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The KWR International Advisor Macro-Outlook

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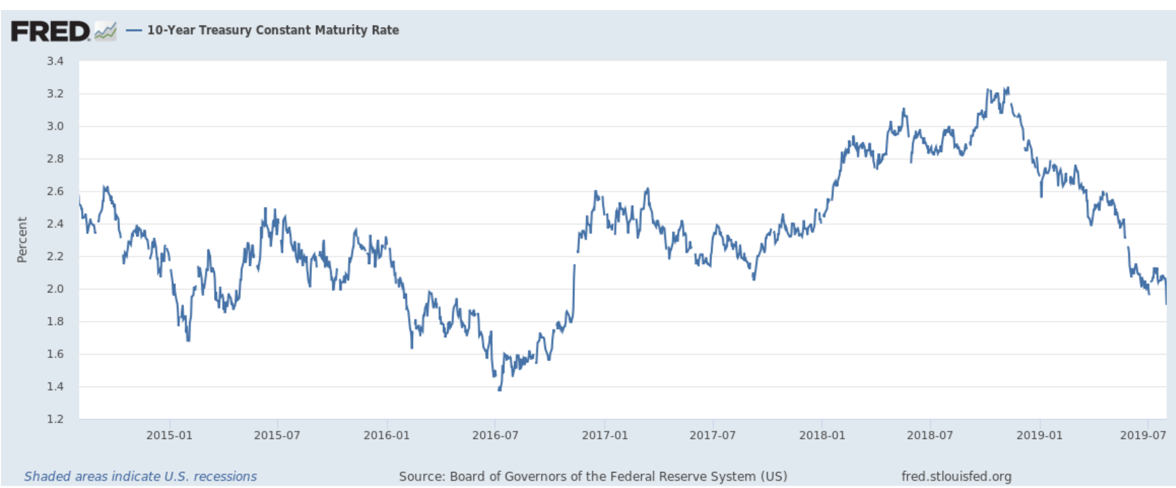
The Fed and Tariff Man, Hong Kong Jitters, and Boris' Wild Ride

Summary: In the week ahead, Hong Kong looms large as political tensions threaten to boil over between the protest movement and the Hong Kong government, backed by the People's Republic of China. If not handled diplomatically, Hong Kong could be China's new Tiananmen Square. Other things to watch include whether the Puerto Rican Senate will confirm Pedro Pierluisi as the island's new governor; more on the Sino-American trade war; troubles in the Persian Gulf, and the last round of the earnings season. Of these we think Hong Kong has the potential to morph into a larger crisis. The combination of the above spells more volatility to global debt (especially with the 10 year Treasury yield now under 2.0%) and equity markets, but is likely to be good for gold and a strengthening yen.



The Fed and Tariff Man: Last week was dominated by the Federal Reserve's 25bps rate cut and the ensuing press conference fumble. Although the Fed met market expectations of a rate cut, Chairman Jerome Powell was markedly more hawkish at the press conference, suggesting that the rate cut was perhaps not the beginning of a new rate cut cycle, but perhaps a tweak. On the news markets tumbled, the dollar strengthened and President Trump (Tariff Man) let his displeasure be known. Over the weekend, Trump Trade Advisor Peter Navarro took another swipe at the Fed, blaming the U.S. central bank costing the economy "over a point of growth." *(Navarro also insisted that there is no cost of tariffs on the U.S. consumer, contradicting data from the U.S. Labor Department and most U.S. corporations).*

Three things to watch at the Fed:

1. In the aftermath of the July FOMC meeting, top-ranking members of the bank will work at damage control and seek to calm markets. The message is the Fed is more dovish than hawkish;

2. After the announcement by President Trump of the imposition of 10% tariffs on roughly $300 billion in Chinese imports that are not currently taxed starting September 1, the Fed is likely to cut rates again in September, possibly again in December. The reason is that the new tariffs are heavily in the consumer good area and costs are likely to be passed on to the U.S. consumers. Higher prices could function as a brake to purchases, which, in turn could dampen manufacturing which is already struggling. The more tariffs, the more the drag.

