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July 1, 2020

Macroeconomic and Geopolitical Risk: Review and Outlook

1Q-2Q 2020

Summary

Given the immense psychological and market volatility of the first six months of 2020, it may be hard for many to fathom that **US equity markets are currently only marginally below where they began the year** (the S&P 500 closed at 3258 on Jan. 2; at 3100 on June 30). This apparent disconnect between market outcomes and underlying fundamentals is often attributed to the massive liquidity measures undertaken by the Federal Reserve during the 2020 COVID crisis. Our further assessment is that **current market levels reflect a previous overestimate of the severity of COVID-19 and its impact** on the US economy during the first half of 2020.

This assessment can be hard to reconcile with headline data that indicates a historic -35% drop in US GDP during Q2 2020 and massive unemployment. However, it is important to recall that these **headline data are the result of "lock down" policies that froze economic activity rather than voluntary changes in behavior by US consumers and producers**. Moving forward, macroeconomic risk will be driven not only by the legacy of these policy moves but especially the potential for any return to "mass quarantine."

No More Inefficient Quarantines

Our analysis has consistently indicated that lockdown policies as implemented in the US are an exceptionally inefficient means of responding to COVID. A return to this approach remains a threat due to political risk, but **the prospect of this source of economic damage is significantly reduced** given what is now a relatively well-established understanding of COVID-19 dynamics.

Interventions that prevent the buildup of concentrations of COVID in indoor environments through respiration have been clearly demonstrated to be the most efficient means of stopping the virus. These policies – most notably the use of masks in public indoor environments - offer **significant potential for COVID to be stemmed while economic activity is maintained in all but a few sectors**.

Though this assessment indicates a sustained negative impact on certain sectors – in particular public indoor food and beverage consumption – it implies a relatively limited impact on other sectors unless a major shift in consumer behavior materializes. **Political risk associated with previous policy missteps, misinformation, and a lack of effective leadership to guide the public towards implementation of these optimal policies now represents the US's primary short-term macroeconomic and epidemiological risk.**

Damage Less than Feared

Markets are typically forward looking, but extreme uncertainty during the COVID crisis has led to an unusual lack of direction and a dependence on backward-looking epidemiological and consumer data. Recent strength in retail sales and the real estate market indicates that - beyond headline unemployment numbers and production losses resulting from lockdowns - **the lasting macroeconomic damage of COVID is likely not as significant as feared thus far**. This data-driven market optimism is reinforced by careful analysis of COVID death and infection data, which similarly indicates **a significant gap between perceived epidemiological impact vs. reality**.

COVID death counts have unfortunately become a political topic rather than a purely scientific one, but our analysis of **excess death data indicates the actual mortality of**

COVID is likely to prove significantly lower than expected, other than in a few key jurisdictions. Similarly, relatively simple interventions of indoor mask usage have demonstrated **a clear potential to thwart the virus's impact**.

US GDP is forecast to drop by an astounding -35% in 2Q 2020, but this is significantly better than early June forecasts*. **The financial and macroeconomic impact of previous anti-COVID measures appears to a great extent to have been absorbed and compensated for by a resilient US consumer and government stimulus.**

This optimism that data is indicating things are much better than feared is balanced by a variety of concerns coming into the second half of 2020. **The sustainability of this first-half of 2020 dynamic can be expected to come into question should epidemiological data deteriorate markedly.**

Epidemiological Trends Not Dire

Our analysis continues to indicate that **current epidemiological deterioration is not as dire as headlines imply, epidemiological stabilization is well within reach, and the primary risk of epidemiological deterioration is in the fall when seasonal factors shift**. The primary risk to sustaining this positive short-term perspective is the prospect that necessary measures will not be taken to achieve optimal epidemiological outcomes due to political instability, combined with the potential that **withdrawal of Pandemic Unemployment Insurance will soon remove a key support of consumer spending**.

These conventional concerns are complicated by ***significant political risk scenarios we think have the potential to develop into strong bearish pressures*** *during the second half of 2020.*

Market Political Risk Scenarios

The first of these scenarios relates to what we see as **a significant market underestimation of the potential for acute conflict to break out between China and the United States**.

