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Monthly Market Review

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CULTURAL REVOLUTIONS

Hong Kong the new flash point; winds of change across America

The epic bull market that started on March 24th was still in full swing in early June, as better-than-expected jobs data for May further buoyed the V-shaped recovery thesis while investors celebrated their "liberation" from the dreary lockdown. The S&P 500 Index briefly climbed to positive territory on a year-to-date basis at the closing on June 8th, and the tech-heavy NASDAQ Index hit its all-time-high on June 23rd, 13% above its year-end 2019 closing. However, the optimism may be premature as Fed Chairman Powell took pains to warn of the economy's persistent fragilities and extraordinary uncertainty. More alarmingly, daily new COVID-19 case counts in the U.S. have soared to new highs, forcing states such as Texas and Florida to re-impose some emergency measures for social distancing. While re-opening the economy would indeed lead to more infections, most other countries coming out of lockdowns have fared much better. It's distressing that some of our compatriots still do not take the virus seriously and refuse to comply with simple measures such as wearing masks or avoiding crowd gathering. Most municipalities also lack adequate testing and contact tracing capabilities. We would all love to forget about the virus and get on with our lives, but the virus does not forget about us.

The resurging COVID-19 caused the S&P 500 Index to give up much of its initial gains, but it was still up 1.8% for the month. U.S. Treasury yields were largely unchanged in spite of an intra-month surge. Non-U.S. stocks had strong gains as re-openings abroad were progressing much better; these markets were also playing catch up to the U.S., having lagged materially during the first five months of the year. Improving demand from re-openings around the globe drove up commodity prices such as copper and crude oil. The currency market moved in a rather narrow range, but gold gained 3% and seemed poised to break out to the upside. The barbarous relic has become an enlightened choice in an era of massive fiscal deficit and fiat money printing.

On the geopolitical front, China's "wolf warriors" modus operandi continued to shake up the status quo. Beijing imposed a controversial national security law on Hong Kong, and repeatedly sent fighter jets into Taiwan's airspace. There were also clashes on the Sino-Indian border, the deadliest since at least 1967. Domestically, China has been hit with the worst floods in decades in the south and a new COVID-19 outbreak in Beijing. These developments with the world's second largest economy bear watching as they could roil the market's complacency.

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THE PEARL OF THE ORIENT

It was a typical subtropical evening of heat and humidity, with alternating drizzles, downpours, and brilliant hues of gold and orange suffusing the sky. However, June 30, 1997 was a momentous and bittersweet day for Hong Kong, as the British Empire was about to conclude 156 years of colonial rule over the territory and hand over the sovereignty to China at mid-night, July 1st.

For the people of Hong Kong, there was always a love-hate relationship with their colonial rulers. On the one hand, they resented Western condescension and being treated like second class citizens in their own land. On the other hand, Hong Kong had flourished under the British system, and they enjoyed unprecedented prosperity, stability, and freedom, especially compared to the motherland to the north. When the British first hoisted up the Union Jack in 1841, Hong Kong had less than 8,000 inhabitants scattered in fishing villages. By the time Hong Kong was handed back to China, it was a bustling financial center with 6.4 million people.

Cognizant of these sensitivities, the outgoing Governor Chris Patten called attention to his country's contribution to Hong Kong in his farewell speech that evening: the rule of law; clean and light-handed government; the value of a free society; and the beginnings of representative government and democratic accountability. He also called Hong Kong "*a very Chinese city with British characteristics*" and closed his remarks with the statement, "*Now, Hong Kong people are to run Hong Kong. That is the promise, and that is the unshakeable destiny.*"

The "promise" that Patten pointed to was the 1984 Sino-British Joint Declaration regarding Hong Kong's future after July 1, 1997, when the U.K.'s 99-year lease of the New Territories was set to expire. Since the New Territories made up 86% of the Hong Kong Territory, the U.K. had decided to return to China not only the leased regions but also the Hong Kong Island and Kowloon Peninsula. China agreed to a "one country, two systems" framework that would give Hong Kong a high degree of autonomy, except in foreign and defense affairs, for 50 years until 2047.

The Sino-British agreement generated much anxiety among Hong Kong residents, and led to a wave of migration out of the territory. In order to shore up confidence, Chinese leadership re-iterated on multiple occasions its commitment to the 50-year autonomy. In January 1990, at a televised meeting with Hong Kong business tycoon Li Ka-Shing, Deng Xiaoping, then 85 years old, expressed his wish to live long enough to visit Hong Kong after it is returned to China. He repeated the promise that Hong Kong will not change for 50 years, and said he saw no reasons to change even after 50 years. Deng never fulfilled his wish of setting foot on Hong Kong as he passed away at 92, just a few months before the handover.

