ALPINEMACRO
A Unique Mind On The Markets

Alpine's Special Report, "Three Macro Misperceptions" explains why the so-called "fiscal risk premium" is a flawed concept. We also address the general misperception that China's economy has fallen behind America's since the pandemic crisis. Finally, the report explains why rising tariffs, trade protectionism, and manufacturing rerouting are deflationary rather than inflationary.

SPECIAL REPORT

June 3, 2024

Three Macro Misperceptions

In recent years, our conversations with clients have often revolved around three major macro topics, namely: U.S. public sector debt, deglobalization and its long-term impact, and the secular trend in China's economy.

Specifically, there is strong, underlying apprehension about the long-term fiscal health of the U.S. economy, the potential inflationary impact of deglobalization and where China is going under President Xi Jinping.

In This Report

Although none of these issues directly affects financial markets on a day-to-day basis, they do matter hugely for the macro backdrop of investment markets and for long-term investment strategy.

Money Equivalence Of Public Debt

Is there a hard limit on government deficit and debt? The answer is no. We published a series of pieces on the issue of public sector debt, deficits, and fiscal policy[1], but many investors have not been convinced by our conclusions.

While most can see the central bank's role as the "buyer of last resort" for local currency public sector debt, they have a hard time believing that the debt load can always increase without any bad economic consequences.

How debt and deficit interact with the economy and central bank is fairly complex. To clarify the discussion, a simple thought experiment may be helpful:

Assuming there are two countries, Country A and B. Country A completely bans government debt and its budget deficit is entirely financed by money printing *via* a special account held with the central bank. Country B finances its fiscal deficit by issuing government bonds, but completely bans any central bank purchase of government debt.

We further assume that each year, both governments run the same amount of budgetary deficits, say at $100 each. How will these two countries look in the next five years?

- Country A has zero public debt, while Country B's debt load increases by $100 every year, so its total debt load will have jumped by $500 in five years. On the flip side, Country A's money supply will increase by $100 more than Country B's every year (assuming the money multiplier is 1). In five years, Country A's money stock will be $500 bigger than Country B's.

1 Please refer to Alpine Macro *Global Strategy Special Report* "What Debt Crisis?" (April 1, 2024) and Financial Times Op-Ed "Stop worrying about Chinese debt".

- Businesses and consumers in Country A will see their balance sheets increase by $100 in assets each year. These assets are either sitting in cash or in bank deposits, as there is no stock or bond market. In five years, their balance sheets will rise by $500 in assets, still either in cash or bank deposits.
- Similarly, Country B's private sector balance sheet will also gain $100 in assets per year. In five years, the private sector's bond holdings will increase by $500 (also assuming no equity market).

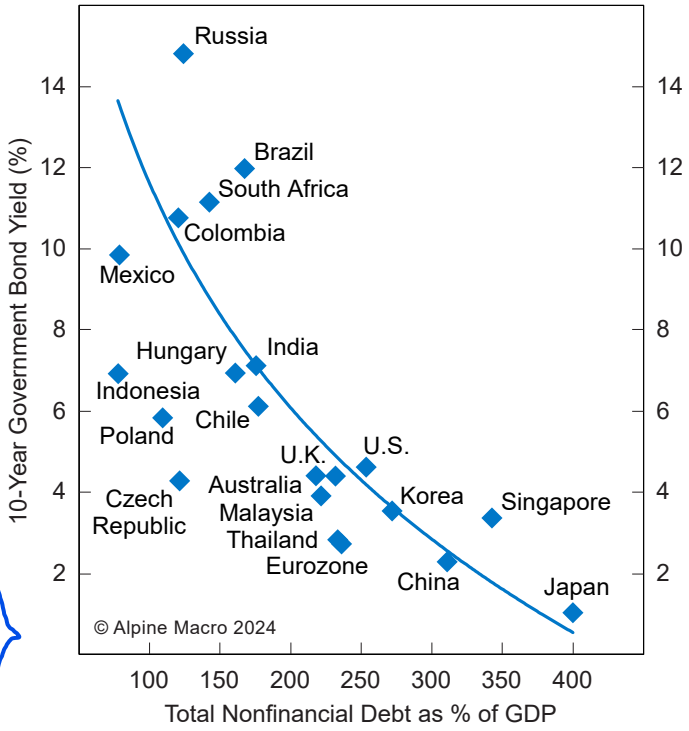
By the end of the five-year term, Country A will end up with a $500 expansion in money supply, while Country B will accumulate $500 more in government debt. In both cases, the private sectors have lent $500 to their respective governments. In Country A, the government borrowing is done *via* money issuance by the central bank. In Country B, it is done *via* the bond market.

