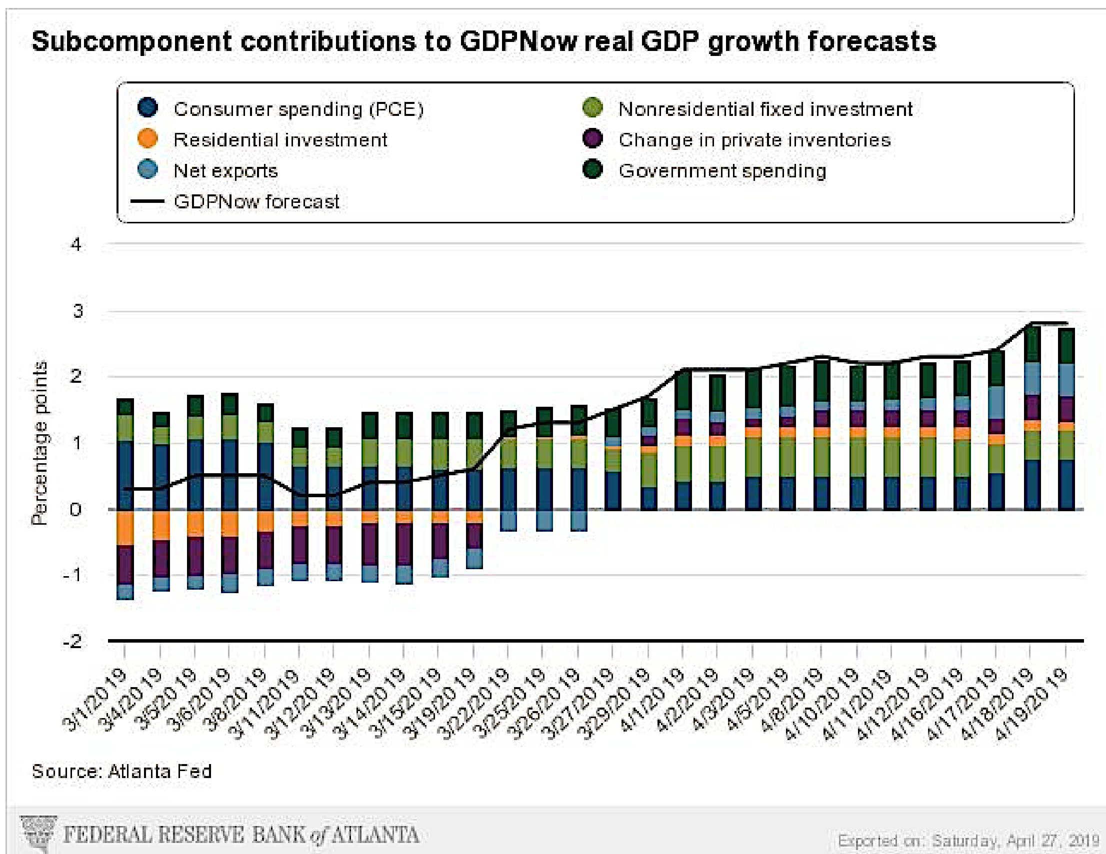
Geopolitical dynamics in NE Asia also evolved in April in a way that indicates a strong possibility of further deterioration. **North Korean regime behavior demonstrated in April a clear pattern towards an escalation of tensions with the US**, including in-person efforts by Kim Jong-Un to draw Moscow leadership further into North Korea's resistance to American pressure.

Trade negotiations with China continue to be problematic, with agreement proving elusive. Detailed analysis of US-China macroeconomic dynamics and the progress of trade negotiations indicates that any upcoming trade deal is unlikely to comprehensively address the underlying trajectory of increased China-US disputes. We further find a **high probability that prior to any agreement being signed there may be a significant headline deterioration of negotiations with short-term market impacts.** This is to a great extent because of how macroeconomic variables have evolved, as discussed in the next section of this report.

A Shifting Macroeconomic Environment

Coming into April, **economic forecasts saw substantial upward revisions** as first quarter concerns about weakness in macroeconomic growth abated. A combination of upward revisions in macroeconomic forecasts, an unambiguous March shift in Fed policy guidance away from a tightening bias, and ongoing positive market momentum combined to sustain bullish market sentiment in April. Talk even emerged of the possibility of a pending market "melt up."

However, a closer look at actual data for Q1 2019 as reported in April reveals underlying macroeconomic weaknesses.



Headline Macroeconomic Data Very Strong

Strong employment data and a high GDP growth rate alongside a lack of inflation appear on the surface to indicate broad and sustainable macroeconomic strength in the US economy. Data released in April further indicated that during the first quarter of 2019 all four categories of economic activity that define GDP recorded positive growth, contributing in a fairly evenly distributed manner to the overall GDP growth rate.

