Quarterly Economic Update

June 12, 2024

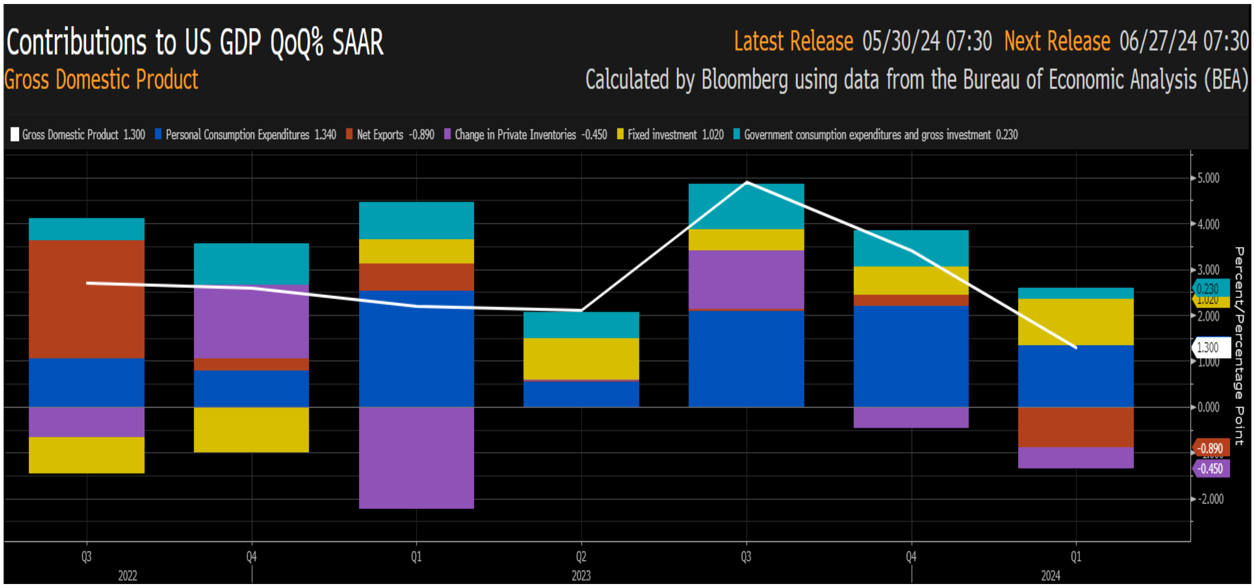
MACROECONOMIC COMMENTARY

Economic Outlook

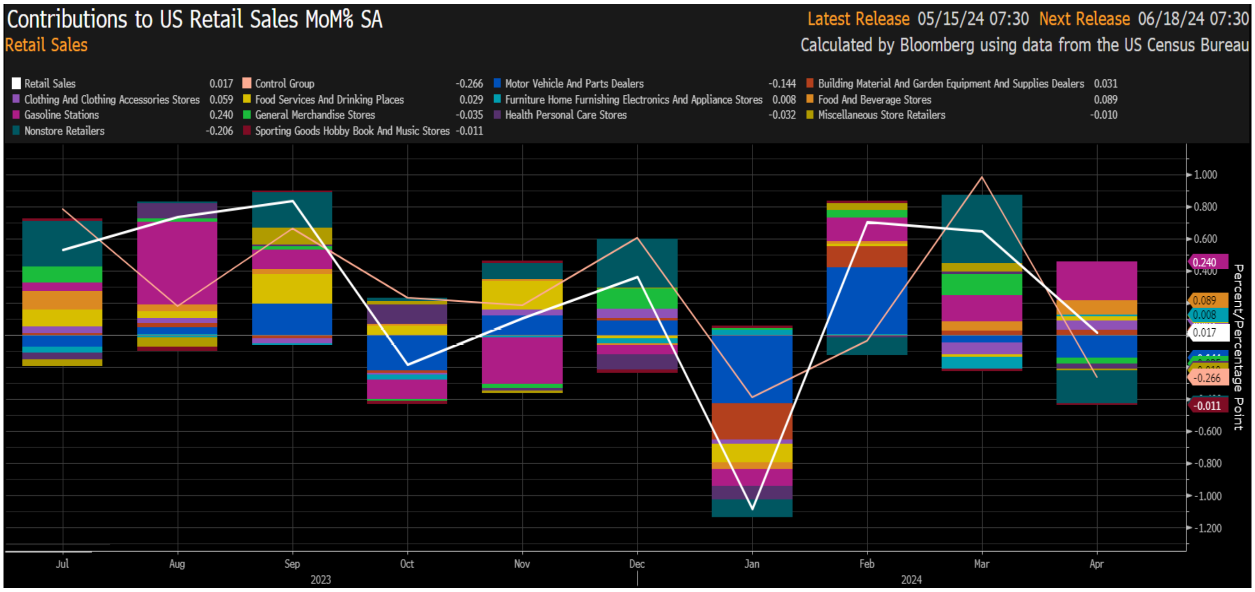
By Bobby Long

Economic conditions can support continued expansion, however economic strength does appear to be slowing as tailwinds fade and conditions become less accommodating. Excess money supply previously injected into the economy has been a boost that works with a lag and is now reversing. Higher policy and real interest rates are becoming more restrictive as inflation wanes. Consumer spending trends are still at healthy levels but may be reaching exhaustion. This will make economic growth harder to achieve. Strong financial markets and assets prices are supporting households. Employment is also still healthy. These conditions will play a big role in the path forward.

Real Gross Domestic Product (GDP) for the first quarter of 2024 grew at an annual rate of 1.3%. This was noticeably slower than the prior quarter's growth rate of 3.4% and marked the second consecutive quarter of decelerating growth. Net exports and inventory investment contracted for the quarter, pulling the overall rate of growth down. Personal Consumption Expenditures (PCE) remained positive, increasing 2% over the prior quarter, but weaker than the previous quarter's growth of 3.3%. The growth in PCE was driven by a 3.9% increase in spending on services, which has accelerated over the past three quarters. Spending on goods declined by 1.9% in the first quarter with weaker motor vehicle sales primarily responsible for weighing the number down. Private fixed investment expanded by 3.2% for the quarter, supported by a 15.4% increase in residential investment and a 3.3% increase in nonresidential investment. Stronger investment across information processing equipment, industrial equipment, software, and research and development supported nonresidential investment. This was offset by a decline in transportation equipment investment. Government spending increased 1.3%, however it was more modest than the previous quarter with higher state and local spending offsetting a decline in federal spending. The chart highlights how GDP and its components have trended over the past several quarters.



Consumer spending has been a large driver to U.S. economic growth and a major source of strength over the past several years. Any shift in spending habits bears watching closely. After strong spending in the months of February and March, retail sales and personal spending measures weakened for the month of April. Reduced spending on recreational goods and services led the decline, with additional weakness in other discretionary categories.



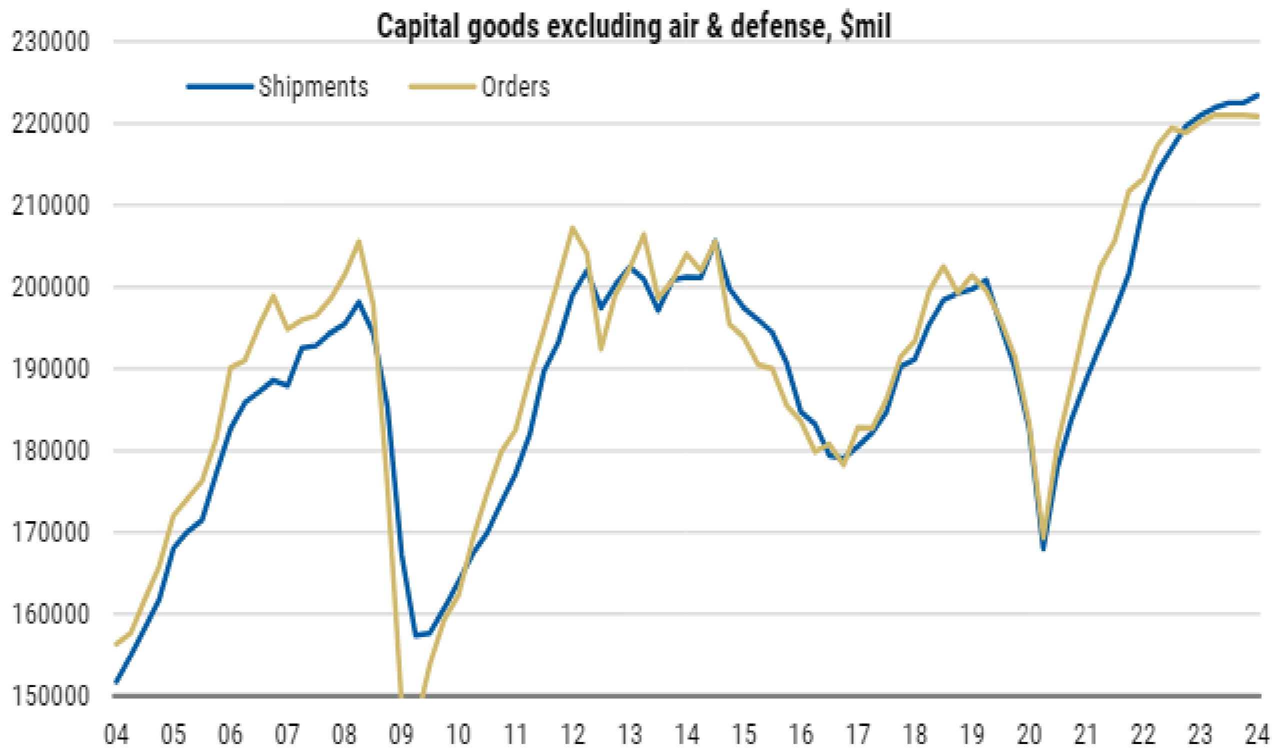
Consumers remain healthy overall and largely seem to still be spending, however discretionary income is tightening some across most income brackets. Net worth remains elevated with support from financial markets and home prices, yet some consumers may be spending a little more conservatively with wage growth moderating and inflationary pressures lingering in non-discretionary items. There may also be some exhaustion following elevated spending levels over the past several years.

With labor conditions still supportive, consumers do not seem to be experiencing stress, although younger consumers and lower income households may be feeling pressure from higher interest rates and tighter lending conditions. Credit card utilization and delinquencies have been modestly ticking higher for these consumers, who are more exposed to variable rate debt and weaker balance sheets. Despite some signs of stress in these lower income brackets, the two bottom income brackets make up a smaller percentage of total spending at a combined 22% and have less of an impact on overall spending. Higher income brackets still drive the bulk of spending and are less susceptible to slowing economic conditions. While these higher income households may hold spending habits at stable levels, it is more difficult to determine what would drive a step up in spending from current levels. This may leave the incremental rate of change in spending more dependent on lower income brackets who have a higher sensitivity to the business cycle. Lower income households have curtailed some spending and have been trading down on purchases. As long as employment conditions hold steady, this is likely to be only a modest drag. If conditions weaken and job losses begin to rise, that could trigger a more substantial shift in spending patterns that would gravitate up income levels as well.

With the consumers marginal propensity to spend potentially becoming more limited, a pick up in business investment could provide additional support to economic growth. The Business Roundtable CEO Economic Outlook Survey improved off low levels in the first quarter with 39% of CEO's indicating they expect to increase capital spending in the next six months versus the prior quarter's survey of only 32%. CEO's who expected to decrease capital spending fell to 11%. This improvement is a positive signal for future capital investment.

Investment in nonresidential structures has been slowing. Federal spending programs, like the Inflation Reduction Act and CHIPS Act, have supported investment in tech manufacturing infrastructure over the past year. This tailwind will be less supportive going forward and the investment growth from the prior year is likely to fade. Lending standards have also continued to tighten over the past several quarters and remain a headwind. Banks have reported that lending standards and demand trends are not broadly deteriorating at the same pace, suggesting some improvement in conditions.

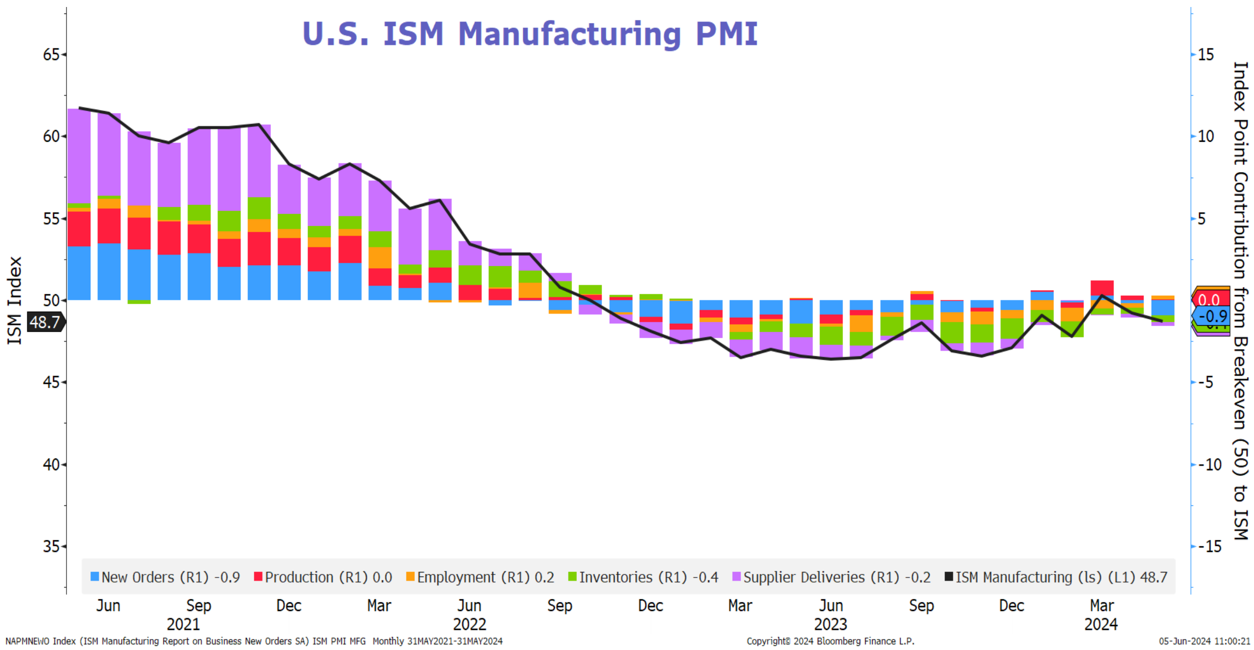
Equipment investment has been weak over the past year and the signals are mixed going forward. If employment and broader growth remain supportive, then there may be some pent up demand as expectations and credit conditions improve. Capital goods orders are still at healthy levels, however they have been trending sideways for the past year. The chart shows that capital goods orders have been running below shipments, which may signal faltering conditions.