Through this very simply model, the following points have become immediately clear:

First, it is silly to conclude that Country B's fiscal health is worse than Country A's because the former has a larger debt load than the latter. Here, the levels of public debt do not tell you anything about a country's fiscal condition. The structure of financial intermediation (in this simple model, A bans bonds, while B bans QE) determines why some countries have higher debt levels than others.

Here, the so-called "fiscal risk premium" based on debt levels is a flawed concept. In the real world, interest rate levels are, in fact, negatively correlated with levels of government debt – the higher the public debt load, the lower the bond yields

Chart 1 The Higher The Debt Load, The Lower The Bond Yields



(Chart 1). This implies that the levels of debt are the result, not the cause, of the rise and fall in interest rates. It also confirms the fallacy of the so-called "fiscal risk premium".

Second, on a more profound level, both the Country A and Country B governments owe the same amount of public sector debt to their respective private sectors. In Country B's case, the public sector debt obligation is expressed as government paper. In Country A, it is expressed as the central bank's IOUs, or money.

Money, like government paper, is also a form of public sector liability owed by the central bank to the public. The only difference between the two IOUs is that the central bank debt – money – has zero maturity, while government paper does have a maturity date.

ok but what about this is proof of good fiscal health? looks like these guys are heavily invested in US and do not want to listen to arguments that the fiscal situation is horrible rn

Logically, if you are concerned about the public debt burden of a nation, you should be equally concerned about the levels of money stock. It does not make sense if you worry about one form of public liabilities but not the other.

Third, will Country A be more prone to inflation than Country B because the former has a bigger money stock? Not necessarily. Inflation is the result of aggregate demand exceeding aggregate supply, and neither money supply nor bond insurance has a direct impact on aggregate demand.

This is amply demonstrated by the fact that the large-scale QE programs across the G7 did little to lift inflation or output throughout the 2010s, though they might have benefited asset values.

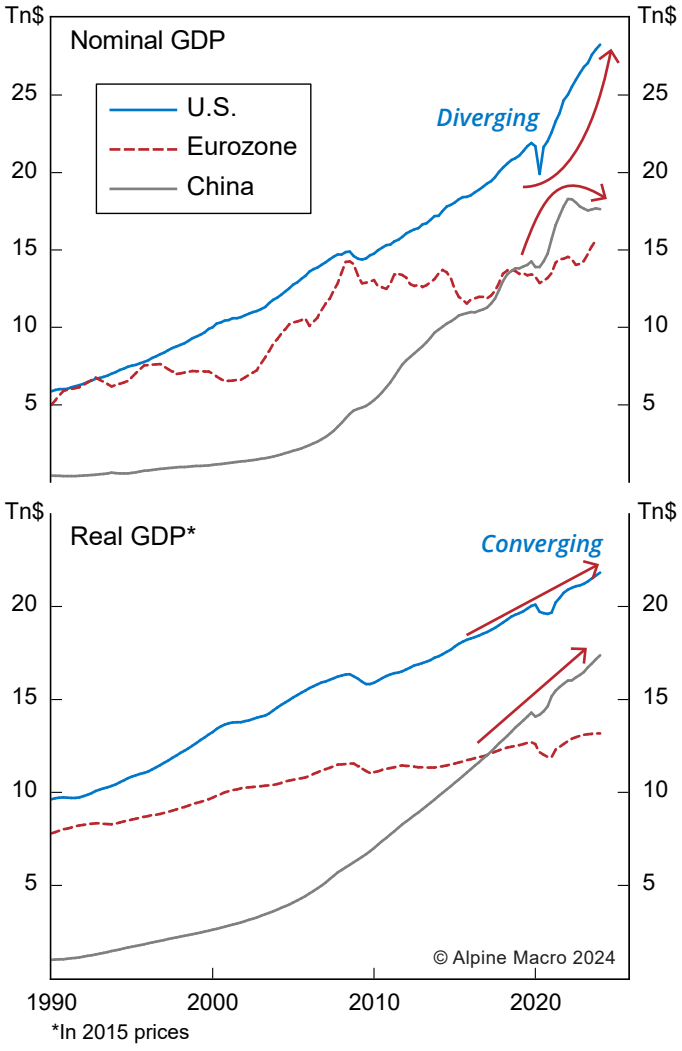
The bottom line is that as long as government debt is denominated in local currency, there is zero chance of a sovereign default. The levels of debt only mirror what has happened in fiscal policy in the past. If there are distortions or misallocation of resources, it already happened at the time when the government conducted its fiscal policy.

