In April 2017, *Vigilante Investor* predicted that Russia would invade Ukraine. This same issue explained the Russian invasion could consume U.S. resources and lead to a Chinese invasion of Taiwan.

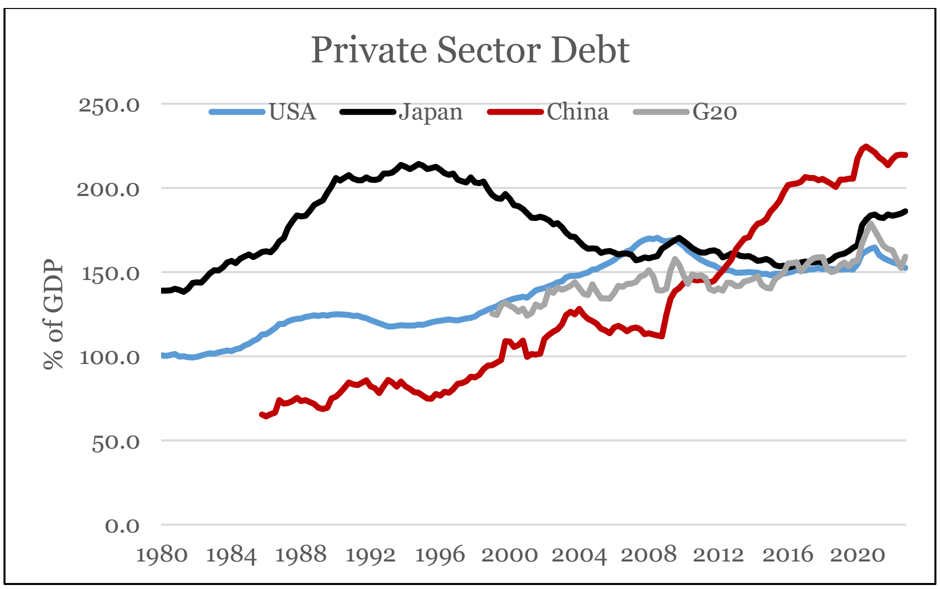
The Ukraine war has dragged on, causing the US and Europe to spend significant resources. Recently, the U.S. sent Ukraine controversial cluster bombs in lieu of artillery shells because, according to President Biden, the U.S. supply of artillery shells is running low. Meanwhile, the U.S. military is experiencing recruiting shortages.

So, as the U.S. military focuses on Ukraine, it has run short on ammunition and short on soldiers. If China ever wants to invade Taiwan, this is the time.

Chinese Leadership Needs a War of Unity

China's so-called economic miracle is living on borrowed time – and money. For more than ten years, debt expansion has funded all of China's economic growth. Figure 1 compares China's private-sector debt to other economies.

Figure 1: Chinese Private Debt History Compared to Major Economies



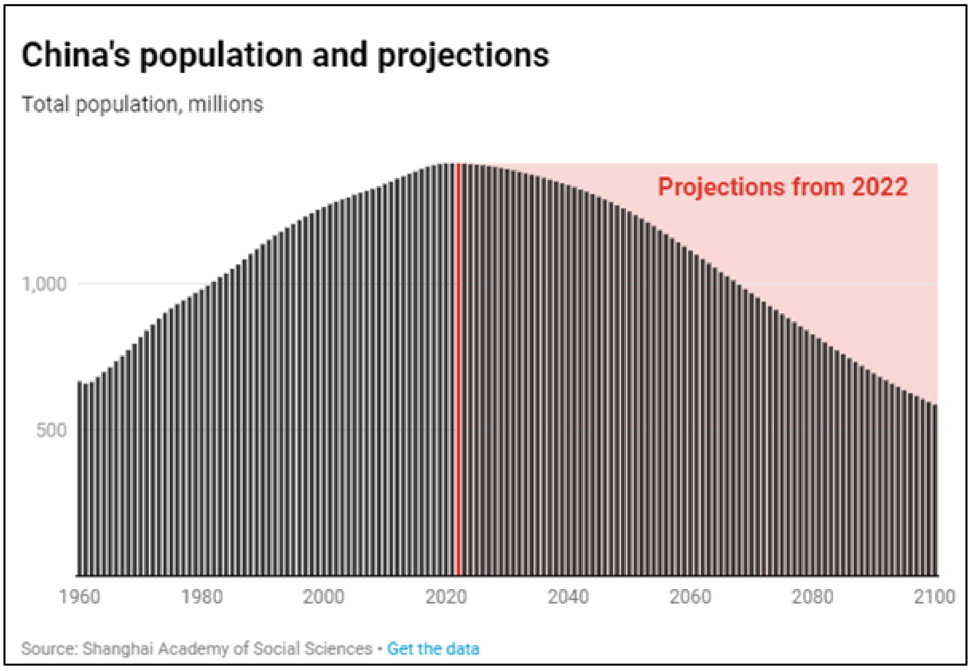
Source: Bank for International Settlements

