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### Superpower Struggle: from unpredictability to opportunity

“Some things are true whether we believe in them or not”

-The Angel Seth, in the movie *City of Angels*-

2Q 2019



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## Superpower Struggle: from unpredictability to opportunity

### Certainty on unpredictability?

Writing about the US-China trade war seems to be suitable for daily publication only, due to the volatile and fast-changing nature of the issue. Thanks to President Trump's unconventional way of communication and his intention to be unpredictable, any news on the matter becomes old rather quickly. As such, we will not be writing on "the latest" moves, but on the implication of the resulting uncertainty.

#### "I'd rather not play my cards... I want to be unpredictable"

-(Back then American Presidential candidate) Donald Trump, during a campaign event at the Adler Theater, Saturday, Jan. 30, 2016, in Davenport, Iowa. -

While it seems like the situation changes daily, we believe that the essence has remained largely unchanged. After more than a year of negotiations, the path to reconciliation is still unclear, and the topic of the trade war is still in the spotlight.

This raises the question: should we dismiss the jabbing and ferocity between the two giants as mere political posturing to reach a trade deal? Or is their behaviour a symptom of a much larger geopolitical rivalry, as what the more pessimistic view suggests?

As noted in an article by the Economist<sup>1</sup>, the US and China are currently contesting in every domain, from semiconductors to submarines and from blockbuster films to lunar exploration. This makes the issue bigger than Mr "unpredictable" Trump and may remain a challenge for multiple administrations to come.



CartoonStock.com

<sup>1</sup> "China v America - a new kind of cold war". Economist. May 16<sup>th</sup> 2019, retrieved from <https://www.economist.com/leaders/2019/05/16/a-new-kind-of-cold-war>



### US stance on China is likely to stay, regardless of the 2020 election result

With the upcoming 2020 US presidential election, one might wonder whether the US stance on China could change. On the Republican side, Trump is very likely to win the Republican nomination. According to a poll by Gallup in April 2019, nine out of ten Republicans approved Trump’s performance. This suggests any challenger will have a slim chance of winning.

What is worrying is that even in the democratic camp, the top four candidates for the 2020 nomination<sup>2</sup> are all trade hawks. Thus, even if Donald Trump will not be re-elected, chances are that the US-China tension will continue.

2020 Democratic presidential primary – All the top 4 candidates are critical of Beijing			
Joe Biden	Bernie Sanders	Kamala Harris	Elizabeth Warren
			
Source: NBC	Source: NBC	Source: Business Insider	Source: CNN
“We are in a competition with China. <u>We need to get tough with China.</u> They are a serious challenge to us, and in some areas a real threat.”	“Since the <u>China trade deal I voted against,</u> America has lost over 3 million manufacturing jobs. <u>It’s wrong to pretend that China isn’t one of our major economic competitors.</u> When we are in the White House we will win that competition by fixing our trade policies.”	“Whether it’s the nuclear threat of North Korea and Iran, chaos and oppression in Venezuela, or confronting <u>China’s unfair trade practices,</u> the U.S. is most effective at confronting global challenges when we work in lockstep with our partners.”	“ <u>China weaponized its economy</u> without ever loosening its domestic political constraints”

“The expected never happens; it is the unexpected always”

-John Maynard Keynes-

### China is unlikely to back down either

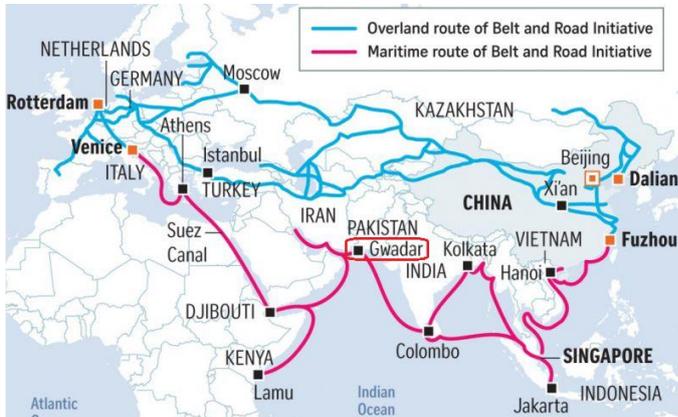
In the meantime, the news flow from the Chinese side suggests that China is not backing down either. The ongoing rivalry motivates China to court US’ enemies and furthered its ties with- and influence in regions like the Middle East and South Asia.

For instance, China has been maintaining a warm relationship with Pakistan to develop and gain access to Pakistan’s deep-water port of Gwadar. China’s access to Gwadar is a game-changer. Critically located close to

<sup>2</sup>Top 4 candidates based on a poll by RealClearPolitics. [https://www.realclearpolitics.com/epolls/2020/president/us/2020\\_democratic\\_presidential\\_nomination-6730.html](https://www.realclearpolitics.com/epolls/2020/president/us/2020_democratic_presidential_nomination-6730.html)



the mouth of the Persian Gulf and close to the Strait of Hormuz, the world’s busiest oil transit chokepoint, it is a vital sea corridor of the ambitious Belt and Road Initiative.



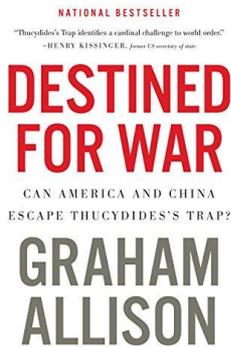
Gwadar is strategically located in one of the world’s most important sea trade route chokepoints. A vital part of China’s maritime Belt and Road Initiative and maritime strategy.

Source: Asiagreen

Gwadar is also of significant strategic importance to China’s maritime strategy, allowing the Chinese Navy to expand its footprint in the Arabian Sea and the Gulf of Oman. It is a crucial factor supporting China’s ambition to dominate the Indo-Pacific region.

The importance of Gwadar to China is illustrated by the grant of a US\$10bn loan to Pakistan facilitating the development of the port. Another example is the commitment by a Chinese company to invest US\$500mn just for the first phase of a project, to build houses in Pakistan for some 500,000 Chinese professionals that are expected to work there by 2023.