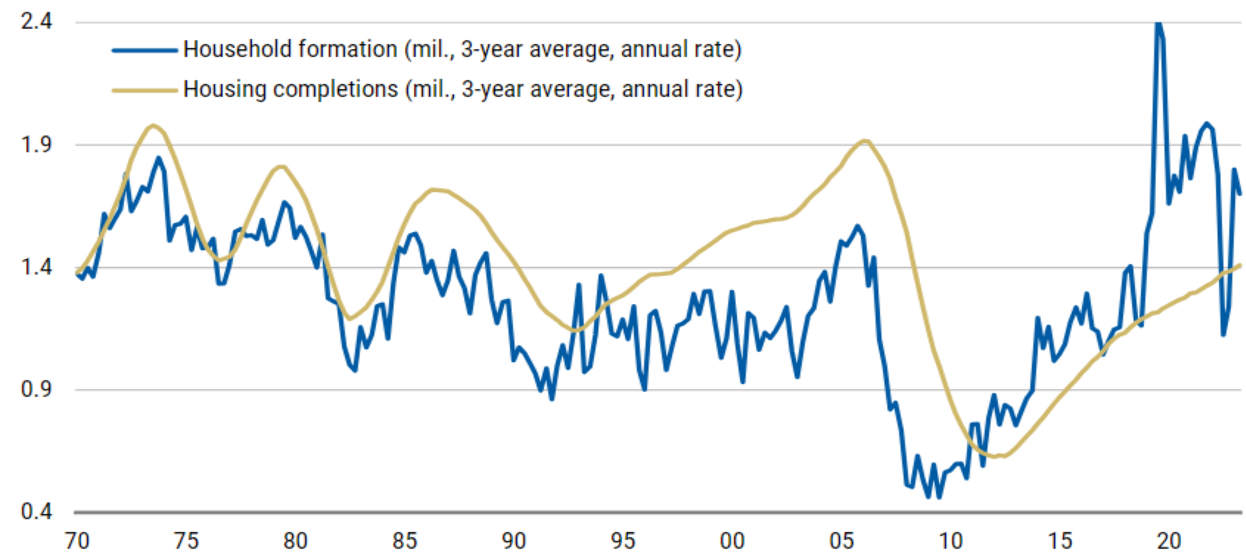
Source: Census Bureau, Morgan Stanley Research

Manufacturing activity continues to be mixed. Industrial Production remains at supportive levels but has been rangebound with the most recent report weighed down by weaker motor vehicle production, wood products, electrical equipment, and machinery. Business equipment production has fallen in four of the last five months. Consumer goods output has been slightly positive and exports modestly softer. The most recent manufacturing capacity utilization rate fell to 76.9%, and the overall industrial capacity utilization rate remained unchanged at 78.4%. Both have been trending lower over the past eighteen months.

After briefly moving into expansion territory in the month of March, the Institute for Supply Management's Manufacturing Purchasing Managers Index fell back into contraction territory in April and declined further in May. The measure has been weak, but the survey data late last year and in the first quarter indicated the soft conditions may be improving. The past two months are a setback and indicate the March report may have been a head fake. New orders fell by the most in nearly two years for the month of May, with only one of the six largest manufacturing sectors reporting an increase in orders. The recent report noted that housing, construction, and capital expenditures activity have continued to underperform since the beginning of the year.



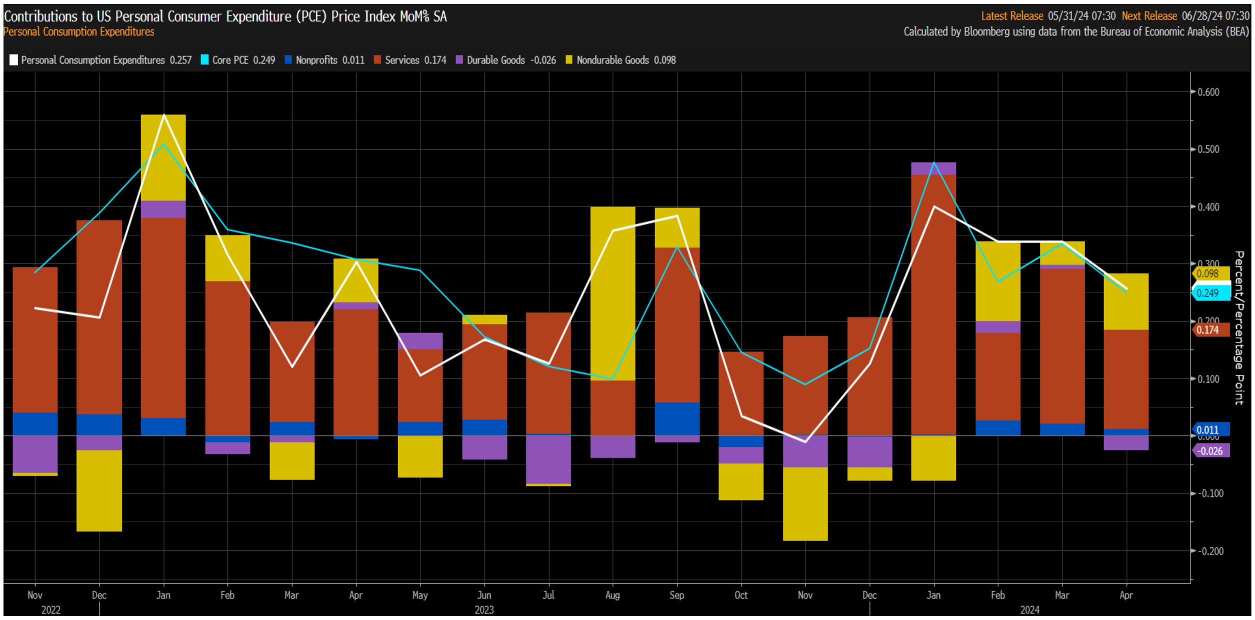
Housing activity continues to be driven by unique supply and demand trends. As the next chart shows, household formations have outpaced housing completions since the Great Financial Crisis. This has led to a shortage of housing. These conditions, combined with previously low mortgage rates, have pushed home prices and rents higher. As mortgage rates have risen and elevated home prices have persisted, affordability has become challenged. With a majority of existing homeowners having locked in lower mortgage rates over the past few years, it is limiting turnover of the existing housing stock as homeowners are reluctant to move given the higher refinancing rates. This has significantly depressed existing home sales and any activity associated with it, including home remodeling, appliance and furniture purchases, and landscaping expenditures. Homebuilders have continued adding supply with demand intact and limited existing homes available, but affordability is still a headwind. Building permits did drop for the months of March and April. Higher mortgage rates will limit activity but any relief would likely provide a boost to both new and existing housing activity.



Source: Census Bureau, Morgan Stanley Research

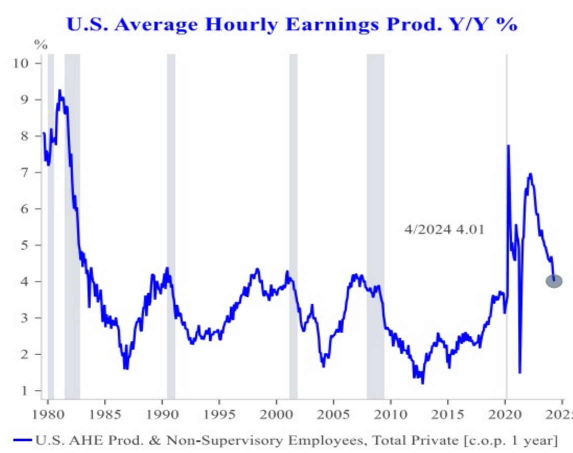
Given the supply and demand imbalances, home prices are expected to remain high. The recent University of Michigan inflation expectations survey showed consumers' house price appreciation expectations for the next five years had surged to a sixteen year high, marking a level it last hit in 2007 as it preceded the housing crisis. The underlying conditions driving higher prices are different than the prior cycle, but it may signal some overly optimistic views around the current housing cycle that are worth considering.

The decline in inflation measures may have stalled but broadly they still appear to be trending lower. For the month of April, the Consumer Price Index (CPI) registered 3.4% on a year over year basis and core CPI excluding food and energy was 3.6%. The PCE Price Index was 2.7% and core PCE was 2.8%. Inflation measures began ticking back up in the first quarter on a monthly basis, leading to concerns that inflation may be reaccelerating after the progress made over the past year. April's month over month inflation change moved back down slightly and there has not been further reacceleration, providing some relief that the uptick over the first quarter was just a scare. The concern has always been that as it moves down from elevated levels, further progress toward the Federal Reserve's 2% target may be harder to achieve, as some stickier inflationary components linger and there is risk of another inflationary wave. The chart illustrates the monthly trend and shows that higher services inflation and nondurable goods were behind the increase.



You can dig deeper behind the numbers and explain away various increases as being short-term in nature and likely to reverse over coming months, but part of the risk with inflation is that it keeps popping up somewhere else like a game of whack-a-mole and proves more persistent than anticipated. Labor conditions remain relatively tight and are keeping pressure under wages even as wage growth slows. Housing constraints are also adding pressure and a large portion of the population is still positioned to keep spending elevated. These conditions are making it more difficult for additional progress.

Wage pressures have continued to ease, with tight labor conditions loosening. Both Average Hourly Earnings and the Employment Cost Index have declined to around 4%. The Atlanta Fed Wage Growth Tracker has also been declining steadily to 4.7%. Wage growth above the 4% level has historically challenged further economic expansion, so it would be welcomed to see this number move lower for both broader inflationary pressures and continued economic growth.



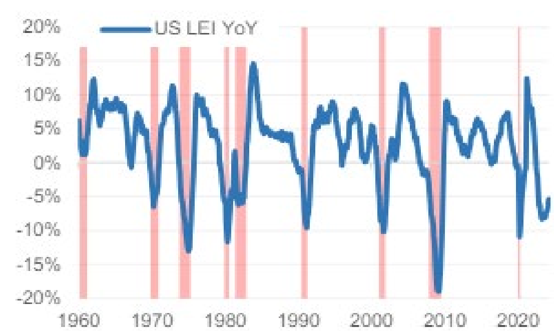
Employment conditions are still strong and unemployment is at a low 4.0%. The unemployment rate has ticked up off its lows. This can be attributed, in part, to an increase in labor supply, however the most recent household survey did report a decline in employment that contributed to the increase in the May unemployment rate. Nonfarm payroll growth slowed for the month of April, with only 165,000 jobs added. This rebounded the following month and the May payrolls report added 272,000 jobs. Layoff announcements have been on an upward trend over the past several months but have not risen to alarming levels, and jobless claims have remained low as those finding themselves unemployed have been able to secure new jobs.

While the unemployment rate remains low and widespread layoffs have been limited, many measures of labor force tightness indicate that conditions have eased and signal the labor market is cooling. The JOLTS job openings index has continued to trend lower, with declines over the past two months, and has fallen below its longer run trend line. The quits rate, which measures employees voluntarily leaving their jobs, has also trended lower. The Conference Board's "jobs plentiful minus jobs hard to get" survey also echoes this trend. These point to a better balance in labor markets that is more sustainable, not necessarily softer conditions that should garner more concern at this point.

Companies have broadly indicated conditions are stable and earnings have still been okay. Evercore ISI conducts company surveys across a wide number of industries; these surveys indicate sales and overall conditions are still solid in the US. The most recent survey did record a sharp deterioration for technology equipment and software manufacturers. Trucking surveys have also remained weak and historically have the highest correlation with real GDP. Outside of the US, both China and Europe surveys have been weak.

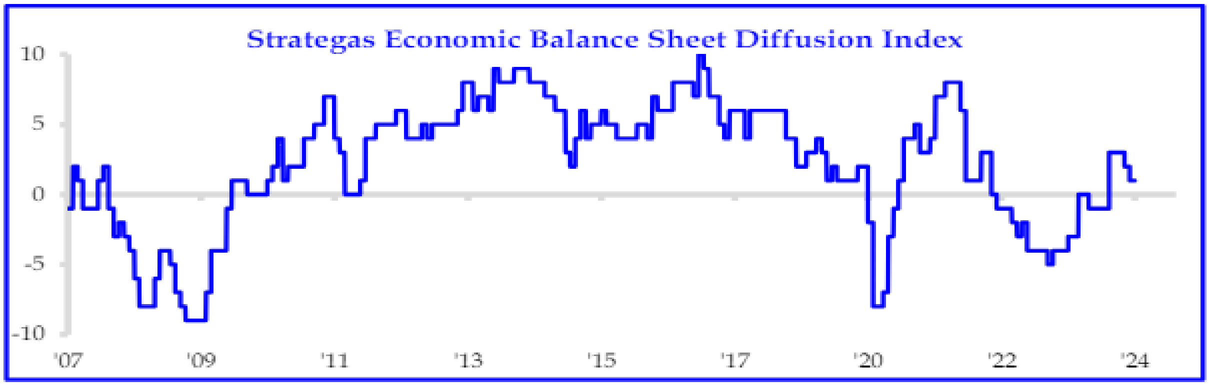
Economist Ed Hyman with Evercore ISI has highlighted that despite the continued economic growth and strong labor conditions, there are measures that historically have signaled slowing conditions ahead of previous contractions. He points out that preceding both the 1991 and the 2008 recessions, there was an 18-month lag between the yield curve inversion and when the recession started. He also notes that in 2008, there was a lot of discussion of how the yield curve inversion was "different this time" due to the longer lag time and highlights that we are now in the 19th month. The charts below show previous yield curve inversions. On the right hand side, it shows how Leading Economic Indicators have declined currently and ahead of previous economic contractions.

Recessions Shaded. Source: Bloomberg, Evercore ISI Research



Recessions Shaded. Source: Bloomberg, Evercore ISI Research

Lastly, we include the Economic Balance Sheet Diffusion Index below from economist Don Rissmiller at Strategas Research Partners. This index is an attempt to summarize the state of the economy by categorizing various economic sectors as either assets or liabilities to economic activity. The diffusion index remains tilted slightly to the positive side with the housing sector having most recently moved over to a liability as high mortgage rates have lingered. Manufacturing is probably at some risk of sliding over to the liability side. Employment remains a key asset and, if it begins to weaken, it probably takes consumer spending and consumer confidence with it.



Assets	Neutral	Liabilities
Capex Eqp	Trade Deficit	Int Rate Envr
Employment	Nonres Constr	→ Housing
Cons. Spend.	Govt Deficit	
	Credit Environ	
	Wage Inflation	
	Business Conf	
	Manufacturing	
	Cons Conf	
	Price Infl	

Economic growth has been growing above trend over the past seven quarters and is facing less supportive conditions over the next year that make it likely growth will slow. This may not lead to recessionary conditions, but incremental growth will be harder to achieve. Risk conditions are not necessarily elevated, but a sudden increase in job losses would kick off a negative cycle where consumer spending deteriorates quickly and could expose more challenging conditions.

RSA PORTFOLIO STRATEGY

Fixed Income Strategy

By Nick Prillaman

At our meeting in early March, economic growth was proving resilient while inflation was failing to decline as quickly as hoped, which prompted market participants to reduce their expectations of interest rate cuts from six to three for 2024. Unemployment figures were remaining steady as well. In mid-March, inflation concerns were reinforced by the hotter-than-expected producer price index (PPI). According to the Bureau of Labor Statistics, prices rose 0.6% for the month while core PPI rose by .3%. Both were higher than estimated and interest rates rose in response to the data. Yields, however, did not keep rising as the Federal Reserve met on March 20th. The Fed maintained its federal fund target range at 5.25% to 5.50% and prompted a rally in bond prices with its dovish messaging. Peter Boockvar, author of The Boock Report, said “Jay Powell clearly leaned dovish today as even a strong labor market he said would not stop the beginning of rate cuts. And this why the short-end yield fell as it did.” Even though yields oscillated throughout the month, net progress was muted. The 2-year Treasury yield ended flat while the 10-year Treasury yield fell 5 bps.

Performance among fixed income asset classes was net positive for the month as Treasuries in the Bloomberg U.S. Aggregate Index posted a .643% total return. Agencies underperformed with a .459% return while mortgages posted a decent 1.05% return. High grade corporate bonds were the best with a 1.293% return. The option-adjusted spread (OAS) fell by 6 bps, which aided performance. Utilities and industrials were similar in their performance among corporate sectors while financials trailed. Gross corporate supply came in at $143.8 billion, which was down from $198.2 billion in February. For the entire first quarter, supply was the highest on record at $535 billion per BofA Global Research. High yield lagged their better-rated counterparts with a 1.183% return. While the OAS compressed by 13 bps, high yield’s lower duration hurt its return at the margin relative to high grade corporates.

After a benign March, the bond market experienced multiple bearish selloffs in April. On the first day, the Institute for Supply Management (ISM) said its manufacturing gauge rose to 50.3, signaling the first expansion in activity since 2022. This, combined with higher-than-expected prices paid, caused the 10-year Treasury yield to rise by almost 11 bps. The second push higher in yields came in response to the blockbuster jobs report where nonfarm payrolls increased by 303,000 jobs versus the estimated 214,000. This indicated to investors that the economy was strong, which reduced the urgency for the Federal Reserve to cut rates. The final major rise in yields came in response to the hot March Consumer Price Index (CPI) report, where prices rose .4% month-over-month versus an expected .3%. The core CPI topped expectations as well. The 2-year Treasury surged an incredible 23 bps while the 10-year Treasury rose 18 bps.