Equity Markets Indices[1]	5/29/20 Price	6/30/20 Price	MTD Change	YTD Change
MSCI All Country World	509	520	2.0%	-8.1%
S&P 500	3044	3100	1.8%	-4.0%
MSCI EAFE	1725	1776	2.9%	-12.8%
Russell 2000®[2]	1394	1441	3.4%	-13.6%
NASDAQ	9490	10059	6.0%	12.1%
TOPIX	1564	1559	-0.3%	-9.4%
KOSPI	2030	2108	3.9%	-4.1%
Emerging Markets	930	994	6.8%	-10.8%
Fixed Income				
2-Year US Treasury Note	0.16%	0.15%	-1	-142
10-Year US Treasury Note	0.65%	0.66%	0	-126
BarCap US Agg Corp Sprd	1.74%	1.53%	-21	60
BarCap US Corp HY Sprd	6.37%	6.30%	-7	294
Currencies				
Chinese Renminbi (CNY/$)	7.14	7.06	-1.0%	1.4%
Brazilian Real (Real)	5.34	5.46	2.3%	35.4%
British Pound ($/GBP)	1.23	1.24	-0.3%	7.0%
Euro ($/Euro)	1.11	1.12	-1.1%	-0.2%
Japanese Yen (Yen/$)	108	108	0.1%	-0.6%
Korean Won (KRW/$)	1238	1203	-2.9%	4.0%
U.S. Dollar Index (DXY)	98.34	97.39	-1.0%	1.0%
Commodities				
Gold	1730	1782	3.0%	17.4%
Oil	35.5	39.3	10.7%	-35.7%
Natural Gas, Henry Hub	1.85	1.76	-4.9%	-19.7%
Copper (cents/lb)	243	272	12.0%	-2.9%
CRB Index	132	138	4.3%	-25.7%
Baltic Dry Index	504	1794	256.0%	64.6%

Source: Bloomberg

While the center of attention on that historical evening was the handover ceremony, there was a gathering of several thousand demonstrators in front of the Legislative Council building, where Martin Lee, the leader of the pro-democracy camp in Hong Kong's disbanded legislature, told the crowd that he was "more proud than ever" to be Chinese, but "if there is no democracy, there is no rule of law." Hong Kong's pro-democracy movement had gained momentum after the signing of the Sino-British agreement, and Patten is credited with expanding the territory's democratization, often with the help of Mr. Lee and at the wrath of Beijing.

Moments before mid-night, the Union Jack and the British colonial flag of Hong Kong were lowered for the final time to the British anthem "God Save the Queen." Prince Charles, Governor Patten and his family soon left the ceremony and headed to Victoria Harbour, where they boarded royal yacht Britannia for the long journey home. The ship sailed into the dark night with memory of the empire's past grandeur, leaving behind ripples that faded into the glistening reflection of Hong Kong's skyline.

Fast forward 23 years to the morning of April 18, 2020. Hong Kong's usual vibrancy and energy had dissipated under a COVID-19 lockdown. After returning home from a morning walk around Victoria Peak, Martin Lee, now retired from politics but still active in the pro-democracy movement, was confronted by seven police officers at his door. On May 25th, Lord Chris Patten, now 76 years old and serving as the Chancellor of Oxford University, penned an article on Project Syndicate expressing his concern over Hong Kong's future. He lamented that "more than 7,000 people have reportedly been arrested as a result of the demonstration, including such venerable figures as the barrister Martin Lee, now aged 81." The article was titled *The Lonesome Death of Hong Kong.*

A NEW EAST-WEST FLASHPOINT

Most Hong Kong residents have long prioritized making money ahead of democracy, but they got a wake-up call in early 2019, when Hong Kong Chief Executive Carrie Lam tried to establish an extradition agreement with China which would have undermined the civil liberty of Hong Kong residents and visitors by subjecting them to China's legal system. Months of protests finally forced Lam to withdraw the proposal. Beijing, however, was not willing to have its authority challenged and decided in May 2020 to impose a national security law on Hong Kong, which was passed by China's legislature on June 30th. The new law criminalizes acts deemed subversive and secessionist, and lets China establish a national security agency in Hong Kong. Some suspect that the new law will be used to conveniently quell protests and disqualify pro-Democracy candidates before Hong Kong's all-important September 6th legislative election.

To many Hong Kong residents and the West, the new law is the final nail in the coffin for the "one country, two system" framework. Beijing has essentially chosen to double down on its wolf warrior approach on Hong Kong and dared the West to do something about it. President Trump has ordered its administration to start the process of revoking Hong Kong's preferential status as a separate customs and travel territory from the rest of China. On June 25th, the U.S. Senate unanimously approved the Hong Kong Autonomy Act, which would impose sanctions on entities that violate the 1984 Joint Declaration.

The rising political tension has already damaged Hong Kong's business climate. Its elites have felt the pressure to publicly support the new law without knowing its content. HSBC, one of the largest banks in the world, had to break its political neutrality to endorse the national security law on Chinese social media, a move that was condemned by both Secretary of State Pompeo and various U.K. politicians. There were also signs of capital outflow and higher intention of emigration. Financial markets, however, have remained rather complacent. Investors seemed to believe that things will be back to normal after some transient turbulence, as the local community will eventually bend to Beijing's will due to economic necessity. Optimists also contend that Beijing will then dole out economic stimulus to demonstrate the benefits of closer integration with the motherland and support Hong Kong's international financial center status.