Since 2008, China private-sector debt has soared from 112% of GDP to 220% of GDP. To put that into perspective, private debt has grown by 4.5% per year more than GDP. In other words, if China's private-sector debt had not grown at all, the economy would be shrinking by 4.5% per year.

The past decade of Chinese growth is nothing more than a pyramid of debt. Figure 1 indicates that China's capacity for debt is nearing the limit. The economy will collapse as the debt cycle turns toward debt collection.

Chinese population trends reinforce the need for debt contraction. In 2022, the Chinese population shrank for the first time in recorded history. Current trends foretell a massive decline in the Chinese population.

Figure 2: China Population Trends



China cannot sustain economic growth without a massive productivity leap. But Communist China has not demonstrated that it can innovate sufficiently to improve productivity. Without a productivity miracle, China is destined for long-term economic decline… which will likely lead to unrest. Without growth and expansion of wealth, the communist government will struggle to keep the country from splintering.

However, the communist government has one option to boost innovation and inspire national unity. By invading Taiwan, China could capture the technology needed to boost productivity while inspiring wartime unity.

China is Prepared for War

China has long been preparing for war. In fact, China's preparation is almost complete.

In a recent address to the Hudson Institute, Kyle Bass discussed China's costly and elaborate preparations to invade,[1] as summarized below.

Military Readiness Simulations: China completed its first invasion practice drill in August 2022, when it simulated the destruction of Taiwan's air defenses. Then in April 2023, China practiced a mass mobilization, including the seizure of strategic domains for total control of the airways, sea, and mobile communications around Taiwan. China's final simulation, an

[1] https://www.hudson.org/events/china-prepares-war-timeline-miles-yu-kyle-bass

amphibious assault, is the final exercise. After it is completed, China will be ready to invade. Note that due to seasonal tidal patterns, China can probably launch an invasion only during the months of August, April, or May.

Preparation to Confiscate Foreign Assets: In January 2020, China updated its Foreign Investment Law to allow confiscation of foreign assets during times of war. In June 2021, the Foreign Sanctions Law permitted the detention of expat employees and seizure of assets of companies that cooperate with sanctions against China. In April 2023, espionage legislation banned transfer of national security data and broadened the definition of spying.

Mainland War Preparation: In March 2023 China announced the completion of 18 air raid shelters in Fujian Province, adjacent to Taiwan. In the same month, China completed construction of the world's largest combat hospital. This is a telltale sign that China really wants to invade. It would not have built this combat hospital if it wasn't committed to invade Taiwan.

In June 2023 China staged its first-ever large-scale power outage drill. Also in June, the government revoked travel privileges for millions of citizens due to low social credit scores. At the same time, the government encouraged citizens to raise their social credit scores by donating blood.

Financial Preparation: China is taking aggressive action to insulate itself from sanctions and the seizure of overseas assets. China's central bank redeployed foreign assets, buying Gold and other assets.

