



## Is Our Empire Crumbling?

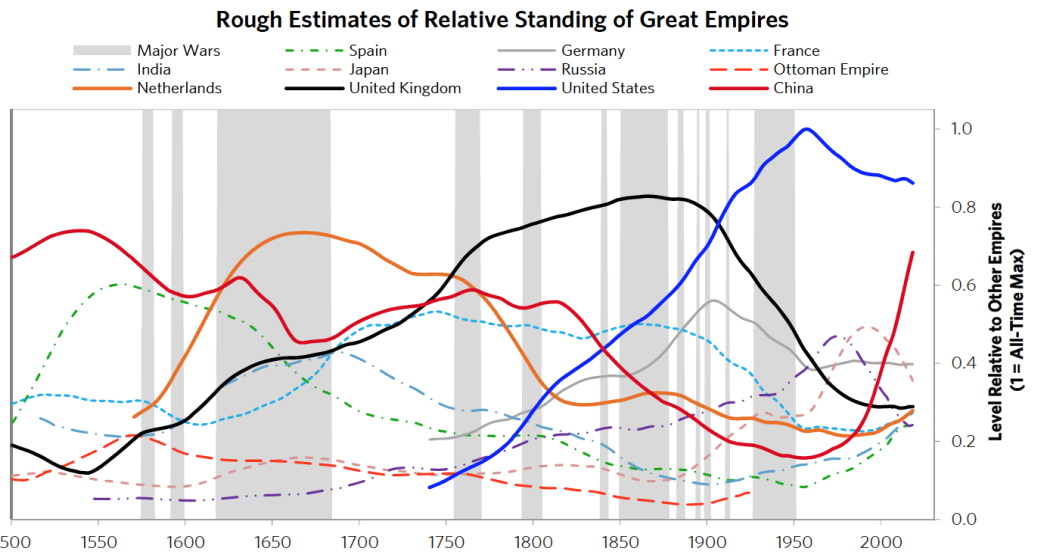
December 2020 – Q4 Explorations

Immediately following the end of World War II, the US dominated as no empire had in the history of empires. We were the only country with a nuclear bomb, giving us supreme military power over the world<sup>1</sup>. We had officially recreated the world order at Bretton Woods, dictating new trade policy among other policies, beneficial to both us and the world. We controlled 80% of the world's gold. We accounted for half of the world's production output. From a relative strength standpoint, that was the height of our empire.<sup>2</sup>

Flash forward to today and, as can be seen from the chart below, China is quickly gaining ground on us. Simply inferring from the trend of the lines, it seems relatively straightforward that China will surpass us as the leading world empire. However, it is never quite so simple.

For example, China, on the back of its tremendous population and geographic features has generally been one of the most powerful countries in the world (note graph on page 5). But due to these same qualities (population, geography), the country has tended to have an authoritarian bent that restricted innovation. For example, Chinese innovation resulted in the printing press and gun powder<sup>3</sup> but not really any books (due to

restrictions on what one could say) or bullets. The list goes on. Is what is going on now with Alibaba<sup>4</sup> similar to US and European regulators curbing monopolistic activities, or more a power play of government vs. private entity, which goes further in potential limiting innovation?



<sup>1</sup> The Russians caught up relatively quickly. While the US thought they had a 10-year window at least, the Russians had a nuke by 1949. This was due to spies in the system! Agent Sonya (Also a title of a good read by Ben Macintyre), among others, thought it important from a world parity perspective for Russia to have it. While in the minority, there were those in the US who thought we should use the bomb to take out some of our enemies at the time. I for one have always been proud that we did not use it as I suspect many powers in the past (Napoleon? Mongols?) just may have.

<sup>2</sup> Ray Dalio - From his forthcoming book *The Changing World Order*, some of which has been released on LinkedIn.