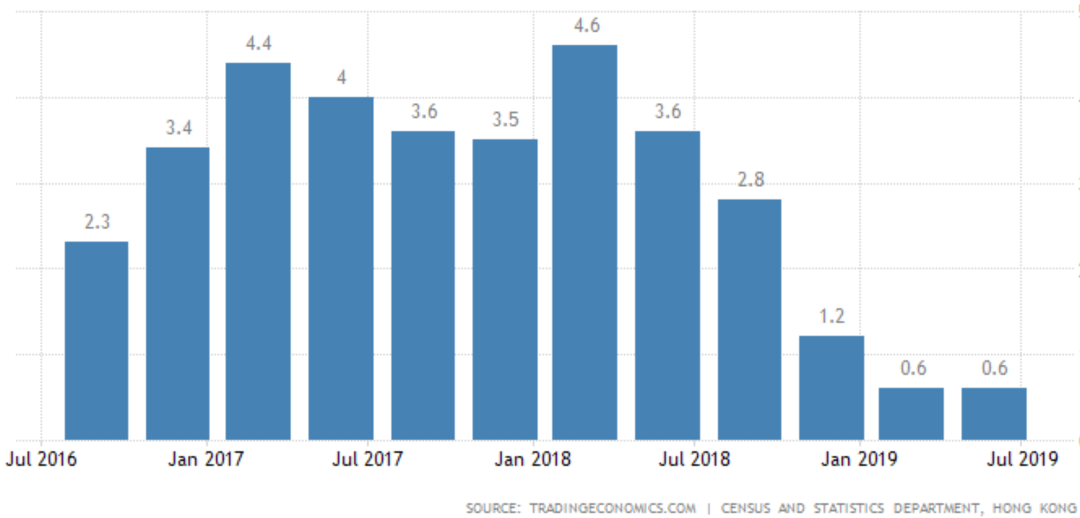
3. The political nastiness from the White House vis-à-vis the Federal Reserve is likely to increase in the months ahead. President Trump wants to be re-elected and he needs a growth story to do so. With tariffs likely to increasingly brake growth, he needs lower interest rates. This also coincides with the development of competitive central banking as other countries are aggressively cutting their rates, leaving the dollar stronger and less competitive in terms of trade.

Hong Kong-China Jitters – Another Tiananmen in the Making?: The week begins with Hong Kong heading into its first general strike in 50 years. The movement has morphed from opposition to a proposed extradition treaty between Hong Kong and China to demands for democratic reforms and an independent inquiry into police brutality. Weeks of demonstrations, some of them violent, have effectively slowed the Hong Kong economy and risk becoming a major geopolitical flashpoint.

What makes easily rolling up the protest movement difficult is that it has tapped a deep pool of resentment over Beijing's political heavy handiness that has been growing in recent years. It also appears to have drawn in the professional classes, which could greatly complicate the situation. This was underscored late last week when hundreds of employees from Hong Kong's banking and finance sectors gathered for a brief "flash mob". There are indications that some of the Special Administrative Region's (SAR) civil service are supportive of the movement as well.

For its part, the Hong Kong government is warning the protest movement that they are disrupting the economy. Cathy Pacific has cut a number of flights traveling in and out of the airport and businesses have closed their doors in those areas where the authorities and protestors are active. A spokesman for the SAR stated: "Any large-scale strikes and acts of violence will affect the livelihood and economics of Hong Kong citizens. This will only undermine further the local economy that is facing downside risks, as well as the confidence of the international community and overseas investors in Hong Kong's society and economy." According to the World Bank, the Hong Kong economy expanded by 3.0% in 2018, but the current unrest could reduce prospects for 2019.