Given the magnitude of the rise in yields, returns in fixed income were negative for April with Treasuries returning -2.327%. Among government-related sectors, agencies posted a respectable -.98% versus mortgages losing 3.025%. The duration differential was the primary driver of the returns as agencies are materially shorter than mortgages. Mortgage OAS widening by 7 bps didn't help either. High-grade corporates struggled alongside mortgages with a -2.545% return. OAS in high-grade corporates tightened by 3 bps but could not offset the long duration drag. Gross supply volume slowed down for the month to $105.0 billion but was close to the average since 2016 per BofA. High-yield bonds delivered the best return at -.94%.

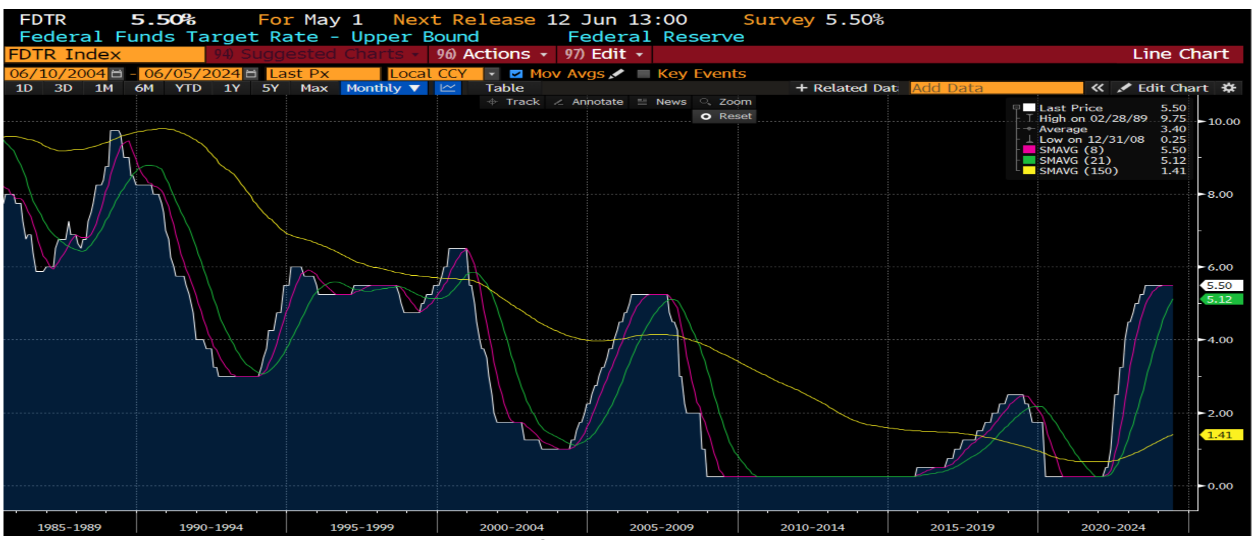
The month of May began vigorously for fixed income investors as interest rates fell in the first three trading days. On May 1, the Federal Reserve met and maintained the federal funds target rate at 5.25% to 5.5%. The Fed did announce that its balance sheet runoff within Treasuries would be reduced from $60 billion to $25 billion a month, which was seen as a positive for liquidity as well as reducing upward pressure on bond yields. Fed Chair Powell's press conference also enthused the market as "the tone and content of Powell's remarks were notably more dovish than the initial statement suggested" per Mohamed El Erian, chief economic advisor at Allianz. Powell essentially took the potential of further rate hikes off the table. Two days later, a softer employment number drove yields lower. According to the Bureau of Labor Statistics, nonfarm payrolls for April came in at 175,000 jobs versus an expected 240,000 jobs. The unemployment rate ticked up to 3.9% from the prior 3.8% and average hourly earnings missed expectations as well. Rita Nazareth at Bloomberg News said, "the latest employment print gave fodder to the believers in an economy that is gradually slowing and would allow a data-dependent Fed to start easing policy as early as September."

Cooler economic data in mid-May continued to push interest rates lower. The Bureau of Labor Statistics said core CPI, which excludes food and energy costs, came in at .3%, after increasing 0.4% in each of the prior three months. On a year-over-year basis, core CPI rose 3.6% and was the lowest reading since April 2021. Weaker retail sales data also contributed to interest rates dropping. The Commerce Department said retail sales were flat for April versus an expectation of .4%. Bonds, however, could not advance indefinitely and reversed later in the month. A strong PMI print showing an expansion in U.S. economic activity was one of the catalysts behind the move, as well as weak Treasury auctions. Finally, benign PCE inflation data induced a bond rally on the last day of the month.

While interest rates were volatile in May, yields generally fell across the board with the 2-year Treasury falling 16 bps and the 10-year Treasury declining almost 18 bps. The major bond asset classes were positive for the month with mortgages leading the way with a 1.998% return. High-grade corporate bonds returned 1.87% while Treasuries posted a 1.457% return. Agencies and high yield corporates lagged at .979% and 1.099% in total returns as their lower-duration profiles drove their underperformance. High-grade corporate new issuance was healthy with $132.7 billion in gross supply, which was better than the $105.3 billion in April per BofA.

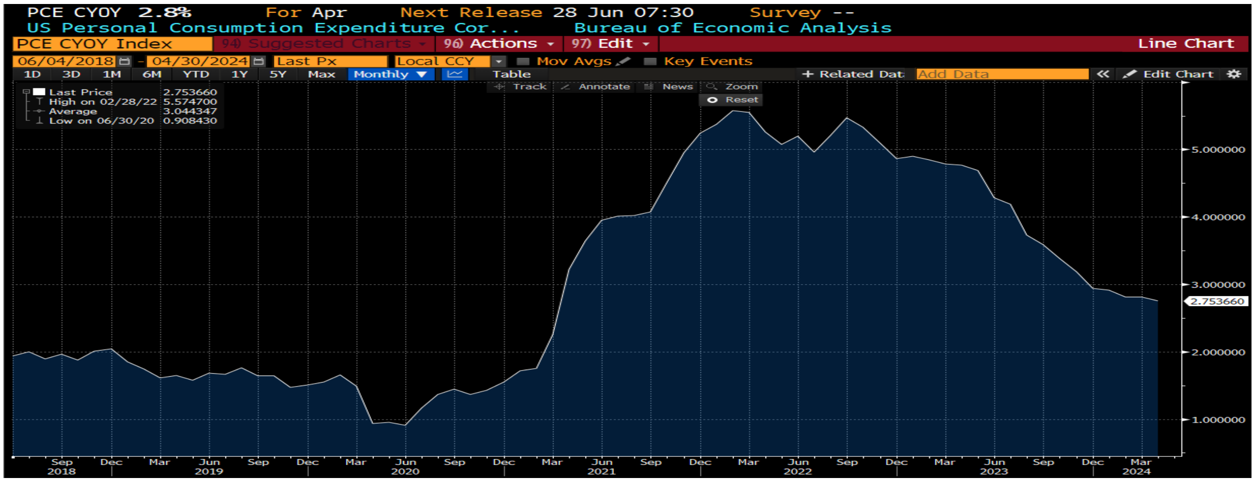
With regards to activity in the RSA's fixed income portfolio, we made several adjustments to the Treasury sector. For example, we sold a portion of our November 2024 Treasury position and added to our March 2026 notes. As interest rates continued to rise, we believed it was prudent to swap out of shorter-dated securities and lock-in a solid rate over a longer term. We also completed a similar swap later where we sold another portion of our November 2024 Treasury notes and bought a block of October 2027 notes. A third example of our Treasury sector activity was purchasing an August 2031 deeply-discounted Treasury security which increased our weighting to the sector and raised our duration as well. These various trades increased duration to help guard the fund against a move lower in interest rates as the portfolio was and is short duration versus the index.

Our outlook for interest rates is that we are at the top of the interest rate cycle and as time passes, interest rates should move lower. As one can see in the chart below, history shows that after an intense rise in rates like we had in 2022/2023, the cycle usually rolls over as restrictive interest rates weigh on the economy. An inverted yield curve is a hallmark of a top in interest rates, and we have had an inverted 2s/10s curve for the longest period since 1976. According to the CME Group, the 2s/10s curve surpassed the previous record of 423 days on March 15th, 2024 and has stayed inverted since then. We would expect the curve to eventually normalize as front-end rates decline as the cycle progresses.



Source: Bloomberg

Softening inflation is one catalyst for lower interest rates. As one can see in the chart of core PCE inflation on a year-over-year basis, it has been moving lower since 2022. The most recent print showed core PCE rising a moderate .2% m-o-m and 2.8% on a yearly basis. We expect this declining trend to continue which will allow the Fed to cut rates as inflation pressures weaken further. Right now, Fed funds futures are currently implying interest rates falling to 4.86% by December of 2024 with the Fed cutting in September and December.



Source: Bloomberg

The second catalyst is a deterioration in the economic environment. Recently, market observers have seen pockets of weakness with ISM manufacturing missing expectations for May, slumping pending home sales, and job vacancies according to the JOLTS data registering their lowest level since 2021. On the other hand, nonfarm payrolls, as well as initial and continuing jobless claims, have so far stayed steady in a baseline pattern of full employment. If the employment picture remains resilient, the economy will hold up even as other data ebbs and flows. However, if job losses begin to accumulate, the ramifications for the economy will be severe and the Fed will be forced to act by lowering interest rates to support growth.

For activity in mortgages, we primarily reinvested prepayments as the rise in interest rates since the lows at the beginning of the year presented attractive yields. We purchased multiple 30-year Fannie Mae pools ranging from 4.0% to 5.5% coupons. For example, the 5.5% coupon pool had an estimated static yield of 5.922% with a spread of 127 bps over the 5-year Treasury. It had an option adjusted spread of 40.8 bps and an option adjusted duration of 4.48 years. Beyond providing a great yield, it appeared prudent to incrementally reduce duration and raise our weighting in upper coupon mortgages as interest rates had been marching higher on the back of hotter-than-expected inflation data and a more resilient economy.

We view mortgages to be attractive as an asset class as the Bloomberg U.S. MBS Index Yield to Worst is currently in the upper end of the historical 20-year range, which can be seen in the next chart. Receiving a yield of 5.17% for a government-related security is appealing. Future spread movements should, however, be muted as the Bloomberg U.S. Agency MBS OAS is currently at 47 bps, which is not particularly rich or cheap. Prepayment activity will continue to be subdued for some time as many homeowners are sitting on materially lower mortgage rates from the 2020/2021 period.

Source: Bloomberg

In the corporate bond sector, we bought various bonds to replace a couple of corporate maturities in the portfolio. One purchase was a 2029 CRH bond where we felt it was prudent, at the time, to lock in a 5.21% yield for five years in a company with a solid financial profile. Another example was a JPMorgan 10-year issue with a 5.85% yield and a spread of 115 bps. It provided a great yield in one of the most important banks in the country. Besides replacing maturities, we were also opportunistic by adding bonds from Glencore and Public Service Enterprise Group at yields of 5.37% and 5.23% for 5-year securities. With corporate spreads being tight, the fund was selective in the names it was adding to the portfolio.

Our view on the corporate bond market is bifurcated because on one hand, yields are among the high levels since the Great Recession per the next chart. Getting a 5.40% yield for the corporate bond index is very attractive. On the other hand, the second chart shows how incredibly tight corporate spreads are. At 88 bps in OAS, corporate bonds are fully valued. Any slowdown in the economy should place upward pressure on spreads. Given these two competing forces, we will be focusing on high-quality companies with resilient balance sheets as they allow us to take advantage of robust yields while also limiting the potential spread widening in the event of an economic upheaval.

Source: Bloomberg

Source: Bloomberg

Domestic Equity Strategy

By Kevin Gamble

The broader U.S. equity market, as defined by the S&P 500, has now more than fully retraced its drawdown in 2022 and is currently setting new all-time highs on the back of strong global liquidity conditions! Despite the fastest rate hiking cycle in U.S. history, record-breaking expansionary fiscal policy (partially financed with the excess liquidity leftover in the system from Covid) has enabled the fiscal planners to creatively borrow to fund the large budget deficits, while simultaneously bringing the inflation rate down from the high-single digits to the low-single digits. While we have yet to reach the Fed's annual inflation target of 2%, enough progress has been made for the equity bulls to latch on to a soft-landing thesis. The bulls also hold the very logical conclusion that those presently in fiscal authority will continue to take all legal measures to support both the financial markets as well as the economy between now and the upcoming November presidential election.

Exhibit 1: S&P 500 Performance Fiscal Year-to-Date

Source: Bloomberg

As for monetary policy, the Fed has all but indicated their next move is going to be a cut in rates as they feel the pressure to reduce the government's interest expense, which has now easily eclipsed our national defense spending on an annual basis. Additionally, there is significant pressure in the levered commercial real estate market the Fed would like to ease. The Fed must balance the pressure to cut rates with the risk of setting off another ramp of inflation ala the 1970s experience. In a recent television interview, we heard our very own Alan McKnight make the reference to Clash's "Should I Stay or Should I Go Now" and agree that is the perfect 1970s British punk rock band analogy for the Fed's current predicament. The lyrics go on to say, "if I go there will be trouble, and if I stay, it will be double."

While the equity bulls are currently in control as we enter the summer months and the home stretch of our fiscal year, below are just some of the many questions on our mind as we navigate a complex world of both inflationary and deflationary pressures.

- Will everything continue to come up roses for equity investors or are we simply "whistling past the graveyard" wearing rose-colored glasses while warning signs flash?

- Where will the money come from to finance the trillions of dollars the U.S. government is going to need to borrow in the coming years once the excess Covid liquidity from the drawdown of the reverse repo facility is exhausted?

- Will the bond market vigilantes eventually force the hands of federal politicians to make tough decisions on spending and taxes?

- Will the inevitable de-inversion and steeping of the yield curve from an inverted state prove to be a bearish signal as it so often has in the past? Will this take the form of a bull steepener or a bear steepener?

- What is the breakout/bull market in silver, gold, and bitcoin telling us about the future?

- Is a recession looming ahead or have we already entered the early stages of a recession?

- Is the lower-end consumer facing a Wile E Coyote moment?

- Should we continue to hedge a larger portion of our U.S. equity exposure given the exceptionally strong performance fiscal year-to-date?

- Why has oil been so stable despite bombs flying in the Middle East?

- Will the significant concentration of riches at the top of the U.S. equity market (as well as society-at-large) last?

- Is the bull market in growth relative to value equities approaching its end?

- Will we have a blow-off move higher in equities? Are we currently amidst that move? How high could it go?

Given the many unanswered questions and the fact that none of us know the future, what we would like to do today is lay out 10 important observations (some bullish and some bearish) about the current investing backdrop that we think all interested parties should consider.

10 Important Observations

1) **We are scheduled to have a Presidential election this November and the leading candidate in many of the polls has just been tried and convicted of making illegal hush payments to an adult film actress.**

Politics is arguably crazier than ever, and the above statement of truth speaks to this assessment. “Lawfare” is a new term which we have never heard in U.S. politics until recently, but it has now entered the U.S. political lexicon. While the equity market has arguably yet to turn its focus to November, that will likely change this summer as we approach the Republican convention in July and the Democratic convention in August. In addition to the conventions, the candidates have now agreed to two debates on CNN and ABC, respectively.

As of this writing, it is assumed that voters will have a choice between Joe Biden, Donald Trump, and Robert Kennedy Jr. No Labels decided against running a ticket this November despite toying with the idea. Kamala Harris is the presumed running mate for Joe Biden and Donald Trump is likely to make his VP choice closer to the Republican convention in July. RFK Jr. has selected Nicole Shanahan as his running mate, the ex-wife of Google founder Sergey Brin. While this is the current situation, it surely seems like this is one of those years to expect the unexpected!

