

## Strategy Bulletin Vol.174

## Excellent prospects for “seventh continent” prosperity and renewed US hegemony

**Happy New Year**

*The Musha Research team extends its sincere wishes for a happy and healthy 2017 and many successful investments.*

*New Year's Day 2017  
The Musha Research*

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**(1) The world today from the viewpoint of Churchill**

December 2016 was the 75th anniversary of the Pearl Harbor attack, which was the start of World War II in the Pacific. People around the world were moved by the sight of Prime Minister Shinzo Abe and President Barack Obama joining hands in peace at the memorial in Hawaii. In response to Japan's attack on December 8, 1941, British Prime Minister Winston Churchill stated that he was now confident of winning the war and slept very well that night (according to *The Second World War* by Winston Churchill). Why was Churchill so certain about victory at a time when the media in Japan were ecstatic about the war? The reason is that he could see two realities. First, there was no doubt that the Allies would win with the participation of the United States, which had an overwhelming lead in economic power. Second, Pearl Harbor instantly reversed public opinion, which had been the barrier to US entry in World War II. As expected, US participation in the war led to an Allied victory and an unconditional surrender by Japan.

**The US is gaining strength as China declines**

An analysis of the global situation today also requires identifying key realities rather than becoming fixated on a multitude of complex factors. Many unexpected events occurred during 2016. Consensus views based on traditional methodology, whether academic or analytical, were meaningless with regard to political, geopolitical and economic forecasts. Understanding events that appear to be complicated and even bizarre requires going back to the simplest facts of all. In other words, the type of insight that Churchill had is what is needed. Exactly what are today's realities? To determine these realities, we need to answer two questions. First, will the overwhelming economic power of the United States make the country stronger or weaker? Second, is China entering a period of significant decline caused by an intrinsic contradiction? We need to focus on these two questions because the current world order is determined by the United States and China. Europe, Russia and Japan are not involved. Musha Research believes that a strong US upturn and significant Chinese downturn are almost certain to take place. Furthermore, these trends will probably become clearly evident in 2017.

**(2) Leadership in the “new continent” cyber space will underpin US economic growth****Vibrant seventh continent growth will create unprecedented prosperity**

Many signs that globalization is reaching a dead end are appearing in China. The lack of growth in global trade activity has given people the mistaken impression that capitalism worldwide is in decline. However, the world is also witnessing strong growth of a new stage for business and consumer activity: the seventh continent. The seventh continent is a cyber

space that has no shape or national borders. The discovery and growth of this virtual continent is very likely to lead to a period of dramatic progress on a scale rarely seen in the history of the world.

The internet has become a resource just as essential as air and water to the economy and our everyday activities. The internet is also the largest source of the creation of value. The age of agriculture, which defined almost the entire history of mankind, ended long ago. About 200 years ago, the world advanced to an era in which people could live and do business without using land. This was the transition to capitalism. Unfortunately, we are now seeing a rapid downturn in the supply of capitalism's two vital economic resources: capital and physical labor. Instead, we now live in an age where everyone cannot survive without information networks and smartphones and other devices that function as gateways to that information. Labor is still required. But this time intangible (mental) rather than physical labor is what is needed. As a result, it is wisdom instead of capital that is growing in importance. *(Note 1)*

The emergence of this seventh continent must be closely watched. Otherwise the seventh continent's contribution could be overlooked when compiling economic statistics despite its immense importance. This oversight is the underlying reason for the spread of erroneous pessimism. Growth of the seventh continent is having a big influence on the economy. One way is cutting cost and making a huge improvement in convenience. Another way is by creating entirely new products (serving as a framework for meeting needs), a process spawns new industries and companies. From a macroeconomic standpoint, these benefits greatly increase corporate earnings and lower the cost of goods (because of higher productivity), which boosts purchasing power. The result is a new business sector that is beyond the reach of economic statistics.

#### **The United States is the discoverer, growth engine and beneficiary of the seventh continent**

Despite this significant oversight of the seventh continent by statistics, there are signs of this component of the economy in official statistics now that the seventh continent has grown to its present magnitude. All signs are intangible. Specifically, indications involve activity like services and finance that have no visible products. US companies account for the vast majority of innovation. Dramatic growth of the seventh continent has been responsible for raising US economic fundamentals to an all-time high. Many key US economic indicators are higher than ever before. Primary examples are (1) record-high corporate earnings backed by the information/internet revolution, (2) highly competitive industries due to the greatest innovative thinking in the world, (3) low interest rates in tandem with ample funds available for investments (substantial savings), (4) sound public-sector finances, and (5) minimal inflation. Slow economic growth is the only problem. A few regions and population segments of the United States are unable to benefit from economic growth. But this problem can be easily solved by implementing necessary measures. Consequently, President-elect Trump will be in an excellent position to raise the economic growth rate through fiscal measures and deregulation. Rising stock prices demonstrate that investors are embracing this outlook.