### Destined for “peace”?



With the US and China being involved in the most salient geopolitical contest of our time, many people wonder how all this is going to end. Graham Allison, a professor at Harvard University and a former US assistant secretary of defence, looked at historical precedents where a rising power threatens to displace a ruling one.

To Allison, China’s challenge to the United States is a prime example of what he calls the “Thucydides’s Trap”<sup>3</sup>. This is a term he coined in his book “Destined for War” to refer to the situation that when a rising power causes fear in an established power, it often escalates to war.

Examining historical records of the past 500 years, Allison identifies 16 occurrences of the trap, with 12 cases ending in violence. As such he concludes that China and the

US are currently on a collision course for war.

Fortunately, Allison also admits that ‘war is no longer an acceptable option’ given US-China economic interdependence and constraints imposed by nuclear weapons. Yet, the US and China could still engage in other forms of war, including economic and cyberwar.

We believe that the two super-powers have no choice but to face the new reality, and probably both be forced to agree to painful compromises over the coming decades. What is certain, is that the ongoing tension will last long and create a lot of uncertainty ahead.

### “Plans are worthless, but planning is everything”

-General Dwight D. Eisenhower-

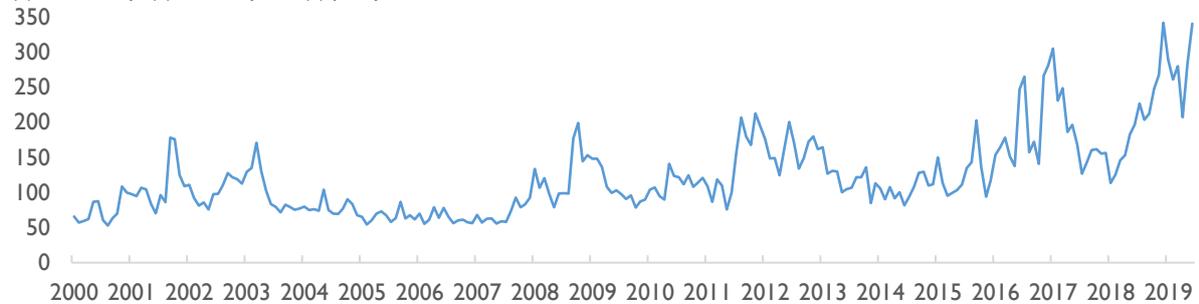
<sup>3</sup> Thucydides (c. 460 – c. 400 BC) was an Athenian historian and general. His work “History of the Peloponnesian War” recounts the fifth-century BC war between Sparta and Athens until the year 411 BC. Thucydides wrote: “What made war inevitable was the growth of Athenian power and the fear which this caused in Sparta.”



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### Global policy uncertainty index

Global policy uncertainty index is calculated based on monthly count on the number of articles that contains all three terms pertaining to (1) uncertainty, (2) economy and (3) policy.



Source: Davis, Steven J. "An Index of Global Economic Policy Uncertainty," Macroeconomic Review

### Suspicion of rising powers: Spy Trains

The following story of a "spy train" accusation highlights the political motivation behind the US-China trade war.

It is taken from an FT article published on June 17, 2019, titled "Trade war: will US espionage fears scupper Chinese rail group?"



CRCC assembling facility in Springfield Massachusetts, a trade war victim. Despite its significant contribution to local society, the facility was hit by US tariff and silly accusation of espionage.

Source: Jake Belcher, Financial Times

The story is borderline funny and tragic. It is about how CRCC, a Chinese company, invested US\$95mn to build a rail car assembling facility in Springfield Massachusetts in 2014. The investment was welcomed by the locals who claim, "it bought this part of the city back to life." Yet, the company has recently been accused of being a national security risk.



A small lobbying group called the Rail Security Alliance (RSA), backed by some of America’s top freight rail companies, has been beating the drum hard about the dangers allegedly posed by CRRC.

This is the “potential danger” as cited from the FT article:

“As for the concerns about hacked subway cars, the RSA points to the advanced technology that is contained in modern rail cars, with sensors and systems used to track and regulate everything from temperature to location.

The allegation levelled against CRRC that it **could be a vehicle for espionage strikes** a particular nerve as the company enters the Washington Metro race. **“You have members of Congress, the intelligence community, Department of Defense officials, staff, whoever [riding the DC Metro],”** says Mr Olson [from RSA]. “We don’t think CRRC will do anything nefarious and start a war or anything, but could they track people, could they use this as an intelligence gathering tool? One hundred per cent.”

John Scavotto Jr, the leader of the local chapter of the sheet metal workers union says that the CRCC presence is a “godsend”, creating high paying jobs.

His view about the (trade or cold) war? “This guy (US President Donald Trump) wants to have his war with China, let him have it, but leave us alone in Springfield,”

We trust that the story above illustrates the frustration experienced by both the US and Chinese sides, in dealing with one thing that President Trump administration is consistent about: unpredictability.

### What Do Business Leaders Think?

To get a better view of how the situation impacts business, it is worth considering what some business leaders have said. We quoted some comments below.

<b>Ren Zhengfei, Huawei’s Founder</b> – in an interview with Bloomberg	“I will ignore Trump. Then with whom can he negotiate? If he calls me, I may not answer, but he doesn’t have my number. I see his tweets and think it’s laughable because they’re self-contradictory.”
<b>Jack Ma, Alibaba’s Founder</b> – during Alibaba Investor Day 2018	"The US-China trade war is going to last long, it’s going to be a mess, maybe 20 years. Even if Donald Trump retires, the new president comes, it will still continue."
<b>Samuel Allen, CEO of John Deere</b> – CNBC’s Squawk on the Street	“We’re more concerned about the structural changes that it might force on the global supply of soybeans and other commodities,”
<b>Pierre Brondeau, CEO of FMC (Food Machinery Corporation)</b> – company’s earnings call May 2019	“We’ve been very, very highly focused not only at fixing long-term problems by diversifying away from China our supply, but also by creating, through our procurement organization and supply chain, a number of partnerships which are almost standby partnerships, ready to jump in as soon as we have issues,”
<b>Richard Turnhill, Chief Investment Strategist Blackrock</b>	“Trade tensions are here to stay ... Even without a full-blown trade war, escalating frictions could weigh on business confidence and growth ... Economic fundamentals are still running strong.”