Hong Kong Real GDP Growth Rate



Beyond the Hong Kong government is President Xi Jinping in Beijing. Already dealing with an increasingly more difficult trade war with the United States, tensions in the South China Sea and slipping economic growth, President Xi no doubt finds Hong Kong a major and unwanted headache. Beijing is solidly opposed to anything that gives the appearance that democracy is blooming anywhere under its jurisdiction that includes Hong Kong. Moreover, a messy outcome in Hong Kong is likely to reinforce Taiwanese sentiment that any rejoining with mainland China will come with a curbing of political freedoms. Taiwan has developed a democratic political system, with its citizens having become accustomed to voting for their representatives and president.

It is somewhat ironic that tough decisions over what to do with Hong Kong come shortly after the death on July 22, 2019 of former Chinese Premier Li Peng, who used his authority to declare martial law and ordered the June 1989 military crackdown against the student pro-democracy movement in Tiananmen Square. For that brutal and bloody action, Li Peng has often been referred to as the "Butcher of Beijing." China was broadly criticized and the U.S. Congress voted to impose economic sanctions against China, citing human rights violations. China's economic growth went from double digit real GDP growth figures to 4.2% in 1989 and 3.9% in 1990 before recovering in 1991.

President Xi is between the rock of authoritarian China and the hard place of Hong Kong pro-democracy protesters. There is no easy solution. This has left Beijing sending Hong Kong the message that it will not tolerate much more of this. Very recently Major General Chen Daoxiang, a senior Chinese officer in Hong Kong, let it be known that the PLA would put down the protest movement in the SAR if President Xi gives the order. He stressed that "Violent protests were absolutely impermissible."

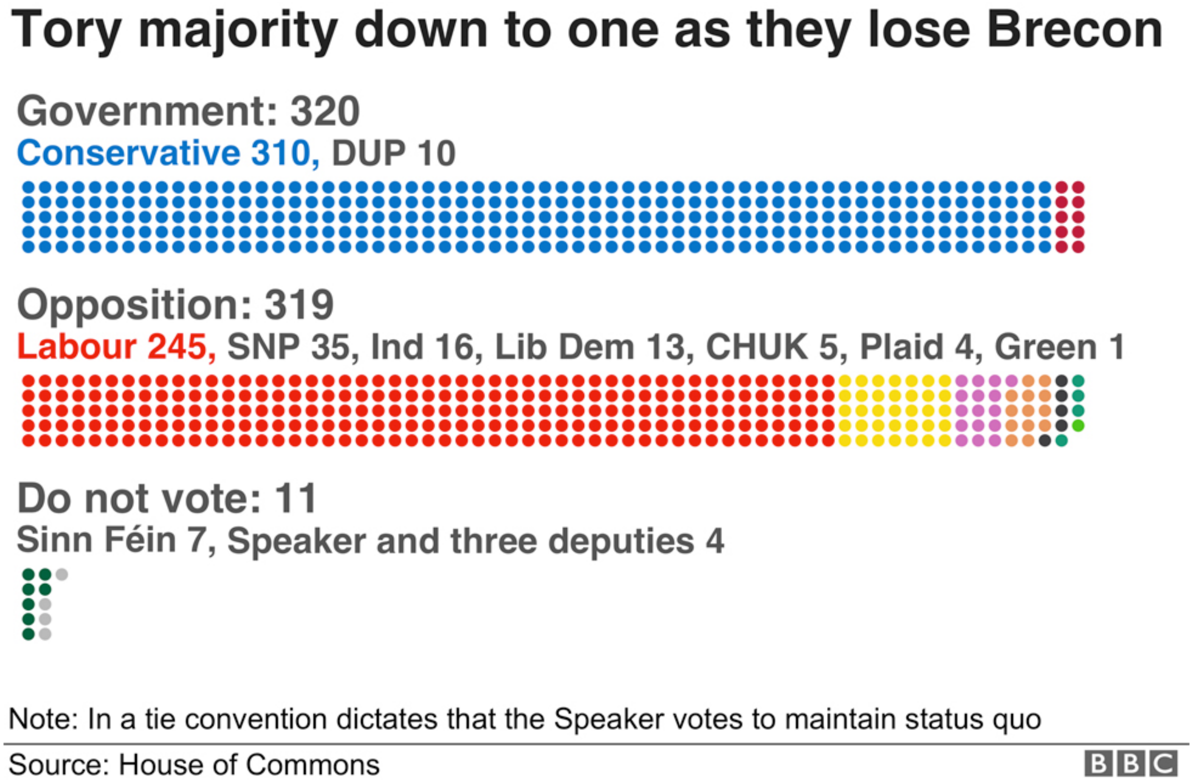
President Xi is keenly aware that history could remember him in the same light of Li Peng. A PLA intervention would have international consequences, which could include economic sanctions with the U.S. and Europe. Although the China of 2019 is far stronger than the China of 1989 and the U.S. has already used the tariff weapon against Chinese goods, further external disruptions to the mainland economy would hit at a vulnerable time.

