

What Happens Next – Sunday June 6, 2021
Stopping Aging, IRS Audits, and China
Marko Papic QA

Larry Bernstein:

You make fun of experts. We had Phil Tetlock on this program about a year ago, where he too questioned the capability and accuracy of experts in every dimension, particularly in geopolitics. I think investors have historically looked to former policymakers in the relevant country to help predictive decision making, and they have done poorly. What would you advise investors in evaluating expert testimony?

Marko Papic:

Well, unfortunately we have to trust ourselves, and that's what the book is about. The book is a manual for investors to start thinking about politics and geopolitics as part of a critical portion of being an investor.

My point is that politics and geopolitics should be in that toolbox. You can't get some former official who's now retired, doesn't have access to their security clearance anymore, basically regurgitate Financial Times op-eds to you across your boardroom table. That's what's happening with the industry for the most part. And I think that what we need to rely on is our own ability. When you're talking to someone from that field, it's like asking a race car driver how their car works. They're going to try to push it to the limit. You want to talk to the engineers.

The two approaches that I really promote in my book is, first talk to the academics that nobody ever talks to, because they've actually thought about these things in a much more holistic way. The second is focused on the material constraints to policymakers. You shouldn't care what they think, you shouldn't care what their preferences are, you should care what they can actually do given a holistic set of constraints.

Larry Bernstein:.

As you think about this US-China example, what are the constraints that will limit both US and Chinese actions, as a case study for the constraint method of analysis?

Marko Papic:

I would say the three most important constraints, first and foremost in China is the unwritten agreements between the Communist Party of China and the people it rules is that it will deliver a middle-class lifestyle, that so-called China dream, to its population. That's the first constraint.

The second constraint is the allies of the United States. The allies of the United States just don't

see China as big of a threat. The United States is not going to have an easy time coalescing a coalition against China.

Then the third constraint is that China is going to face significant macroeconomic difficulties going forward because of its demographics.

Larry Bernstein:

The IMF and the State Department have been encouraging China for decades to spend money, consume American products, and to not run this enormous deficit.

Marko Papic:

It's actually succeeding. This is the irony. The US policy makers, including the Biden Administration, have now suddenly decided that that's not going to work anymore. But, first of all, the data doesn't reveal that. Current account surplus of China has gone from 12% of GDP to flirting with a deficit. It has been happening.

I think that American policymakers have to pause, breathe, and maybe count until 10, and realize that mercantilist China is eroding.

The reason for that is that people are getting wealthier in China. They're seeking to buy foreign goods from China or going on these trips abroad and buying a lot of stuff there. Eventually Chinese demographics is the sort of Damocles that will kick what is currently a precariously balanced current account into a deficit.

Larry Bernstein:

Sebastian Strangio mentioned in his talk. He mentioned a different kind of constraint, which is the relationship of domestic politics within China and its relationship with the Communist Party, the CCP. He was focusing on Chinese nationalism as an excuse for being both militarily aggressive and oppositional with its neighbors. How do you think about domestic Chinese constraints in this calculation?

Marko Papic:

I'm very sympathetic to that view. I thought Sebastian's talk was really, really good, especially when he talks about the way the neighbors of China have this love and hate relationship.

In terms of nationalism versus this middle-class aspiration, I think that's something that we need to think about really carefully. Because if you're a China hawk, you're going to talk about nationalism. If you're a China dove, you're going to say that, "But they want middle-class lifestyle." I think the truth is somewhere in the middle, that there's an interplay of those two factors.

Larry Bernstein:

Do I understand your point is that we should separate military and foreign policy from foreign trade? That they really don't have anything to do with each other? That if tensions increased between the US and China, we shouldn't expect material changes in the amount of foreign trade between China and the West?

Marko Papic:

Prima facie? Absolutely. There's absolutely no evidence in human history that the two go hand in hand. The only reason that the investor community is obsessed about this is because the only geopolitical event that they're anchoring to is the Cold War. Cold War was a unique situation. Honestly, throughout human history, we haven't had that re-decoupling between two camps.