Alongside COVID and liquidity data, **market participants have appeared focused on continued progress in the implementation of US-China trade agreements as a source of confidence**. This severely underestimates the extent to which US-China relations have deteriorated since the onset of COVID, and in the past two months in particular.

Traditional political risk assessments that US-China relations are evolving along the lines of a Cold War 2.0 significantly misread deeper US-China strategic dynamics. As a result, we believe the potential for an acute deterioration in US-China relations has been significantly underestimated - particularly under a scenario of the re-election of President Trump.

Should a scenario emerge that President Trump is not re-elected, we expect any potential temporary defusing of US-China tensions to be more than offset by **the threat of a shift in policy priorities and the domestic business environment under Democratic leadership**.

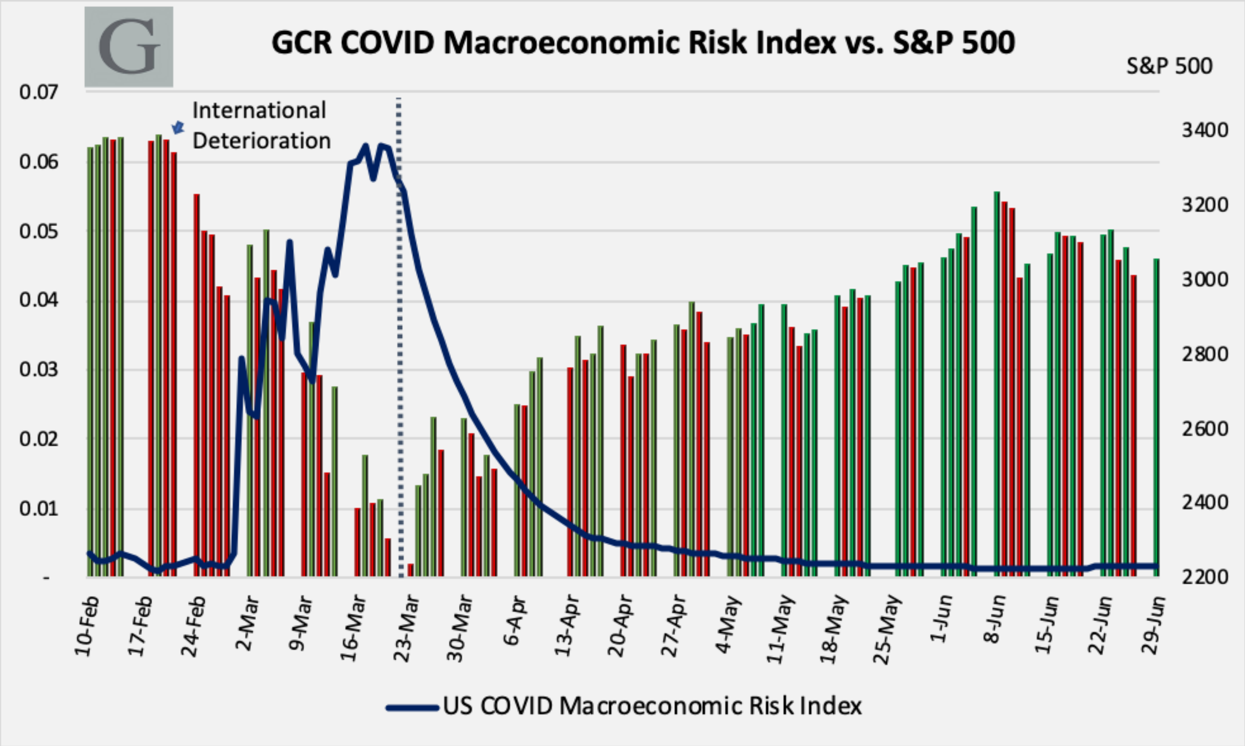
* Source: Atlanta Fed GDPNow forecast

A rapid shift in tax structure and the regulatory environment is a major threat under this scenario, with extensive market implications.

In summary, we currently see markets as experiencing **positive short-term momentum due to a realization of actual COVID dynamics** but facing a combination of two contending bearish pressures medium and longer term: **US-China dynamics can be expected to significantly deteriorate if President Trump is re-elected**; but the **domestic US business environment can be expected to significantly deteriorate if Biden is victoriou**s.