<sup>3</sup> For a fascinating read and the source of this statement, read "The Invention of Invention" chapter of *The Wealth and Poverty of Nations*, by David S. Landes

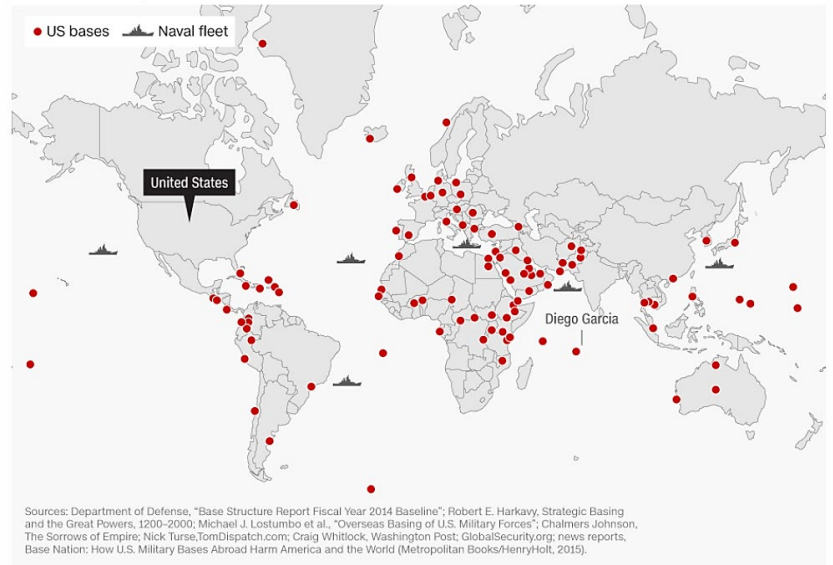
<sup>4</sup> [China orders Jack Ma's Ant Group to overhaul its business - Axios](#)



## America As Empire?

America has historically been isolationist. And for good reason! After all, we fought for our freedom from a classic empire, Great Britain, and we generally have the luxury to decide whether we want to enter a war given our ideal location between two oceans and our blessed land with navigable rivers, a large breadbasket, and oil, among other benefits that allow the country to be quite self-sufficient. Perhaps we are not an “Empire” in the traditional sense in that we are not directly<sup>5</sup> imposing ourselves on surrounding countries. But we are definitely indirectly doing this! Most transactions in the world are still conducted in our currency. We continue to lean on countries’ political approaches and provide the ability to borrow from us and buy sensitive products (e.g., military products) and services from us in return for our friendship. And, perhaps closest to the typical empire, our armed forces have bases in foreign lands around the globe. The US is an Empire!

### US military bases abroad, 2015



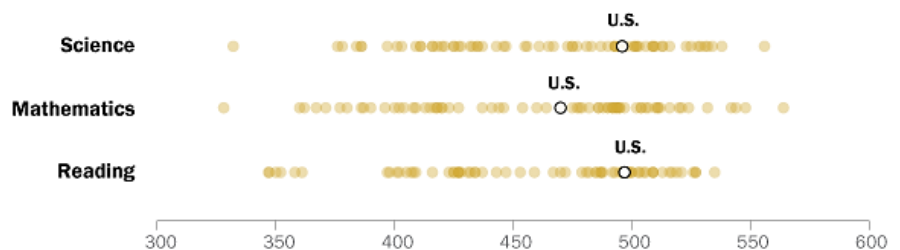
## Leading Indicators of Decay

America has the best ranked universities in the world<sup>6</sup>. However, less than 50% of Americans actually complete college<sup>7</sup>. And while there are different statistics floating around that attempt to quantify the relative quality of our primary and middle school education, most findings put us middle-of-the pack at best, as the graph on right illustrates.<sup>8</sup>

Furthermore, our top colleges have not increased enrollment size to adjust for population changes (something Canada does), and also take a number of international students. This further limits the ability of America’s youth to attend<sup>9</sup>. Declining education has a direct effect on competition,

### Internationally, U.S. stands in middle of pack on science, math, reading scores

Average scores of 15-year-olds taking the 2015 Program for International Student Assessment



Note: Scale ranges from 0-1,000. Results from China not included because only four provinces participated in PISA 2015. Source: OECD, PISA 2015

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<sup>5</sup> Meaning, we’re not literally making other countries simply our outpost and posting a flag...

<sup>6</sup> [2021 Best Universities in the World - US News](#)

<sup>7</sup> [Educational attainment in the United States - Wikipedia](#)

<sup>8</sup> [Internationally, U.S. stands in middle of pack on science, math, reading scores | Pew Research Center](#)

<sup>9</sup> Cost being another limiting factor





especially in a competitive, global world. Companies consistently set up shop in areas that can provide a well-educated workforce, which typically translates to increased pay.