Summary Timeline

Note: RFK Jr. needs to poll over 15% to participate in the debates

June 2: Hunter Biden trial begins

June 13-15: G7 Summit in Puglia, Italy (Canada, France, Germany, Italy, Japan, the UK, and the U.S.)

June 27: First Trump/Biden debate hosted by CNN (earliest general election debate in modern history) in Atlanta with no audience present, moderated by Jake Tapper and Dana Bash

July 11: Trump sentencing

July 15 – July 18: Republican National Convention in Milwaukee, Wisconsin

July 26 – August 11: Summer Olympic Games in Paris, France

July/August: VP debate TBD

August 19 – August 22: Democratic National Convention in Chicago, Illinois

September 10: Second Trump/Biden debate hosted by ABC during primetime with David Muir and Linsey Davis as the moderators

September 30: Last day of our fiscal year

October 22-24: BRICS Summit 2024 in Kazan, Russia (Putin can attend this year as the summit is being held in Russia)

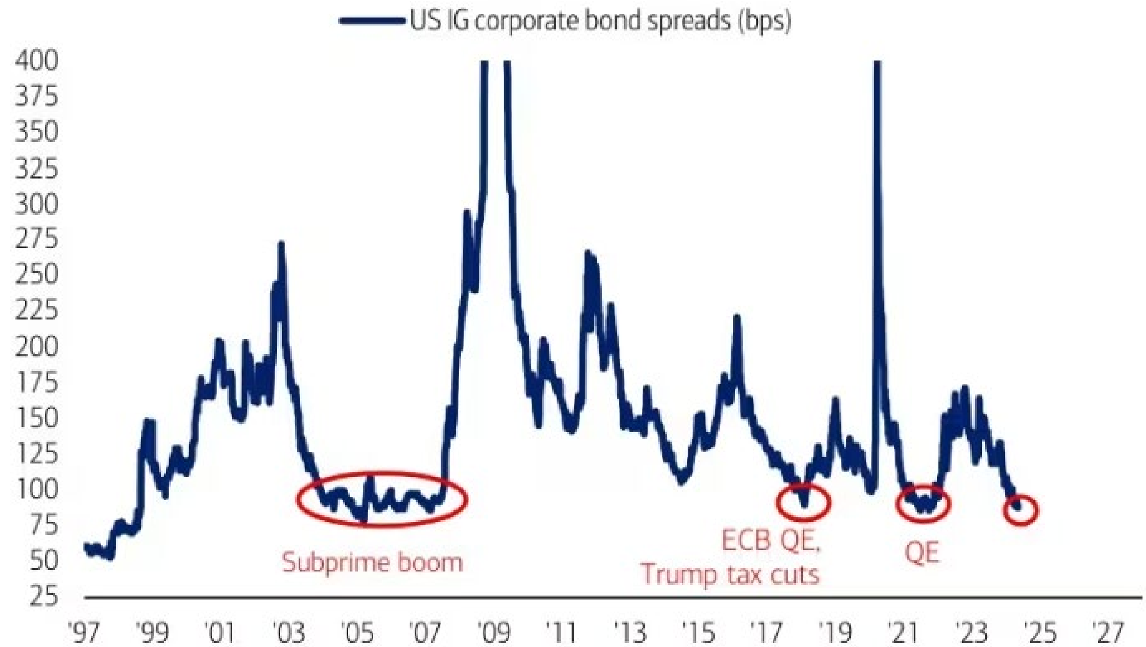
November 5: Presidential election day

We would expect volatility in the equity markets to begin to rise toward the end of June as election year rhetoric picks up steam with all the various twists and turns. Healthcare is often a sector which gets caught in the crosshairs, as well as the potential for "big tech" to become a bipartisan villain.

2) **Credit spreads have remained extremely tight, which has supported the current bull market in equities and the notion that liquidity is sufficient in the corporate bond market.**

The corporate bond market has performed extremely well relative to U.S. treasuries with the associated tight spreads. This is typically a very strong signal for corporate health and for the equity markets, as most often a deterioration in spreads is a leading indicator for equity weakness ahead and we simply have yet to see any warnings signs on this front. On the more cautious side of things, extremely tight credit spreads historically happen closer to eventual peaks in equity markets rather than deep valleys, so we are likely late cycle.

Exhibit 2: U.S. Investment Grade Spreads are at Historically Low Levels



Source: BofA Global Investment Strategy, ICE Data Indices LLC.

3) U.S. Treasury yield curve (3mo/10yr) has now been inverted for the second longest period in U.S. history – second only to 1929

The 3mo/10yr yield curve in the U.S. has now been inverted for roughly 560 days, the second longest period of inversion since 1929, when the yield curve stayed inverted for a little over 700 days. An inverted yield curve is generally not a healthy signal, but interestingly the U.S. equity market and economy tends to do fine during the inversion; it is the de-inversion which has historically been the signal for equity markets to correct due to a pending recession. The de-inversion is typically caused by something eventually breaking from the inverted state. Importantly, there has been a strong positive correlation between the length of yield curve inversion and the eventual drawdown post inversion. In other words, the longer the yield curve stays inverted, historically the greater the eventual correction. The most recent 3mo/10yr extended yield curve inversion was for 530 days prior to the Great Financial Crisis. A catalyst inevitably shows up to kick off the recession/correction, which has most often included oil spikes and, on very rare occasions, stock market crashes and pandemics. If past is prologue, the 3mo/10yr inversion is more of a warning for the future than a great tool in calling the exact top in the current bull market. The 3mo/10yr yield curve is still inverted and history shows it can stay that way for longer than you think while equity markets can keep going higher than one might expect, just as they did in 1929. The longest historical U.S. equity rally in the face of an inverted yield curve has been 657 days prior to the October 1929 high.

Exhibit 3: Strong Positive Historical Correlation of the Preceding Length of the Yield Curve Inversion with the Corresponding Market Drawdown

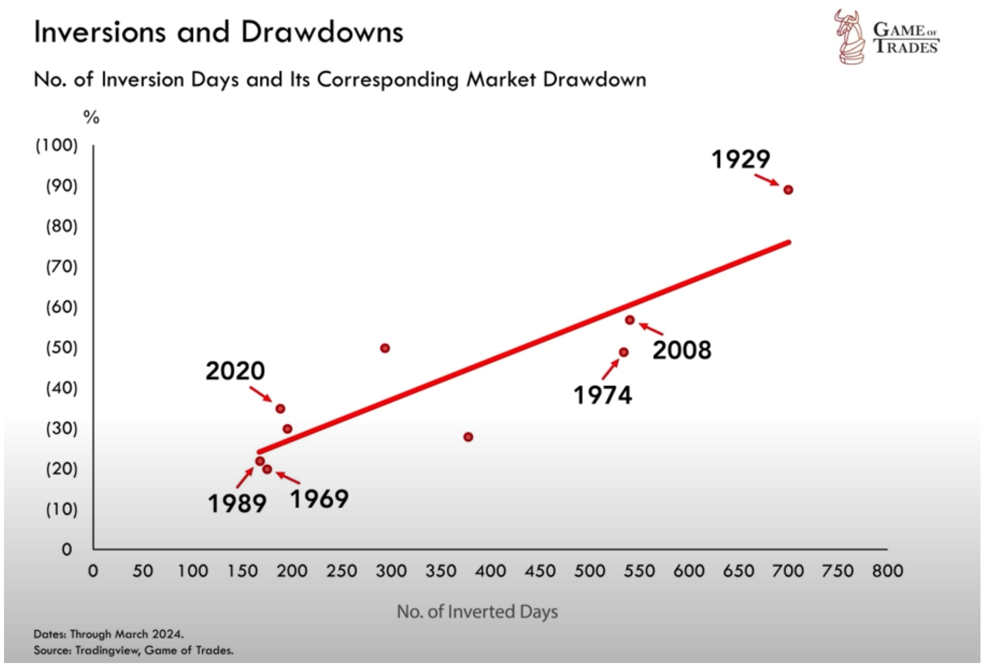
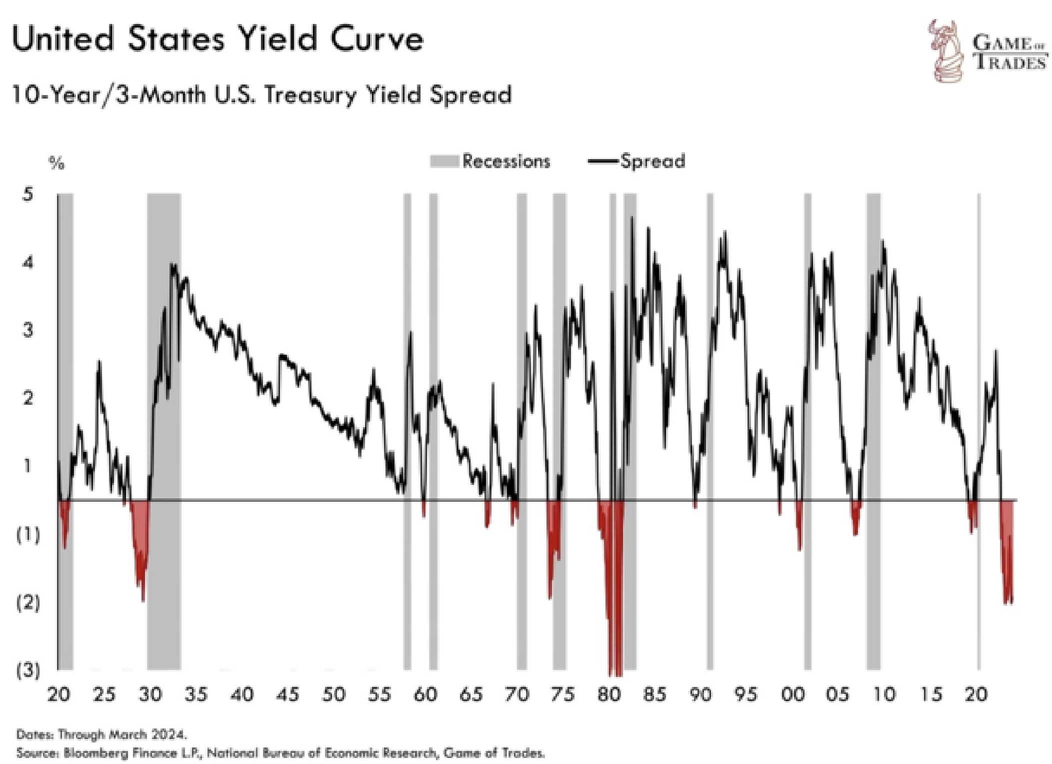


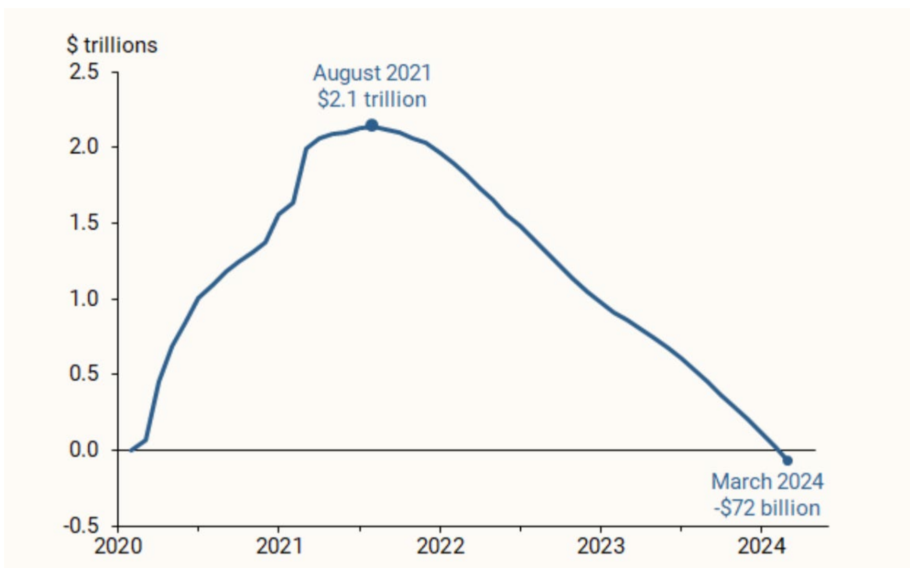
Exhibit 4: U.S. Yield Curve and Recessions



4) Pandemic era excess savings have now been spent.

More than $2 trillion of excess savings accumulated through the Covid stimulus programs have now been completely exhausted. Given this depletion, it is logical that we start to see the U.S. consumer weaken, at least within the 60% of the population who operate paycheck to paycheck. We are certainly beginning to see this in Q1 quarterly earnings for consumer companies as consumers collectively push back against the higher prices at Starbucks, McDonald's, and Target, as an example, and rotate their spending toward more value-oriented offerings including Wal-Mart, Costco, and Amazon. Wal-Mart even mentioned high-end shoppers trading down leading to their strong earnings report, so it is not just the 60% of folks living on the edge who are pushing back against the high prices.

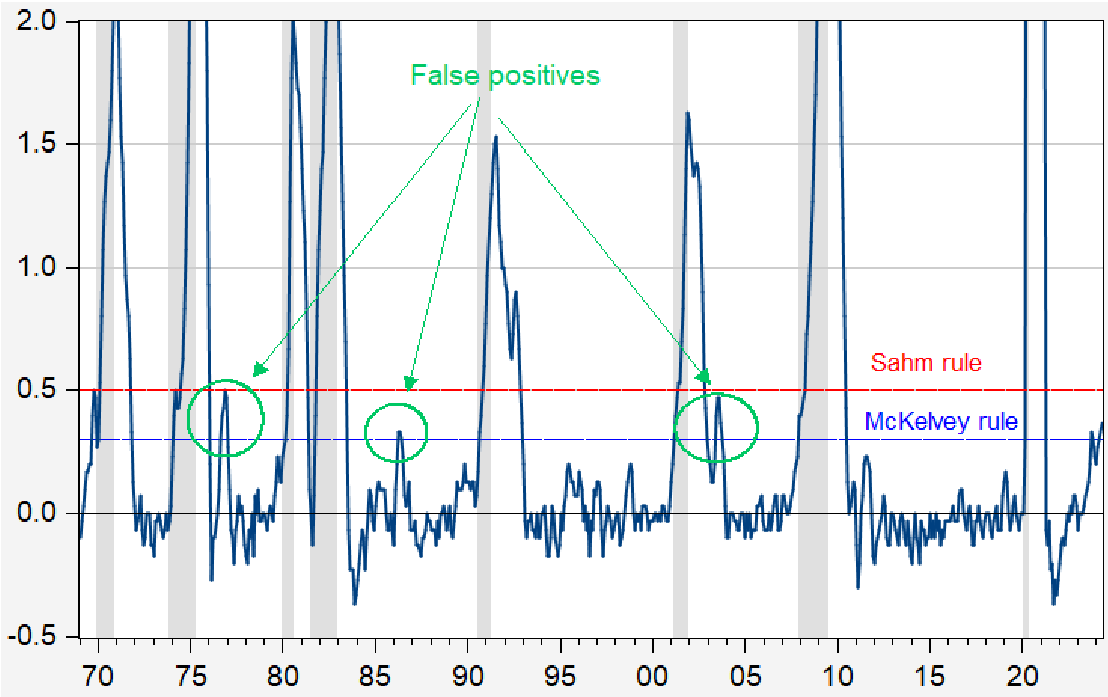
Exhibit 5: Cumulative Pandemic-Era Excess Savings



5) Sahm rule says a recession has not necessarily begun yet, while the McKelvey rule says that we are in the early stages of a recession.

According to the Sahm rule, we have entered the early stages of a recession when the three-month moving average of the U.S. unemployment rate is 50 bps or more above the lowest three-month moving average unemployment rate over the previous twelve months. The McKelvey rule has a similar formula to the Sahm rule but has a lower threshold for calling a recession at just 30 bps. While the McKelvey rule has a lower threshold and calls it earlier, it has led to more false positives over the years, such as 2004, 1987, and 1977, when considering revised data. The more conservative Sahm rule has called historical recessions with complete accuracy. Either way, the employment data should be monitored very closely moving forward to assess the potential early onset of a recession.

