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Imminent US-China agreement means the technical correction exit is not far away

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(1) A resolution of the US-China trade war

Q: Autumn volatility in stock markets has been very high. Now markets appear to have calmed down somewhat. Apparently, there is an underlying fear among investors of an enormous crisis triggered by a further worsening of the US-China trade war. What is your outlook for this trade war and China's economy?

Musha: On October 4, Vice President Mike Pence gave a speech at the Hudson Institute that was extremely critical of China. Unlike in the past, his criticism was not restricted to trade and the economy. Mr. Pence talked about China's unfairness involving politics, the military, information and technology. These remarks reinforced the view that a US-China cold war is about to begin, resulting in an era in which national security takes precedence over economic issues. Worries about a cold war were one reason for the sharp drop of global stock prices in October. Between the vice president's speech and the end of October, the Nikkei Average suffered one of its largest downturns ever, falling ¥3,000 yen, or about 12%. Investors are worried because they cannot foresee the outcome of the US shift to treating China as an enemy.

However, for the time being, the US-China cold war will not destroy the economy or US-China trade relations. Once this point becomes clear, I think investors will regain their confidence. Argentina will host a G20 summit on November 30. President Trump and President Xi Jinping plan to hold a meeting during this event. If some sort of agreement is reached, we can expect to see the dark clouds over US-China trade start to dissipate. The United States wants China to end its unfair trade practices. To apply pressure, the U.S. has imposed a tariff of 10% on imports from China worth $250 billion. If China does not accede to US demands, this tariff will be raised to 25% in January 2019. China will probably have no choice other than to give in to many of these demands and is preparing to submit a response covering 140 items.

The critical point regarding the US-China trade war is the magnitude of the negative impact on total demand in the two countries. The bottom line is that there is almost no impact on demand in the United States. But in China, there is an obvious negative effect from declining capital investment as companies move factories to other countries. Nevertheless, the negative effects in China will not spark a global financial crisis by breaking the back of the entire economy or causing an enormous downturn in total demand. China can offset slower capital investment by propping up the economy with infrastructure investment, monetary easing, financial support for private-sector companies and other initiatives. Furthermore, those companies that cut back on capital expenditures within China will probably start making these investments instead in Vietnam, Taiwan, Thailand and other countries.

With the world on the verge of the 5G and IoT era, the global smartphone demand cycle has reached a turning point with growth currently stopped at more than 2 billion units. In the semiconductor industry, there has been a big drop in demand for equipment used for virtual currency mining. But these localized problems will not hold down capital spending or cause a recession.

Q: There is some disagreement within the US government about the proper stance to adopt concerning China.

Musha: Right now, reporters are focusing their attention on disputes within the White House. Peter Navarro, a hawk regarding China, has been critical of the more accommodative positions of former wall street financiers such as Steven Mnuchin, a former Goldman Sachs executive, and Henry Paulson, the former Treasury secretary who is also from Goldman Sachs. Mr. Navarro says these individuals are acting like agents of China instead of thinking of US interests. Worries are growing that China hawks like Mr. Navarro will prevent a US-China agreement. But this is peculiar. Arguments among administration insiders are making headlines even though President Trump should be tightly controlling these people. The conclusion is that all of this infighting may be nothing more than an act. I think these arguments are absolutely the president's strategy for using the strong criticism from China hawks to force China to give in even more to US demands.

(2) Assessing the US monetary policy shift and midterm election results

Q: Rising US interest rates are widely regarded as another reason for the stock market sell-off. What is your view of the ongoing increase in interest rates?

Musha: Long-term interest rates are clearly moving up in the United States. But the current level of 3% is still only half of the nominal economic growth rate of 6%. Furthermore, the spread between long- and short-term interest rates is sufficiently large. In the past, there was a reversal of long and short rates when the economy overheated and reached a turning point. This happened when the long-term rate exceeded the nominal growth rate of the economy. Right now, the interest rate, which is an expense in relation to the economy's actual strength, is still low. There is no reason to expect an economic recession or bear market to start when US interest rates are at this level. However, there is no doubt that higher interest rates have affected the stock market by prompting investors to alter asset allocation.

Q: How do you think the outcome of the midterm elections will influence the US economy?

Musha: I think the elections will have a positive effect on public-sector finances. Although President Trump is a Republican, he is a believer in big government, and so are the Democrats. Until now, many Republicans wanted a small government and resisted increases in government spending. But with a Democratic majority in the House of Representatives, there is an increasing likelihood that the president and the House can reach an agreement about a bigger government. This agreement is most likely to involve infrastructure spending. Both the Democrats and President Trump want to make accomplishments involving infrastructure something to brag about in the next elections. Some people are critical of this spending because the budget deficit will increase. But what worries investors most is the possibility of an economic slowdown in 2019 as the benefits of the recent tax cuts wind down. More government spending would have the positive effect of offsetting the end of these benefits.