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The choice of their words:

- adjust to a new era
- structural
- diversifying away from China
- tensions are here to stay
- going to last long
- going to be a mess
- maybe 20 years
- even the new (US) president comes, it will continue

This should explain why Trump's big tax cut has failed to do what it was intended for; to stimulate investment. The tax cut resulted in a decline in effective tax on profits from 19 per cent in the third quarter of 2016, to only 10 per cent in early 2018. Meanwhile, real non-residential private fixed investment to GDP inched up by only 0.8 percentage points to 13.8 per cent in the first quarter of 2019, which is in line with historic ratios.

Clearly, the US-China tension has taken its toll on business confidence.

### Investing in an unpredictable world

If the ongoing trade war is indeed part of a much larger geopolitical rivalry, there are countless consequences, including in the investment world:

- Historic precedents illustrate that it is not just the flow of goods, but also the flow of capital that can be halted during a cold war.
- It is hard to imagine that the two main actors in the cold war, the two adversaries; US and China, can continue to have a linked exchange rate. Is it a matter of time before RMB is eventually de-pegged from its basket of currencies, with US\$ dominating the basket direct and indirectly?
- Under this scenario, RMB will devalue, which will initially send a major deflationary force throughout the world. However, China will then have the needed monetary independence to reflate the economy, which will be inflationary in the long-term.
- A move to contain China is not only a major event politically, but also financially. China's engagement brought to the world "Chinese prices", which has been disinflationary. We wonder if the ongoing rivalry means much higher inflation in the coming years.
- Politically, countries may ultimately have to pick a side: that of the US or China. Asian countries may lose the luxury of seeking defence protection from the US, while at the same time enjoying the fruits of Chinese economic development.

In this report section, we conveyed our view that the US-China tussle will drive major changes going forward and create an uncertain (business) environment for many years to come. In the next sections, we look for investment opportunities that result from these developments. We see opportunities in Indonesia resulting from shifts in global supply chains, and in precious metals as a play on eroding confidence.



## Business moving away from China; an opportunity for Indonesia

### Southeast Asia likely to benefit from manufacturing relocation

One of the major consequences of the ongoing contest between the US and China is the disruption of global supply chains.

A recent opinion piece in the Nikkei Asian Review by Willy Shih<sup>4</sup> highlighted that, given the current situation, companies will have to diversify their manufacturing base with facilities outside of China to serve the North American market.

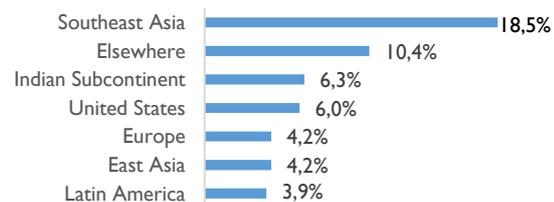
Shih also added that international politics has become an important consideration, aside from the traditional factors such as cost, speed, and efficiency.

Expecting a shift of manufacturing activities away from China, he believes that some emerging-market countries may benefit, particularly those that have a low-cost labour force and a relatively stable political environment.

The mentioned countries include the Philippines, Vietnam, Malaysia, and Indonesia. This matches the result of a survey<sup>5</sup> conducted by the American

### US companies in China prefer moving production to Southeast Asia

% of US companies based in China that have moved production abroad or considering it



About a third of more than 430 American companies have or are considering moving production sites abroad amid the tensions

Source: AmCham China

Chamber of Commerce (AmCham), which indicates that Southeast Asia is the top choice for companies seeking to relocate their manufacturing activities.

Given the sheer size of the Chinese manufacturing sector, it is unlikely that production activities will be relocated to a single alternative country only. For instance, the size of Chinese export to the US is multiple times bigger than the whole manufacturing GDP of every single country in ASEAN.

Industry insiders seem to share this opinion. For example, in a recent Bloomberg interview<sup>6</sup>, Li & Fung's CEO, Spencer Fung, mentioned that there is no single country that has the capacity and expertise to replace manufacturing activities in China.

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**“The amount of goods produced in China compared to the next biggest country is like 10 times.**

**There is not any country that can take over China—there is not even a collection of countries that can take over China—because it is so dominant”**

-Spencer Fung, CEO of Li & Fung-

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He further stressed the importance for companies to internationally diversify their production base, as there is no way for business leaders to anticipate what Trump is going to Tweet next. According to Mr Fung, there is “no safe haven out there”, so diversification is the only way to manage this risk.

Considering these arguments, one can expect that if activities are to move away from China, it will

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<sup>4</sup>Willy Shih. “The high price of breaking up global supply chains” Nikkei Asian Review. 2 July 2019. Retrieved from: <https://asia.nikkei.com/Opinion/The-high-price-of-breaking-up-global-supply-chains>

<sup>5</sup>AmCham Shanghai. “Impact of U.S. and Chinese Tariffs on American Companies in China” AmCham China. September 2018.

<sup>6</sup>Daniela Wei and Jinshan Hon. “The CEO on the Trade War’s Front Lines Says It Isn’t All Bleak” Bloomberg. 11 July 2019. Retrieved from: <https://www.bloomberg.com/news/articles/2019-07-10/li-fung-ceo-china-factories-can-still-benefit-from-trade-war>

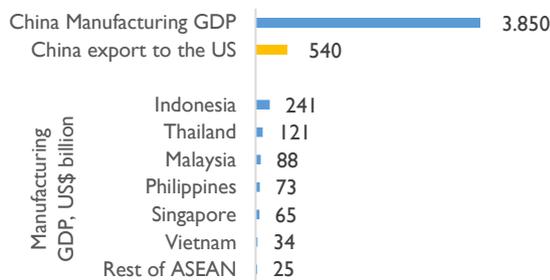


spread to many different countries including Indonesia.

While Indonesia may not be the main beneficiary of international production relocation, the volumes are so substantial that even a small allocation to Indonesia will have a significant impact on the nation.