Exhibit 6 : Sahm Rule vs. McKelvey Rule and Historical U.S. Recessions



Source: BLS

6) A bull market in gold is typically not consistent with goldilocks – likely spells trouble for either stocks or bonds or both.

Going long gold in some ways is a way for investors to short central bank and fiat money credibility. A strong bull market in gold has historically signaled an issue for either stocks or bonds, and gold prices are currently hitting all-time highs. The Dow to Gold ratio tends to turn down in advance of stock market corrections. Given the S&P 500 is currently making new all-time highs as well while the Bloomberg U.S. Aggregate Bond Index has experienced its longest drawdown in its history, at least to this point, the strength of gold has been signaling trouble in the longer duration government bond market.

Exhibit 7: Bloomberg U.S. Aggregate Bond Index: Longest Drawdowns 1976-2024

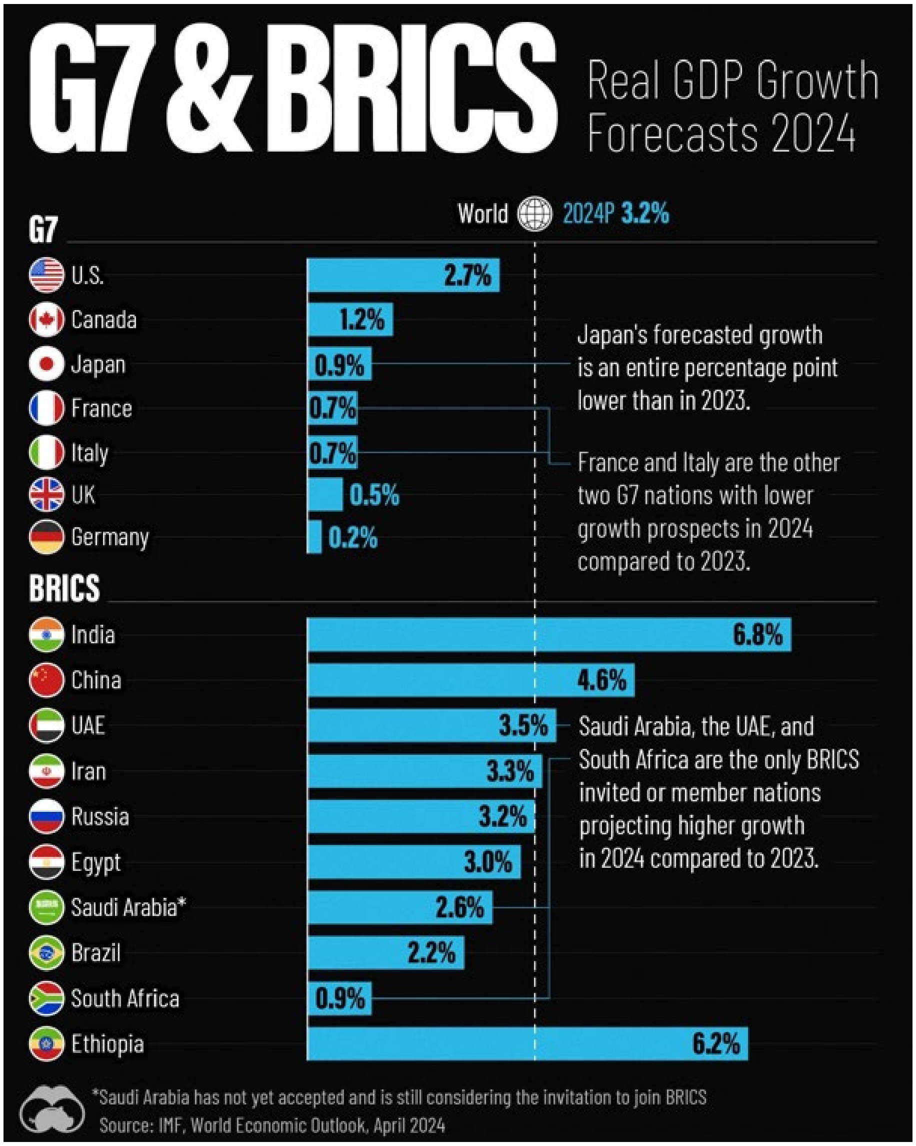
Bloomberg US Aggregate Bond Index: Longest Drawdowns (Monthly Data, 1976 - 2024)			
Start of Drawdown	End of Drawdown	# Months	Max Drawdown During Period (Monthly)
Aug-20	?	46	-17.2%
Jul-80	Oct-81	16	-9.0%
May-13	Apr-14	12	-3.7%
Aug-16	Jul-17	12	-3.3%
Feb-94	Jan-95	12	-5.1%
Mar-87	Nov-87	9	-4.9%
Aug-79	Apr-80	9	-12.7%
Apr-08	Nov-08	8	-3.8%
Feb-96	Sep-96	8	-3.2%
Jun-03	Nov-03	6	-3.6%
Feb-84	Jun-84	5	-4.9%
May-83	Aug-83	4	-3.5%
CREATIVE PLANNING	@CharlieBilello	(As of 5/31/24)	

Source: Creative Planning

7) The world order is increasingly dividing between the G7/NATO countries and the rise of the expanding BRICS nations

Globalization has been challenged both by the Covid pandemic as well as geopolitical threats around the world, which we have discussed many times in previous board updates. What is interesting is that the BRICS alliance is expanding to new countries. Putin was unable to attend last year's BRICS summit in South Africa for legal reasons as he has an arrest warrant outstanding against him for alleged war crimes in Ukraine, but this year's summit is being held in Russia in October and he and President Xi will be on the world stage together. The world alliances seem to be increasingly splintering between the G7/NATO countries and the growing BRICS alliance. The BRICS alliance is very focused on de-dollarization efforts as the bloc seeks to lessen international reliance on the United States, which is very much a threat to U.S. dollar hegemony. In addition to the 5 countries which joined the alliance last year, Thailand, Venezuela, and Turkey have indicated their interest in joining the growing BRICS bloc.

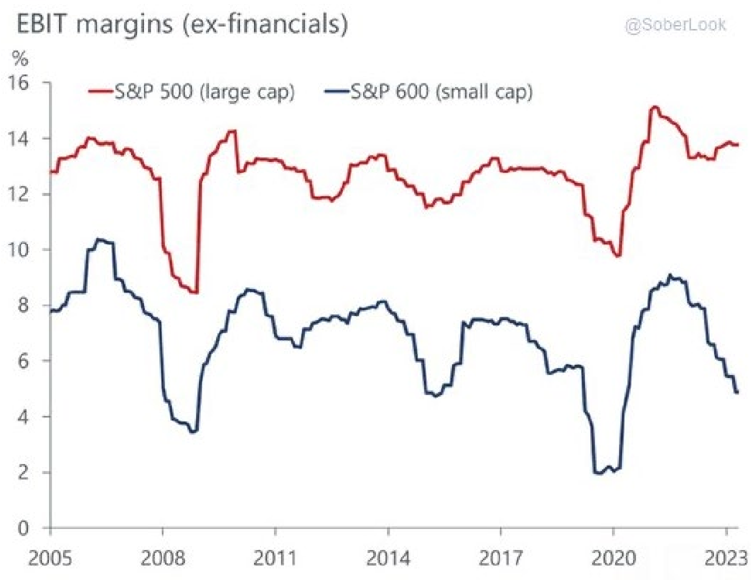
Exhibit 8: G7 & BRICS Real GDP Growth Forecasts 2024



8) Large corporations have effectively defended their operating margins during these inflationary times.

Large corporations have defended their operating margins effectively during the post-Covid period by passing on cost increases in the form of price hikes, as well as managing SG&A costs such as their real estate footprint and travel expenses. Small corporations have not fared quite as well, which helps explain the performance divergence.

Exhibit 9: Operating Margins of Larger S&P 500 vs. Smaller S&P 600 Companies



Source: Oxford Economics/Refinitiv Datastream

9) U.S. Covid recovery has been very K-shaped.

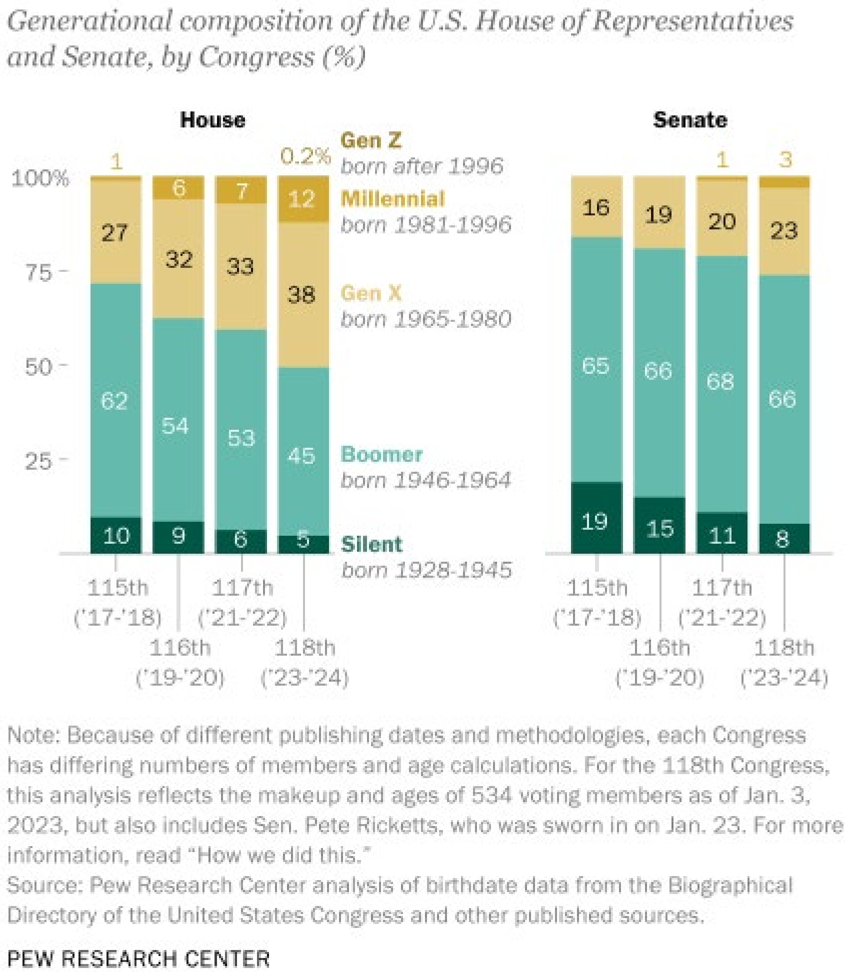
We often hear of V-shaped or U-shaped recoveries in this business, but the shape of the Covid recovery is best described as a K. In other words, the policy response has really blown up the gap between the "haves," or wealthy asset owners, on the winning limb of the K and the "have nots," or those without assets including residential housing and large equity portfolios, on the losing limb of the K. The cost of the recovery has largely been spread out to all of us in the form of well above trend inflation, which of course hurts the lower-end consumer disproportionately. The rise in inflation has predominantly been in services inflation over goods inflation.

Following the pandemic and the associated K-shaped recovery, it is clear different generations see things quite differently. Baby Boomers who have generally had a rising tide in all asset classes during their lifetime are sitting on much of the wealth of the country, while those younger generations operating in their expensive wake have had a progressively much different experience. Covid has generally exacerbated this difference. It is noted that Baby Boomers currently dominate Congress and the youngest Presidential candidate this November is 70 years old in Robert Kennedy Jr., while Trump will be 78 years old and Biden almost 82 years old on election day!

It is perhaps no wonder we see *OK Boomer* movements, a catchphrase used by the Millennial and Gen Z generations to mock Baby Boomer attitudes, and that many disenfranchised younger folks quite enjoy chasing GameStop and other meme stocks and coins higher to protest the "system" as they see it. While Gen X is slowly coming of age with steadily increasing representation in Washington D.C., Millennials and Gen Z have very little representation as it currently stands. Boomers and the older Silent

Generation still control half the House of Representatives and 75% of the Senate, so it could be a while, or at least an uphill battle, for younger concerns to be addressed.

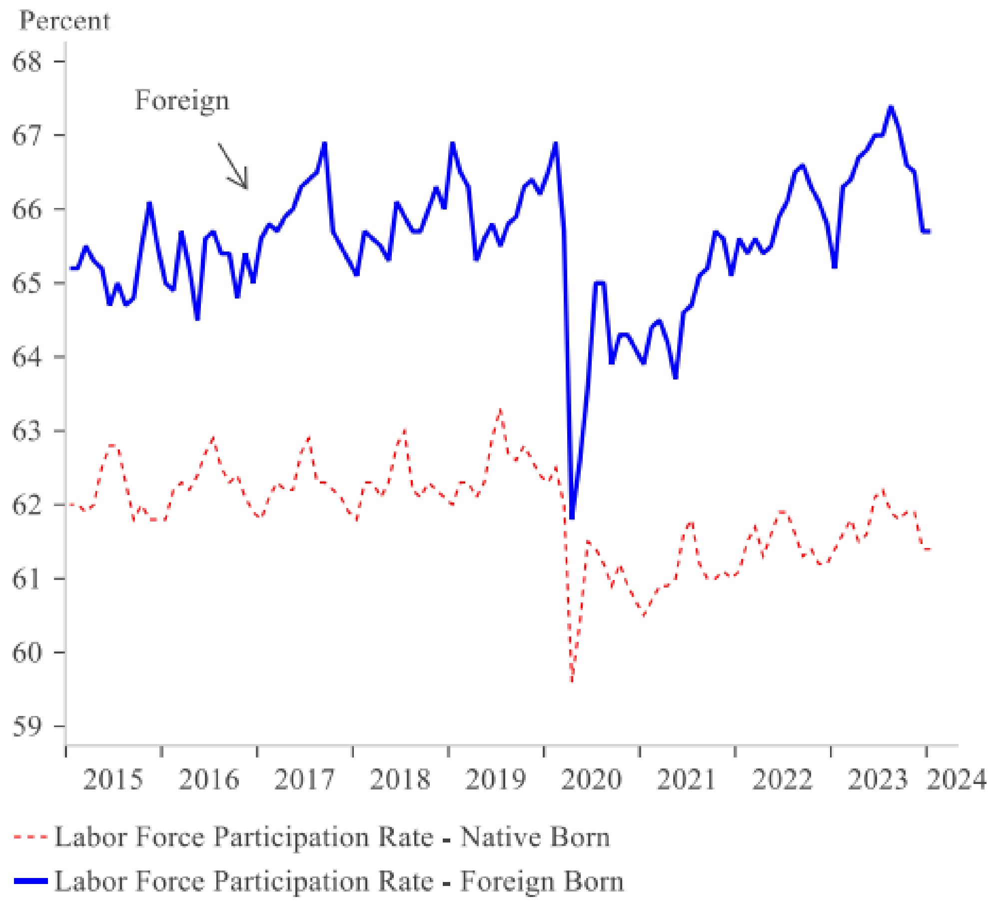
Exhibit 10: U.S. Congressional Representation by Generation (115th - 118th Congress)



10) Democrats have pursued a strategy best described as "big fiscal and big immigration."