A PLA intervention into Hong Kong would also damage the SAR's reputation as place to conduct business due to its reputation of adhering to the rule of law. At risk is the economic and financial halfway house that Hong Kong provides between China and the rest of the world with a GDP estimated to be worth $363 billion. Equally important, Hong Kong is an integral part in global finance as most of the world's major banks and investment funds are active in Hong Kong financial markets as are China's. Rounding out the picture, Hong Kong is also the 9th largest holder of U.S. Treasury Securities at $204 billion as of May 2019; China is the largest at over $1 trillion. Would a major incident over Hong Kong trigger a more fulsome disentangling of the U.S.-Chinese economic relationship, including a sell-off of U.S. bonds? **A brutal crushing of the protest movement by the PLA could function as a potential Lehman movement for global financial markets.**

UK- Boris Johnson's Wild Ride: In its first week in office Prime Minister Boris Johnson's government was hit by a plunging pound, a Bank of England warning that a recession could lurk not too far on the horizon, and claims that the new leader's Brexit strategy – which appears to be charging ahead to October 31st with no-deal – could result in the UK's breakup. The last translates into speculation that Northern Ireland might eventually join the Republic of Ireland, hence remaining in the European Union, while Scotland could hold a new referendum on independence from which they would apply to join the EU. That would leave England and Wales as a rump state of the UK.

The Johnson government was also hit by a defeat in the Brecon by-election. Voters went to the polls in Brecon and Radnorshire (Wales) to elect a seat previously held by the Conservative Chris Davies, who was unseated by a petition following his conviction for a false expenses claim. This time the Liberal Democratic candidate, Jane Dodds won.

The significance of the election is that it has reduced Boris Johnson's working majority in the House of Commons to one seat. As the BBC noted of the precariousness of Johnson's government, "Now, with the thinnest majority, he will have to rely heavily on the support of his own MPs and his confidence-and-supply partners the DUP (Democratic Union Party) to get any legislation passed in key votes."



Last week was not all bad news for Prime Minister Johnson: opinion polls demonstrated what is being called the "Boris bounce" for the Conservatives. One poll indicated that the entry of Johnson into 10 Downing Street opened up a 10-point lead over Labour, siphoning off potential voters from Nigel Farage's Brexit party.

What to take from the rash of developments? First and foremost, if the EU does not want to make concessions, Johnson will move ahead with a no deal. At the same time, he is keenly aware the very unity of the country is at stake, hence his visits to Scotland, Wales and Northern Ireland. The road ahead is not going to be easy to steer.

Johnson is also positioning for a rough ride that is likely to include a national election. He has promised he will not hold an election before the official Brexit day of October 31. This fits his election strategy – a most likely end-game of no-deal Brexit and a big increase in borrowing to fund priorities such as new hospitals, a full-fiber broadband rollout and social care reform. He needs to keep enough of the Conservative faithful, while hoping to pick up Labour voters in the north who voted heavily for Brexit.