With growth in private consumption representing 24% of the overall quarterly GDP increase, headline private investment numbers were on their surface impressive and contributed another 30% of the quarter's increase in GDP. Growth in government spending accounted for 12% of total GDP gains. Significantly, **a change in the overall net export numbers of the US economy was the single largest contributor to GDP growth in the first quarter of 2019.**

This relative increase in exports and drop in imports represented nearly 40% of overall growth in the US economy. The importance of the external sector in recent GDP performance will be discussed further later in this report.

Beyond this encouraging quarterly headline data, American macroeconomic performance looked similarly encouraging and broad-based in strength in annual comparisons. From Q1 2018 to Q1 2019 virtually every category of GDP improved substantially.

	Quarterly % Change (from Q4 2018)	Annual % Change (from Q1 2018)	Q1 2019 Value (USD billions)	Share of GDP (Q1 2019)
Gross domestic product	***0.78%***	***3.21%***	**18,912.33**	
Personal consumption expenditures	**0.30%**	**2.74%**	**13,071.00**	**69.1%**
Goods	*-0.17%*	*2.90%*	*4,606.93*	*24.4%*
Durable goods	-1.36%	2.52%	1,669.23	8.8%
Nondurable goods	0.43%	3.09%	2,947.03	15.6%
Services	*0.51%*	*2.66%*	*8,487.62*	*44.9%*
Gross private domestic investment	**1.25%**	**5.71%**	**3,510.62**	**18.6%**
Fixed investment	*0.38%*	*3.02%*	*3,370.10*	*17.8%*
Nonresidential	0.68%	4.82%	2,781.99	14.7%
Structures	-0.20%	1.34%	540.429	2.9%
Equipment	0.05%	3.67%	1,296.74	6.9%
Intellectual property products	2.09%	8.85%	953.206	5.0%
Residential	-0.71%	-3.11%	596.146	3.2%
Change in private inventories	*32.63%*	*323.14%*	*128.389*	*0.7%*
Net exports of goods and services*	**-5.90%**	**-0.34%**	**-899.287**	**-4.8%**
Exports	*0.91%*	*2.33%*	*2,576.54*	*13.6%*
Goods	1.16%	2.44%	1,795.81	9.5%
Services	0.45%	2.13%	783.229	4.1%
Imports	*-0.95%*	*1.63%*	*3,475.83*	*18.4%*
Goods	-1.12%	1.41%	2,913.12	15.4%
Services	-0.21%	2.57%	562.18	3.0%
Government consumption expenditures and g	**0.59%**	**1.76%**	**3,207.68**	**17.0%**
Federal	*-0.01%*	*2.05%*	*1,237.92*	*6.5%*
National defense	1.02%	5.33%	761.38	4.0%
Nondefense	-1.52%	-2.55%	477.03	2.5%
State and local	*0.96%*	*1.59%*	*1,968.58*	*10.4%*

* for net exports, negative increase of a negative number represents a positive contribution to GDP growth

THE DEVIL IN THE DETAILS

A closer look at recent quarterly data paints a more nuanced picture of the macroeconomic health of the US economy.

Almost 72% of the increase in private investment (and 21% of GDP growth overall) was accounted for by a dramatic increase in private inventories. This line item of inventory changes within private investment is a minor share of GDP overall and historically very volatile: the $31 billion dollar increase in Q1 2019 came within a standard deviation of $59 billion in quarterly shifts over the last two years. **Increases in private inventories also tend to imply a drag on future production.**

Residential Investment Weak

In terms of other elements of private investment, **growth in both residential investment and investment in non-residential structures was negative**. Within non-residential investment, **only investment in intellectual property products saw a significant positive increase**. While this increase contributes to GDP growth overall and can be expected to contribute to productivity, flow-through of intellectual property investments may be less in terms of positive multiplier effects on other aspects of the real economy.

The negative trend in residential investment is particularly concerning as **this was the fifth quarter in a row of negative residential investment growth.** Residential investment has been negative for nine out of the last 12 quarters, and sustained negative residential investment numbers have been a key leading indicator of previous recessions.

Goods Consumption Negative

Consumer spending numbers were also weaker than the overall GDP growth rate would imply. **The sole contributor to what was a minor overall increase in private consumption was growth in the services sector**. Consumption of goods actually dropped.

Growth Dependent on Shifting Trade Balance

Alongside the increases in services and private inventories, **the single greatest contributor to Q1 GDP growth was a shift in net exports.** The US continued to run a substantial quarterly trade deficit of 900 billion USD (4.8% of GDP), but a marginal increase in exports ($23 billion) combined with a marginal reduction in imports (-$33.7 billion) to contribute a 60-billion-dollar accounting boost to GDP (nearly 40% of the quarter's overall GDP growth).

