

## Hardening of the Economies

By John Mauldin | May 21, 2022



China Panel: Extended Lockdowns

Zulauf: Vicious Cycles

Marks: Pendulum Swings

Wood: Innovation Wins

Maybe Dallas, a Gamble, and on...

Atherosclerosis, or hardening of the arteries, occurs when substances like cholesterol accumulate and impede your blood flow. This keeps your body from delivering nutrients where needed. Left untreated, it usually doesn't end well.

Something similar is happening to the global economy.

Like atherosclerosis, it's been building toward a crisis for years. Central bank policy errors, fiscal mistakes, trade protectionism, inadequate infrastructure investment, COVID-19, Russia, and more all blended into a toxic brew that is now blocking our financial circulation.

We talked about all this at the Strategic Investment Conference. Today, I'll continue recapping some of the sessions. You can read my previous summaries [here](#) and [here](#). Or, better yet, [get your own Virtual Pass](#) and have full access to video, transcripts, slides, and downloadable audio.

As with bodily atherosclerosis, curing our economic condition may require lifestyle modifications. But in one sense, it will be even worse: We're all going to get the cure whether we want it or not. We'll get its side effects, too... and you can bet there will be many.

## China Panel: Extended Lockdowns

China is one of our key economic arteries. Worse, it's very hard to bypass, so the country's current self-induced COVID lockdown is a critical blockage. Our China panel—Emily de La Bruyere, Bill Bishop, and Louis Gave with Jacob Shapiro moderating—wrestled with that question. They reached a quick, unanimous conclusion, too. They think Beijing will stick with its “Zero COVID” strategy, whatever the cost.

Emily noted, astutely, that the government is implementing a variety of steps to mitigate the economic impact of the country's extensive lockdowns. For instance, they're allowing some companies to operate in a “closed-loop” system where the workers stay onsite and have no contact with their families or the public. The fact that they are making these efforts means the broader policy isn't going away. Further, they are clearly shifting the impact outside China as much as possible, thereby minimizing domestic pain.

Bill Bishop agreed, based on his monitoring of Chinese leadership statements. They continue to push slogans like “persistence is victory” while punishing anyone who doubts the policies. They will make tweaks and adjustments, but the Zero COVID strategy won't change. Leadership seems to believe that letting COVID spread would be even more damaging to the economy. (And given their low uptake of low-quality vaccines, they may be right.)

Given how dependent the rest of the world is on Chinese exports, this will probably add to inflation pressure everywhere. Lower Chinese purchases may offset some of this, but not all. And in the long run, China is helping end the same globalization that enabled its growth.

Louis Gave looked at it not only as an analyst, but as a business owner with a presence in China. From the SIC transcript:

We have an office in Beijing, we have an office in Hong Kong, and running a business out of China just gets harder and harder. None of your ex-pat staff wants to stay there. All your ex-pat staff says, “Look, I haven't seen my kids who are in US colleges or European colleges for two years. I want out. I don't want to live here anymore.”

I think that's going to be a big hurdle going forward. Who's a senior manager at, I don't know, at Apple or Peugeot or Volkswagen, who today puts their hand up to move to China? Two or three years ago, it was an exciting adventure. You'd move to China, and it's a country moving, it's a 5,000-year-old culture, it was extremely exciting. The excitement's gone.

Xi Jinping may be perfectly fine with this. He would prefer the Chinese version of capitalism be run by Chinese people, not ex-pats, particularly now that China has acquired enough skills from those ex-pats to do things on its own. Having foreigners underfoot is less helpful than it once was.

However, this points to the theme Louis and others mentioned repeatedly. As globalization fades, the world is fragmenting into national and regional economic blocs. These economic blocs will also be financial and currency blocs. It isn't just the flow of goods on the line; capital flows are being blocked, too. That will mean big changes in the coming years.

## Zulauf: Vicious Cycles

On Day 5, we heard from the legendary Felix Zulauf, whom you may know from his long presence on *Barron's* money manager roundtable. I asked Grant Williams to interview Felix, and they quickly exposed more hardening of the economies.

Felix began by talking about his work on cycles. The economic and financial markets aren't linear. They go through long-term cycles, within which are shorter cycles, all of which have peaks and valleys. Understanding where you are in the cycles is key to anticipating what will happen next. This is currently harder than usual because two big events—the pandemic and now the war—interrupted the cycles in unprecedented ways.

Felix sees these cyclical breaks as key to our problems. COVID restrictions disrupted normal supply and demand patterns, causing enormous damage that still isn't fixed. Highly optimized, efficient businesses can't always add or reduce production quickly. That led to shortages of some goods and services and an excess of others. These had unequal effects but caused a lot of pain for a lot of people.