Chinese officials ordered companies and individuals to sell foreign assets and repatriate the proceeds. In response, Chinese banks sold international aircraft leasing operations. This eliminates the risk of China-owned aircraft being seized (abroad) as part of a sanction's regime.

On the liability side of the balance sheet, Chinese property developers have already defaulted on 65% of outstanding dollar-denominated debt… the same property developers defaulted on only 21 % of Yuan-denominated debt. The implication is clear. Chinese companies know they will lose access to overseas capital after the war. They see no value in spending resources to satisfy foreign creditors.

Hoarding of Critical Supplies:

China is increasing stockpiles of grain and energy.

After surging their imports from South America and Ukraine, China now holds 70% of global grain inventories. China's wheat inventory can meet 1 ½ years of domestic demand. China continues to add to imported stockpiles.

China is expanding imports of crude oil, LNG, and coal, each by about 25%. Considering that the economy is barely growing (0.8% in Q2), most of the additional energy imports are going into storage.

Implications of Invasion

Taiwan's armed forces are equipped to inflict considerable damage on invaders. However, Taiwan cannot win. China will unleash world's biggest army, supported by the world's largest fleet of littoral (coastal) naval ships. Taiwan cannot repel a determined Chinese invasion.

The Chinese takeover of Taiwan will mark the beginning of a protracted, strategic conflict. It will pit China against an alliance of the U.S and Japan. The alliance will seek to control strategic supply lines and infrastructure. The war will feature cyber-attacks, asset seizures, sabotage, satellite bombing, naval blockades, and piracy.

A Strategic War of Attrition

The U.S. - Japan Alliance can defeat China in the strategic war…if is doesn't lose its nerve.

Allied naval forces can block most critical supplies from reaching China. The U.S. can deploy as many as 9 separate Carrier Strike Groups. With ships powered by nuclear reactors, each of the 9 U.S. carrier groups can travel the globe and deliver more firepower than the entire Chinese Navy. Japan brings the world's second strongest Navy to the alliance, with significant range and firepower. The combined navies of the U.S. and Japan can control Pacific Ocean shipping lanes that supply most of China's resource needs.

The key choke point for Chinese petroleum supplies sits beyond the reach of the Chinese Navy… in the Strait of Malacca. China has very few naval vessels that can travel this far from home ports.

Figure 3: Strait of Malacca

Source: Geography.name

The narrow strait serves as a choke point between the Indian Ocean and the Pacific. A blockade at this single chokepoint would intercept over 2/3 of Chinese oil imports. Aided by satellite reconnaissance, allied forces could block most other sea routes to China as well.

It may take a couple of years for China to run out of vital supplies. When supplies run out, the population will grow hungry and desperate. The current leadership may not survive.

China's Path to Victory

For China, victory would be defined as gaining control over Taiwan and then inflicting enough pain, military and economic, for the U.S. to agree to a peaceful settlement. If China can appeal to the allies' worst instincts, greed, and fear, it can achieve victory.

<u>Appeal to Greed</u>

Powerful forces will encourage the U.S. to go easy on China. The Taiwan manufacturing giant, Foxconn, manufactures iPhones for Apple in Chinese factories. Apple – and many loyal customers - will lobby for the U.S. to go easy on China.

The profitability of many other U.S. companies depends on exports to China. For example, China represents 26% of Nvidia chip sales. These chips are critical to Chinese efforts to build data centers for AI applications. Nvidia (and other similar tech companies) have proposed selling "dumbed-down" chips to China. If that continues, post-invasion, it will help China immensely and create a wedge in the sanction regime.

Eventually, China will capture the foundries and factories of Taiwan Semiconductor Manufacturing Company ("TSMC"), the global leader in semiconductor manufacturing. TSMC manufactures most of the high-end chips produced globally, including Nvidia's GPU chips for AI applications. With China in control, sanctions should starve the world of the chips that now drive the AI boom. That would cost the tech world and Wall Street dearly.