If you spend some time reading history and looking at the economic relationship of countries that were enemies against one another prior to conflict, you will see that decoupling of trading investment flows almost never happens. There's some erosion of enthusiasm for plowing into long-term FDI in your enemy, but trade and investment continues.

Larry Bernstein:

I want to give you a hypothetical, and then apply the toolbox to analyze the geopolitical problem with the concept of constraints. Here's the hypothetical.

We had Admiral James Stavridis on the program a couple of weeks ago, and he discussed a piece of fiction he wrote called 2034, which was about a war between the US and China. In his example, the Chinese decided that they wanted to take Taiwan, and their first move was to take out an American aircraft carrier in the South China Sea. Let's just imagine that there's heat going on in the South China Sea and Taiwan is up for grabs and China is being bellicose, and financial markets are starting to be chaotic. How should investors place bets, how to evaluate the likelihood of China succeeding and buying the dips on Taiwanese semiconductor companies?

Marko Papic:

I think that the biggest constraint of China is that it simply doesn't have enough power projection to fight a war with the United States over Middle East oil supplies, and other wider global trade routes. And so, that's why I think the scenario you've painted is focused very much in China's neighborhood, where I do agree they have their own home court advantage, but they are constrained by the wider realities, which is that the US is a global power. They're a regional power. And so, that's why I do think you will eventually have a buy and dips opportunity in a crisis like that.

Larry Bernstein:

It's funny, when you described the Australian wine issue before, where Australia reduces exports to China and the US filled the gap, the way you kind of described the problem was Australia was doing us a favor and how could we have cheated and backstabbed them? What I think is interesting in the example of Southeast Asia, it's the other countries in Southeast Asia trying to co-opt American military and foreign policy to benefit them, not the other way around.

Every country wants to cheat, not only in the economic sphere, but also in the military sphere. So, back in the sixties, during the Vietnam war, the Australians helped, but they weren't critical in protecting against communism in Southeast Asia, when they would expect to be the true beneficiaries of American policy. When you think about Taiwan should we think of the US trying to get the other allies to help them? Or should we think of the other countries in the region trying to get the United States to help them to preserve Taiwan?

Marko Papic:

Well, I don't think anyone really has Taiwanese interests at heart, to start with, and I'm making just a geopolitical realist point, which is that it's not clear to me that anyone really worries about Taiwan. What will it mean for me?. They will ask the United States for help for maintaining the status quo.

But where I think the US will struggle is in getting these countries of Southeast Asia that, Sebastian talks about, Japan and South Korea to change the status quo, to push China into a box. That's not going to work, and it's not going to work because for most of these countries, the United States ceased to be a relevant economic power 20 years ago. They're all completely addicted to China. So, if the United States policy is to maintain the status quo, that's fine. But if the United States policy is to somehow tip China into a crisis or force China to weaken, to basically beat down China, that's not something these countries are going to go along with.

The United States, especially under the Trump Administration, but also in the Biden Administration, has been going around the world creating a coalition, but it's been using rhetoric that just doesn't resonate with the rest of the world. So, China's not the Soviet Union, they need to acknowledge that's the messy multipolarity that we exist in today. And throughout human history, that messy multipolarity has been the norm. The Cold War was not the norm.

Larry Bernstein:

And just for fun, how would I use your toolkit to analyze the next French presidential election, particularly as it relates to Le Pen? It seems that when you get the talking heads in the room, they say there's just no chance of Le Pen; she was beaten very badly in the runoff race last time

with Macron. How would we use our toolkit to evaluate that sort of risk?