Governments and central banks tried to reduce this pain, but it's hard in the first place, and they lacked the right tools and talents. Their interventions may have prevented even worse outcomes. Nevertheless, they generated yet more problems: stimulus payments, QE, and low-interest rates enabled spending that generated supply chain snarls and price inflation, which the Russia-Ukraine War would later aggravate.

Felix thinks this inflation will persist into the mid-2020s. Inflationary psychology is now embedded in the economy, and he doesn't see Jerome Powell as another Paul Volcker. But he also doesn't foresee 70s-style stagflation. It will be "something else" that will destroy confidence in both institutions and currencies. Then people will turn to gold.

## Marks: Pendulum Swings

Later that same day, I interviewed celebrated fund manager Howard Marks. He picked up on the cyclical theme as well but described it as a "pendulum." Here's a snippet from the transcript.

To me, the concept of the pendulum is extremely important. Human thinking does not stay centered at what my mother used to call "the happy medium." It usually swings from too much in one direction to too much in the other, from greed to fear, from optimistic to pessimistic, from risk averse to risk tolerant, and excessively.

I like to point out that in the real world, things fluctuate between pretty good and not so hot, but in the markets, they tend to go from flawless to hopeless. The swings are overdone. Whenever human thinking and psychology are involved, I think A, the pendulum swings, and B, it usually swings to excess.

There is a pendulum with regard to offshoring, for example. If you go back 60 years in this country to when you and I were boys [he was talking to me, and we are basically the same age], virtually everything we consumed was made in America. And then, over time, back about 60 years ago, there were a few, literally I think, a few Volkswagens and what we call Datsuns imported to America. Fast forward to the '80s, the Japanese car makers were forced to sign on for a voluntary limitation of imports of something like 1.6 million cars a year. And sourcing, manufacturing, et cetera, went from Japan, which was cheap and became expensive, to China, which was cheap and became expensive, to Bangladesh and Pakistan.

We used to make 80% of the world's semiconductors. Today we make few, if any, and most... 80%, I think... come from Samsung in Korea and from Taiwan. Taiwan's the big one. But the pendulum swung very strongly toward offshoring and importation because it was cheaper, and people make these decisions on one dimension and its cheapness, but the recent events—the supply chain complications of the last year and a half—have shown that there are things that matter other than cheapness.

I think the pendulum will swing back somewhat with regard to critical goods, not baseball caps and t-shirts that are made in Bangladesh, but with regard to critical goods like semiconductors, where people will say, it's not just cheapness... we also have to worry about safety and security of our supplies. And so, we're going to bring, for example, semiconductor fabrication back onshore. And we're starting to see this. Both Samsung and Intel have announced new domestic fabrication plants.

He said all that matter-of-factly, but it has enormous consequences. US offshoring generated the giant trade deficit that gives the US dollar its global reserve status and finances our domestic debt. Can we reverse it? Maybe, but it will take time. And it will lead to a vastly different kind of economy than most of us can remember.

Howard went on to describe another pendulum in Europe involving energy. The issue there wasn't so much price as a desire to protect the environment. They tried doing this with renewable energy sources like wind, solar, and nuclear. It turned out not to be enough, and some people didn't like the nuclear plants. That led some countries, mainly Germany, to import most of their energy from Russia. We know where that dependence led, and now the pendulum is swinging the other way. Having secure energy supplies is outweighing the green concerns. All these pendulum swings create investment opportunities, the kind Howard adeptly identifies and jumps on.

Finally, we talked about political extremism and Howard's work on the "No Labels" organization. It is growing more important as we face a possible economic crisis. He thinks the Fed will keep pushing until something breaks, and then may push even more. Getting through it will require the kind of cooperation that, at this point, is almost nonexistent in Congress. I say "almost" because the bipartisan Problem Solvers Caucus is actually working to find solutions. These will require a dirty word: compromise. That's unpopular in both party bases, so Howard says the real challenge is to create an environment that fosters problem solving.

## Wood: Innovation Wins

Since we're talking about problems and solutions, I'll end this letter with Cathie Wood. Her firm's funds have struggled lately, but that's normal in her space. The simple fact is that many of the technologies and companies she invested in became their own bubbles. Anyone remember Amazon or Microsoft in 2001? But great buying opportunities. I don't think we are there quite yet, but when the Fed hopefully kills the inflation monster, those tech stocks will be the Amazons and Apples of the future.

Cathie looks for innovation because that's what solves problems. Innovation is inherently risky. Sometimes the solutions don't work, or you need a long time to make them work. Impatient investors don't like that part, but it goes with the territory.