This critical contribution of net exports to overall growth - and the projected continued significant contribution of this component to GDP growth figures moving forward - has important political implications that are highly relevant to the Grey G Capital Research framework.

A Coordinated Policy Outcome

In the immediate aftermath of President Trump's election, our reports highlighted the centrality that trade policy - in particular trade policy vis-a-vis China - was likely to play in Trump administration strategies to boost overall GDP numbers. **The recent shift in GDP growth and its dependence on a decrease of the US trade deficit may represent the fruition of Trump administration efforts**. Prior to discussing geopolitical implications - in particular for the outcome of negotiations with China - an assessment of other possible explanations is worth exploring.

Increased US exports may simply reflect increased economic strength and consumption overseas. The Q1 2019 growth in US exports does approximate IMF global growth estimates, and it appears thus that trade policy may not necessarily be responsible for the increase in US exports. But **US exports don't seem to have suffered significantly in terms of global retaliation against US tariff policy**.

On the other side of the increase in net exports, a relative reduction of imports into the US could simply reflect a general weakening of goods consumption in the US

economy. As has been noted, overall goods consumption in the US economy as reported in April was negative during the Q1 2019, decreasing by -0.17%. Imported goods, however, decreased at a significantly higher quarter-to-quarter rate of -1.12%. This **significant reduction of imported goods appears to have been driven by something beyond the overall reduction in US demand for goods.**

"Winning" the Trade War

In terms of boosting GDP growth numbers by improving the economy's net exports, **recent GDP data may be interpreted - particularly within the White House - as evidence that the Trump administration is "winning" its trade wars.** Economic theory would imply a more complex reality, with costs to the US economy medium- and long-term that are not immediately apparent in these headline GDP numbers. Nonetheless, the strategy's apparent success in boosting GDP numbers can be expected to shape ongoing Trump administration policy.

This is particularly important in terms of ongoing trade negotiations with China. Initial analyst consensus after President Trump's election was that his administration was unlikely to actually pursue aggressive trade policies with major global partners (Grey G Capital Research highlighted this perception early as a likely misreading of administration strategy). After the administration did in fact initiate what most analysts viewed as adverse trade policies, consensus then shifted to an expectation that trade tension would be short-lived and a trade deal with China was pending.

The importance of continuing to drive a positive shift in net exports as a critical component to deliver headline GDP growth should not be underestimated in terms of its impact on Trump administration strategy and Chinese trade negotiations.

Deteriorating Context of US - China Negotiations

From the perspective of a cost-benefit analysis, a trade deal with China has potentially significant costs for the Trump administration - particularly if the deal does not markedly advance stated priorities yet gives China renewed full access to the US market. These costs are not only political in terms of being able to cite a US victory in negotiations.

Reducing tariffs on Chinese goods and any resulting increase in imports from China could entail significant economic costs in terms of how this might limit the ability of the administration to deliver impressive US growth numbers. As noted, GDP growth numbers are increasingly dependent on an improvement in the net exports position of the US economy. **There is thus a built-in incentive for a hard line in trade negotiations with China.** This dynamic is likely underappreciated in consensus expectations of a quick trade deal.

At a minimum, this dynamic can be expected to lead to a harder line in Trump negotiating positions - likely to the surprise of many market participants. Such an outcome appears likely not only because trade negotiations have thus far seemed characterized by Chinese intransigence on major underlying economic issues. Progress on the elimination of structural subsidies for Chinese industries appears to be elusive, as has resolution of IP-issues related to data and the development of the US and Chinese AI industries.

IMBALANCES IN RELATIVE NEGOTIATING POWER

Another likely indicator of a hardening US negotiating position is the distinct imbalance of power in terms of Chinese dependence on exports to the US vs. US dependence on exports to China. While exports to the US have hovered in the 18-20% range of total Chinese exports with no major structural change during negotiations, US exports to China currently account for only 6.8% of total US exports. This share of US exports has trended downwards by nearly a third since the beginning of the Trump administration.

Whether this relative reduction in US exports to China is indicative of a more effective targeting of American goods by Chinese authorities or a structural shift by American exporters away from the Chinese market, there is a clear discrepancy of negotiating power. **The Chinese economy is significantly more dependent on and remains vulnerable regarding exports to the US in comparison to American dependence on the Chinese market.**

To make up for this discrepancy of potential economic concessions and leverage, Chinese authorities have been pressed on a variety of geopolitical positions. None of this pressure seems to have resulted in sustained progress. The recent deterioration of negotiations with North Korea should be considered in this context.