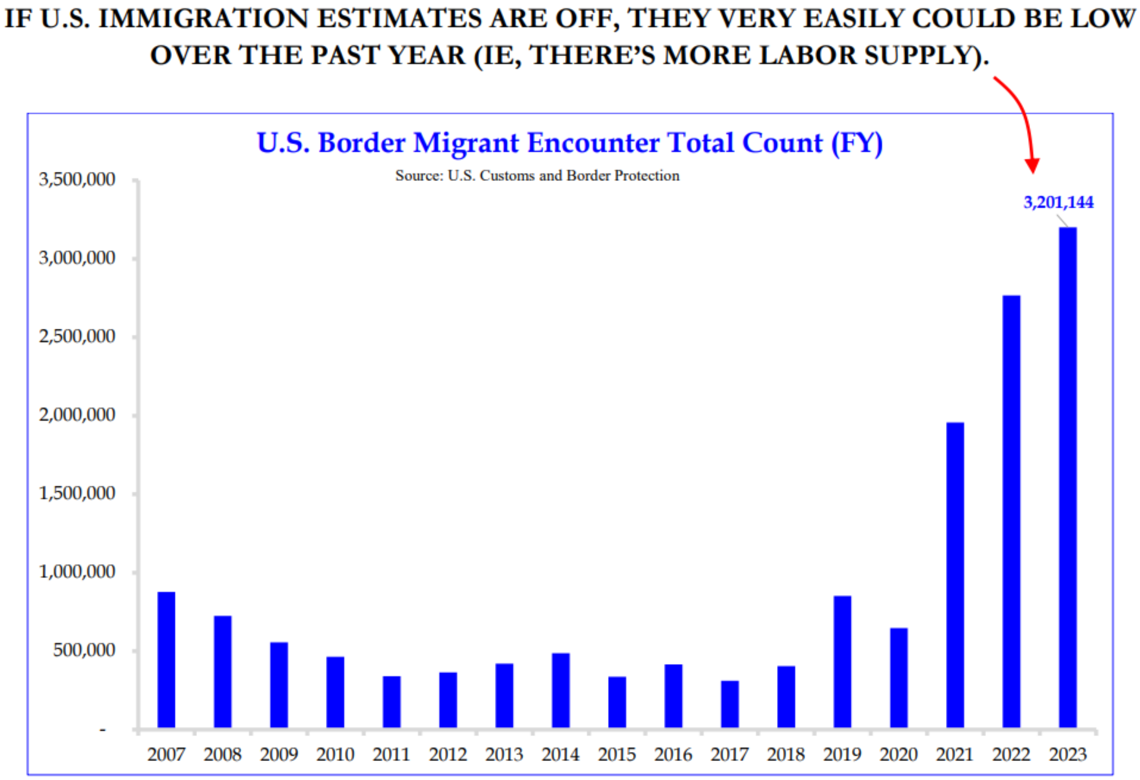
The Democrats' agenda can best be characterized by the combination of big fiscal (budget deficits on par with World War II levels despite full employment) combined with big immigration. The big immigration is a key offset to the record fiscal spending to both support key economic statistics, such as monthly non-farm payroll numbers, as well as to keep wage inflation from getting out of control for employers. The large amount of immigration has also supported growth figures such as GDP. The Democrats are pulling out all the stops, including $167 billion of student loan forgiveness, tapping the Strategic Petroleum Reserve, as well as a Strategic Gas Reserve put in place after Hurricane Sandy (which has never been tapped before), to keep gas prices as low as possible heading into the summer holiday season and the fall presidential election. $4+ gallon gasoline would represent a huge risk for the Democratic party and they are likely to do what they can to avoid it!

Exhibit 11: U.S. Labor Force Participation: Foreign/Native



Source: Strategas

Exhibit 12: U.S. Border Migrant Encounter Total Count



Source: Strategas

10 Honorable Mention Observations:

1) U.S. is better positioned than in the past to deal with oil supply disruptions.
2) Blackrock, Vangaurd, and State Street are at the top almost all equity holder lists.
3) U.S. equity markets are testing the top of a generational trend line.
4) Consumer delinquencies are rising rapidly from relatively low levels.
5) 34x on the Case-Shiller P/E with late cycle leadership emerging.
6) Buffett sitting on close to $200 billion in cash – cash is not trash!
7) Similarities with fiscal dominance of the 1940s.
8) Fertility rates are dropping.
9) Meme stock frenzy makes a comeback/Crypto ETFs are now here.
10) Median U.S. mortgage payment is at a record high of $2,894/month.

Equity Strategy Moving Forward

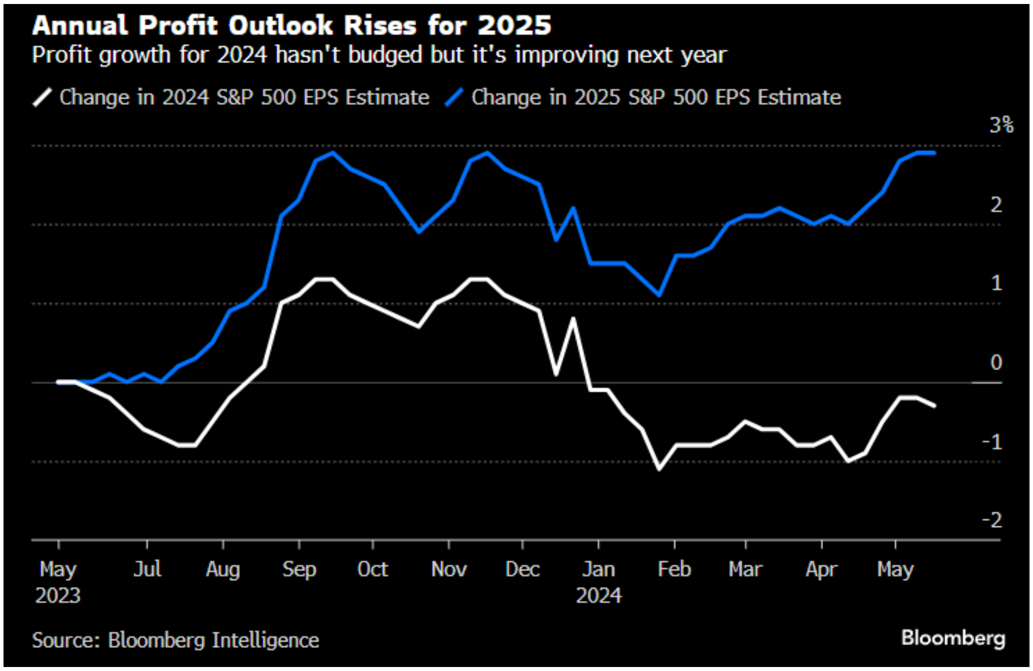
Following the especially strong rally in the equity markets fiscal year-to-date and the extremely compressed index volatility in the marketplace, we see a fairly- to fully-valued U.S. equity market at the current time. This view is generally consistent with Wall Street strategists' year-end targets and the expectation for roughly $245 per share in 2024 earnings for the S&P 500 or 21.7x expected earnings for the calendar year. The 4.6% earnings yield on the equity market based on 2024 expected earnings is right in line with the yield on the 10-year U.S. treasury note.

Exhibit 13: Wall Street Strategists' S&P 500 Targets

Wall Street firm	2024 S&P 500 target as of May 20	2024 S&P 500 target as of March 25
BMO Capital Market	5600	5100
Wells Fargo Investment Institute	5535	4625
Deutsche Bank	5500	5100
Oppenheimer Asset Management	5500	5500
Société Générale	5500	5500
Morgan Stanley	5400 (12-month forecast)	4500
Bank of America	5400	5400
Yardeni Research	5400	5400
RBC Capital Markets	5300	5150
Barclays	5300	5300
Goldman Sachs	5200	5200
UBS Global Wealth Management	5200	5200
Fundstrat	5200	5200
Citi	5100	5100
JPMorgan	4200	4200
Average	**5289**	**5117**
Median	**5400**	**5200**
Source: MarketWatch		

While the profit outlook for 2024 has stayed consistently around $245, the annual profit outlook for 2025 has recently been rising, which is a sign of optimism that margins and profits can continue to be defended and that we can stay out of a recession.

Exhibit 14: 2025 Annual Profit Outlook Has Been Rising in Recent Months



Within our active funds, we continue to focus on improving our micro equity selection which includes owning quality companies with strong balance sheets, resilient business models, dividend yields, and positive cash flows. We want to continue to actively avoid "zombie" companies which need access to the capital markets to stay afloat given their lack of cash flow.

We see value-oriented equities as relatively attractive versus the longer-duration growth equity assets. Growth equity assets had a strong 14-year relative performance run which arguably peaked with massive QE and negative real interest rates present during the pandemic. While it has certainly not been a straight line given the violent "arm wrestling" match between value and growth for the last few years, we see a reasonably high probability value relative leadership emerges on the other side and takes the performance baton from growth.

Following the strong absolute equity performance out-of-the-gate this fiscal year, we executed several put spread collar legs which give us a healthy amount of put spread protection through the remainder of our fiscal year should we see a September equity correction which has happened so often in the past.

Our active funds continue to underweight the very top of the S&P 500 given the top-heavy nature of the index. While this stance can hurt active returns in very top-heavy years, it makes great sense from a diversification standpoint across our total domestic equity portfolio given our significant long exposure to these heavyweight names through our large, market capitalization weighted S&P 500 index holdings. The top 10 companies now represent a record 35% of the S&P 500, which is a significant level of market concentration in just a relatively small handful of companies. Furthermore, with Nvidia officially joining the $3 trillion market capitalization club along with Microsoft and Apple, just three companies now represent 20% of the entire index!

Exhibit 15: Top 10 Companies as a Percentage of the S&P 500

Source: BofA Global Investment Strategy, Bloomberg.

Given the always uncertain nature of the future and investing markets, especially with the coming of age of artificial intelligence, perhaps we should all take heart that the Jonas Brothers' neighbor has been to the year 3000 and can report that "not much has changed, but they lived underwater, and your great-great-great granddaughter is doing fine."

International Equity Strategy

By Steve Lambdin

The global equity markets continued to move higher to start 2024 as expectations of central bank interest rate cuts, falling inflation, higher-than-expected earnings growth, and stable economic data points pushed many equity markets to all-time highs. U.S. stocks led the way as the artificial intelligence (AI) theme continued to gain traction with investors, pushing growth stocks higher in the period. Large-cap stocks outside the U.S. as well as emerging market equities also managed to post good upside, just not to the degree we saw in the U.S. Much of the “recession chatter” running around many of the global economies a year ago proved to be too pessimistic as the global economy was stronger than expected. Global Purchasing Managers Indices (PMIs) are improving as manufacturing levels are rising from a need to rebuild inventory levels. We would expect this trend to continue in the coming months.

One of the biggest surprises of the quarter was the historic shift in interest rate policy by the Bank of Japan (BOJ). The BOJ raised its key interest rate for the first time in 17 years as it moved away from its negative interest rate policy. Investors now expect the BOJ to raise interest rates over the next few years. Just as we mentioned last quarter, any pivots in major central bank policies can lead to aggressive changes in equity prices, and this pivot was no different. In its recent update, the International Monetary Fund (IMF) raised its projection for 2024 global growth to +3.2% from +3.1%, as U.S. and European growth expectations continued their positive upward trends. Inflation readings in the Eurozone and United Kingdom (U.K.) continued to fall in the period and investors now expect these central banks to begin an interest rate cutting cycle sometime over the next few months. Perhaps this will lead to even higher equity markets in the months to come. Chinese equities posted a fourth consecutive quarter of losses. The economy remains slow amid a difficult property sector, while deflationary pressures have increased. Investors are on edge as government growth targets may be difficult to achieve for the balance of the year.

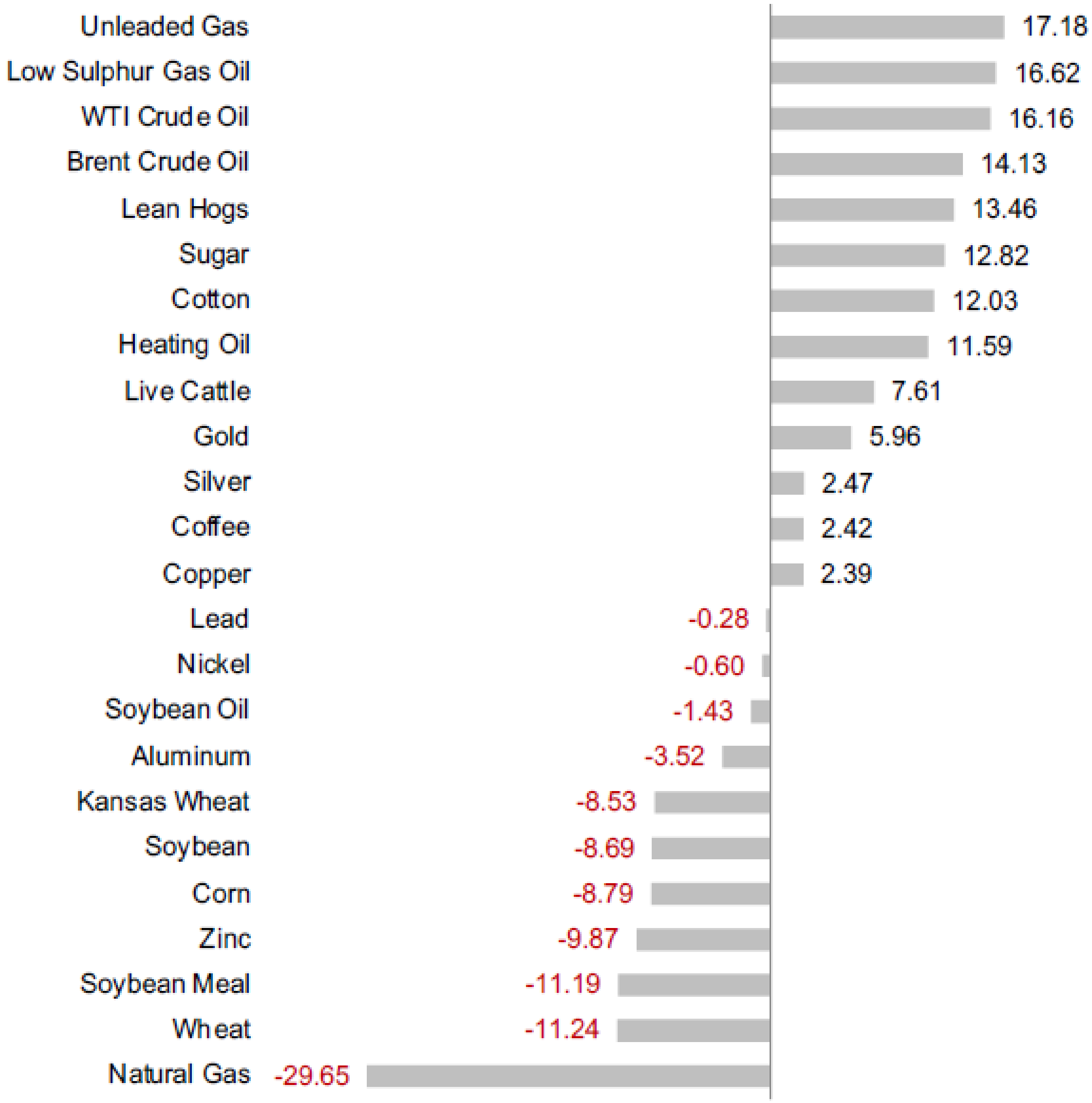
On the geo-political front, the conflict between Israel and Hamas continued to deepen as Israel moved even further into Gaza. This has strained relations with the U.S. and the rest of the world even more as no end appears in sight over the next couple of months. Russian forces continued to push further into Ukraine since our last update and appear to have a lot of momentum. However, in late April the U.S. Senate passed a $95 billion war aid package bill to send additional military aid to Ukraine. In addition, President Biden recently gave approval to use U.S. weaponry for deeper strikes into Russia to limit their ability to push further into Ukraine. This change of policy seems to be an escalation of efforts in the region. All in all, considering the geo-political challenges, global equities were very strong as investors embraced central bank actions and economic developments.