Cathie talked about three top problems she thinks technology is ready to solve: inflation, energy, and supply chains. These solutions will help countries become more resilient and less vulnerable to these global contagions. She pointed out that innovative solutions are, by definition, different from the current standards. That draws criticism, but it's also what makes them work.

Tesla, for instance, started out doing something new with electric vehicles. The automotive industry's vast supply chains weren't set up to do what Tesla needed. This forced the company to become vertically integrated—something business schools usually say is a terrible mistake. Tesla had to bring almost everything in house, at least in its early days. That's been costly, but now it makes the company less dependent on outside suppliers. That is allowing it to expand quickly while much larger, global brands race to catch up.

My partner Ed D'Agostino, who was interviewing Cathie, pushed her on that point. He said US equity markets don't like vertical integration, and it often draws in activist investors who push for change. Here is Cathie's response.

This is the way innovation often evolves. If you look at the early days of cell phone manufacturing, for example, I think many people are surprised to learn that Qualcomm felt compelled to build its own phones because it wanted to speed up adoption, and nobody believed that cell phones were going to take off the way they did. Tesla had to do the same thing. And we've talked to Tesla about this. You know, the cell phone industry, of course, evolved so that it wasn't so vertically integrated after all. And I do think Tesla is thinking that with time, as supply chains become more, shall I say, commoditized, it probably will move away from verticalization.

But there's one thing that could prevent it and which would present it with an incredible barrier to entry, and that is if Tesla is successful at evolving the first national autonomous taxi platform, it will have done so because of its AI chip—artificial intelligence chip—this is the equivalent of Apple designing its own chip for smartphones because nobody thought of that or believed smartphones could happen. Apple redefined the industry.

Tesla's doing the same in the transportation industry with autonomous, and what we're finding out with the use of artificial intelligence and given the importance of safety when you're talking about autonomous driving, you have to titrate the cars very carefully using the data and all of the sensors. It's a very delicate balance, and it changes from car model to car model. So we think that these years of vertical integration could extend if Tesla becomes successful in the autonomous taxi platform market.

Again, this is something with macro consequences if correct. Millions of driver jobs—taxi, delivery vehicles, long-haul trucks, and more—are at stake. Can Tesla develop chips that will push goods through the economy more efficiently than human drivers? I think we will find out. And if it's not Tesla, it will be someone else.

Cathie went on to talk about technology and “precision agriculture” solving many of our food challenges. Intelligent farm equipment can increase crop yields while using less fuel, fertilizer, and other inputs.

Reading the transcript, I was once again struck by the parallels between the economy and our human bodies. The automotive industry is racing to make the economy's circulatory system work better, eliminating arterial blockages and helping “nutrients” flow better. Meanwhile, the agriculture industry is using technology to expand the supply of nutrients that keep us healthy.

My biggest personal investment is a private company that will completely change the agricultural space. They can literally help a plant or crop evolve multiple traits like resistance to herbicides and disease, or to be more nutritious, more productive, and less reliant on fertilizers and chemicals. It isn't GMO, but more a way of speeding up the evolution that would occur over centuries. Combine that with precision farming? Game changer for the ag world and cheaper prices and abundance for everyone.

Once again, I've only given you a very superficial summary of these deep, nuanced discussions. You can [learn so much more by watching, listening, and reading them for yourself](#).

## **Maybe Dallas, a Gamble, and on...**

I am flying back from Vancouver, where I saw so many old friends: David Rosenberg, Danielle Di Martino, and Rick Rule, as well as lots of readers. It was fun.

It feels like old times. I am finishing this letter in an airport (Newark) on a long layover flying back home to Dorado, PR, late Thursday. This airport is busy, which is a good thing.

The Dallas Mavericks amazed everyone by trashing the Phoenix Suns in Games 6 and 7. Phoenix owned the Mavs on their home court this season, so it was a surprise to me. Now, Dallas plays the Golden State Warriors in the Western Conference Finals. I sold my tickets to a friend (Howard Getson), who eventually upgraded them to floor seats under the basket. He offered me Game 1 in Dallas (Game 3 of the series) or Game 3 in Dallas, which means Dallas has to win two games to get to a game 6 for the series.

As a 35-year season ticket holder, the energy in a Game 6 championship series is electric. I will gamble that Luka and the underdog Mavs can get there. If so, I will be in Dallas next Saturday. I watched Dirk's first and last game. Luka may be the second coming.

Time to hit the send button. Have a great week and spend some time with friends. Looking forward to seeing Shane tonight and maybe a quick surprise side trip. And [follow me on Twitter!](#)

Your happy to be on the road analyst,



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