With higher-paying jobs increasingly necessitating a 4-year college degree, lower levels of education also contribute to wealth inequality and perhaps even the partisan divide.

This of course did not occur overnight. Due to globalization (which America pushed), innovations, (which America pushed), and increasing wealth, (which Americans, unequally, begot), we basically destroyed the ability for many in our middle class to keep up.

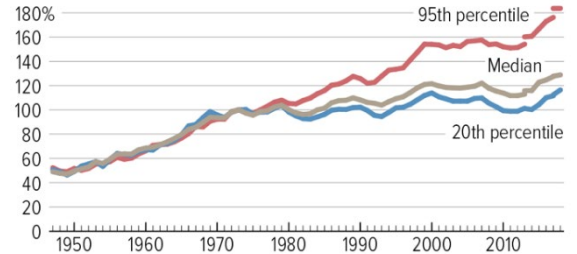
Both a partisan divide and wealth gap lead to a lack of government action. On one side, wealthy citizens, with their oversized grip on wealth, have more power than ever to dictate policy (note Koch brothers and Bloomberg – opposite sides, same concept). At the same time there are more voters who believe the system is working against them and a large

number who believe that they have either been disenfranchised through widespread fraud, voter suppression, or that their vote doesn't ultimately matter. These voters want changes which may help in understanding the extremes of the Left and the Right – frustration over one's lot in life resulting in a demand for change from one's country based on where the perceived faults are placed. This is all perhaps exacerbated by social media. It all results in less cohesion as a country, which in turn creates more political gridlock and less long-term development.

Declining education levels and gridlocked government should lead to diminishing competitiveness. The last chart on right from Ray Dalio, generalizes factors characteristic of a rise and decline of an empire.

## Income Gains Widely Shared in Early Postwar Decades – But Not Since Then

Real family income between 1947 and 2018, as a percentage of 1973 level



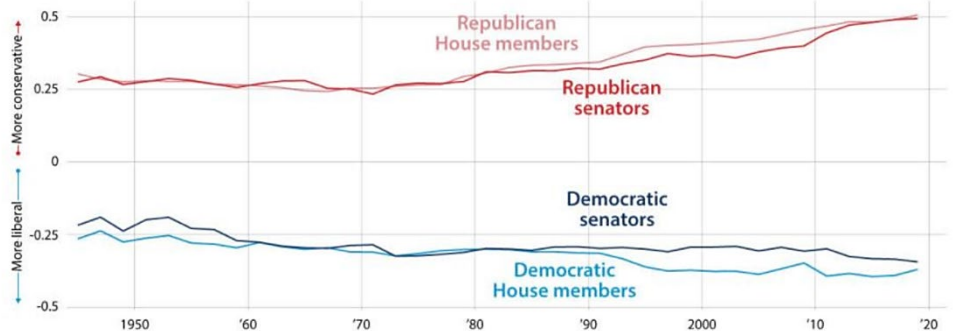
Note: Breaks indicate implementation of a redesigned questionnaire (2013) and an updated data processing system (2017).

Source: CBPP calculations based on U.S. Census Bureau Data

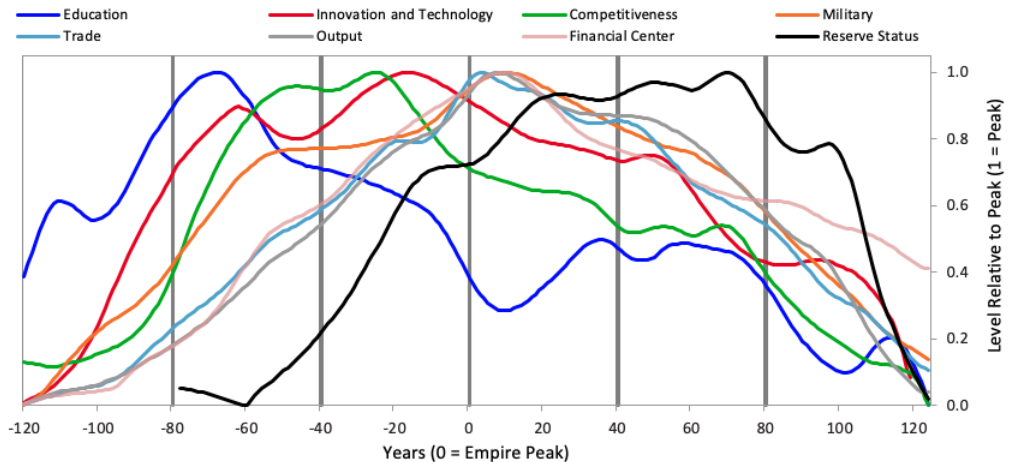
CENTER ON BUDGET AND POLICY PRIORITIES | CBPP.ORG