THE IMPORTANCE OF NORTH KOREA

Facing retrenchment by North Korea regarding denuclearization, President Trump has framed ongoing progress in terms of his confidence that Kim Jong Un will "keep his word." This is a not-so-subtle negotiating strategy that implies a significant loss of face for Kim should negotiations fully break down. This strategy may backfire in terms of Kim's personality, but it should also be seen as a warning to Chinese leaders.

Efforts to denuclearize North Korea are but one element of a complex coordinated strategy by the Trump administration to engage threats it sees emanating from Northeast Asia. Any perceived Chinese failure to help resolve the North Korean issue should be considered in this context. **Geopolitical deterioration with North Korea is a precursor to further tension in the US-China bilateral relationship**, and at a minimum this may engender a harder US negotiating line. It might also lead to a willingness of Trump administration negotiators to walk away without a comprehensive trade deal. This would likely surprise many market participants.

THE IMPORTANCE OF RUSSIA

The visit by Kim Jong Un in April to meet Russian leadership in person in Vladivostok was a clear effort to gain support for North Korean resistance against American pressure. This move in itself should be seen as a clear signal of a likely imminent deterioration of the geopolitical situation in NE Asia, regardless of Russian intentions regarding North Korea denuclearization. However, **it is Russian actions regarding Venezuela that may pose a significantly greater macroeconomic and geopolitical risk.**

As opposition leaders launched efforts to overthrow the Maduro regime in Venezuela at the end of April, the Trump administration issued a very strong warning to Cuba: no foreign intervention, particularly of foreign military troops, would be tolerated; all foreign troops must be immediately withdrawn. The US also expressed a

willingness to use all measures available in response to foreign military intervention in Venezuela, to include the application of crippling sanctions. This may portend a deterioration of US-Cuba relations, **but the message to Cuba was likely intended for Russian ears.**

This highlights a tail-end risk that Grey G Capital Research believes may currently be underappreciated in markets. Any breakdown of dialogue with North Korea or China might lead to increased tension and could certainly have an impact on global markets. But despite current challenges faced by the US economy, the immediate US macroeconomic impact of such an outcome might to a great extent be mitigated by policymaker stimulus efforts.

A significant deterioration of geopolitical relations with Russia, however - as could be expected should Russia intervene further in Venezuela - could be significantly more challenging. This likely would entail severe consequences for the global oil market, and even just talk of sanctions against Russia's oil industry can be expected to have major destabilizing effects.

Potential Convergence of Oil Supply Risks

As noted previously, this represents a tail end risk that we gauge to have a very low current probability in terms of an ultimate outcome being sanctions on Russian oil exports. However, **there is likely a significantly higher probability that such a possibility will drive speculative activity in markets**, particularly should Russia make moves towards intervention in Venezuela. Though Venezuela production represents just three percent of global oil production (per US IEA data), this dynamic comes at the same time that US policy is pushing to fully isolate Iranian production from global markets. The pending visit of Iran's foreign minister to meet with his Russian counterpart in early May seems a potential indicator of instability at this end of the oil market.

Though currently a tail end risk, should Russia intervene further in Venezuela a path is foreseeable whereby sanctions target Venezuelan oil exports (3% of global supply), Iranian oil exports (5% of global supply), and Russian oil exports (14% of global oil supply). These recent production numbers per the US Energy Information Agency likely overestimate the extent of global oil production that might be withdrawn from world markets. This very low probability outcome is nonetheless worth tracking given the outsized effect it would have on world markets.

Despite the low likelihood of this ultimate outcome, any further intervention by Russia is likely to increase talk of such an outcome and thereby have a destabilizing effect on world markets. **This risk is particularly challenging since any associated significant increase in global oil prices could be expected to have an inflationary impact and threaten the ability of US monetary authorities to use rates flexibly to stimulate the US economy.**

OUTLOOK AND PROJECTIONS

Detailed analysis of debt and asset markets per the above and other points, as well as market projections, are reserved for Grey G Capital Research clients. Public release of research and the above summary is delayed to maximize client value.

For further information on Grey G Capital Research client options or bespoke research possibilities, please contact: client.relations@greygcapital.com

Further discussion or comments on points covered in this research summary are welcomed by the report's editor and principal author, Mark Reedy. Contact at: reedy@greygcapital.com

This report builds on previous Grey G Capital Research monthly and special reports, including:

"Geopolitical Shifts and Secular Bull-Bear Market Dynamics"
(Grey G Capital Research, October 2018)

"Implications of Global Economic Imbalances and the US-China Dynamic"
(Grey G Capital Research, November 2016)

"Mini-Market Cycles vs. Bull Market Momentum: a 'New Monetary Reality' and Possible Lessons from Japan"
(Grey G Capital Research, September 2016)