Recently, the drop in stock prices has been accompanied by a decrease in interest rates and a big decrease in the price of crude oil, which had been climbing steadily. All of these events exert downward pressure on inflation and hold down the cost of doing business. This has the effect of prolonging economic growth. Some people think it is time to sell stocks because lower oil prices are an indicator that the global economy is about to start becoming weaker. But there is no justification for this thinking.

Q: Big government spending programs could cause US interest rates to go even higher. Do you think there is no problem as long as interest rates stay at the 3% level?

Musha: Downsizing of the Fed's balance sheet may be one of the biggest force behind the upturn in long-term interest rates. Rising long-term interest rates are not completely beyond the control of the Fed and other policymaking institutions. It is vital to understand that rates are climbing with the tacit approval of these institutions. Both the Trump administration and the Fed want to push back the next recession as much as possible. They want to avoid a yield curve reversal, which is one cause of a recession. If a reversal is about to happen, the Fed has the ability to influence long-term interest rates by altering the tempo of its balance sheet downsizing. The conclusion is that it is too soon to worry about monetary policy pulling the rug out from under the economy and killing this bull market that has survived for so many years.

(3) The extended upturn in stock prices is not over

Q: Musha Research has repeatedly stated that this recent drop in stock prices is a technical correction. Please explain the causes of this correction.

Musha: One cause is trading that uses algorithms and artificial intelligence. AI trading goes far beyond the thinking of people. The result of this menacing force is a speculative market where conventional human tactics have no chance of success. A second cause is the end of the bottom-up flow of money into the stock market. In the past, investors generally selected individual stocks after researching fundamentals. But now top-down money is inundating the stock market. Index funds and ETFs account for about half of mutual funds. Even a small interest rate movement triggers a change in asset allocation. When a huge amount of money goes into the stock market, most of the buying targets the constituent stocks of indexes. Volatility increases as a result and the speculative nature of the stock market becomes even stronger.

Another cause is share buyback, the only source of buying in US stock markets. Individuals and households have been net sellers of stocks during the past several years. For example, during the three-and-a-half-year period that ended in the middle of 2018, companies spent $2,600 billion to buy back their stock. At the same time, there were net sales of $410 billion by households and $330 billion by mutual funds. That means the supply-demand balance shifts almost entirely to the sell side during periods when companies are unable to buy back their stock. At these times, it is easy to move stock prices with manipulative selling. The sharp drop in stock prices in early February and early October this year both took place during the start of periods when companies were not repurchasing stock. Consequently, we can expect to see a big reversal in supply-demand dynamics once these periods end and stock repurchases resume. Furthermore, the sell-off was limited to stocks. There was almost no change in the dollar-yen exchange rate, interest rates and the credit risk premium.

These points lead to the conclusion that turbulence created by internal stock market forces was responsible for the recent global drop in stock prices. I believe this was not caused by investors shunning risk in all financial markets. Also, no major reason involving fundamentals was linked to this bear market. Index buying caused a surge in the stock prices of Internet platform companies like Apple, Amazon and Alphabet. Then index sales dealt a severe blow to these stocks. Next, we will probably see a return to a rotation among different sectors of the stock market.

Q: Most investors think that the October stock price plunge was so big that prices are unlikely to recover to the highs of early October by the end of this year.

Musha: That may be true. The unexpected drop of stock prices and extremely high volatility has severely damaged risk takers. This is why a recovery may take place only at a gradual pace. But stocks that were sold for technical reasons will be bought back for technical reasons, too. So, a very rapid stock market rebound is also possible. A large number of people think that the bull market that has survived for nine years since the end of the global financial crisis is over. Are they right? Furthermore, some people think the double top was observed this year, when stock prices peaked in February and October, is a sign that the prolonged stock market upturn has run out of steam. In fact, there was no double top. The main reasons are that the September high was above the January high and the October low was not below the February low.

I think this correction is very likely to be much less severe than the drop in stock prices that happened during the so-called China shock of 2015. If my view is correct, prospects are excellent for the stock market to regain its strength early in 2019. One particularly significant factor is China's initiatives to prop up the economy without caring about what others think about these actions. In 2015, the bottom dropped out of the Chinese economy. But the fundamentals of the global economy today bear no resemblance at all to the situation in 2015. Commodity prices worldwide have been declining since the summer of 2018 because of China's sluggish economy. However, China's economic correction in the first half of the year was intentionally created by the government. Now China's economic policies have shifted 180 degrees and commodity prices seem to be bottoming. This is why pessimism about China will probably not be the cause of a big decline in stock prices for several more years.