## Congress has become steadily more polarized since World War II.

Congressional party voting averages by year



## The Archetypal Rise and Decline by Factor





## But is China really Poised to Take Over?

A clear focus on the importance of geography on a country's DNA comes courtesy of Peter Zeihan. Based on China's topography, soil, landscape, rivers and so on, they ultimately relied on huge amounts of person power. The ability to tame their rivers, to build the Great Wall of China, and so on were all completed by aggressively taking advantage of human capital. Unlike America, China is not optimally laid out. Its population lives off of a much smaller breadbasket than ours. Its shoreline is not optimal in almost any regard. These characteristics affect military might and political approaches. For example, the need to manage huge initiatives like taming rivers and protecting from folks like the Mongols necessitated centralized management<sup>10</sup>. The US simply needed to inhabit the land - there was no work to be done other than to provide some incentive to move our population increasingly West<sup>11</sup>.

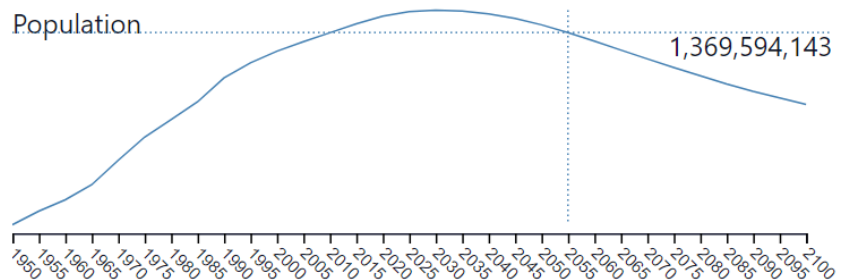
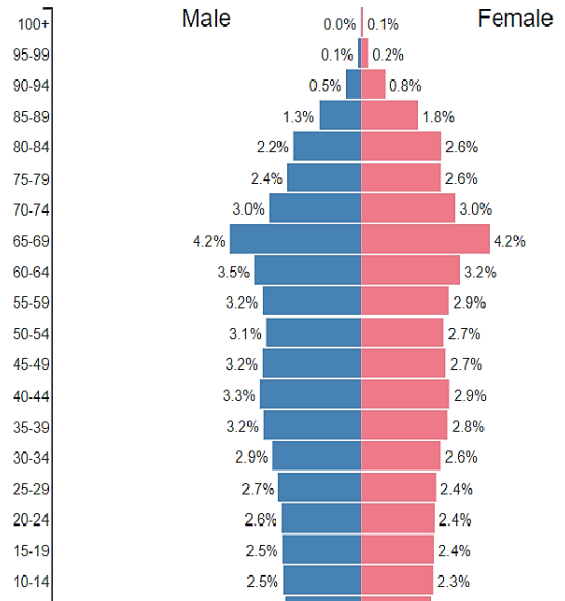
The One Child policy China put in place in 1979 will result in some crushing demographic realities in the coming years. Not only will its population decline, but the ratio of working age people to those generally thought of as retirement age<sup>12</sup> will be crushing.<sup>13</sup>

The One Child policy was originally instituted for a number of reasons, including poverty and potential famine, as the government tried to navigate to the optimal population size<sup>14</sup>. Can you imagine what would occur in the US if our government told us we couldn't do as we please? It is worth noting what is occurring in Hong Kong at the moment as compared to the vision of "One Country, Two Systems"<sup>15</sup>.

China has done an incredible job of competing in our global trade system. It did this through centralized government creating special zones of industry in order to leverage its vast population to focus on specific items<sup>16</sup>, e.g., shoes.

China ▼  
2055

Population: 1,369,594,142



<sup>10</sup> Does geography dictate optimal government philosophy? Military approach? It definitely has a hand in it. Peter Zeihan is the best writer I have seen on the topic, though my research in the matter is not rigorous by any stretch.