**Any small spillover from China would make a meaningful impact on the Southeast Asian manufacturing sectors**

China export to the US, China and Southeast Asia nations manufacturing GDP in 2018, in billion US\$



*China's export to the US is multiple times bigger than the whole manufacturing GDP of every single country in ASEAN.*

Source: Bloomberg

**News headlines reveal many plans for production relocation to Indonesia**

Indonesia is already receiving quite some interest. Starting from early this year, almost every week we read news headlines about Chinese companies planning to move manufacturing activities to Indonesia.

Sure, many of them are still in a planning stage, so viewing these headlines with a healthy dose of scepticism would be prudent.

Yet, given that we get similar signals from Indonesian manufacturers and industrial estate developers we think this is the beginning of a secular trend.

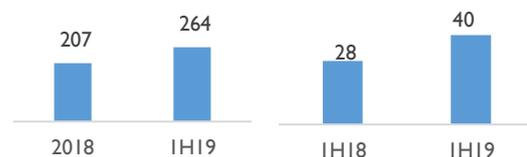
**The headlines are well-affirmed by the industrial estate developers**

Inquiries about industrial land plot have become more frequent according to our recent meeting with the industrial estate developers.

Not only from the usual Japanese and Korean businessmen, but also increasingly from the Chinese as well. More and more frequently, do we see Chinese expat engineers alongside their long-established Japanese and Korean peers in popular drinking and hotspot places.

**All charts below are pointing at the potential re-acceleration of the Indonesian manufacturing sector.**

Industrial land inquiries, in ha Industrial land sales, in ha



Source: Companies (BEST, DMAS, SSIA) data

**Chinese toy, stroller factories looking to relocate to Indonesia amid trade war: AMI**

News Desk  
The Jakarta Post

**Apple Kaji Relokasi Pabrik di Tiongkok, Salah Satu Opsinya Indonesia**

**Chinese EV makers may relocate plants to Indonesia**

The Jakarta Post

**Pegatron shifts from China to Indonesia as trade war bites**

Leading iPhone assembler accelerates diversification strategy

LAULY LI, Nikkei staff writer  
DECEMBER 05, 2018 19:02 JST

**Taking Steps to Exit China**

**Hyundai Motor to Relocate Production Base to Indonesia from China**

**Sharp, LG to relocate factories to Indonesia**

News Desk  
The Jakarta Post

Source: The Jakarta Post, Kompas



Based on data from the top three industrial estate developers in Indonesia, the outstanding industrial land inquiries measured in hectares rose by 28% YTD as per June 2019.

Growth in realised industrial land sales in hectare is even stronger, with sales volume in the first half of 2019 being 41% higher as the comparable period last year.

### Li & Fung already working hard to match foreign demand with Indonesian manufacturers

To get a better view on how the manufacturing relocation might play out, we visited Li & Fung, the global supply chain management company.

Li & Fung helps its customers to source goods internationally, which comes in handy for companies wishing to shift their product sourcing outside of China.

In the meeting we learned two important things:

1. Li & Fung Indonesia sees a strong pickup of apparel sourcing in Indonesia, as well as foreign companies planning to build manufacturing facilities in Indonesia;
2. Indonesia will benefit from manufacturing relocation, despite not being the first choice;

#### Strong pickup of apparel sourcing activities

When we met with their team in Indonesia, we could see that they are busy. Very busy. The company has seen a significant pickup in the demand for their services as compared to previous years.

Their customer base mostly comprises US-based retailers who need to diversify product sourcing very quickly. The issue at hand is so big that some customers requested the Li & Fung team in Indonesia to be available 24/7.

Li & Fung indicated that they received significant orders for apparel and some inquiries on hard goods such as furniture.

They mentioned a recent move by two sizable Korean-based apparel manufacturers to build factories with 100-150 production lines in Tegal, Central Java. These new factories will employ about

5,000 employees and may generate US\$ 200mn in revenue in total.

Based on our conversation, we learned that the main charm of Central Java is no longer just cheap labour. The connectivity to the main seaport in Jakarta is now also an important factor, thanks to the new Trans Java toll road. This means the newly built infrastructure has successfully brought more investments to Central Java!



*We have tested the toll road and it cut traveling time of Jakarta-Semarang by more than half to only 5 hours*

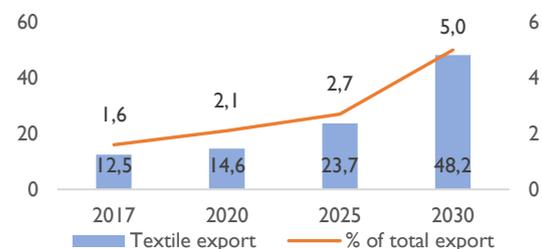
Click [here](#) for our IQ 2019 report

Another giant that is looking to relocate its capacity to Indonesia, according to Li & Fung, is Eclat Textile, Nike's major supplier. Li & Fung indicated that, if Eclat Textile were to open a production line, it would be a very sizable one.

These stream of investment in the apparel manufacturing should bode well with the industry target to grow textile export by close to fourfold in 2030.

#### Government expect to boost textile export by close to fourfold in 2030

Indonesia's textile export in US\$ billion and contribution as % of total export



Source: Association of Indonesian textile producer

#### Indonesia not the first choice but limited capacity in other countries

When we talked about how Indonesia's manufacturing industry compares with regional peers, Li



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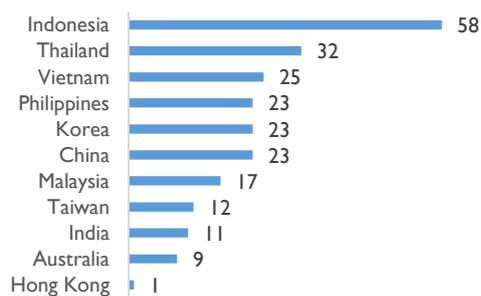
& Fung confirmed that Indonesia would not be the first choice as it is not the most competitive.

Top choice would be Vietnam. It is no secret that Vietnam's labour productivity is higher than in Indonesia. According to Li & Fung, the gap is about 20-30%.