Bad fiscal policy is when a government can either run a too-big or too-small budget deficit, causing either rising inflation or price declines or dramatic currency moves. In other words, although there is no such thing as "fiscal risk premium", there can be inflation or currency risk premia embedded in bond prices.

China: Peaked Out And Stagnating?

Since the pandemic, it has become fashionable to compare China's nominal GDP with America's, with many big-name economists concluding that China's economy has peaked and the gap between the two largest economies has been increasing anew. This is a mistake.

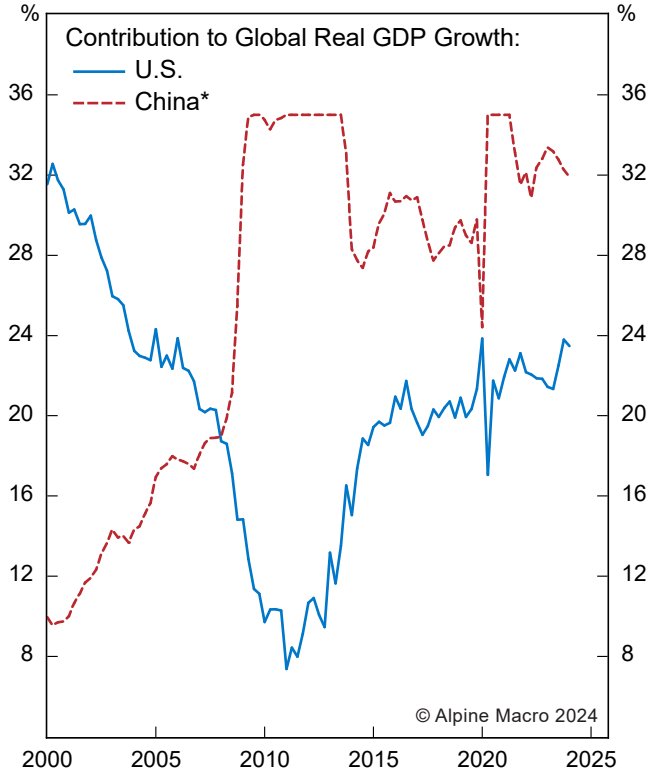
Chart 2 GDP Comparison: Nominal Versus Real



U.S. nominal GDP has jumped sharply since the pandemic crisis because general price levels, measured as the GDP deflator, have soared more than 17%. Real output has grown by 10% since 2021 (Chart 2).