<sup>11</sup> I compare here the work needed to tame rivers and other land management projects, rather than the impact of migration on indigenous populations, which is beyond the scope of this Exploration.

<sup>12</sup> I was working hard here not to be agist by not using "old people" vs "young people"

<sup>13</sup> Both images are from populationpyramid.net

<sup>14</sup> [One-child policy - Wikipedia](#)

<sup>15</sup> [One country, two systems - Wikipedia](#)

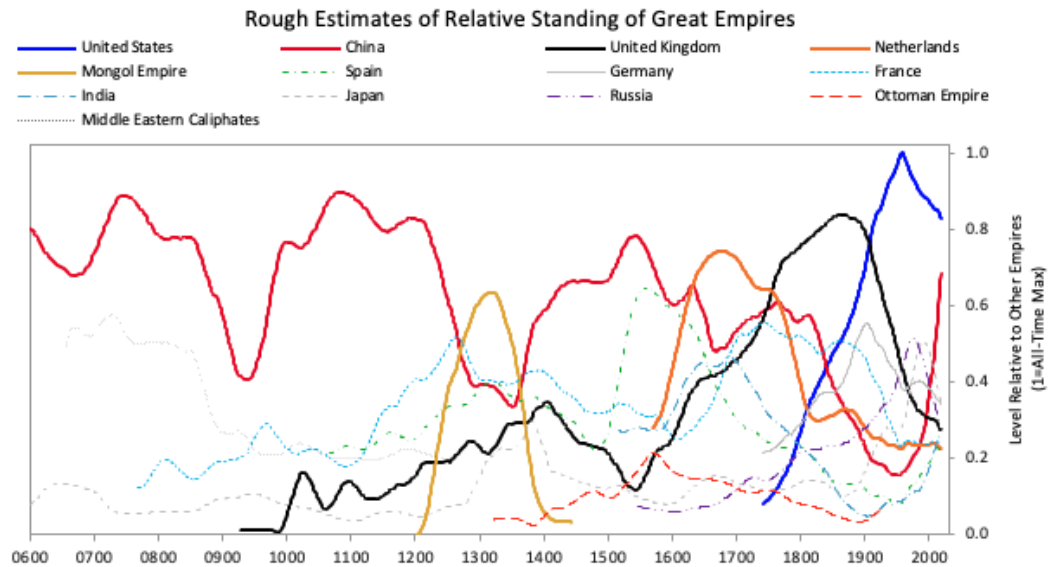
<sup>16</sup> Some may argue stealing IP, cheating on trade agreements etc helped as well but that is not the thrust of this Exploration



But a government with too much control creates a higher cost of innovation and a higher cost of entrepreneurship, as the government can take it all away, as it pleases. This is the reason the Chinese people did not take advantage of the printing press when first created – free speech was dangerous. And perhaps it is the reason that Jack Ma and the government are currently at loggerheads.<sup>17</sup>

The point is, while the slope of the line on the graph opening this Explorations shows a rather unfettered move to pole position with respect to global might, China has a number of internal issues that can get in the way of their current growth trajectory. Further, the US, which had materially assisted China in getting to where it is today, is now naturally becoming an economic foe at the least. Combined, these two characteristics (internal issues and US-based pressures) can slow down

or even reverse the growth of China. Odds are that China will remain a key player on the world scene consistent with the chart above<sup>18</sup>, but it is definitely not a given that they will overtake the US, despite how it may look on that initial graph.



## The Four “D”s and their effects on the World Order:

### Demographics, Debt, Deglobalization & Declining Productivity

We have focused on three of the four “D”s in past Explorations and plan to discuss further on the [webinar scheduled for Thursday, January 21<sup>st</sup>](#). A summary of our findings is as follows:

- **Demographics:** The US is estimated to be in way better shape over the next thirty-five years<sup>19</sup> with the population over 65 increasing slowly from 16.5% today, to 22.9% in 35 years. Meanwhile, China’s average age explodes with the over 65 population increasing from 11.8% today, to 29% in 2055<sup>20</sup>! This is with an overall declining population to boot. We had discussed demographics and its effects in detail in our [Q2 2019 Explorations](#).
- **Debt:** In our “Is the US Money Good?” ([Q2 2020 Explorations](#)) we discussed the issue of spiraling debt in the US. One of the reasons China is still considered an emerging market despite their size is due to checks and balances in their financial system. It is one of a few reasons the US will hold onto its reserve status for quite a bit longer. However, it seems like China is in better