While the minimum wages in Vietnam and Indonesia are similar, Indonesia's severance pay is twice as high and even ranks the highest in Asia. This is considered to be a significant drag to Indonesia's international competitiveness in the manufacturing sector.

### Indonesia severance pay (redundancy dismissal) is the highest in Asia

Minimum severance pays (redundancy dismissal), in weeks of salary



Source: CEIC

On a more encouraging note, Indonesian labour is perceived to be much easier to manage as compared to Vietnamese labour. The Vietnamese labour union has proved to be quite a nuisance in some cases.

Even though such factor is not captured in labour productivity data, we believe foreign manufacturers will take this into consideration.

When talking about the textile and garment industry in particular, Bangladesh is often preferred over Indonesia. Even though Indonesian labour productivity is superior compared to that of Bangladesh, the Bangladeshi manufacturers have better equipment and production facilities.

Given the importance of the textile and garment industry to the Bangladesh economy, its government incentivised foreign investors to invest heavily in advanced equipment.

In Indonesia on the other hand, the manufacturing industry has been characterised by serious underinvestment in machinery in the past few decades. Even until now, Indonesian industrialists prefer to see real orders before investing in new machinery. They are still climbing the wall of worry, which could be a good (bullish) contrarian indicator.

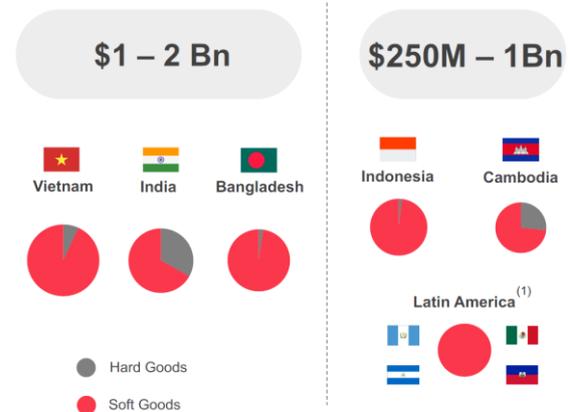
The problem of Vietnam and Bangladesh however, is that their manufacturing capacity is already overloaded and is simply not sufficient to absorb significant orders from China.

With a workforce that is bigger than that of Vietnam and Bangladesh combined, Li & Fung believes that Indonesia has the potential to capture a substantial share of production relocation.

### Still Early Days

### Plenty of room for manufacturing growth for Indonesia, at least from Li & Fung

Li & Fung production volume outside of China, in US\$



Indonesia still has a lot of room for growth at least from Li & Fung's point of view. Li & Fung Indonesia expect to upsize its contribution to total sourcing goods of Li & Fung.

Source: Li & Fung investor presentation

Li & Fung Indonesia foresees more orders coming from the US, as Indonesia is the next obvious alternative to Vietnam. It is a bit like a champagne tower where glasses represent manufacturing countries. While Vietnam may be placed on top, the abundance will soon spill over to Indonesia and other ASEAN countries.

When we asked Li & Fung about Indonesia's prospects in the textile and garment industry, they



indicated that Indonesia has the potential to grow five-fold. That means the industry is still nascent.

### Interviews with Indonesian industrialists confirm pickup in activities

We talked to some leading industrialists in Indonesia and generally speaking they share Li & Fung's view.

#### **Integra Indocabinet (WOOD IJ)**

This large Indonesian furniture manufacturer counts many US retailers as its client. One of these is Target. The company has been getting a lot of orders because Target's Vietnamese supplier is overloaded.

The company used the word "desperate" in describing how their customers tried to secure supplies. So desperate that one customer gave them a US\$ 10mn purchase order before having the chance to review samples. Absolutely unusual.

The company is in a rush to expand its capacity to accommodate the surge in demand. They expect a 25-50% increase in sales for FY19 depending on how fast they can finish their new factory.

#### **PT Sat Nusapersada Tbk (PTSN)**

This Batam based manufacturer of smartphones and electronic appliances also experienced a surge in orders. In this case for assembling electronic products for Pegatron and Asus.

According to the company, Vietnamese factories are struggling with new orders, and it will take a few years before new capacity becomes operational. The company's sales surged to nearly fourfold in IQ 2019 and they are looking to expand their capacity in anticipation of further growth.

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**"The opportunity (for Indonesia and the company) has arrived"**

-Abidin Fan, CEO of PT Sat Nusapersada Tbk-

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#### **Aneka Gas Industri (AGII IJ)**

With Indonesian manufacturing activities on the cusp of expansion, industrial gas producer Aneka Gas Industri has also been busy with inquiries.

If some of these inquiries are turned into orders, we could see a rapid ramp-up of the company's production capacity utilisation. This would result in tremendous growth of the firm's net profit.

With its vast distribution network across the country, the company is very well positioned to enjoy the fruits of a manufacturing renaissance in Indonesia.

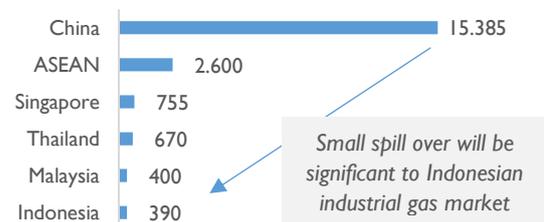
As we wrote in our previous report, Aneka Gas has a first-mover advantage as competitors only have a presence in the Western and Eastern part of Java.

The company's strong position in Central Java is likely to be expanded to regions outside of Java. With a network of 44 air separation plants and 104 filling stations across the archipelago, any potential competitor of Aneka Gas will think twice before attempting to cross its moat.