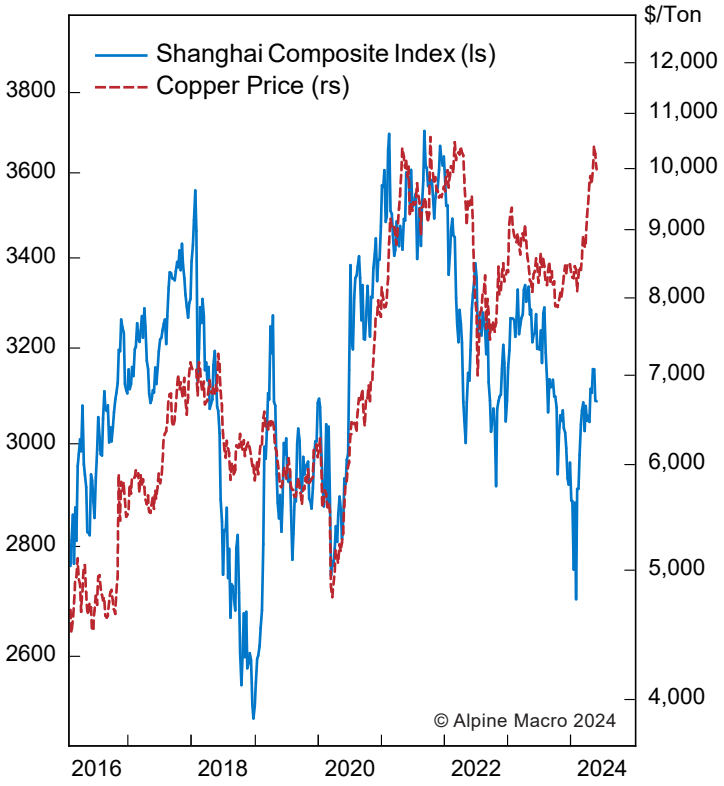
For China, the GDP deflator has only risen by 5%, while real output has expanded by 23% for the same

Chart 3 China Versus The U.S.: Contribution To Global Growth



*Truncated at 35 to remove GFC period
Note: Both series are shown as 5-year moving average

Chart 4 China Remains A Major Swing Factor For Industrial Commodities



period. In the meantime, the Chinese currency has depreciated 9% against the dollar since 2021.

Clearly, these very different inflation pictures between the two economies, together with a strong dollar, are a key reason why U.S. nominal GDP has outgrown China's by a significant margin in recent years.

The appropriate measure for cross-country comparison should be real GDP measured in constant dollar terms, or PPP. These measures strip out distortions cause by inflation or short-term foreign exchange fluctuations.

For instance, the dollar dropped more than 20% throughout the 2000s. Does that mean the U.S. economy shrank by the same amount relative to the rest of the world? Of course not.

Real GDP reflects the true size of an economy, its productive capacity and economic well-being. The bottom panel of **Chart 2** compares real GDP between the U.S., Europe and China, in constant dollar terms.

It is clear that the gap between the U.S. and China has continued to shrink, uninterruptedly since 1980, even though China's economic growth has slowed sharply this decade.

So what?

First, China is still a key swing factor for global growth and commodity prices, as evidenced in **Chart 3**. It has continued to generate a third of the world's economic growth. We suspect the recent spike in copper has something to do with improving growth expectations in China (**Chart 4**).

not really. it was mostly a shortage of Cu supply at COMEX, and also an overestimation of demand

Second, with both the population and labor force shrinking in China, the Chinese economy can only rely on increasing labor productivity to sustain economic growth. This is easier said than done.

So far, China has eked out labor productivity growth of nearly 6% by adopting new technology and automation (**Chart 5**). The dilemma is that large capital investment is the only way to bring about technological advances and productivity growth, but China also faces a lack of consumption. How to achieve these two conflicting goals? Only time will tell.