<sup>17</sup> From Ray Dalio’s forthcoming book – which partially can be accessed on LinkedIn

<sup>18</sup> Courtesy of Ray Dalio

<sup>19</sup> Though immigration definitely plays an interesting role here

<sup>20</sup> Note Pyramid above which shows a narrow base supporting a widening older group. All data comes from Populationpyramid.net





shape than us from a debt to GDP standpoint, which makes sense given trade imbalances have favored them for quite a while.

- **Deglobalization:** The fact that the US is the largest consumer in the world, combined with a trend towards regionalization, should favor the US going forward. This dovetails nicely with the assumed stance of our government in driving business away from China. This ultimately benefits other nations (e.g., Mexico, Vietnam) as well as the US. We had discussed this in detail in our [Q3 2019 Explorations](#): “What is Really Happening With Global Trade”.
- **Declining Productivity:** We have not really explored this topic so perhaps a future analysis? Tune in for our webcast where we plan to ask our guest his thoughts!

Ultimately, the US should be in better shape relative to China with respect to trends in demographics and deglobalization. That being said, the current debt situation has put the US in a tough spot. High debt levels is a classic characteristic of receding empires – a concerning sign for the US.

## Challenge to the World Order

In 1945, the US essentially dictated the new world order with us at the center. We controlled global trade and generally policed the world. We had a cold war with Russia but they never truly competed with us economically. Once Russia crumbled<sup>21</sup>, there was no competitor to challenge our supremacy on any level that mattered. The world order feels like it is changing. 30+ years of trade imbalances illustrate that global trade is not quite in our favor any longer. With China at 4x our population, quicker current growth, and a huge GDP base, we now have an economic challenger. It is the reason that the outgoing administration’s attitude to China will very likely continue under the new administration<sup>22</sup>. It is time for the US to change the rules for its benefit. Will the world become divided, like in the days of the Cold War with Russia, where countries will need to pick sides? Perhaps.

Will Europe win, given their size and importance and the ability to play off the two sides? Or will they lose as America forces them to pick a side? Do countries like Taiwan, with their expertise in semiconductors, become a winner given their increased importance to either side, or are they simply gobbled up by China given their geographic location (and therefore a loser)? Or does Taiwan spark a war as America decides the territory is too important and too sensitive to let go without a fight<sup>23</sup>?

There are obvious cracks in the US story. But we have had issues prior and grown stronger from them – the Civil War being an obvious example. Additionally, great powers of the past, like Great Britain, seem to be doing just fine now even though they had quite the difficult ride in the most recent change in World Order (as they essentially went bankrupt). What should be of consolation is that the longer-term trend for the world has been in the right direction for millennia. We continue to build on our knowledge and create a better world<sup>24</sup>, at least for us humans.

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<sup>21</sup> Perhaps biased by my US upbringing, whatever criticisms we have of our approach to government, it seems that we humans are incapable of functioning in a true communist manner. On a separate note, in the “Wind of Change” podcast – a great conspiracy theory-based listen – one comment that blew my mind was how a Russian interviewed on the podcast believed we were the ones *behind* the Iron Curtain! Seems obvious in retrospect.

<sup>22</sup> The approach will almost definitely change, but China will be viewed as an adversary in the Biden administration and most likely for the foreseeable future regardless of party in power.

<sup>23</sup> Can Taiwan become the Cuba of China – US relations?

<sup>24</sup> The more research is done, the more it seems like the “Dark ages” is a misnomer – evidently progress was made even then.





## **Removed US Bias in Equity Investments; Continue to Analyze Effectiveness of the 60/40 Portfolio**

Our general approach to investing on your behalf is to take a top-down approach in creating diversification of risks and returns in one's portfolio. Let's unpack that. A top-down approach means we start by viewing the high-level investing opportunities. Equities vs. Fixed Income exposure first. Then within equities, US, Developed Markets (e.g., Europe & Japan), and Emerging Markets (e.g., less-developed markets like China & India) and so forth. We continue on this path to actual strategy and manager selection. Diversification of risks and returns means we invest in multiple exposures on your behalf in order to increase the likelihood we'll have varied return streams as well as risk streams. Since we do not know with certainty (nor does anyone else to our knowledge) what investment will do best, we attempt to smooth out the experience. We do have biases though.