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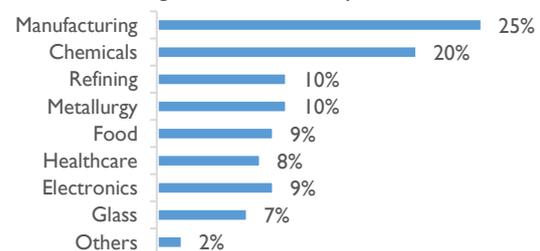
### Small relocation could already have a huge impact on Indonesia's small base

The industrial gas market size in 2015, US\$ million



### Manufacturing is a major driver of Industrial gas use in ASEAN

ASEAN industrial gas mkt breakdown by sector, 2015



Source: Gasworld

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## Make Indonesia great again: reforms on the way to improve competitiveness

Obviously, the spillover of manufacturing activities from China to Indonesia could be temporary as Vietnam and other countries in the region will expand their capacity to accommodate more demand.

Fortunately, Indonesia is not standing still either.

Captured in our previous report, former furniture company owner, Jokowi, has demonstrated a solid track record in building-up Solo, Jakarta, and various projects across the country.

Indonesia's regional competitiveness has improved as infrastructure projects are being developed in particular to alleviate logistics cost.

According to the World Bank Logistics Performance Index – a measure that scores countries on how efficiently they move goods across and within borders - Indonesia has moved its position up from 53rd in 2014 to 46th in 2018.

However, tackling logistics issues alone is deemed insufficient. Hence, regulatory measures are set by President Jokowi in his second term, aiming to improve Indonesia's competitiveness.

- **Tax incentives.** One of the quick fixes to improve competitiveness are tax incentives. Immediately after securing his re-election, Jokowi issued a decree on three tax incentives for new investment in the categories below, whereas tax incentives for industries heavily focusing on export come next.

Requirement	Tax deduction
Labor intensive industry	60% of total investment
Human capital development	up to 200% of total investment
New invention/technology	up to 300% of total investment

- **Lower corporate tax.** The government is considering lowering the corporate tax rate from 25% to 20%, bringing Indonesia on par with Vietnam and Thailand.
- **Revising the labour law.** Here comes the tricky part where the government is looking to revise the sixteen-year-old labour law. President Jokowi stressed the urgency to overhaul the

current labour law as it is perceived to hamper investments.

Reforming punitive labour law is an uphill battle, and many past attempts are rather futile, for the current labour law is highly populist in nature.

Changing it will be politically sensitive and require a strong political push from President Jokowi. We believe there is a fair chance of labour law revision since the President vowed to implement sweeping reforms during his second term in office.

Unburdened by re-election concerns, it is rather piquant to watch Jokowi's way forward to accelerate the slumbering manufacturing sector in Indonesia during his second term.

## All signals point to a probable revival of Indonesia's manufacturing sector

In short, our observations point out that Indonesia stands to benefit from the disintegration of global supply chains.

Despite that Indonesia may not be the first choice for production relocation, international inquiries and orders are already starting to pick-up.

With Jokowi being unburdened with re-election concerns and fully committed to pushing for sweeping reforms, we expect Indonesia to become a more attractive destination for manufacturing activities.

With all these factors at play, we foresee a probable revival of Indonesia's manufacturing sector and will be actively looking for companies that could benefit from this secular trend.

**"Because this is my last term, I have no burden. I have nothing to lose."**

-Jokowi-



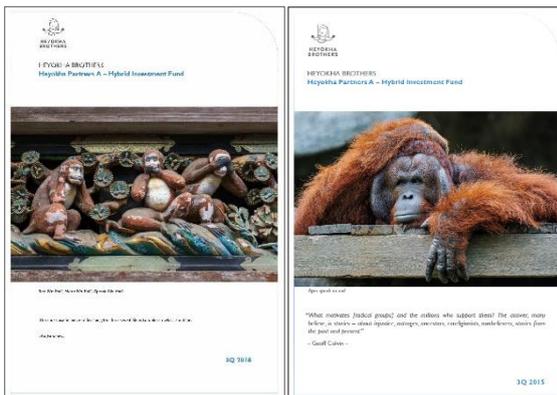
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## The case for precious metals keeps improving

Earlier in this report, we concluded that rivalry between the U.S. and China speaks more than just trade, creating an uncertain (business) environment for many years to come. As we will show below, this is unfolding against a backdrop of escalating of anger and distrust.

As an investor, it is important to anticipate the risks of the current *Zeitgeist* and position our portfolio accordingly. In our previous reports, we made a case for investing in precious metals as a hedge against political and economic unpredictability.

Considering the recent developments, we believe that the case for investing in precious metals keeps getting stronger.



Click [here](#) for our previous reports on precious metals

### Anger, distrust and perceived risk continue to rise further

First, post-GFC extreme monetary policy adopted by central banks continues to widen the inequality gap, fuelling mass anger and the rise of the populist movement.

Case in point is the inequality-fuelled anger that sparked a chaotic “yellow vest” protest in France. And the recent largest Hong Kong protest, a metamorphosis of the 2014 umbrella movement, is another clear expression of anger and frustration.

Various perspectives see different underlying reason for such mass anger, but we believe that the disparity in wealth and opportunity played a very big role.



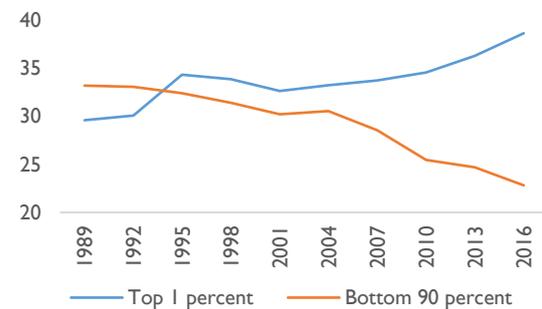
Massive protests in Hong Kong (left), and France (right) fuelled by anger?

Source: Straits Times, Euronews

Inequality is turbocharged by central banks’ extreme monetary policy, while the anger is exacerbated by the rise of social media and technology.

### Inequality has been on the rise

US share of total wealth by percentile



Central banks’ extreme monetary policy post-GFC continues to widen the inequality gap, as previously discussed in our [1Q 2016 report](#).

Source: Survey of consumer finances

Today, social media undoubtedly exert a significant influence on society. Coveted more than news websites, social media are the most popular source of news among the younger generation, according to a survey<sup>7</sup> run by Pew Research Center in the U.S.