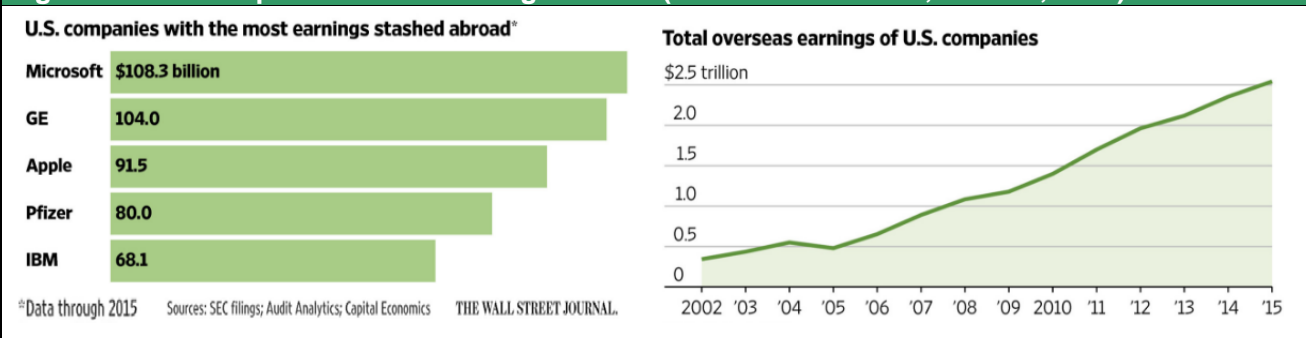
#### **The smaller US international deficit will increase the shortage of dollars**

Studying the US international balance of payments from this standpoint reveals that a significant change has already started. The change involves the improvement in the international balance of payments and the shortage of dollars that is currently not clearly visible. As the competitive superiority of US companies grew, the position of the United States within the international division of labor has become much more powerful. People and companies around the world (except China, which often uses intellectual property rights without permission) are relying on platforms supplied by US companies for the global data network infrastructure. This includes the internet, smartphones, cloud computing and many other elements of this infrastructure. US technology is also dominant in the financial services sector. Figure 1 shows profits held overseas by US companies, according to The Wall Street Journal. At \$2.5 trillion, earnings parked in other countries by US multinational companies are enormous. The magnitude of these earnings demonstrates the remarkable profit structures of US companies that generate earnings from direct investments and the export of services rather than international trade.

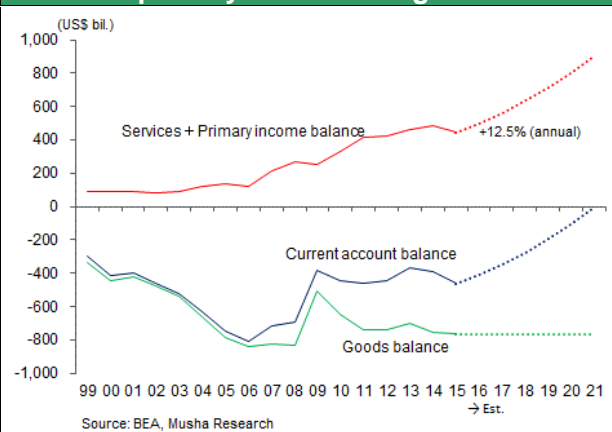
The strength of the United States is producing a big improvement in the international balance of payments. Between 2005 and 2015, the US current account deficit has dropped sharply from \$806.7 billion (5.7% of GDP) to \$463.0 billion (2.6% of GDP). Services like financial services, payments for intellectual property use and business services

improved dramatically. The service current account surplus surged from \$68.6 billion in 2005 to \$182.4 billion in 2015, an increase of almost four times. The primary income balance, which includes direct investments, portfolio investments and other items, also improved significantly, rising from a surplus of \$67.6 billion to \$182.3 billion, an increase of 170%. However, the US trade deficit has been largely unchanged, moving from \$782.8 billion in 2005 to \$762.6 billion in 2015. If the service and primary income surpluses continue to increase at an annual pace of 12.5% as in the past ten years while the trade deficit remains unchanged, the US will have a current account surplus starting six years from now. The impending end of current account deficits in the US, which has the world's key currency, would create an enormous shock. Due to the end of this deficit along with the Trump administration's spending plans and monetary tightening, the United States will probably attract a large amount of the world's capital. These events will quickly reduce the volume of dollars that the United States supplies to other countries.