Equity index returns (%)	March 2024 U.S. dollar	March 2024 Local currency	1Q 2024 U.S. dollar	1Q 2024 Local currency	2023 U.S. dollar	2023 Local currency
S&P 500	3.2	3.2	10.6	10.6	26.3	26.3
MSCI ACWI	3.1	3.4	8.2	9.5	22.2	21.6
MSCI ACWI ex USA	3.1	3.7	4.7	8.2	15.6	14.1
MSCI World	3.2	3.4	8.9	10.1	23.8	23.1
MSCI Emerging Markets	2.5	3.0	2.4	4.5	9.8	9.9
MSCI EAFE	3.3	4.0	5.8	10.0	18.2	16.2
MSCI Europe	3.7	4.4	5.2	8.3	19.9	14.3
MSCI Pacific	2.5	3.2	6.7	13.2	15.3	20.1

Source: RIMES; Capital Group

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +5.8% and +2.4% respectively during the first quarter of 2024 vs. +10.6% for the S&P 500 Index. U.S. stocks continued the recent string of outperformance as AI themed equities remained hot. The U.S. dollar index climbed +3.2% in the period, hurting the returns for unhedged U.S. investors in the MSCI EAFE Index and, to a lesser extent, investors in the emerging markets. Interest rate differentials and better economic growth in the U.S. vs. other major developed markets were the main reasons for the strength in the U.S. dollar. For the first quarter, the Asian region was stronger than the European region as the Japanese equity market rose to a record high in the period. Ten out of eleven sectors of the MSCI EAFE Index posted positive returns, with technology, communications, energy, financials, and industrials leading the way in the quarter. The Bloomberg Commodity Index was a mixed bag, but rose +2.19% in the quarter, led by a large increase in WTI crude oil +16.2% and a significant decline in Natural Gas of -29.7%.

Ranked Returns (%)



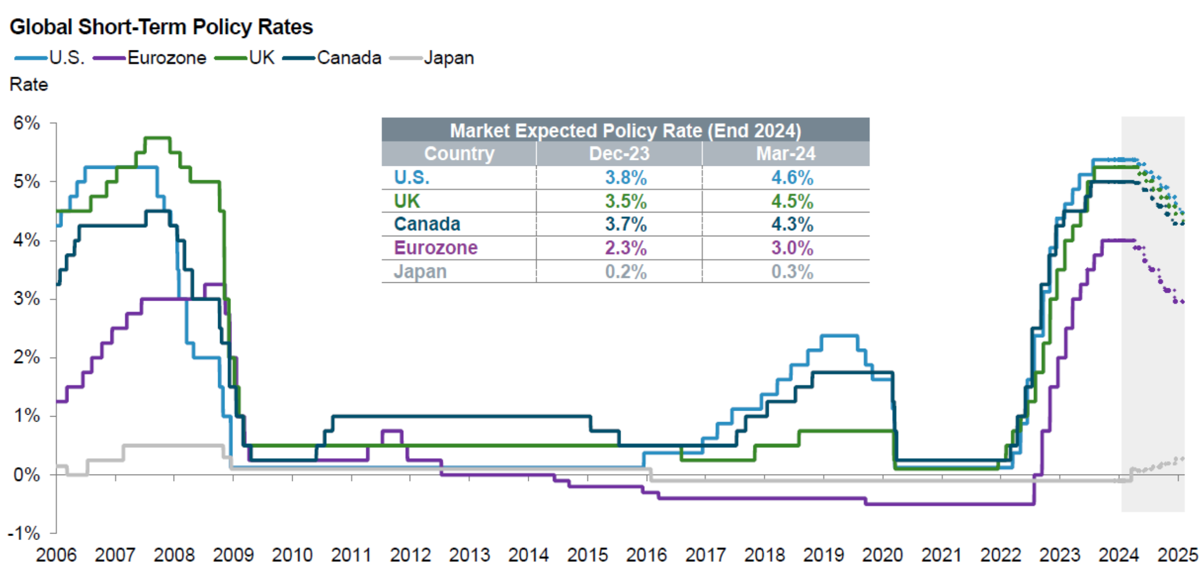
Sources: Arcadia Wealth Management

So far into the second quarter, the global equity markets have been quite volatile and seem to sway with the weekly releases of economic data points and news flow, providing no clear pathway in either direction. Major economic readings have been a mixed bag, with some releases being equity friendly, while others put pressure on risk assets. Inflation readings continue to fall in most major regions, whereas economic activity readings have been slightly better than forecasted. So far in the second quarter, the MSCI EAFE Index and the MSCI Emerging Markets Index are up +1.0% and flat respectively, while the S&P 500 Index is flat as we are nearing the end of May. Equities have been a good place to be thus far into our current fiscal year.

The following pages provide an update to what we see as relevant issues in the marketplace which could set the direction of equity markets over the next few months.

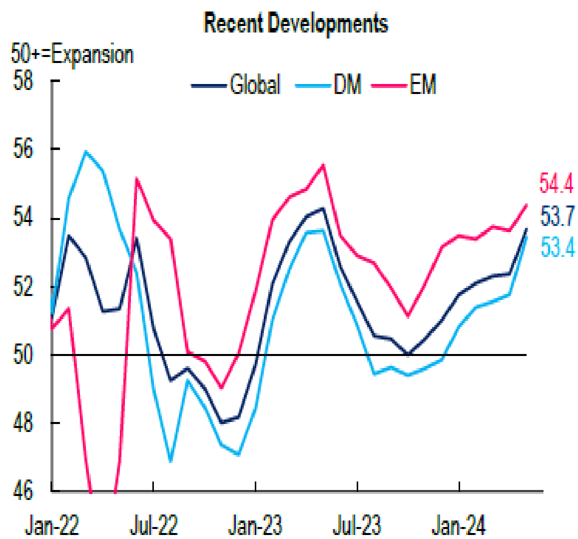
Issues/Points:

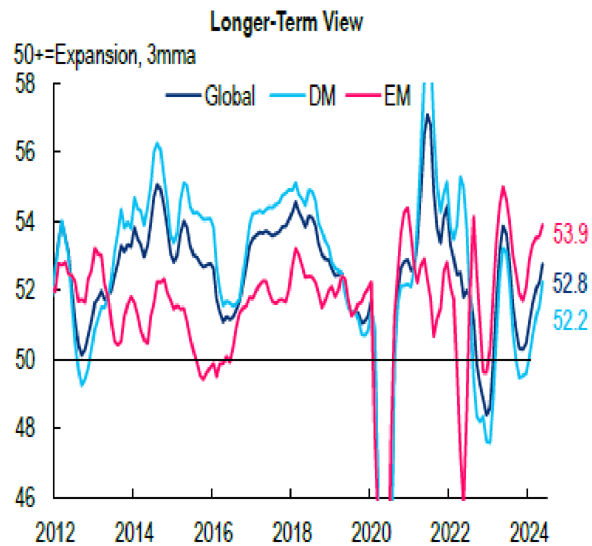
Global Central Banks Easing Cycle – We believe we are on the cusp of a global central bank easing cycle. Over the next six months, we expect the European Central Bank (ECB), Bank of England (BOE), and the U.S. Federal Reserve (FED) to lower their respective benchmark interest rates as inflation looks set to fall in the coming months. Confirming our thoughts on this was the March interest rate cut by the Swiss National Bank (SNB). With this surprise move, the SNB became the first major central bank to trim rates. We expect most central banks to follow their lead. This could be a key driver of global equity markets over the balance of 2024.



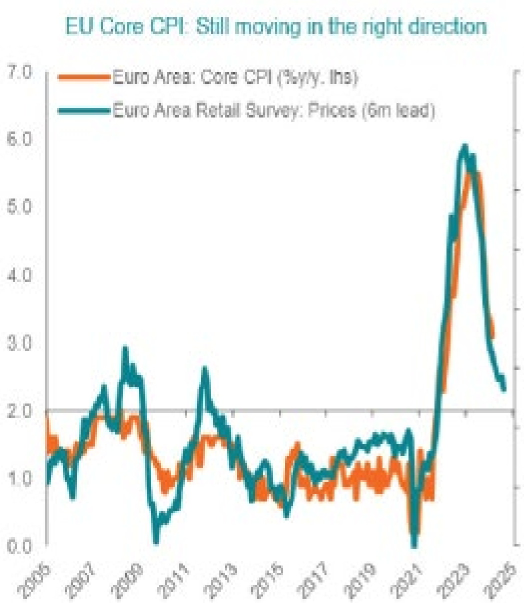
Source: U.S. FED, ECB, BOJ, BOE, Bloomberg, Fidelity Investments

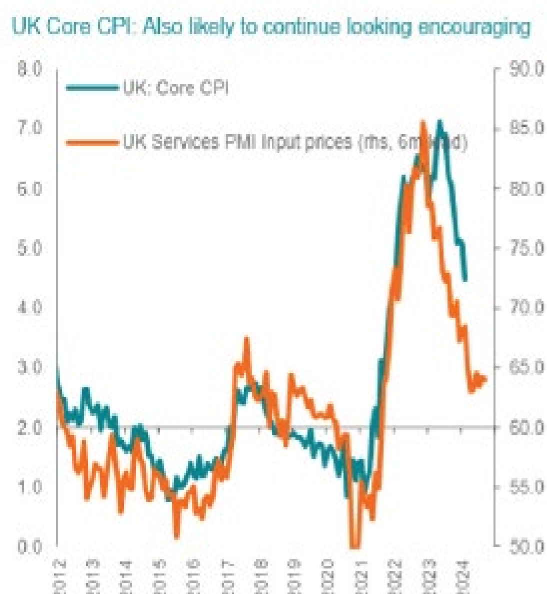
Global Economy – While we would not characterize the global economy as "strong," it does seem to be steady and stable to us. We have been impressed with its resilience as economic data points generally surprised to the upside, especially in Europe. The global PMIs are still above 50, while economic confidence readings are improving in many regions around the globe. These are good readings for continuing strength in the global equity markets.





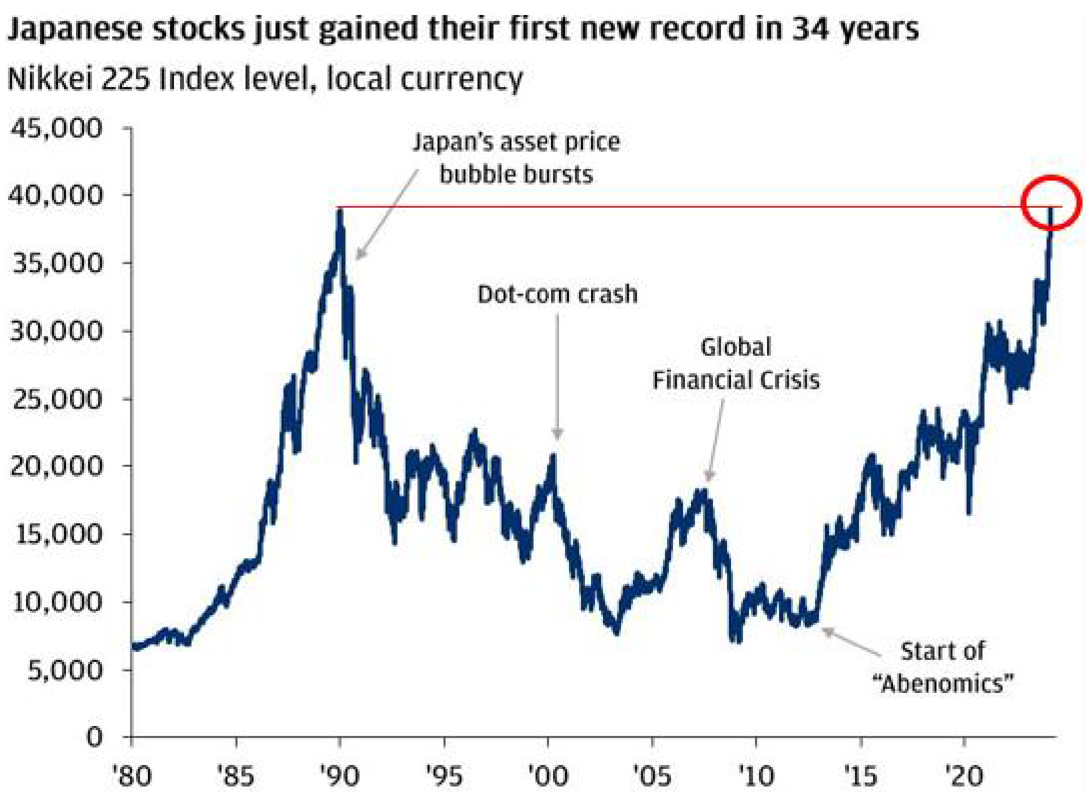
Source: S&P Global; Haver Analytics; Citigroup



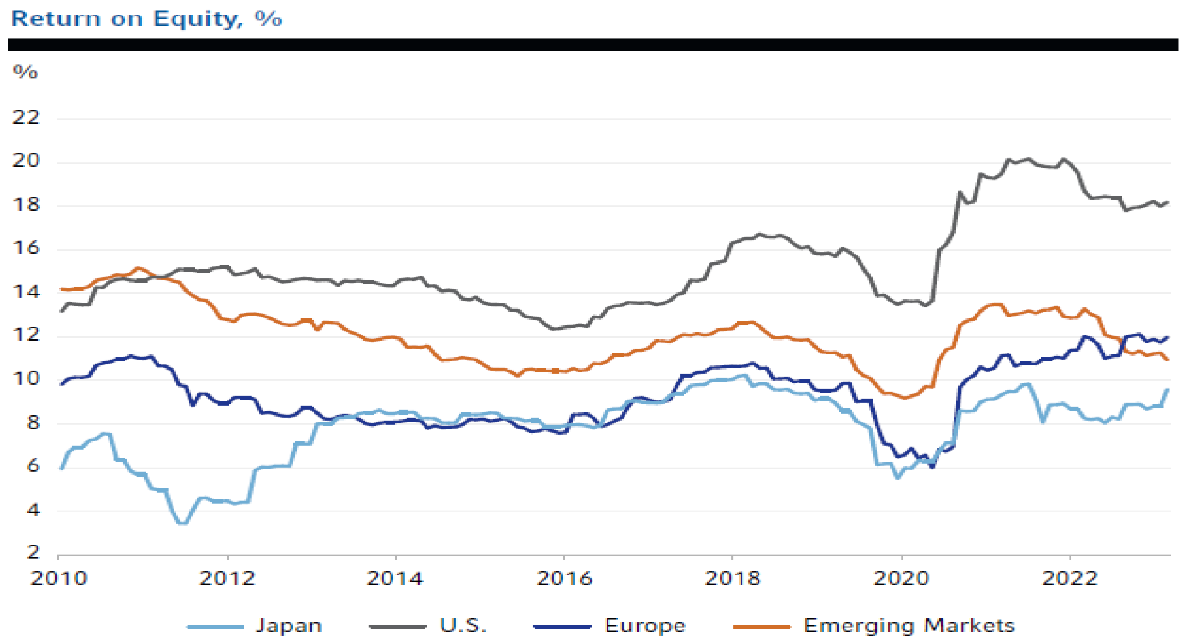


Source: Datastream; BNP Paribas Exane; Eagle Global Advisors

Japan – The Japanese equity market was among the best performing of the major markets around the globe in the quarter. The Nikkei-225 index hit a record level for the first time since 1989. We saw several very positive developments in Japan over the first quarter, including the BOJ ending its negative interest rate policy as they raised interest rates for the first time in over 15 years. Deflation seems to be a thing of the past as core inflation rose to +2.8% in February. Secondly, the region avoided a recession as the PMI rose to 48.2 in March, the highest level in six months. Employment remained very strong and wage growth was robust, which helped consumer confidence and spending. Also, since the Tokyo Stock Exchange (TSE) announced an emphasis on corporate performance about a year ago, we have seen a flood new share buyback programs, shedding of non-core assets, and operating margin enhancement strategies. These are all aimed at improving returns on equity (ROE) and hopefully share prices. We believe these initiatives have been very successful and have resulted in equity markets rising to new highs. There remains plenty to do on this front and perhaps this can be a nice secular thesis for this market going forward.