Marko Papic:

And it's so funny because in 2017, it was the exact opposite that you remember. Actually, this was one of the most lucrative investment calls I've ever made, which was to just go long the Euro ahead of the French election. Why? Well, because Brexit happened, then Trump happened, and then all the talking heads are like, "Well, we have to linearly extrapolate. Next is Marine Le Pen." And she was trailing in the polls massively. And actually, if you looked at her appeal, her approval rating in France was basically precisely the opposite of support for the Euro. So, she made a critical mistake in 2017, she was anti-Europe, and the median voter on the European continent is just not a Euro-skeptic. The journalists in New York and London are Euro-skeptics, but the actual voters are not. And so, she got crushed.

And the funny thing about this is that the data was clear she was going to get crushed. And I think that they're just not looking at the polls again. She's actually very close. It's neck and neck with Macron. And the reason it's neck and neck is that she has finally understood her ultimate constraint. She has learned from her previous errors, that her ultimate constraint is Euro-skepticism. And so, she has modified it. She's become pro-EU, accepted the Euro area, the way that Charles de Gaulle begrudgingly accepted European integration. That's why I think she has a chance to win.

Larry Bernstein:

Polling. We've done a number of programs on What Happens Next, analyzing the deficiencies in polling. We focused mostly on Trump-Biden and Trump-Hillary. I'm wondering how we should consider the use of polling in examples of French elections or English elections, Brexit. Is there something broken in global polls?

Marko Papic:

Polling is extremely useful, let me put it that way. If you think the opposite, then you're being irresponsible as an investor.

What I mean by that is you should think of polling the way you should think of a casino setting a line on a football game. The Patriots are favored by 10 over the Bills. Okay? That's the line that's set by the casino. You can bet on it, or you can bet against it. You can go over, you can go under. That's the way to think about polling. It's really the combination of polling which informs the sentiment of where the market is. Then that's it. You can't use it to actually predict the outcomes.

For example, Marine Le Pen versus Macron in 2017. Polling was clear that Macron had a huge lead over Le Pen. I think it was 20%. Yet the betting market, especially the price of the Euro, were pricing in a much tighter election. That was a mistake.

Larry Bernstein:

It seems like the investment community oftentimes has a different consensus than the rest of the population. I'll give you two examples. The investor community was individually very pro-Biden. They actually didn't know many people that were pro-Trump. The same would go with Brexit. If you went to the London investor community and said, "Who's going to win Brexit or not?" They would have gotten that wrong because everyone they knew was opposed to Brexit and saw no reason to go for it.

Marko Papic:

Oh, man, that's such a good question.

So, you're so right about that. I would say that it goes two ways, though. A lot of people tried to correct for the bias of their friends in the financial community, but they over-correct in really stupid ways. How many times has somebody told you that they spoke to a cab driver in Milan or Athens to your Euro crisis?

Because talking to people is a mistake. Driving into the heartland of America to check signs is not a statistically significant form of analysis. And the best way is to understand where the median voter is. That's it. If you look at the Biden-Trump election swung to Biden because he won the 50 to a hundred thousand dollar income group of people. Relative to Hillary Clinton, he had a 10% gain with that population.

I called it for Biden in 2019. I doubled down on the call after the pandemic, and my reasoning was very simple. Trump did not actually do enough for the median voter, specifically the 50 to a hundred thousand group. When Mitch McConnell prevented that stimulus effort ahead of the election, that to me was the death nail. So, if you're a Republican, if you're a conservative, and you're mad that Trump lost, go back to that September, October, November, period, and look at Mitch McConnell's behavior. In my view, he lost that election to Trump. Why, I don't know.

The easiest explanation is that McConnell misjudged the median voter in the United States, because the loss of support in that income segment was massive for Donald Trump ahead of the election. And that's something that Biden won, and I think that Trump didn't, I think he didn't work enough in those last moments to push McConnell to pass the yet another stimulus effort.

So what I would say to you is it's a combination of kind of figuring out where the median voter is, what mood is the median voter in, and also figuring out what the polls are saying. definitely not looking at yard signs or talking to the financial industry, or talking to cab drivers.

Larry Bernstein:
Marko, thank you very much.