**Figure 1: U.S. companies retain earnings abroad (Wall Street Journal, Nov. 25, 2016)**



**Figure 2: US balances on current account, services+primary income and goods**



**The strong dollar will reaffirm the US as the world's only superpower**

A shortage of dollars coupled with a stronger dollar will reinforce US power for the following four reasons.

1. Mutually complementary roles are a key element of the international division of labor. US companies with monopolistic control over markets are strengthening their positions worldwide. A stronger dollar will allow these companies to sell their products at higher prices, and allow the US people to buy goods at lower prices which translates into an improvement in the terms of US trade.
2. Trumpnomics will probably cause inflation to increase, just as Reaganomics did.
3. A stronger dollar will make it easier for US multinationals to make acquisitions and other investments in other countries.
4. A stronger dollar will greatly increase the global stature of the United States. This will be beneficial for defense expenditures and the US global standing, such as its share of the world's GDP.

All of these factors are likely to produce a virtuous cycle. As the US economy becomes more powerful, the country will be able to accomplish the Trump administration's "Make America Great Again" agenda. This will result in more growth of the Trump administration's political capital. As a result, the United States will reinforce its position as the world's sole superpower.

### (3) Problems involving fundamental contradictions will speed up China's decline, but Europe will muddle through

#### Fundamental contradictions of Chinese state system

The administration of Xi Jinping has abandoned the strategy of Deng Xiaoping, which was to conceal one's strengths and bide one's time. China is no longer hiding its ambition to become the Asian hegemonic power. Due to this stance, China has established a foundation consisting of three basic principles that cannot exist at the same time. The first is communism and single-party rule (the principles of Marxism-Leninism and Mao Zedong Ideology). The second is capitalism and a market economy. The third is Sino-centrism, the belief that China is the sole center of global civilization surrounded by barbarians or is unique relative to other countries.

The first two principles were put into practice by Deng Xiaoping in the form of a socialist market economy. Using this approach was not unusual for a developmental dictatorship in an emerging country that was just about to take off. However, China has started to take actions based on Sino-centrism that has existed since ancient times. For example, the country is using territorial rights from many years ago to exert its claim in the South China Sea. China's stance is making international cooperation very difficult. Under normal circumstances, China's economic growth should lead to more democracy and a decline in single-party communist rule. However, the centralization of power has instead increased as China stepped up censorship and the control of people's thoughts and ideas.

China has been extolling the virtues of an open market economy for some time. But now progress toward this economy is about to rapidly slow down because of pressure from the first and third basic principles. Within China, the first priority is the third principle: Sino-centrism (China's core interests). The next priority is Communist Party rule. Ranking behind these priorities is a market economy, which is the foundation for economic prosperity. This stance points to an endless economic downturn in China. The Trump administration will probably make strong demands for China to change its policies because of the detrimental effects overseas of the first and third principles. Exactly how will this intrinsic contradiction emerge as the economy weakens? This is the greatest risk of 2017.

#### China's crisis is contained at least for now

The events that deepened China's crisis from the summer of 2015 until 2016 have come to an end for the time being. The reason is that China has dealt with the two causes of the crisis. Rapidly slowing economic growth was the first reason. For example, China was experiencing declines in rail cargo volume, electricity consumption, crude steel output, and imports and exports. China reacted with massive spending programs and infrastructure investments accompanied by huge monetary easing. The outflow of capital caused by looser capital controls was the second reason. To reduce the flight of capital, China tightened restrictions on foreign currency.

#### The multitude of contradictions in China

China's decision to enact a series of stopgap measures in response to these basic contradictions has created an impasse between necessary policies in all aspects of the country's economy and government.

1. The growth driver antimony – China needs growth fueled by consumption, but the country would be forced to continue making excessive investments in order to produce immediate demand.
2. The private-sector company growth antimony – China needs to foster the growth of private-sector companies but must place priority on government-owned companies in order to preserve the foundation for the government's authority.
3. The currency antimony – Both a stronger yuan (making China less competitive) and a weaker yuan (capital outflows and increasing risk of a sharp drop in the yuan's value) create difficulties for China. The only option is allowing the yuan to decline slowly.
4. The financial antimony – Both higher interest rates (essential to protect the yuan but likely to burst China's asset bubble and damage the economy) and lower interest rates (more downward pressure on the yuan) create difficulties for China. The country will probably continue its half-baked monetary easing policy.
5. The commerce antimony – Both opening up markets and moving in the opposite direction create difficulties for China. The government will probably implement a complex mosaic of economic and business policies.

6. The geopolitical antimony – An expansionary stance will hit a US wall and a stance of withdrawal will spark the opposition of the Chinese public. China will probably either adopt a cooperative stance while retaining its stature or perhaps use brute force.