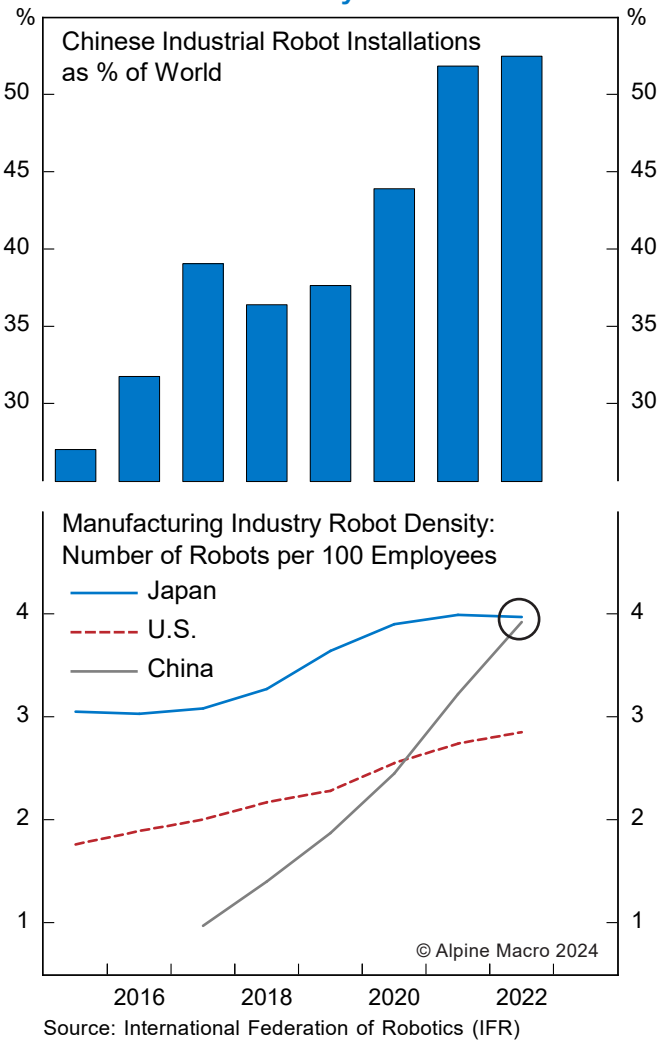
Finally, China's economic policy under the current administration has been a major hurdle for productivity growth, with stated policy goals incoherent and often in conflict. In addition, the government seems to be frustratingly slow in reacting to changing global and domestic economic conditions, thus often missing the best opportunities to act.

For example, it took an incredibly long time for the government to end its disastrous zero-Covid policy. Even today, the government has been extremely stingy to stimulate the economy, although signs of deflation and excess savings are prevalent.

On a positive note, although President Xi is very into control, he has not inflicted too much damage on the free market system. The downward pressures in the economy are forcing him to pivot to pro-growth policy.

So long as Xi stops his policy flip-flopping and allows private businesses to thrive, we are cautiously optimistic about the prospect of China's economic growth, even though the mood toward China has decisively darkened in the rest of the world.

Chart 5 How Has China Squeezed Out Productivity Growth?



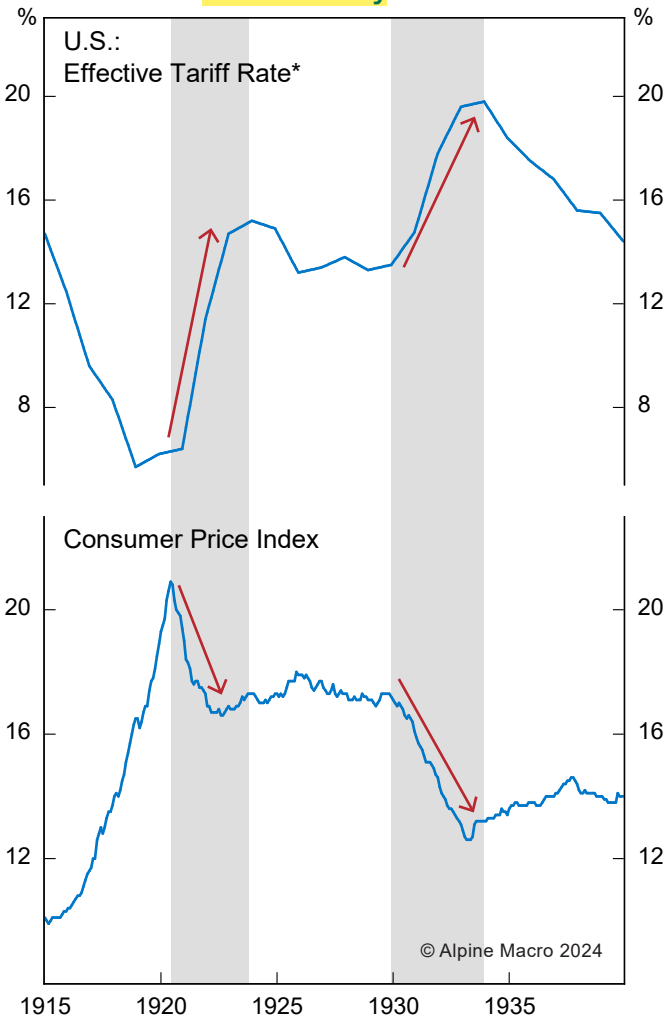
Source: International Federation of Robotics (IFR)