QUANTIFYING THE MACROECONOMIC RISK OF COVID INFECTIONS

The below graph highlights US macroeconomic risk related to COVID infections per Georgetown Capital Research's proprietary US COVID Macroeconomic Risk Index. The index spiked rapidly in March in correlation with the major market drop but has since steadily reduced alongside the recovery of equity markets. **Despite widespread reports of a second wave of COVID infections, our index has indicated only a marginal increase in economic risk.**



This divergence is in part explained by the dynamic we forecast in our May 8 report: **the bulk of rapid infection increases in the US over the last two months have occurred in states that are of minor economic significance**. Our COVID Macroeconomic Risk Index assesses the speed of infections' exponential growth in all US states but adjusts each states' index weight to match its contribution to GDP. This captures that **the overall**

impact of recent spikes in infections is of limited current economic significance despite the dire headlines we advised in our May 8 report were likely to emerge.

Assessing Epidemiological Risks

California, Texas, and Florida are the individual states that currently contribute the most to our risk index given their importance in GDP. However, though these states have seen a recent acceleration in COVID infections, **the exponential growth of the virus in Texas and Florida is currently less than a fifth of early April levels, and in California less than one tenth**.

Per epidemiological best practices, we measure infection numbers in logarithmic terms to assess the exponential growth of the virus. The recent spike in infection rates has been significantly less than what was previously seen in the economically critical states where COVID first hit, per this analysis.

The spread of the virus is clearly not "accelerating" markedly in the US, but these small marginal increases are now coming on a large base of infections. This can result in a large increase in case numbers that place significant pressure on health systems, even as the virus is having difficulty replicating.

Risks Related to Health Care Systems

Due to these absolute numbers of new infections, **there continues to be a risk that officials concerned with health system overload will return to economically destructive "lock down" policies**. The underlying problem, however, should be understood currently less as a virus acceleration and more a failure to develop health system capacity since COVID emerged.

With loose mass lockdowns fundamentally inefficient in preventing the spread of COVID, it is increasingly critical to implement the primary policy that has proven effective at stopping the virus's spread with minimal economic damage: use of face masks in enclosed areas. **Any indoor or mass outdoor activity that does not allow for face mask usage – notably the social consumption of food and beverage – can be expected to continue to suffer a significant economic impact as effective COVID mitigation policies advance.**

The Continued Scale of the COVID Threat

Concentration not Prevalence

COVID is now extremely prevalent in the US; however**, it is the concentration of the virus in environments as opposed to overall prevalence in the population that poses the actual health threat**. It increasingly appears exposure to a small level of virus particles is common and sustainable for most individuals. **Exposure to high concentrations of the virus is the primary factor leading to an individual's immune system being overwhelmed and the potential for hospitalization.**

Effective policies in the US must thus focus on limiting concentration of exposure as opposed to absolute elimination of the virus. **Any enclosed space where multiple individuals are gathering in close proximity and breathing without face masks poses the**

greatest risk of concentration. These environments have been identified as the primary source of "super-spreader" events.

Measures that minimize the potential for virus concentration to build – most importantly **the wearing of face masks to minimize contamination in enclosed spaces – allow concentrations to be limited dramatically even with social interaction**. The US unfortunately faces a significant challenge in implementing face mask usage, given the level of misinformation and misguidance that has circulated regarding COVID.

Increase in Prevalence Can Be Positive

This challenge is compounded by the fact that **optimal policy would in fact encourage low levels of exposure in individuals that are not susceptible to severe complications**, as a way to build up individual resistance and herd immunity that minimizes the number of potential carriers in the population long-term. This policy prescription is balanced by a reality that as-of-yet it is unclear how long COVID remains in an individual's system and they might be infectious. Nor is it established how long individual "immunity" lasts. **Even individuals that have proven resilient to infections at low concentration levels of COVID exposure might be overwhelmed by high concentrations of the virus.**

Non-Linear COVID Dynamics

COVID infection has proven to be not a linear up or down dynamic characterized by binary absolutes, but rather a cyclical process. This has been captured in significant challenges with testing accuracy both for infections and antibodies, as well as recurrence of symptoms in individuals previously thought "cleared" of COVID.