Post-invasion, business leaders will argue that TSMC should produce and export high-end chips in Taiwan. But if that occurs, Chinese companies will reverse engineer high-end chips. China would then become a force in AI.

If it develops AI, China can develop novel attacks on allied aircraft carriers. One such attack would involve swarms of drones that can instantly react to ship defenses. A single drone breakthrough can sink a ship.

<u>Create Fear</u>

War delivers fearsome losses to all parties. Even without a long-range naval force, China can deliver heavy blows. China boasts a strong air force that could damage and sink allied ships. China can also deploy hypersonic missiles are nearly impossible to intercept.

Unconventional warfare could also inflict damage. Cyber-attacks could potentially bring down the American grid or telecommunications. Chinese fishing trawlers that operate around the world could stage a surprise attack on a naval vessel. Groups of military-aged Chinese males that recently crossed into the U.S. from Mexico could organize sabotage or terrorist attacks within America's borders.

If Americans suffer heavy losses, the country could lose the will to carry on the fight.

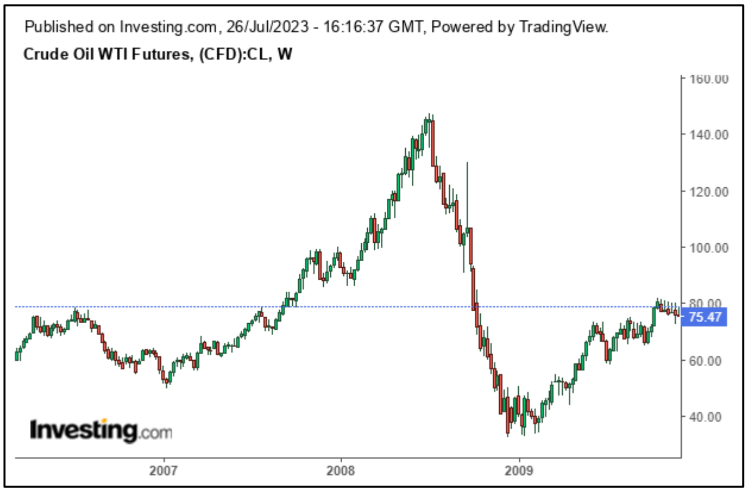
Market Implications – Commodity Price Volatility

Between now and the invasion (in 2024 or 2025), China will fill its oil tanks and grain bins to the maximum possible level. Leading up to the start of the invasion, China's buying will support commodity prices.

Crude oil prices will take a wild ride. Crude oil producers generally maintain steady output over time, and the market features a relatively tight balance between supply and demand. As China sustains outsized purchases to build inventory, prices will soar.

This has happened before. Leading up to the 2008 Beijing Olympics, China bought up supplies to build inventories, and the crude price nearly doubled (from $75 to $145).

Figure 4: Crude Oil Price History, 2007 to 2009



Crude prices settled back to around $100 when the Olympics were held. Then China stopped buying as it consumed its excess inventories. Simultaneously, the Great Financial Crisis caused global crude demand to fall. Crude prices collapsed to $40. In less than two tears, the crude price went from $75 to $145… and then down to $40.

Crude oil may be in for a similar ride over the next couple of years. Prices will rise as China hoards supplies leading up to the invasion. Thereafter, sanctions and blockades will stop China from buying seaborne crude shipments, resulting in a crude oil glut, and collapsing prices.

Economic Dislocation Risk

Electronics: Electronics production will fall. The most notable shortage will be for Apple iPhones. How long would it take for Foxconn and Apple to rebuild productive capacity after the U.S. blocks Chinese imports and China confiscates Foxconn's Chinese factories?

Pharma: About half of pharmaceutical inputs are now made in China. How long will it take for pharmaceutical manufacturers to develop new sources? How much will the new (and more expensive) inputs cut into pharma profits?