This past quarter we have removed the US bias we had held in our models over the last couple of years. While the US still has many material advantages compared to the rest of the world, as detailed in past Explorations, we had concerns about the US election and perceived lackluster performance fighting COVID despite the US entering the pandemic recognized as the country most ready to combat an epidemic globally. Perhaps of most concern is the tremendous divide our society is currently experiencing, likely exacerbated by social media. We now add fear of a weakening dollar. These reasons led to our decision to remove our US bias until these perceived risks hopefully pass.

Fixed income has been a meaningful part of investor portfolios for the last few decades. Beyond potential returns, it was viewed as ballast for a portfolio. However, with risk-free rates at historical lows – with 10-year US government bonds yielding a scant 1% annually, holding longer term fixed income becomes riskier. Less ballast and less potential for decent returns create a need to find other potential exposures. We have defined the issue but do not have the answer – it is something we are actively working on.

## **Concerns: *Social Media Exacerbating Partisan Gap***

We continue to share this concern due to the damage we believe it creates. Feel free to skip over if you read last quarter. At this point, it seems fair to state that social media is exacerbating the unfortunate social divide we are experiencing. A recent documentary on Netflix called "The Social Dilemma" brings up a lot of interesting (and to be honest concerning) points about how all of these gigantic internet companies are operating. Several tech experts, many of whom have worked for years in the industry, share their opinions/concerns about the business practices of these powerful and unregulated companies.

We all scroll through the legal fine print ("scroll" but not "read") and just click agree on pretty much anything that these companies demand in order to use their apps/technology. But what are we really agreeing too? What are we actually allowing these companies to do?

What you are agreeing to is the ability for all your activity on these apps/websites to be monitored, stored, and analyzed in an effort to target you with ads (e.g., they can tell how long you are looking at your ex's pictures on Facebook/Instagram). All these tech companies want to do is make their products as addictive as possible so you spend more time on them. The more time you spend using their apps, the more data they can collect, and the better they get to know you. In this situation, the user (you), is actually the product. As mentioned in our most recent market commentary, an author received 14 million pages of self-documentation upon a request to Google<sup>25</sup>.

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<sup>25</sup> [https://theamericanscholar.org/our-post-privacy-world/#.XO\\_KiS2wOWo](https://theamericanscholar.org/our-post-privacy-world/#.XO_KiS2wOWo)

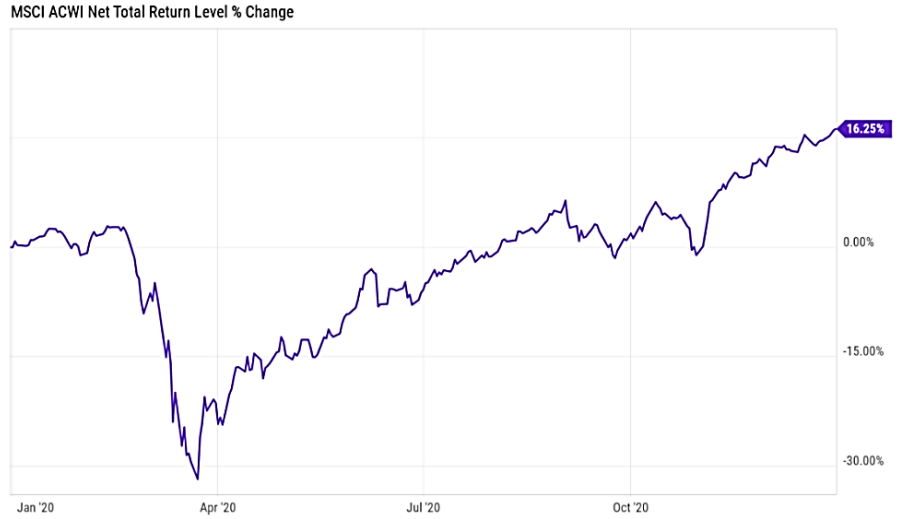




We receive “free” banking but there are risks in our fractional banking system. We receive “free” social media – I am afraid that the cost in reality may be very great to us collectively as well as individually. Social media is a chief concern of ours as it will continue to increase uncertainty and volatility in pretty much everything it touches.