The complexity of this dynamic and its communication to the public is further complicated politically by the fact that COVID deaths have likely been severely overestimated.

The Actual Impact of COVID

We reach the above conclusion based on a review of CDC data that assesses excess deaths, i.e. the amount of deaths that have occurred in the US during the COVID pandemic vs. the average amount of deaths over the same period in previous years.

Death Toll Appears Overstated

As of Jun. 20th, the CDC estimates that deaths have been 103% the average level in the US since Feb 1. This represents a 3% excess death rate, equaling **just under 37,000 excess deaths in the US**. This is **vastly different than the well-over 100,000 deaths commonly reported as attributable to COVID in the US.** These excess deaths are also highly concentrated in just a few jurisdictions, in particular New York City (208% of expected deaths), New Jersey (143%), and Massachusetts (123%).

This gap between the number of excess deaths vs. the number of deaths reported as due to COVID has multiple possible explanations. Our primary conclusion is that this represents another **indication that COVID is far more prevalent than has been widely appreciated**, with its presence and the presence of COVID-related symptoms leading to the virus being documented as the cause of death even if it was not the proximate cause.

Another possible explanation is that lock-down policies reduced human activity, thus reducing baseline deaths below that of previous years. This is contraindicated by the fact that areas where no lockdowns were implemented have deaths below previous years' levels. Furthermore, motor vehicle deaths typically account for less than 1.5% of total US deaths, and deaths from all "unintentional injuries" related to common activities account for only 5% of deaths.

Heart disease, cancer, chronic respiratory disease, stroke, Alzheimer's, diabetes, and flu are the primary causes of death in the US, all of which (as well as age) have been cited as statistical "risk factors" leading to severe COVID complications. Fundamentally, they are in fact risk factors leading to death.

Political risk is a key focus of this report, but our purpose is not to get involved in political arguments, rather to merely ensure data is accurately assessed. Based on this assessment, **it appears US metrics as a whole regarding COVID outcomes and infection levels are not as dire as commonly reported.** This is another potential source of recent market optimism vs. public perception.

US Relative Performance and Strategy

We see US relative performance in tackling COVID as a long-term political risk factor due to its potential to discourage adoption of American values and governing norms.

Even with the above caveats about infection levels and numbers of deaths, **the US has underperformed a significant portion of the world in terms of minimizing the health impact of COVID**. Two districts within the US have by far the highest numbers of COVID deaths as a percentage of their population of any jurisdiction in the world: New Jersey (168.8 deaths per 100k of population) and New York (161.4).

Similar and Often Better than Europe

As a whole, the United States has had 38.4 deaths per 100k of population – **a mortality level that is significantly below other nations**, including Belgium (89.3), the UK (65.3), Spain (60.2), Italy (57.6), Sweden (51.6), and France (46.0). US mortality levels are, however, **worse than most of the rest of the world, especially relative to East Asia** (0.7 deaths per 100k residents). These values are based off the high number of deaths reported in the US as attributable to COVID, which we have highlighted in the above analysis are likely misleading. **US numbers would be approximately 2/3 lower if based on excess deaths alone.**

Much worse than East Asia

In assessing repercussions of US COVID performance for political risk and the potential path moving forward, **the gap between US and East Asia performance in terms of mortality is particularly noteworthy**: East Asia (0.7 deaths per 100k population) vs. US (38.4 per 100k population). Even using the lower "excess death" metric for the US, this still indicates that the US has *at least 20 times the number of deaths per capita from COVID compared to East Asia.*

We believe **this performance gap has significant potential long-term global implications in terms of the attractiveness of US political norms vs. East Asian norms**, and perceived moral authority in policy prescriptions for governance issues. **This may prove to be the single greatest long-term impact of COVID.**

Financial Impact of COVID

We have highlighted that **significant previous misperceptions related to COVID might justify market optimism**, but we have not addressed the major financial impact that COVID has had on the US economy. In part, this is because **Federal Reserve actions have proven relatively effective at minimizing the macroeconomic flow through of COVID financial dislocation**, and the Fed has repeatedly indicated it is willing to continue to take all actions necessary to prevent COVID financial dislocation from evolving into a broad financial crisis.