Protectionism Versus Inflation

Most investors have taken it as a given that protectionism, tariffs and deglobalization are inflationary. With the prospect of a second Trump presidency becoming a realistic possibility, many are seriously worried about the secular trend in inflation.

It is intuitive to think that protectionism, rising tariffs or manufacturing re-routing will add production and import costs, leading to higher prices. In reality, however, this has not been true.

Chart 6 Rising Tariff And Protectionism Is Deflationary

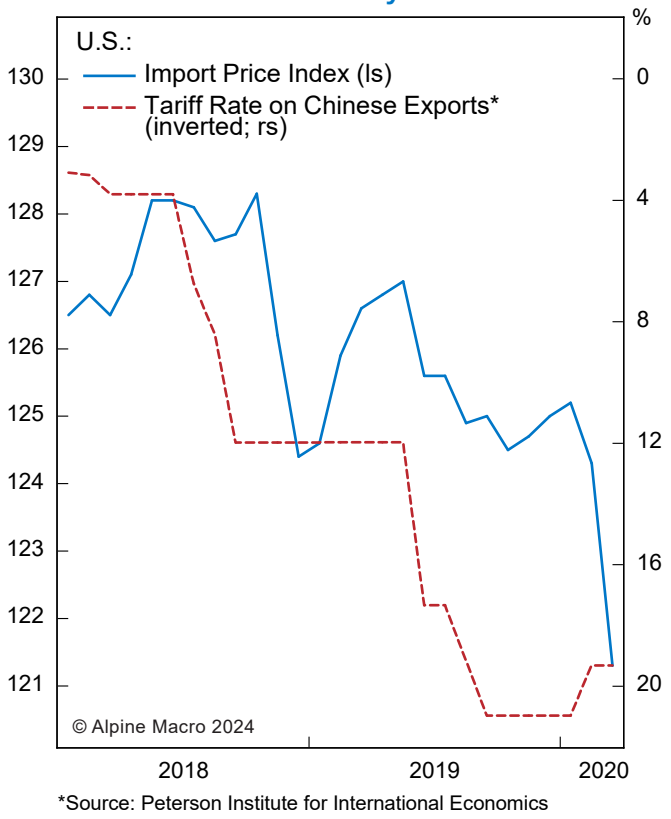


*Total import duties collected as a % of total value of imports
Note: Shading denotes periods of rising tariff rates

The U.S. government enacted the Emergency Tariff Act in 1921, pushing up the average tariff rate by 5 percentage points. This was followed by the 1922 Fordney-McCumber Tariff Act and the 1930 Smoot-Hawley Tariff Act, resulting in an additional 8.4 percentage point surge in the effective tariff rate.

Nevertheless, each wave of a tariff spike resulted in massive price declines, or deflation, as evidenced in Chart 6. Why so? The reason is that tariffs caused a huge contraction in global trade and income levels.

Chart 7 China-U.S. Tariff War Is Deflationary



*Source: Peterson Institute for International Economics

As a result, the negative income effect dwarfed the relative price effect of higher tariffs.

Even as recent as the 2017-18 China-U.S. tariff war, tradable goods prices fell in both the U.S. and China (Chart 7). The corporate sectors of both countries refused to pass on higher duties to consumers in order to maintain competitiveness. Rather, rising tariff rates ate into corporate profit margins.

If Donald Trump wins the November election and indeed makes good on his campaign promises of jacking up tariffs by 60% against China and also heavily taxing European imports, this could represent a major deflationary shock that threatens to sink the world economy into recession, causing prices to drop.