Semiconductors: TSMC dominates the production of semiconductors. Currently, TSMC manufactures 100% in Taiwan. If you cut off TSMC chip supplies, it will slow the production of countless high-value products… from cars to computers, data centers, and more.

As a result of pandemic-era supply-chain problems, several companies began a geographic diversification of chip production. TSMC is building foundries in the U.S. and Japan, but production will not begin until 2025 or later. Intel has started to build new foundries in the U.S. and Europe. But it will take years for these foundries to start production.

No matter how you look at it, the global economy cannot afford to lose TSMC's Taiwan-based chip production.

RTX Corporation

When wars proliferate, everyone should be defensive, including investors.

What better way to invest defensively than to buy a leading defense contractor.

RTX is the world's largest aerospace and defense company. RTX Corporation was composed by merging three industry- leading businesses... Collins Aerospace, Pratt & Whitney, and Raytheon Technologies. The merger of these companies has resulted in substantially lower costs and better profit margins.

RTX Business Segments

Collins provides avionics, navigation, environmental control, and aviation control systems for aircraft manufacturers, airlines, governments, and defense contractors. Collins represents about 30% of RTX revenues.

Pratt & Whitney supplies aircraft engines for commercial, military, business jet, and general aviation customers. Pratt & Whitney has been a leader in the development of quiet, fuel-efficient jet engines. Pratt& Whitney also represents about 30% of RTX revenues.

Raytheon Intelligence and Space produces integrated space, communication, sensor, and cyber solutions to intelligence, defense, and commercial customers. It represents about 20% of RTX revenue.

Raytheon Missiles and Defense produces some of the most amazing missile and missile defense systems. It represents about 20% of RTX revenue.

Table 1: RTX Corporation as of 7/27/2023

Ticker	RTX	**EPS**	$3.74	**Forward P/E**	14.75
Price	$85.17	**EPS Forecast**	$5.78	**Expected 5-Yr Growth**	10.8%
Book/Share	$49.78	**Market Cap**	126.7B	**Credit Rating LT Deposit**	Baa1
Dividend Yield	2.74%	**Enterprise Value**	$157.1	**Debt/Equity Ratio**	47%

Sources: Finviz.com, Yahoo Finance, Shareholder Report

RTX reported second quarter earnings last week. Over the past year, sales have increased 13%. Earnings per share increased 11%. The company slightly raised its forward earnings guidance.

However, share prices tanked when the company disclosed a manufacturing defect that will require accelerated fleet inspections.

There is no telling how much it will cost Pratt & Whitney to address the defect. Considering that the stock price dropped 12%, the market has discounted a significant risk premium. The company has not yet lowered earnings guidance.... And even if it does, the stock price is deeply discounted. Considering that Pratt & Whitney is about 30% of the company, the 12% stock drop represents a 40% loss of value for the Pratt business. It would be surprising if the reported defect extracts more than 40% of business value. The risk is reasonably discounted.

Figure 5: RTX Corporation as of 7/27/2023

Source: Finviz.com

For a dominant defense contractor with strong expected growth and forward PE Ratio of 14.8, RTX looks like a pretty good deal.

Recommended Strategy**:** Buy a full position of RTX Corporation below $90. Use a $60 sell stop to manage downside risk.

The Economy and Markets

Despite the highest interest rates of the past 20 years, the U.S. economy is still growing. The Vigilante scorecard favors growth by a narrow margin. Inflationary pressures continue to persist, so the Fed may hike rates even further.