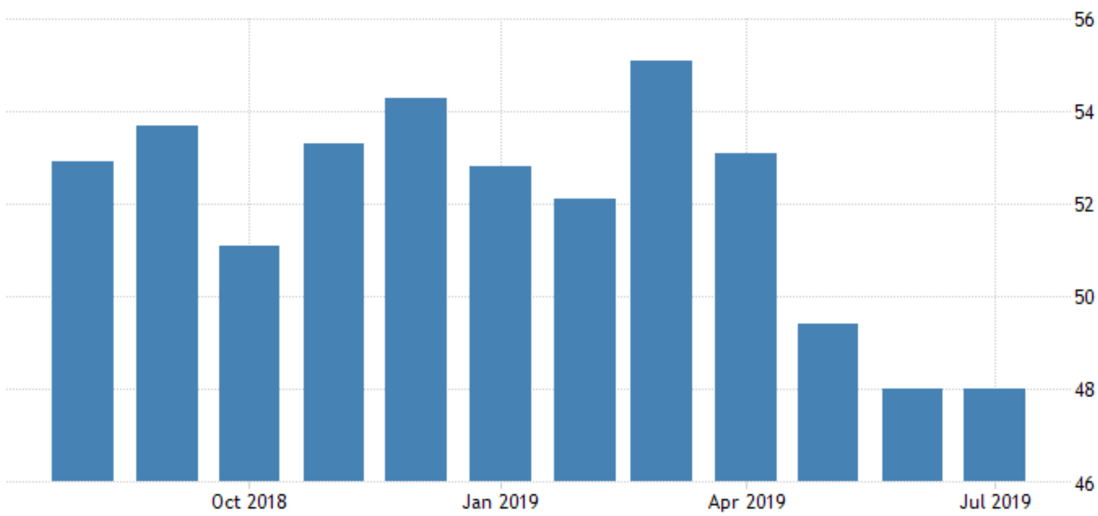
Johnson faces three risks to his strategy.

- **First and foremost, after the Brecon by-election his majority in parliament is wafer-thin**. His government could fall at any time if a major vote is taken and lost or if any Conservative MPS leave the party or fail to follow party lines in a vote (and there is considerable party rancor within the Conservative ranks).
- **Second, British politics are undergoing a realignment based more on the lines of pro- and anti-Brexit.** Significantly, this could play into the hands of the Liberal Democrats, who are the only clear-cut support of a "remain" policy. The Brecon by-election is notable in that Plaid

Cymru (the Welsh nationalist party) and Greens decided to align with the Liberal Democrats, potentially an election alliance in the making, which also feeds on discontent with Labour.

- **Third, the British economy is wobbly.** UK manufacturing output has fallen to its lowest since July 2012 due to slower global economic growth, political uncertainty and the unwinding of earlier Brexit stockpiling activity. Production volumes fell at the fastest pace in seven years as clients delayed, cancelled or rerouted orders away from the UK. A no-deal Brexit would cause a double hit for British manufacturing as they are slammed by both a slump in international demand and disruption from leaving the EU. **The Bank of England recently downgraded its real GDP outlook from an earlier forecast of 1.5% for 2019 to 1.3% and down from 1.6% in 2020 to 1.3%.**

UK Monthly Manufacturing PMI



The UK is currently rated Aa2 (stable)/AA (negative)/AA (negative watch). Considering the stance of S&P and Fitch, the UK's ratings are already under pressure. And on August 1, Moody's commented that the new government's tax and spending promises could further weaken the UK's credit profile. If a no-deal Brexit occurs, we would expect the UK economy to slip into a recession, debt borrowing is likely to increase and further political uncertainties will continue, including the potential for another Scottish referendum. We could see the UK go to low AA.