



A Top Economist's Contrarian View on China, Mexico and Trump

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by Robert Huebscher

You're wrong if you believe that China will be an economic superpower, Mexico is on the decline, or that President Trump will run for a second term. Philippa ("Pippa") Malmgren laid out those contrarian views in a provocative address last week.



Malmgren is an economist, author and investor. She served as a special assistant to President George W. Bush for economic policy on the National Economic Council and is a former member of the U.S. President's Working Group on Financial Markets.

Malmgren was a keynote speaker at the Markets and Finology Summit in Sydney, Australia on February 20. I attended this conference and highly recommend it. It is as good as any U.S. conference for those interested in research on economics, investing and behavioral finance.

Trouble for China

Chinese political leaders are clear that they can't generate the GDP growth necessary to keep a stable society, says Malmgren. The threat of social unrest is why Foxconn moved the manufacturing of its Apple phones to the U.S.

China is certain it cannot regain its footing as a low-cost producer, she said, which is why it is implementing its "belt and road" initiative. The goal of that initiative is to build a network of highways, railroads and sea-travel lanes to facilitate commerce and movement between China's coastal industrial centers and its inland consumers. "China is creating a digital network that will work in its favor," she said.

Malmgren's most revealing – and disturbing – concern was about China's social credit system. She described it as an, "Uber score for individuals based on social compliance." Everyone in China has a score based on their behaviors. One's score goes down, for example, if you jaywalk, leave a bicycle in a footpath or have debt. Personal scores are publicly broadcast. Your score dictates your place in society and your prospects for the future. Party members have the highest score.

It is self-destructive, according to Malmgren. She quoted the rock legend Frank Zappa, who said, “Progress comes from deviation from the norm.” China is seeking conformity across its society, she said, and the social credit system works, “hugely to the advantage of the West.”

Mexico is the new China – and other contrarian views

“China is not the future,” she said. “Mexico is the new China.”

Mexico is positioned to supplant China as the leading exporter to the U.S., according to Malmgren.

Indeed, China is even investing in production facilities in Mexico, where wages are 20% to 40% cheaper. Mexico is already tightly integrated into the U.S. supply chain. For the last four to five years, the U.S. has been the best performing industrial market, but Mexico was the best performing emerging market.

President Trump’s proposed border wall won’t matter, Malmgren said. Trains and planes will still deliver commercial goods.

Malmgren delivered another contrarian view by arguing that Britain will benefit from Brexit.

Brexit carries a high degree of uncertainty, she said, but Britain is unlikely to reap substantial benefits from trade with Germany and France. The U.K. is leading in cutting-edge disciplines such as engineering and biomedicine, and the benefits of freer global trade in those goods outweigh the loss of commerce with the European Union.

Malmgren helps run a U.K. company that produces commercial drones. “Everyone wants a foothold in the U.K. because they want its rule of law,” she said. “Britain will do more business with the rest of the world, which is growing faster than Europe.”

“The belief that the E.U. has held Europe together and prevented a third world war is wrong,” she said. Italy, Sweden and Denmark are all facing populist revolts, according to Malmgren. “It’s not just Britain. Change is going to happen.”

The future of technology investing

Malmgren challenged those who are skeptical about investing in high-growth technology companies. A lot of money went into risky businesses like the “FANGs” following the global financial crisis. Now, she said sovereign wealth funds are “loaded with cash” and pension funds need to invest because they are underfunded and need higher returns than the public markets offer. In January, following the poor fourth quarter performance, she said a lot of “dry powder” was invested in U.S. equities because “buyers saw opportunity.” Softer monetary policy from the Fed and other central banks is helping drive equity markets.

“The demand for the next FANG is off the chart,” Malmgren said. “Lots of investors are ready to commit capital.”

China's social credit scoring underscores the profound technology changes that investors don't fully appreciate, according to Malmgren. Investors need to grasp the potential of the massive data collection supporting this effort. China will know everything about its citizens. American companies are poised to acquire the same data on consumer preferences, buying habits and lifestyles. For example, she said that robotic vacuums could determine the size of rooms and provide this data to companies for marketing purposes.

Malmgren foresees technology that will connect independent silos of data using artificial intelligence. "The internet knows more about you than yourself," she said. In a real-life example, she said banks know whether you are likely to get divorced based on the credit scores of spouses. SenseTime is the most valuable startup in the world, worth \$6 to \$8 billion. It has developed facial recognition technology that understands emotional states and can recommend products.

"Emotions will become the driver of investment opportunity," Malmgren said, which is why Vladimir Putin has said that artificial intelligence is the new frontier of geopolitics.

Defense spending is at all-time highs, Malmgren said, and it too is going toward facial recognition.

The technology supporting those applications requires a new generation of computers. Malmgren said that the U.S., China and Russia each have projects to build new supercomputers. "This is the new space race," she said.

Forget "armchair investing"

"We've been taught to be highly analytical," Malmgren said. "The answer lies in the number."

But that is totally wrong, she said, which is why our leaders have been blindsided by Trump, Brexit and the decline of China. Political leaders have placed too much faith in becoming more quantitative, believing analytical computations will have the answer. The problem is they lack the qualitative side. "This is why we were blindsided by populism," she said.

The same applies to investing, she said, which requires assessing the human perception of reality more so than technical expertise.

"Armchair investing" is the belief that you can invest from a chair, passively acquiring knowledge, Malmgren said. But it is false belief, because investors have to see and talk to people building and using the products and services. For example, she said people don't understand what drones can do and make poor judgements about the industry. "You can't know tech like virtual reality unless you go and see and use it," Malmgren said.

People genuinely believe they understand the system of money and accounting, she said. "Nobody believes you can rip up the system and start again." But she outlined a way in which sovereign debt could be eliminated. One way we can deal with debt is to destroy the system and start again, according to Malmgren.

The British used wooden sticks to record assets and liability. It was known as the “tally system,” and in 1834 it was replaced by paper money. People rejected the change. But the British government confiscated the tally sticks and burned them in Parliament. Parliament burned to the ground because they misjudged the heat it would produce. Nonetheless, paper money became the new standard and the Industrial Revolution ensued.

“Government can take away the system of money and accounting,” she said. E-money (digital currency) and blockchain or something similar will replace it.

“If you haven’t thought about this you need to,” Malmgren said. “Cash is about 3% of commerce. We are almost already there. “

A bold prediction about President Trump

President Trump will not run for reelection in 2020, Malmgren predicted.

She gave two reasons why. The legal investigations in the southern district court in New York (not the Mueller investigation) are very serious. They will require Trump to spend a lot of money in order to make them go away.

Second, Trump wanted to launch the Trump News Network (TNN), Malmgren said, which is why he originally ran for president. Trump has been saying that CNN needs a challenger. The Oval Office is a smaller platform than what TNN would be. He will want that bigger platform, Malmgren said, and will chose to launch TNN instead of running for a second term.

Those who hate Trump think that will cause the markets to fall apart. On this last point she did not offer a contrarian view and left the audience in suspense as to how the market would react to a new U.S. president in 2020.