Long-Term Challenges

We have doubts about the Fed's long-term capacity to do this given deeper long-term financial systemic pressures, as highlighted in our previous reports. We have similar **doubts regarding the capacity of the US Federal government to continue to implement massive stimulus efforts** as passed during the pandemic's early stages, due to both fiscal and political pressures.

However, these major issues do at least have **policy prescriptions that can continue to be pursued even if their long-term sustainability is questionable**.

COVID-accelerated Political Risk Dynamics

Of far greater short and medium-term concern are the political risk dynamics highlighted in this report's initial summary: **US-China dynamics significantly deteriorating further if President Trump is re-elected**; and **the domestic US business environment significantly deteriorating under a Democratic Party administration**.

The potential for markets to decline in anticipation of a restructuring of tax and regulatory policies under a Democratic administration is a complex topic that we will leave for a later report.

Risk of Acute Deterioration in US-China Relations

The deterioration of US-China relations is our focus to close this report as we believe it has been massively underestimated in markets.

With China regularly cited by President Trump as to blame for COVID-related problems in the US, there is broad appreciation that the COVID crisis has seen an increase in US-China tension. **The extent to which this deterioration of relations has accelerated on multiple fronts in the past two months appears significantly underappreciated.** This likely relates to a market focus on COVID and liquidity dynamics, alongside the fact that US-China trade agreements continue to be implemented.

Outside of trade, **Chinese policy turned markedly more aggressive in 2Q 2020**:

Multiple Chinese Moves in Q2

- China's implementation of "national security law" in **Hong Kong** has effectively absorbed the colony into the Party's security apparatus
- A premeditated ambush in mid-June by the PLA on **India** border guards in the disputed Galwan Valley has led to the first combat deaths between China and India in decades. This action was exceptionally brutal in nature, with Indian guards who were carrying no firearms per "tension-reducing" border policies beaten to death by PLA soldiers armed with spiked clubs.
- PLA aircraft made repeated forays in June into **Taiwan**-claimed airspace, well outside of established patterns.
- **Australia** has been targeted by a recent surge of Chinese cyberattacks.
- Chinese diplomats have overtly threatened **Canada** of "the consequences of endangering itself for the gains of the US" regarding its continued detention of Huawei executive Meng Wenzhou (daughter of an influential member of the Chinese Communist Party with strong PLA connections).
- Chinese authorities have repeatedly threatened the **United Kingdom** with severe consequences should it take "inappropriate actions" regarding Hong Kong or Huawei.
- China has expedited efforts to consolidate control in the **South China Sea** and heightened its Coast Guard presence and penetration of waters controlled by **Japan** near the Senkaku/Diaoyutai islands.

Though at an individual level some of these moves fit with previous Chinese actions, **the recent sharp shift in tone of Chinese diplomacy and the concerted nature of recent aggressive actions is highly unusual.** It also extends against nearly all perceived allies of the United States.

North Korea within Pattern

In addition to these direct actions ordered by China's Party leaders, **North Korea** demolished the inter-Korean liaison office with explosives on the same day that the PLA launched its attack on Indian troops. This North Korean action was allegedly in retaliation for derogatory propaganda pamphlets distributed from South Korean territory. However, it represents a significant deterioration in dynamics on the Korean peninsula, and its timing in tandem with China's attack on India is a noteworthy coincidence.

Misreading Cold War Dynamics

These moves have been widely characterized as Chinese pushback in response to perceived pressure from the US. Many analysts see these aggressive actions by China as reinforcing an assessment that a "Cold War 2.0" is emerging between the US and China. Our assessment is **this is a serious misreading of China-US dynamics, with major financial market and direct investment implications.**

A Crucial Distinction

Our assessment derives from a critical difference between US-Soviet Union dynamics during the Cold War and US-China dynamics now: **unlike China, the Soviet Union was never on a trajectory for its economic power and sustainable military production base to eclipse that of the US**.

This dynamic fundamentally changes strategic considerations, making it **crucial from a strategic perspective for the US to engage China sooner rather than later.** Cold War comparisons and expected outcomes are simply not tenable given this dynamic.