Table 2: Vigilante Investor Scorecard of Economic Conditions July 27, 2023

Score	Positive	Neutral	Negative
Growth 3 Contraction 2	US Real GDP +2.6%YOY US Non-Manf PMI 53.9 Global Comp PMI 52.7	Fed Signal +0.9%	US Productivity -0.9% US 2-10 Spread -0.96%
Inflation 3 Deflation 1	CPI +3.0% YOY US Wages +4.4% YOY Gold +7.8% YOY	US Dollar -3.9% YOY Gold / Euro +0.6%YOY	Crude Oil -12.9% YOY
Positive $ 2 Negative $ 0	US-Ger2YR Spread +1.59% US-Ger10YR Spread+1.48%		

Sources: Tradingeconomics.com, St. Louis Fed, and Investing.com

Government spending is fueling growth. From 2020 through 2022, Covid relief lined the pockets of consumers and businesses. Other than student loan forbearance, Covid relief has ended. But government stimulus is intensifying anyway. The government is funding industrial infrastructure spending via the Chips Act and the Inflation *Production* Act.

Student loan forbearance ends in October. That will offset much of the infrastructure spending. This factor, combined with the economic hit from high interest rates, should cause the economy to contract. However, the infrastructure spending will keep feeding growth… so the contraction may be limited.

In the long-term trend, the stock market is beginning to reach expensive valuations. Considering the already high valuation and the risk of recession, *Vigilante Investor* likes holding cash.

Figure 6: S&P 500 Long-Term Log Chart

Portfolio Changes

The Vigilante portfolio continues to hold a combined 40% position in cash and inflation-linked bonds. We recommend harvesting some gains…selling the position in Aflac and selling half of the position in Bank OZK that was acquired last quarter. We will reload on Bank OZK if the stock price sinks back to Tangible Book Value, around $33 per share.

Table 3: The Vigilante Model Portfolio as of 7/27/2023

Sector	%	Selections	Symbol	Initial Price	Price July 27
Defense	4%	Rtx Corporation	RTX	$85.17	$85.17
Financials	16%	Chubb	CB	$165.98	$211.20
		Aflac	AFL	$53.38	$72.06
		AIG	AIG	$47.54	$60.64
		WR Berkley	WRB	$53.58	$62.50
		Bank OZK	OZK	$34.86	$42.98
Energy	28%	ProPetro	PUMP	$8.25	$10.00
		Diamondback Energy	FANG	$61.33	$144.35
		Black Stone Minerals	BSM	$17.36	$17.23
		Coterra (Formerly Cabot)	CTRA	$18.69	$26.97
		Southwestern Energy	SWN	$4.06	$6.25
		Antero Resources Corporation	AR	$32.67	$25.40
		Plains All American Pipeln	PAA	$9.02	$14.89
		Cameco Corp	CCJ	$12.73	$32.98
Agriculture	4%	Mosaic Co	MOS	$28.67	$39.94
Precious Metals	10%	Junior Gold Miners ETF	GDXJ	$46.02	$36.10
		Gold Miners Index	GDX	$29.30	$30.35
		Pan American Silver	PAAS	$21.13	$15.58
		Silver Miners ETF	SIL	$42.00	$26.60
		Newmont Mining	NEM	$53.32	$42.11
TIPS	18%	VG ST Infl Protected Sec ETF	VIPSX	$12.90	$11.82
Cash	20%	Broker Money Fund			

Table 4: Vigilante Investor ETF Model Portfolio 7/27/2023

All ETF Portfolio	%	Selections	Symbol	Initial Price	Price Apr 28
Broad Market	4%	VG Mid-Cap Value ETF	VOE	$122.88	$146.23
	4%	VG Large-Cap Value ETF	VTV	$121.81	$146.23
Financials	4%	VG Financials	VFH	$88.21	$85.52
	14%	iShares U.S. Insurance	IAK	$84.25	$91.60
Energy	24%	First Trust Revere Nat Gas	FCG	$19.01	$24.86
Real Estate	0%				
Precious Matals	5%	VanEck Vectors Gold Miners	GDX	$32.75	$30.35
	5%	Global X Silver Miners	SIL	$39.51	$26.60
	20%	VG ST Infl Protected Sec ETF	VIPSX	$12.90	$11.82
Cash	20%	Broker MoneyFund			
	100%				

Have a great quarter!

Steve Koomar

July 28, 2023

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Disclosures

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