With the subordination of traditional news sources to social media in this context, it takes little effort

<sup>7</sup> Shearer, E. (2018, December 10). *Social media outpaces print newspapers in the U.S. as a news source*. Retrieved from [pewresearch.org: https://www.pewresearch.org/fact-tank/2018/12/10/social-media-outpaces-print-newspapers-in-the-u-s-as-a-news-source/](https://www.pewresearch.org/fact-tank/2018/12/10/social-media-outpaces-print-newspapers-in-the-u-s-as-a-news-source/)



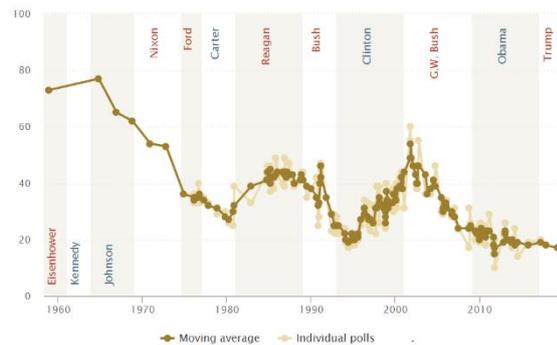
for information to go viral. The same applies to hoax, hate speech, and anger.

Meanwhile, improvement in technology also contributes to the rising inequality gap. Automation has reduced the need and the cost of labour while increasing the profit margin of corporates. As such, a bigger pie of the profit is distributed to the capitalists instead of benefiting the workers.

This prevalent source of anger takes the form of backlash against corporations. Thus, it would be naive to perceive millennials supporting the revival of trade unions as a mere coincidence.

### Public trust in government near historic lows

% who trust the government in Washington always or most of the time



Source: Pew Research Center

A survey by Pew Research Center found that 68% of Americans aged 18 to 29 hold a positive view of unions, while only 46% show a positive view of business corporations.

Millennials now view labour unions more favourable than business corporations. Even Instagram meme creators, who contribute to a big chunk of the platform’s viewership and revenue, are forming a serious trade union<sup>8</sup>.

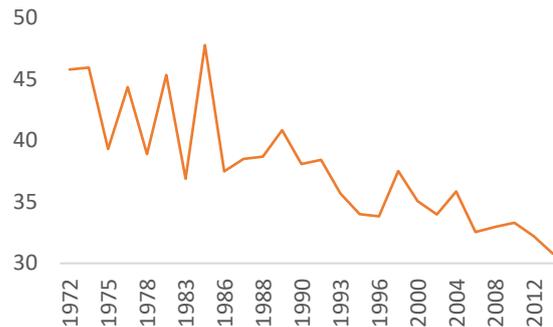
To probe further, public trust in central banks and government institutions has been deteriorating. As seen in the chart below, North Americans’ trust in government is declining to almost a record low.

<sup>8</sup> Lorenz, T. (2019, April 17). *Instagram Memers Are Unionizing*. Retrieved from theatlantic.com: <https://www.theatlantic.com/technology/archive/2019/04/instagram-memers-are-unionizing/587308/>

Similar flagging trend is also observed against the social sphere.

### Public trust is eroding towards both the government and the social sphere.

% who think that “most people can be trusted”



Source: Pew Research Center

Distrust and risk perception go hand-in-hand. As shown in the exhibit below, quoted from BlackRock Investment Institute, market attention on geopolitical risk has reached a record high in 2019 amidst the tension between the U.S. and China.

### Geopolitical risk is at the record high

BlackRock Geopolitical Risk Indicator



Source: BlackRock Investment Institute, with data from Refinitiv. Data as of August 8, 2019

Central Banks don’t inspire confidence either. European Central Bank president, Mario Draghi, has repetitively warned on worse than expected Eurozone economy and global unpredictability.



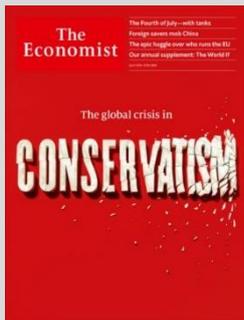
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Federal Reserve chair, Jerome Powel, also wavered back and forth before expressing more dovish stance in 2018, highlighting the unpredictability around trade tensions and concerns on the global economic outlook.

These developments indicate that Central Banks strategy to solve the burden of debt with more debt has failed. With the ongoing tensions and resulting drags to the economy, Central Banks are unlikely to be able to rescue us in the next downturn.

In addition, it seems governments ability to repay their record-high debts without printing money is becoming slimmer by the day. This adds to the case for owning precious metals.

### The rise of the new right



The omnipresent public anger, inequality, and distrust attested in different parts of the world set a stage to the rise of the new right. This breed is notably distinct from the “old-right” conservatives.

The Economist, July 6<sup>th</sup>-12<sup>th</sup> year 2019, exclaimed that the new right is not an evolution of conservatism, but a repudiation. The usurpers are aggrieved and discontent. They are pessimists and reactionaries.

They look at the world and see what President Trump once called “carnage”. The new right is smashing one conservative tradition after another.

While the conservatives respect business and are prudent stewards of the economy, the new right is a lot more willing to disrupt the rule of law on which businesses depend.

**“Conservatism is pragmatic, but the new right is zealous, ideological, and cavalier with the truth.”**

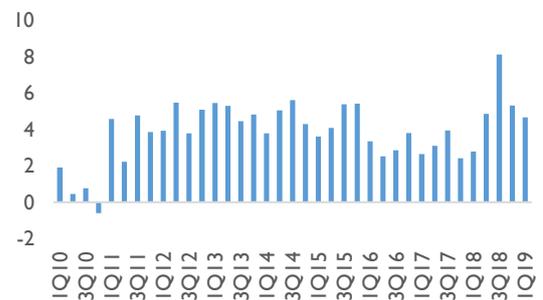
-The Economist, July 6th-12th, 2019, the global crisis in conservatism

### Investors turn their eyes on precious metals again

The ongoing turmoil bears a consequence that central banks continue to diversify away from the US dollar and into gold. Central bank gold purchase in the fourth quarter of 2018 was the highest since 2013.