A final point: manufacturing rerouting and relocation are bound to happen anyway, with or without the pretext of national security concerns and geo-political tensions.

For example, China's land and labor costs have risen sharply. As a result, the economy has been shedding labor-intensive industries to cheaper places such as Vietnam, Laos and Cambodia, while moving into higher value-added sectors (**Chart 8**). This natural evolution of manufacturing relocation has never stopped, which has ensured global tradable goods prices stay down.

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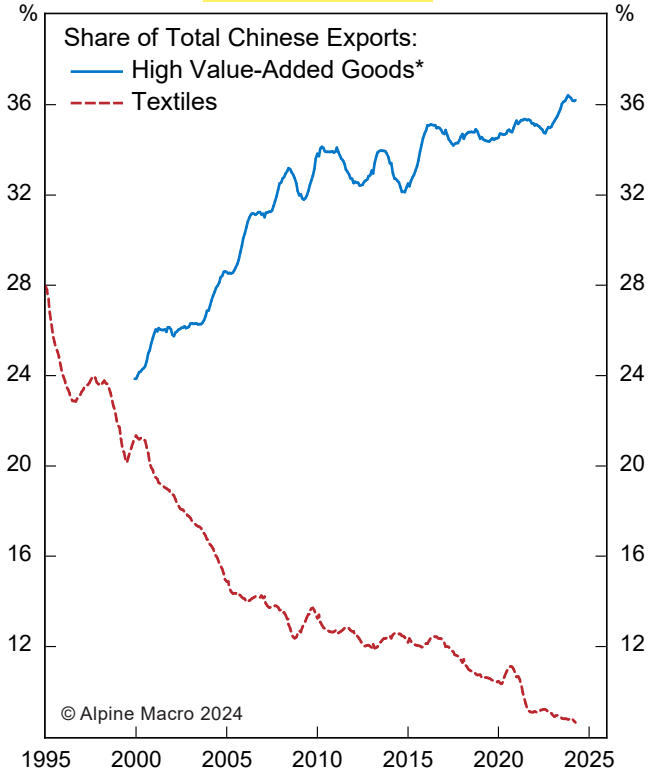
Chief Global Strategist

Chart 8 **Manufacturing Relocation Is A Natural Process**



*Electrical machinery, equipment & parts; transport equipment; pharmaceutical & optical products and precision instrument

Investment Recommendations

Tactical Investment Positions (3 - 6 months)

Recommendations	Open Date	Open Levels	Stop	Closing Date	Closing Levels	P&L Since Inception
Long 10-Year German Bunds/Short 10-Year JGBs	08/07/2023	2.6%/0.62%	-	-	-	4.3%
Long U.S. Regional Banks (ETF: KRE)	12/04/2023	48.12	45	-	-	3.2%
Long Latin American Equities (ETF: ILF)	12/04/2023	27.78	25	-	-	0.4%
Long Russell 2000 (ETF: IWM)	01/08/2024	196.73	185	-	-	4.9%
Long Chinese Equities (ETF: MCHI)[1]	03/04/2024	38.91	Rolling -8%	05/31/2024	44.33	13.9%
Long Gold (ETF: GLD)	04/01/2024	207.82	-	-	-	3.6%
Long S&P 500 Energy (ETF: XLE)	03/25/2024	93.26	-	-	-	-0.1%
Long Italian Equities (ETF: EWI)	04/08/2024	37.36	-	-	-	3.9%
Short 10-Year JGBs	04/29/2024	0.83%	-	-	-	1.2%
Short EUR/USD	04/29/2024	1.07	-	-	-	1.0%
Long Nikkei 225 Hedged	05/06/2024	38,835	-	-	-	-0.9%
Stop-Buy Copper	-	-	4.55	-	-	-
Long Natural Gas (ETF: UNG)	05/27/2024	19.36	-	-	-	-9.1%

Note: P&L is calculated using daily closing prices.
[1] Our Long Chinese Equities (ETF: MCHI) was stopped out on 05/31/2024 with a profit of 13.9%.