To deal with the only dilemma facing the country at this time, China is likely to continue taking actions aimed at preventing the slowdown of an economy that relies solely on government spending. However, this is certain to produce even larger budget deficits. Fortunately, China's actions have very likely prevented for some time an explosive crisis that people had feared in 2015.

The Trump administration's upcoming China policies are a source of concern. Peter Navarro, who is a realist (hawk) about China, will play a key role in the Trump administration. We are therefore very likely to see a major shift in US trade and geopolitical policies under the new administration. Nevertheless, the demand for a more level playing field is justifiable.

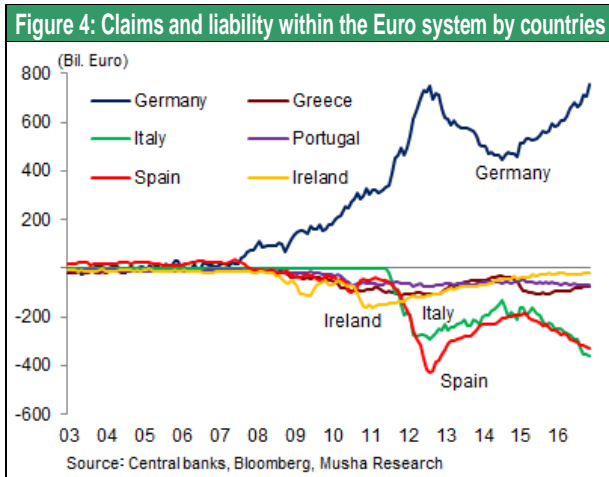
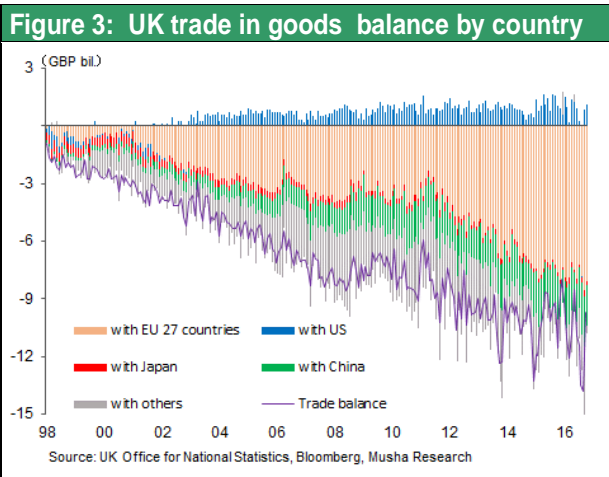
### **Europe has very few options**

Several important elections will take place in Europe, including a presidential and legislative election in France and a legislative election in Germany. Worries are growing about the emergence of right-wing populist candidates. There is no reason for optimism but also no reason to worry too much. Despite concerns about more EU departures, countries other than Britain probably do not have the freedom to leave. Therefore, even if election results create concerns in financial markets, countries will have no choice other than to stay in the EU. Refugees are the most serious problem. The only solution is the establishment of a new world order and a restructuring of the Middle East.

Britain's EU trade deficit accounts for about 80% of the country's current account deficit, which is now more than 5% of the GDP. In other words, Britain is the largest customer of the EU countries. Brexit may result in the loss of markets for EU companies but not for British companies. The weaker pound caused by Brexit could have the benefit of moving manufacturing from other countries back to Britain. The pound already has no ties to the EU. In contrast, Eurozone countries owe more and more money to each other because of the TARGET2 settlement system of the European Central Bank. Canceling these amounts receivable and payable due to the collapse of the euro would be suicidal for all of these countries.

In southern European countries, financing through the private sector came to a halt after the crisis in Greece began. The European Central Bank's system is the sole channel for obtaining funds today. Consequently, the demise of the euro would result in a massive volume of bad debt in Germany. Obviously, allowing the euro to die is not an option. In Greece, even the populist Tsipras administration was forced to become strong supporters of staying in the EU. Clearly, countries in southern Europe and Northern alike are not in a position to go along with any speculative talk about ending the euro or dismantling the EU.

For the reasons outlined in this report, the investment climate in 2017 is expected to be conducive to taking on significant risk against the backdrop of a healthy US economy and strong dollar. As Musha Research has stated for some time, Japan will probably be the biggest beneficiary of this environment. Prospects are excellent for a second phase of the Abenomics rally that will significantly boost prices of Japanese stocks.



*Note 1:* The Third Wave by Alvin Toffler was published in 1980. The Knowledge-Value Revolution by Taiichi Sakaiya, published in 1985, was the first in Japan to predict the advent of an age when knowledge creates value. Now, more than 30 years later, the world has finally reached the point of transitioning to the future these two books envisioned.

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