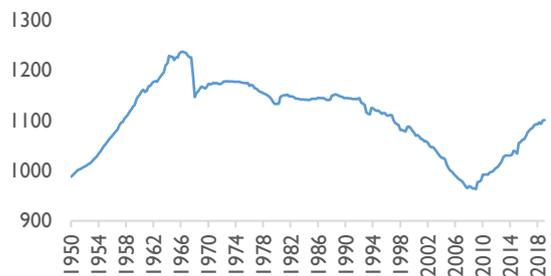
#### Central Banks has been diversifying from US dollar to gold as trust deteriorated

Net gold purchase by central banks (mn oz)



Source: Metals Focus, Refinitiv GFMS, ICE Benchmark Administration, World Gold Council

Gold held by central banks (mn oz)



Source: Bloomberg, IMF

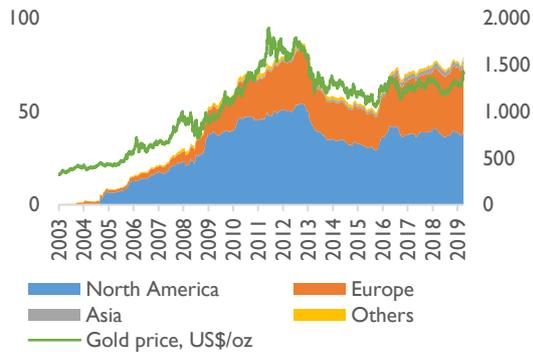
The combination of deteriorating level of trust and rising unpredictability in the economic and political world has also triggered investors’ appetite for gold to grow bigger.



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## Gold holdings surged but it is still largely under-owned

Gold ETF AUM (thousand oz)



Source: Bloomberg, Company Filings, World Gold Council

According to the World Gold Council, global assets under management for gold holdings surged by 15% to US\$115bn in 2019, marking the largest monthly spike since 2012. Yet, we are still convinced that this asset class remains under-owned as low inflation continues to be the consensus view.

### Likelihood of inflation on the rise

Our expectation is that the current era of low inflation will eventually break, partly a contribution of effort made by the U.S. to contain China. As we have previously discussed, manufacturers are relocating from China regardless of any trade truce.

This could end the era of “Chinese prices” that subdued global inflation for many years. In addition, the reshuffling of the global supply chain and the global trend towards protectionism will add to the inflationary pressure.

In addition, the flush of money printing from central banks, record high level of negative-yielding debt, and unsustainably low bond yields have led us to believe that there will be an inflection point whereby a debt squeeze will occur, and governments will need to inflate away their debt.

Under this scenario of inflation, precious metals will be a worthy insurance of our investment portfolio.

**You have the choice between the natural stability of gold and the honesty and intelligence of the members of government. And with all due respect for those gentlemen, I advise you, as long as the capitalist system lasts, vote for gold.**

-George Bernard Shaw-

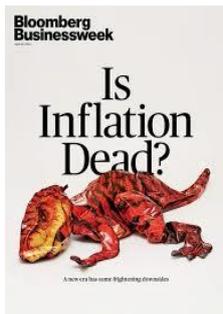


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### The end of the low inflation era? Contrarian signals from magazine cover stories

Investment magazine cover stories often provide a good perspective on the crowd view. These works tell popular stories and may be less concerned with making the right calls in the first place, for their success is measured in magazine sales, not investment returns.

These cover stories can guide us to identify times when the crowd is overly optimistic (or pessimistic). We can use them as a reminder against our natural human bias of herding and the fear of missing out. The following (below) are some of the notable magazine cover stories:



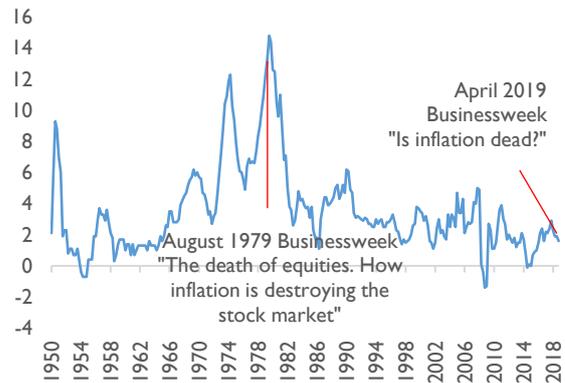
Recently, Businessweek made another remarkable call. Its magazine titled "Is inflation dead", published as of April 22 in 2019, predicted that the long ongoing trend of low inflation will persist. Could this edition be another contrarian signal?

After experiencing multiple years of obstinate low inflation, the current consensus view is that inflation will continue to fall. Central banks' extreme monetary policy has been unsuccessful in stimu-

lating inflation, and the amount of negative-yielding bonds has reached an all-time high of US\$1.3tn.

### Could this be a contrarian signal?

US CPI YoY (%)



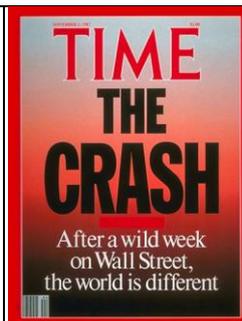
Source: Bloomberg

**"Nothing is more obstinate than a fashionable consensus"**

-Margaret Thatcher-



Time magazine December 1974 cover "Recession's Greetings", (incorrectly) marked the start of a 75% bull rally in the next 2 years.



November 1987 issue of Time magazine "The Crash" which captured the pessimism following Black Monday crash, marked the exact bottom of the US market which recovered by 55% just 2 years later.



August 1979 Businessweek titled "The Death of Equities" predicted that the existing 20-year trend of high inflation will persist. Turned out that it marked the start of a prolonged low-inflation period era that persists until today.



In March 2001, Time magazine cover "Looking Beyond the Bear" highlights the market's optimistic view and to over-look the deteriorating economic indicators. Ironically, the US entered a recession in the same month as the publication.



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Hard assets, such as precious metal, representing a good inflation hedge has become the least favourable asset class. As the trend has persisted for many years, the afore-mentioned view has likely been cemented in the consensus' mind.

However, as explained before, our expectation is that the current era of low inflation will eventually break

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*-The End-*