

Strictly Confidential

AN AMERICAN IN 1942

Monthly Report – March 2025



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TRACE: An American in 1942

“We have nothing to fear but fear itself” – FDR, 1933

Theme: Lessons from 1942 for Investors in China Today

FDR said those famous words in his 1933 inauguration, not long after the stock bottomed in 1932. Subsequent rally lasted until 1937 before collapsing again the following year and trading water until 1942. The fear lingered; it would not disappear because the President said something.

Recently, I have tried to put myself in the shoes of an American investor, how would I have felt about the US stock market and economy in April 1942? Sadly, there would be little to cheer me up.

Though The Dow Jones Industrial Average (DJIA) has recovered from the depressing 1929 low. It still sits at 86% peak drawdown, and 52% underwater if the count started from 1937 high.

To make it more disheartening, at the age of 60, the stock I had bought when I was 24 would still have suffered a 10% loss, as DJIA has moved from 1906's peak of 103.00 to 1942's trough of 92.92! That was a long 36 years and all this happened after the Republic took over the UK as the largest and strongest in manufacturing since 1895, won WW I, erected skyscrapers like mushrooms, revolutionized mass car making with Model T, and became a world superpower. The stock market seemed to make little sense. As if things were not bad enough, the Pearl Harbor got bombed by Japanese in December 1941.

I would have drawn no other conclusion, but stock market be a terrible investment based on the experience and “rational analysis”. I would most likely have liquidated my portfolio, missing, subsequently, one of the biggest bull-runs with no more than 28% drawdown in the next 17 years. DJIA roared from 92.92 in 1942 low to 995.15 high in 1966, returning 970%. By comparison, DJIA had two other superlong bull cycles after that episode, rising 1342% from 1982 to 2000, and 485% from 2009 to 2024.

Since Trump took office, the memory of Smoot-Hawley came back, and investors are busy analyzing the dire consequences of what came after. This letter has done the same over the last few months, including the unintended tail risk of *Mar-a-Lago* Accord, like Smoot-Hawley, to address US trade and financial imbalances in February.

However, this piece is less gloomy, it calls on the potential positive side, in the market we pay most attention to, China, on outlook. The country, curiously, also took over the US as the largest and strongest in manufacturing since 2009, erected skyscrapers like mushrooms, revolutionized mass EV car making with many domestic models and Shanghai Tesla and became a world superpower. Yet, to the chagrin of investors, the Shanghai Composite Index has stuck around 3000 for nearly 20 years, with a 50% drawdown from its 2007 peak.

Fortunately to world, one auspice missing was a hot world war. And I hope we will never see one, ever. Unfortunately to global investors, the Sino-US trade war started in 2018 during Trump's first term, and it now escalated to a global one. Looking at the outcome, I can see why Trump was so angry and wanted to escalate. In 2017, China amassed 500 billion US dollar trade surplus. Fast forward to 2024, it rose to nearly 1 trillion.

Recent escalation takes us into the first stage of a World Trade War (WTW). The first battle ended with both US and China building the stock of firepower and armament by raising tariffs to an eye-popping triple digit level. Early signs seem to suggest that Trump be backing off with more exemptions, but it is way too early to tell. Future outcomes are highly uncertain.

If history offers any clue, it seems to suggest that the stock, sooner or later, shines in the market which possesses the real capability to bear the suffering and sustain the war for longer. In today's world, it is China that owns manufacturing capability as large as G7 combined.

Will China's stock market in the next 17 years repeats US's experience from 1942 to 1965? That is a trillion-dollar question.

Risk: World Trade War Potential Cause for Global Depression

Academic studies still debate on what led to the Great Depression which started in 1929 and persisted through most of 1930s. The theories range from policy mistakes (tight monetary policy, gold standard as too strict a jacket, and Smoot-Hawley tariffs), financial fragility (leverages, bank failures), and structural imbalances (over production / under consumption, debt deflation or balance sheet reduction).

Looking closer, most of the theories explained the length but not the cause. The cause, or the spark, could be found in the timeline. It started with Smoot-Hawley passing the House in May 1929. With over production in place, the threat of the trade war gradually worked into investors' expectations of demand destruction to hurt the future earnings. Tariffs transfer wealth to government pocket and net negative for total wealth creation, at least in the short to medium term. The weaker earnings outlook turned into concern in a market already too bubbly. The market peaked in September and the crash ensued in October. The tight monetary policy was not helping, and the signing of Smoot-Hawley nailed the coffin, and subsequent retaliatory measures from other countries prolonged the pain, and the fear.