## General Market Review: *Economic vs. Financial Market Disconnect Continues*

Equity markets continued to roar back this past quarter on the back of material government support resulting in a very accommodating investment environment. While we have had a V-shaped financial market recovery to date, portions of the US general economy are still struggling. As a result, the government is negotiating another large bail-out while the Fed maintains an accommodative stance, including extremely low interest rates and the promise to purchase certain assets. With an increase in available money, investments should continue to enter the financial markets but in a narrower vein, focused primarily on technology and other firms that seem to fit the new realities and quicker realization of expected secular trends.



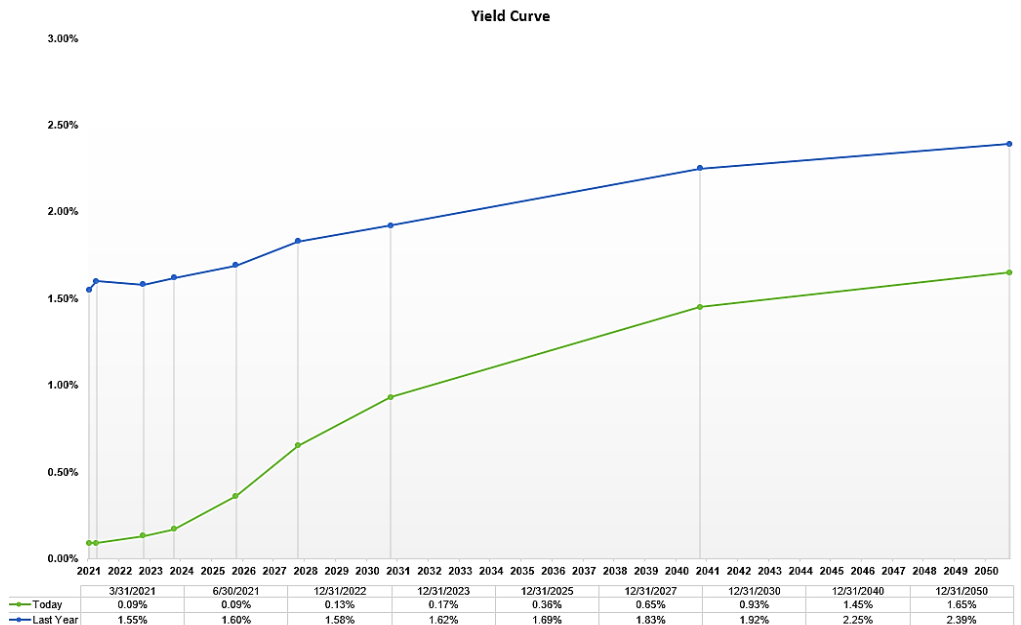
Interestingly, when positive vaccine news came out there was a rotation out of growth and into value. With growth at very high valuations, if we overcome COVID we can envision an overhang on growth as value catches up. We practice diversification rather than speculation within our models but do monitor for opportunities to make slight shifts if we believe there is a beneficial risk/reward payout.

The massive debt load globally, as discussed in recent [Explorations](#), and the fact that the world’s population, especially in developed markets, is becoming older on average, results in large overhangs that seem likely to have negative effects at some point in time – when, who knows? Countering this narrative are the amazing innovations occurring continuously in society that result in further productivity and value creation.

Both the debt load and aging populations are significant contributors to the low yield environment we are currently experiencing. As mentioned above, with yields at

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# FOUNTAINHEAD INSIGHTS

historical lows and a stated lower bound of 0% interest rates by the Fed, the risk/reward may be shifting on fixed income after a 30+ year bull market.

Suffice it to say, financial markets are and will always be incredibly complex. We continue to monitor markets closely and look for opportunity on your behalf from both a risk mitigation and return perspective.

## IMPORTANT DISCLOSURE

The information contained in this report is informational and intended solely to provide educational content that we find relevant and interesting to clients of Fountainhead. All shared thought represents our opinions and is based on sources we believe to be reliable at the time of publication. While we continue to make these reports available, we do not update past reports in light of subsequent events. Nothing in this letter should be construed as investment advice; we provide advice on an individualized basis only after understanding your own circumstances and needs.



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