Our Assessment vs. Conventional Wisdom

Immediately following President Trump's 2016 election, we advised that campaign threats made by the then-President-elect to aggressively engage China should be seen as far more than bluster. When those threats were subsequently implemented in aggressive engagement of China on trade, markets responded very negatively.

Trajectory is Critical

We have continued to advise that this **trade engagement represents only one piece of a major deterioration in US-China relations that is evolving on a trajectory towards significant US-China conflict**. This evolution is far from linear but rather cyclical in nature, and **recent Chinese actions should be understood in terms of this pattern.**

Investors that fail to appreciate this trajectory and hedge themselves against its worst possible outcomes are likely making a significant strategic error.

Conventional Expectations of Trajectory

The potential for US-China conflict has been broadly dismissed as an unrealistic concern due to the scale of associated destruction, with **conventional wisdom evolving towards a sense that trade détente is leading towards a dynamic similar to what was seen during the US-Soviet Union Cold War.** Per this perspective, even as disputes periodically flare up in peripheral countries, actual armed conflict will be diligently avoided due to the prospect of mutually assured destruction.

Reinforcing this perspective is **an assessment that the nature of the Chinese Communist Party is fundamentally different than the Party in the Soviet Union**, insofar as "global Communism" and aggressive expansion is not its overtly espoused mission.

When seen from within the above prism, the recent flare-up of Chinese aggressive activities simply represents a Chinese response to President Trump's aggressive engagement during the COVID crisis.

Rapidly Shifting Psychology

One of the critical impacts of the COVID crisis which we have not covered - though we hinted at it in this report's opening line - is the significant psychological impact of the crisis and its associated social isolation. Economists and political scientists are not generally adept at incorporating and explaining psychological shifts within their models.

We are wary of anything that feeds into a shifting psychology that sees "China" as the enemy when in fact the adversary of the United States is the Chinese Communist Party, whose membership accounts for only 6% of the population of China. Nonetheless, there has been **a palpable shift in policy circles regarding China in recent years and COVID can be expected to accelerate this psychological shift.**

Reassessing Chinese Intentions

This shift recognizes that conventional policy has majorly misread China's trajectory with reform and modernization. In this context, it is critical not to misread China's recent aggressive policy moves by falling into the errors of previous analysis.

The dominant perspective in US administration policy circles currently is that the Chinese Communist Party has been disingenuously taking advantage of the US's good will to develop its economy, military, and national power – i.e. "biding its time" and "hiding its capabilities" as was outlined in Deng Xiaoping's famous 1990 "24 Character Strategy." That stratagem was marginalized as irrelevant by conventional policy makers for nearly three decades but has recently been in sharp focus.

In late June, Secretary of State Pompeo articulated this perspective that the US made a massive strategic error in believing the CCP ever intended to emerge as a cooperative partner and called on the entire world to confront China in unison.

Scenario of Escalation

Our assessment is that current US-China economic dynamics represent a sort of "calm before the storm." Should President Trump be re-elected, we expect this storm to begin to hit with full force. Even should Biden become President and US-China tensions appear to defuse temporarily, this should be understood as merely a cyclical pause within a longer-term trajectory of US-China conflict. This trajectory is driven by fundamentally irreconcilable differences between Chinese Communist Party political norms and authoritarian norms vs. US political norms, alongside Chinese territorial disputes with US allies.

Investors should structure and hedge investments in anticipation of this evolving dynamic, which has the potential to accelerate markedly should President Trump be re-elected.

About our Background in Preparing this Report

In addition to experience as an economist, financial analyst, and diplomat serving in China, GCR Director of Research Mark Reedy was a team leader in pandemic responses for the United Nations. He helped lead the development of infectious-disease prevention and treatment programs on behalf of the Global Fund to Fight AIDS, Tuberculosis, and Malaria on the ground in Equatorial Guinea, Central Africa. Subsequent work focused on advanced data analysis for the assessment of epidemiological trajectory, clinical operations, and best practices with a Gates Foundation / Clinton HIV-AIDS Initiative co-project called the Consortium for Strategic HIV Operations Research.