Weekly Market Insights

May 26, 2020

Looking through an economic kaleidoscope

The U.S. equity markets had a strong performance this past week. The Dow ended the week +3.3%, the S&P 500 +3.2%, the NASDAQ +3.4%, while in contrast, the Hang Seng[1] closed down 5.6%.

We have included the Hang Seng performance because it is an important barometer for analyzing current Chinese political and economic and behavior.

The Economy

As expected, the U.S. economy continued to show significant signs of weakness this past week. All reported indicators were depressed. Interestingly, investors appeared to look past what the economic indicators were telling them and preferred to pay more attention to reports of scientific breakthroughs in finding a vaccine that would halt the pandemic. Market participants were also encouraged by the reports of governors reopening their states to commerce, which would boost the economy. The openings are controversial, with the scientific community warning against, while the political community has encouraged, to a large extent, reopening efforts. Like many reports that move markets, we will have to wait and see who is correct.

The Dollar

The U.S. dollar has been the clear winner through all the turmoil. Irrespective of the miles of written words warning of the demise of the dollar, it remains the currency of choice around the globe. The dollar doubters have good ammunition, large budget deficits, an extremely easy monetary policy and political confusion at home. The dollar bulls have had the upper hand, at least for the moment. As we move into the next segment, the bull argument will become clearer. Investors should remember the value of a nation's currency is almost as dependent on its political strength as its economic.

A political and economic kaleidoscope

Every week, it appears, the political kaleidoscope takes another turn. China has been going through change since mid-2013, the year Xi Jinping was elected President of the People's Republic of China. Until that time, China was following the path prescribed by Deng Xiaoping, the Chinese leader from 1978 through 1992, when he turned the country away from Mao's ultra-Stalinist regime and brought China into a mixed economy integrated into the rest of the world. Interestingly, early on Mr. Xi was welcomed with open arms. The West and many in China expected a continuation or acceleration of the Deng policy of opening China, but that did not occur. Mr. Xi appears to be turning back the clock to a Maoist era. The most recent example is the crackdown on Hong Kong. This is why we included the Hang Seng index. When the People's Congress officially cracked down on Hong Kong this past week, the Hong Kong market fell dramatically. Hong Kong's financial markets are the most open in China and are where most foreign financial transactions take place. It appears to be very poor timing. China's economy is weakening and is certainly not in need of any more disruption. Clearly, with this kind of legislation, the RMB will not challenge the U.S. dollar for its role as the global reserve currency.

The European Union is itself in disarray. Last week, we wrote that economic problems can put enormous pressure on political fissures that were nearly unnoticeable before the economic problems came to light. This is exactly what is happening to the E.U. now. Just as in the rest of the world, the pandemic is creating economic havoc in the European market. The E.U. has the added problem that they had not really recovered from the "Great Recession" as the United States had.

Weekly Market Insights (cont'd)

As we know, there is great economic disparity between the northern E.U. countries and the southern countries. This has caused resentment within the community. Due to the loose political construction of E.U the community, they have had to fight the recession almost exclusively with monetary policy rather than fiscal policy. This has created great financial stress on the community and brought on the ire of the wealthier northern countries. Now the European Community has to find a way to bring the community together to fight the recession.

Emerging Markets

Emerging economies suffer disproportionately when developed economies falter. The reason is obvious as they are suppliers to the developed economies. When a slowdown occurs, demand falters and suppliers suffer.

Another reoccurring problem for emerging economies is that they fall in to the dollar trap. During good economic times, they borrow in dollars and lend in their own currency. When the economy turns down, emerging market currencies fall against the dollar. This makes it very difficult for the emerging countries to pay their debts.

Coda

We started this discussion with the question of whether the U.S. dollar will remain the global currency of choice. We think the argument for continuation is quite strong, and the answer is yes.

[1]The Hong Kong stock exchange.

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