The complacency, however, may turn out to be misplaced, much like the market's dismissive attitude toward the coronavirus in early February. Hong Kong is the new flash point in the Sino-U.S. relationship, and neither President Trump nor Chairman Xi has the political capital to backpedal. Ironically, uber hawk John Bolton's accusation that Trump had sought Xi's help for his re-election will likely compel Trump to be tougher on China. One cannot rule out the possibility of the U.S. actually removing Hong Kong's special status, which would set in motion a series of negative developments for the global economy and financial markets. Capital flight out of Hong Kong will likely accelerate, putting pressure on the Hong Kong Dollar's peg to the greenback. The global financial system could be roiled with rising counterparty risk should the systemically important HSBC, which gets 70% of its income from Hong Kong, run into difficulties. Hong Kong's status as an international financial center could also be undermined, which will wind up hurting China's access to foreign capital. There is also the risk of the U.S. cutting off Chinese banks from U.S. dollar denominated transactions, which would have grave consequence for global trade and geopolitics. In short, Hong Kong is a combustible situation for the already fragile global economy, and it warrants close scrutiny over the coming months.

CULTURAL REVOLUTIONS

Speaking of a combustible situation, the weekslong protests and riots across America have exposed long simmering discontent and legitimate grievances on racial injustice, income inequality, and police misconduct. Family dining rooms have turned into debate chambers, and parents worried if their kids were practicing enough social distancing at protests. Demonstrations and marches are part of the fabric of democracy. Unfortunately, some on the political fringe appeared to have adopted tactics from the Red Guards of China's cultural revolution – discrediting the establishment, inciting hatred and violence, vilifying and intimidating those with dissenting views. The so-called

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"name and shame" boycott campaigns have put many individuals and institutions on the defensive, and some businesses are even being pressured to get rid of executives over their political contributions. Such an atmosphere of intolerance and intimidation will stifle healthy discourse and force some into self-censorship, which is antithetical to our ideals.

Amazingly, Wall Street has largely ignored the chaos on the main street. One strategist had even crowed that big protests were bullish because the absence of material upticks in COVID-19 infection from these gatherings was the best news for risk assets. Some also argued that the worse things get, the more the Fed will have to print.

We suspect the market's epic rally in the midst of the COVID-19 crisis can be partially attributed to a cultural revolution brought on by many newly minted traders funded with stimulus checks. Their disregard of market history and fundamentals actually worked to their advantage in a speculative environment. Some of them have leveraged social media to effectuate market moves. The poster child of this fearless day trading culture is Dave Portnoy, the enterprising and colorful founder of Barstool Sports. He live-streamed his daily trading activities on Twitter and changed the name of his daily sports gambling radio show from "Picks Central" to "Stock Central." He proclaimed himself to be the best in the business while dissing Warren Buffett as "washed up" and making fun of Lee Cooperman for being cautious. His self-promotion was so effective that he is now frequently featured on CNBC and has earned monikers such as "captain" or "supreme leader" of the so-called "retail bros." These retail bros have even made bankruptcy an investment theme – they would swarm into essentially worthless stocks, bid up the prices several fold, and then dump them to the greater fools. The most incredulous example may be the saga with Hertz Global Holdings, the car rental giant that traces its origin to the time of the Spanish Flu but could not survive COVID-19. Following its bankruptcy announcement, its share price had collapsed to a closing low of $0.55 on May 22nd. Traders then swarmed in and drove up the share price more than 1000% to as high as $6.25 intraday on June 8th. Sensing an insatiable appetite for its shares, Hertz management took the unprecedented step of seeking to issue $500 million of equity. It managed to get the approval from the bankruptcy court but had to eventually cancel the stock offering after the SEC intervened. It doesn't take a seasoned pro to notice that this "cultural revolution" has created a bubble, but many have rationalized it with the "don't fight the Fed" meme.

In spite of the frenzied day trading culture and the Fed's continued largess, we suspect COVID-19's resurgence in the U.S. might have marked the end of the market's V-shaped rally phase. Equities are likely to enter a period of see-saw battle in the coming months. On the positive side, we will likely get another round of trillion dollar plus fiscal stimulus from Washington, and there will be progress on COVID-19 therapeutics and vaccines. On the negative side, the pace of economic recovery may turn out to be underwhelming, and political risk is on the rise. Riots and protests have taken a toll on Trump's poll numbers, although many still believe there is a silent majority on his side. With Biden having opened up sizeable leads in key swing states, markets will start to discount higher odds of a Biden Presidency and even a blue sweep – the latter will likely result in market-unfriendly policies such as higher taxes and more regulation. In short, COVID-19's resurgence, rising electoral and geopolitical risks, and elevated valuations are hardly the underpinnings of a healthy market. We believe such an environment still warrants a conservative investment approach that emphasizes quality and resiliency.

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