Had Smoot and Hawley possessed a perfect vision, would they have done what they did? The guess is probably not. Would they have possessed a perfect vision? The answer is no. Few do. Neither do Trump and his administration. The trade imbalance problem was there, the goal to address the issue was justified, the trouble lies in the bluntness, the haphazardness, and the quick fix approach.

Most worrying is the haphazardness. Even today, it remains murky who in Trump administration came up with the tariff formula and on what basis.

It is difficult for governments of other countries to figure out the goal of the Trump administration. Was that the Trump administration wants to have a fair “reciprocal tariff” to level the playing field, or was it striving for a zero-trade-balance on bilateral basis?

If it were the latter, the effort would bound to fail. A country is only a stop between the globe and an individual. The globe has zero trade balance with the rest of planets, but an individual has nearly 100% trade balance with another individual, surplus or deficit in trade or in service. He or she only balances his/her trade with many. The only way to balance trade bilaterally is zero trade. That's Smoot-Hawley allover.

Peak to trough, global trade dropped 63% during the great depression. The country, the US, which started it dropped the most with 69%. Other industrialized nations like Germany, UK and France dropped 50% to 62%.

Such an abyss is a tail risk the market has not priced in.

Asset: A Moment of Uncertainty

It is surprising for the US market to take this long to price in uncertainty given what we have experienced during the first Trump administration and the way he does business. Given the uncertainty around tariffs in the next 90 days, periodic VIX spikes will likely persist, and the low teens era will be unlikely return.

The increased uncertainty, combined with diminished outlook for corporate investment, reduced consumer purchasing power and suppressed trade volumes, will all bode poorly for global equities, especially the US one with one of the highest valuations and the lowest risk premiums amid elevated rates. The rise, instead of fall, during volatile times adds another concern.

The US rates opportunity remains the same. Powell has clearly stated that he will be patient and in no hurry to cut. Relative to the dot plots, the market currently prices in too many cuts this year. We are a payer here. The pain trade is for the market to price even more should the stock tank. Short equity position is not only justified on outlooks but also works out a good hedge.

On the other hand, the market still prices in only one cut and often less during past weeks of volatile time. This is wrong because of heightened risk of recession and high probability of a dovish governor loyal to Trump next year. Bessent's recent comment on the search for the next Fed governor should get market attention. We read Bessent's comment as being frustrated with the 10-year yield rising and he intends to send a signal to the market with the search news. We are a receiver for next year. Investors will start pricing in a new and dovish Fed governor. It is a question of when. Positioning on Fed rates are safer than on Treasury where supply and demand picture looks murky in the next few months.

The tariff headwind blows on China, too. The difference is that the valuation is low, and the risk premium is high with low rates. The new factor is that Beijing finally realizes that the index level might be read as a

signal on who's winning the trade war between China and the US. Thus, it pays much more attention and actively encourages the state sectors to support the market with added PBoC backing (more on this in the capital section). It does not mean the stock will go up a lot, it does lend strong support at last September's level. Buying low for limited gain is the approach we like to take. The volatility will drop.

We still think China's long end rates are too low in the long run, the potential negative impact of trade war on growth created new uncertainty, so we have lowered our exposure of short rates.

On the commodity front, we see the tariff war to hurt exports in steel, further strengthening our conviction in this sector. The curb on production may lead to short term rebound if enforced strictly. It only provides better entry levels.

Unlike the market consensus, we do not see China devalue its currency to fight the tariff war. We do not see currency appreciates either. In turbulent times, Beijing likes RMB to be stable. We see no trade there. We do see the market has overreacted in some ASEAN currencies and think there is room for those to appreciate.

Capital: Tailwind for China Equity and vice versa for US one

China's March money supply data delivered a surprise: stronger-than-expected growth in M1, which rose to 1.6% yoy after flatlining at 0.1% in February. This marks a tentative recovery from a year of weakness, aligning with the rebound first seen in December 2024. Meanwhile, M2 growth held steady at 7.0%, matching consensus, while credit expansion outperformed, with aggregate financing and RMB loans both exceeding forecasts.

The pickup in M1 - a gauge of both household corporate liquidity now - suggests economic activity may be finding a floor. Historically, M1 growth correlates with equity market performance, as improved liquidity signals higher corporate confidence and spending. Now it also captures household demand deposits which could signal more firepower for equity bottom fishing. The Shanghai Composite, already buoyed by policy support, could see further upside if this trend sustains.

There are also more liquidities coming from the central bank to support the equity market. Central Huijin, the state-owned investment arm, has been actively buying stocks to stabilize the market, particularly in the financial and blue-chip sectors. The activity has the backing of the PBoC, which recently signaled its readiness to provide re-loans to backstop market stability efforts. This is the second time the PBoC made such move. The first time was since September 2024 when the governor famously said 500 billion, 500 billion and 500 billion more if the market needs it. The action underscores policymakers' determination to prevent a downward spiral, potentially encouraging risk appetite among domestic and foreign investors.

The implications for bonds are net negative on the margin. More liquidity is good for financial assets in general. But robust aggregate financing and loan growth reduce the odds of imminent monetary easing, despite lingering deflationary pressures. Government bond issuance, a key driver of March's aggregate financing surge, further adds supply pressures.

The US market faces the opposite liquidity issue. Tax dues could withdraw more liquidity from the market while it boosts the TGA balance. The Net-net will be a weekly negative, but monthly neutral since the balance will be drawdown quickly in May and June. The debt ceiling is still in place and the TGA drawdown provides liquidity to the market without bond issuance to absorb it.

However, the TGA balance will quickly drop toward zero after a temporary boost from tax dues. If the debt ceiling is lifted in June, issuance will ensue. The timing corresponds with the highest government bond roll in a time when the rates are elevated, and inflation likely kicks in due to tariffs. All negative factors for US equity.

Economy: Inflation Divergence Poses Risk to both China and the US

The U.S. and China face opposite inflation problems - one too high and the other too low. Hope for the two countries to become each other's remedy seems to be dim at this stage.

China's March CPI dipped -0.1%, slightly better than February's -0.7% but still below flat expectations. Meanwhile, the PPI fell -2.5%, worse than forecasts, signaling weak industrial demand. While deflation may seem like a consumer boon, it reflects deeper issues - sluggish income growth, cautious spending, and a debt-laden economy especially at the local government level.

Beijing experiences this persistent headache. It is trying to revive inflation to around 2%, a new and more realistic target relative to the 3% ceiling for earlier years.

First, low inflation drags down nominal expansion, making it harder to close the economic gap with the US. China needs higher nominal output on top of real GDP growth. Second, mild inflation helps to improve wages and lift corporate earnings. It erodes debt burdens over time, easing pressure on households, local governments, and developers.

The fix isn't simple. Consumption remains weak, and monetary easing has a limited impact when confidence is low. Fiscal stimulus - such as household subsidies or targeted industrial policies - are being deployed with some success. Beijing wants to avoid Japan's deflationary trap. But achieving 2% inflation requires more than piecemeal measures. It demands structural reforms - boosting social safety nets to spur spending, deregulating sectors to attract more investment, and managing industrial overproduction. However, we project a low probability for a large-scale roll-out of such measures. With tariff war hindering exports and leading to more domestic supply, we became cautious on CPI and believe disinflation or deflation will sustain longer than we originally projected.

The US, on the other hand, faces an opposite issue of troubling economic mix - stubborn inflation and weakening growth. The latest University of Michigan survey shows one-year inflation expectations surging to 6.7%, the highest since 1981, while consumer sentiment plunged to 50.8, far below forecasts. These are classic stagflation signals: expectations of accelerating prices and decelerating growth.

Now, add tariffs. A blanket 10% levy on imports, plus 25% on cars and 145% on Chinese goods, will push inflation higher in April and onwards. Estimates suggest these tariffs could add 0.5-1.0% to CPI in the short term, with autos and electronics seeing the sharpest jumps. Meanwhile, GDP growth could take a hit - tariffs act as a tax on consumers and businesses, potentially shaving 0.5% or even more off annualized growth as costs rise and demand weakens.

The Fed is trapped. If it cuts rates to spur growth, inflation expectations could spiral up. If it holds firm, high borrowing costs will further depress spending. The Michigan survey's inflation spike suggests households are bracing for more pain - likely anticipating tariff-driven price hikes.

The bigger risk is a self-fulfilling cycle: if consumers and businesses expect inflation to stay high, they'll demand higher wages and prices, locking in elevated inflation. Meanwhile, slowing growth raises the specter of 1970s-style stagflation.

Washington's bet is that tariffs will boost domestic manufacturing, offsetting the drag. But supply chains take years to rebuild, and consumers will feel the pinch first. The outlook? A bumpy second half - higher prices, sluggish growth, and a Fed with no easy way out. Stagflation isn't inevitable, but the warning lights are flashing.

The trade war will not stop anytime soon, but targeted trade adjustments and engagement in negotiations could turn a vicious cycle into a stabilizing feedback loop. On this front, Trump's recent exemptions on advanced electronics and China's clarification on originality is a welcome step to ease tensions.

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End notes