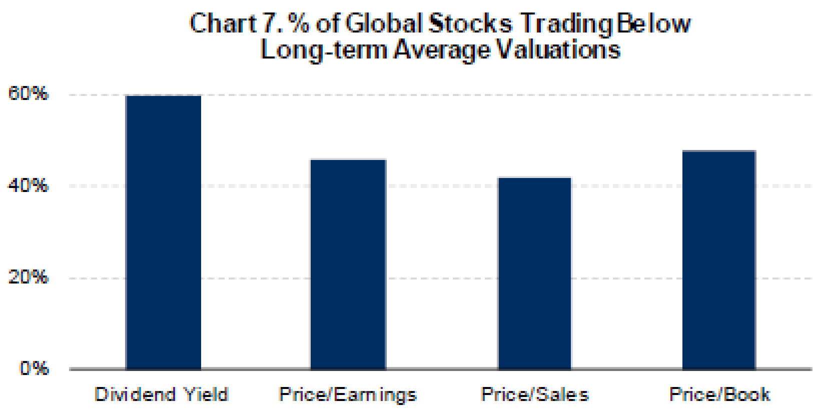
Source: Bloomberg; Todd Asset Mgmt



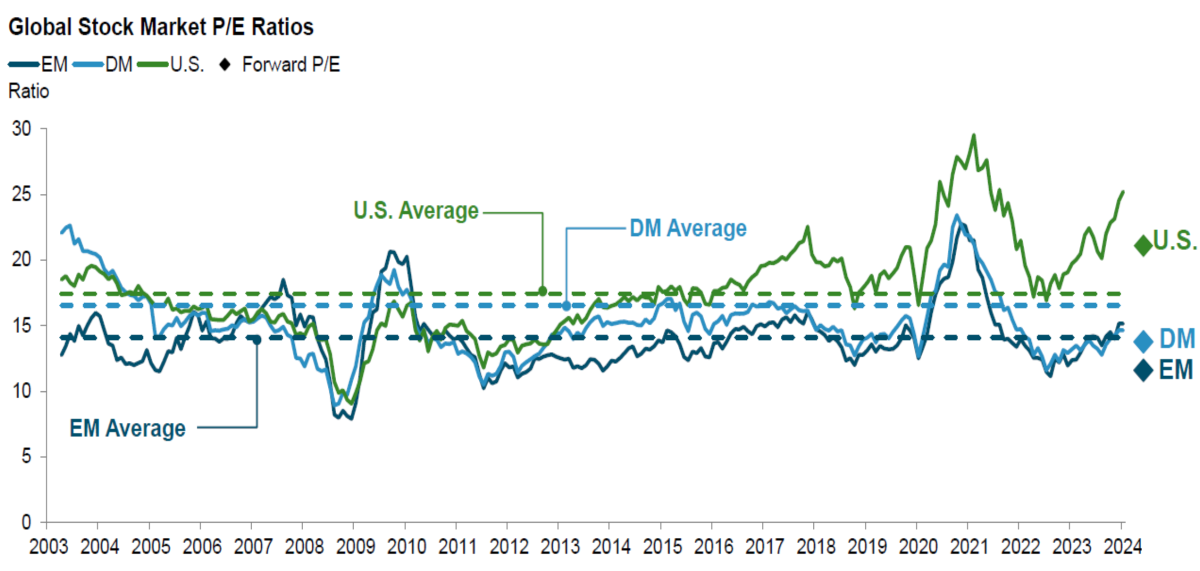
Source: Federal Reserve Bank of San Francisco; Russell Investments

Geo-political = Defense Spending – the geo-political landscape remains as dangerous as we have seen in some time. Conflicts continue to escalate with little sign of resolution. With this in mind, we see defense spending as a secular winner. While the U.S. defense budget is the largest in the world by a wide margin, we see spending ramping up in Asia and Europe. European NATO nations are just now acknowledging the need for substantial increases in spending as several nations are not spending 2% of their respective GDP on defense, as required. As more European NATO countries begin to move defense expenditures toward the 2% target or above, this should be an area economic growth for years to come.

Valuations – From a strict valuation standpoint, international equity markets look decently attractive on several different metrics. Most notably, on a price/earnings basis (PE), many regions are trading well below average. Chinese equities are very cheap and have sharply underperformed most other countries in the MSCI Emerging Markets Index as structural challenges and geo-political risks have turned investors away from this market in recent years. However, as we have said before, valuation in isolation is not a great indicator of future equity returns.

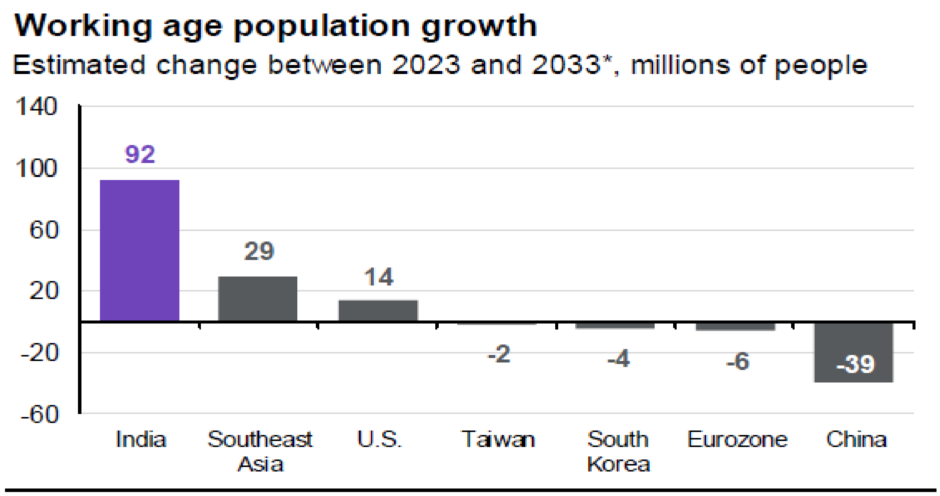


Source: Factset; Altrinsic Global Equities

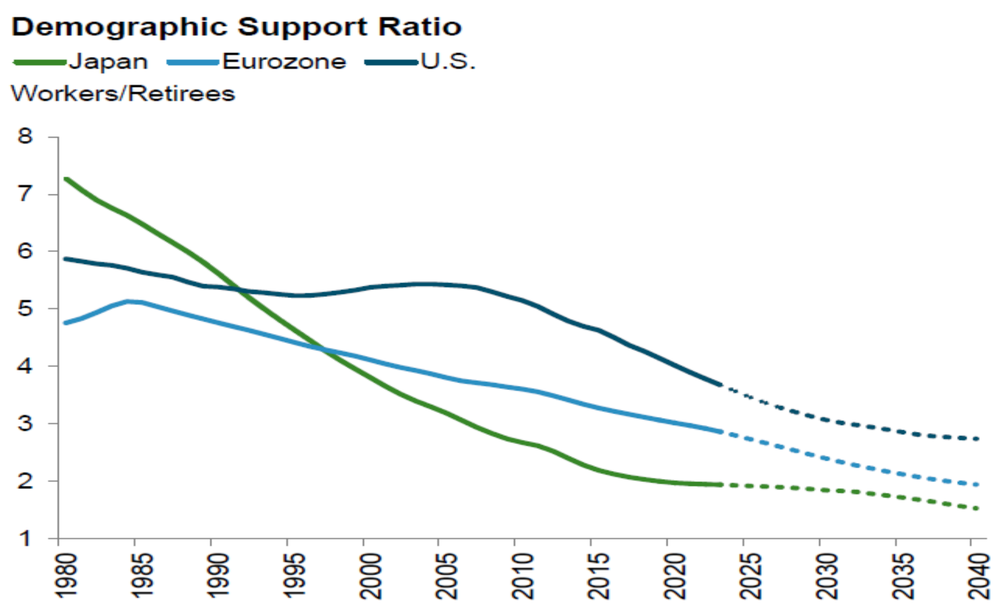


Source: Factset; Bloomberg; Fidelity Investments

Longer Term Issues – As the world population continues to age, this will present some unique challenges for most of the larger economies around the globe. We will see the worker-to-retiree ratio continue to fall over the next 30 years. Social spending on an aging population will be a major challenge for the leaders of tomorrow.



Source: JP Morgan, IMF, World Economic Outlook



Source: Fidelity Investments; United Nations; Haver Analytics

Final Thoughts/Summary

We continue to see a slowly growing global economy coupled with falling inflation. This "goldilocks" scenario should be a friendly environment for most equity markets. The global central banks should continue to be on the forefront of investors' minds over the next few months. Investors continue to expect central banks to cut interest rates in the Eurozone and the U.K., while cuts in the U.S. will probably start later in the year. Any change to consensus thinking on this can make for significantly volatile markets. Inflation seems set to continue to slow in the coming months in Europe and the U.S. How this inflation cycle progresses in the major regions of the world remains a wildcard. Consumers in most regions around the globe remain in good shape as low unemployment and real wage gains should translate into better confidence. Overall, we expect economic releases to point toward a slow, but stable growth outlook in most regions. Global equity market valuations look decent to us outside of the "mega-technology" names in the U.S. market.

We continue to sell a few out-of-the money calls on the Emerging Markets Index to bring in some income, as well as potentially sell just a bit of exposure should a decent short-term rally materializes. Overall, premiums remain attractive in the current equity market. Emerging market equities remain an asset class that looks attractive to us going forward over the long-term. Our current allocation to Emerging Market equities is approximately 2.9% of total assets and approximately 11.5% for MSCI EAFE equities across our TRS, ERS, and JRF portfolios for a total international equity exposure of approximately 14.4%. This is nearly at our target allocation within our investment policy statement. *(Credit is given to the following entities for charts provided: RIMES, Capital Group, Arcadia Wealth Management, U.S. FED, ECB, BOJ, BOE, Bloomberg, Fidelity Investments, BIS, JPM Asset Mgmt., S&P Global, Haver Analytics, Citigroup, Factset, MSCI, DataStream, Eagle Asset Mgmt., BNP Paribas Exane, Russell Investments, Federal Reserve Bank of San Francisco, Altrinsic Global Equities, JP Morgan, IMF, World Economic Outlook, and United Nations)*

Fiscal Policy

By Michael McNair

On May 14, 2024, President Biden announced significant tariff increases on a range of Chinese goods. These include tariffs on steel, semiconductors, electric vehicles (EVs), batteries, solar cells, and medical products. The stated objective of these tariffs is to "protect American workers and businesses from China's unfair trade practices and to support domestic investment in critical sectors." These measures follow in the footsteps of President Trump's 2018 tariffs, which targeted various Chinese imports, including technology, steel, and aluminum, in an effort to address trade imbalances and unfair trade practices.

This brings us to the question: why is the U.S. targeting China with these protectionist measures? The answer lies in examining China's growing trade surplus and its implications for global trade and the U.S. economy.

China's Trade Surplus and Recent Export Dominance

China's burgeoning trade surplus has emerged as a significant disruptive force in global trade dynamics, sparking escalating tensions with its trading partners like the United States. At the core of these trade frictions is China's rapidly growing manufacturing trade surplus, which reached a staggering record of over $1 trillion in 2022. This manufacturing surplus has surpassed even the peak levels previously seen from export juggernauts like Germany, and Japan, and the United States (during the height of World War II).

A major factor fueling U.S. concerns has been China's rise as the world's dominant manufacturing export powerhouse over the past two decades. China now accounts for nearly 30% of global manufacturing exports, up from just 13% at the turn of the century. This steep ascent has been driven by a booming export trade in advanced electrical equipment, machinery, and vehicle products - industries seen as critical to future economic competitiveness.

Particularly noteworthy has been China's aggressive push into emerging green technologies and EVs. Chinese companies like BYD have rapidly scaled up EV production and exports, in some cases outpacing even established global manufacturers like Tesla. While such disruption of a high-visibility industry like autos has raised alarm bells, it ultimately reflects a broader pattern of Chinese dominance proliferating across multiple manufacturing supply chains over recent decades.

This systematic undermining of international competition across strategic sectors is viewed as an existential economic threat by the U.S. and Europe. China's manufacturing juggernaut has reshaped the landscape, with its corporations increasingly controlling crucial supply chains and component ecosystems.

However, it is not just China's manufacturing preeminence that has stoked trade frictions, but the sheer scale of its surplus production that must be absorbed by the rest of the world economy. China's economic model has been heavily skewed towards high levels of investment in manufacturing capacity, which represented a staggering 43% of its GDP output as of 2022. In contrast, household consumption constituted just 54% of GDP - far below the global average of 76%.

This profound imbalance results in China contributing a disproportionately large share of global investment and manufacturing output, while comparatively under-consuming. For every $1 of consumption in China, there is $3.20 of consumption globally outside of China. This surplus manufacturing capacity cannot be domestically absorbed, necessitating large trade surpluses where this excess production is exported.

From the perspective of China's trade partners like the United States, the implications are severe. To absorb and consume such a massive surplus of imported Chinese manufacturing, countries must either rapidly shed their own manufacturing sectors or turbocharge consumption through rising household debt. Neither path is economically sustainable nor politically palatable.

It is this fundamental contradiction - of China producing far more than it consumes while expecting the world to provide effectively unlimited demand - that has fueled the growing backlash against its mercantilist trade policies. The U.S. now sees Chinese export dynamics as an existential threat hollowing out its manufacturing base and disrupting strategic industries. With China showing no signs of reforming its unbalanced growth model, trade frictions appear poised to escalate further.

In Defense of Sustained Chinese Trade Surpluses

China asserts that its trade surplus is a direct result of its ability to lower manufacturing costs and wages. By implementing policies that keep labor costs low and streamline production processes, China has positioned itself as a manufacturing powerhouse. Chinese officials argue that this competitive edge is not the result of unfair practices but rather a testament to China's efficiency and productivity improvements. For example, Chinese Vice Premier Liu He has stated, "China's success in manufacturing is a reflection of our commitment to innovation and technological advancement, which have made our production processes more efficient and cost-effective."

Over the past few decades, China has poured resources into research and development, leading to substantial advancements in high-tech industries. This focus on innovation has not only enhanced China's manufacturing capabilities, but also allowed it to dominate emerging sectors such as green technology and EVs. Chinese Premier Li Keqiang has highlighted this, saying, "Our investments in technology and innovation are driving our economic growth and establishing China as a leader in the global market."

Supporters of China’s trade policies also emphasize the broader benefits of China's economic growth. They argue that China's rapid industrialization and modernization have lifted millions out of poverty and contributed to global economic development. Additionally, as China's middle class expands, domestic consumption is expected to increase, which could help balance trade over time. Chinese officials frequently point to the global benefits of their economic strategy, asserting that China's growth has created new markets for goods and services worldwide.

China's advancements in technology and green energy are particularly notable. Moreover, China's leadership in renewable energy technologies, including solar panels and wind turbines, positions it as a key player in the global transition to sustainable energy.

In response to U.S. allegations of unfair trade practices, China maintains that it adheres to international trade rules and regulations. Chinese officials argue that the U.S. is the aggressor in the trade dispute, accusing the U.S. of starting a trade war that disrupts global trade stability. Chinese President Xi Jinping has stated, "The United States has taken unilateral actions that harm the global trading system and unfairly target China. We are committed to defending our rights and interests while promoting fair and open trade."

China argues that the country’s trade surplus results from its comparative advantage in manufacturing and technological innovation. They assert that China’s economic development has benefited the global economy and that the US's aggressive trade policies are unjustified.

Refuting China’s Explanation for its Persistent Trade Surplus

In a speech on April 30, Chinese Foreign Ministry Spokesman Lin Jian argued that China’s exports simply represent the country taking its natural place as the world’s manufacturer: “The ‘China overcapacity’ accusation may look like an economic discussion, but the truth is, the accusation is built on false logic and ignores more than 200 years of the basic concept of comparative advantage in Western economics. All countries produce and export products of their comparative advantage and this is the nature of international trade.”

However, this argument misapplies the theory of comparative advantage and overlooks several critical economic realities. To understand why, we must first revisit what comparative advantage truly means.

Comparative advantage explains why countries engage in trade by specializing in the production of goods they can produce most efficiently. For instance, if the U.S. excels at growing soybeans and China excels at manufacturing electronics, both countries benefit from trading these goods with each other. This principle assumes balanced trade, where each country exports and imports goods in roughly equal measures, fostering mutual economic benefits.

China's argument that its persistent trade surplus is a natural outcome of comparative advantage is flawed for several reasons. First, comparative advantage theory assumes balanced trade, not the chronic surpluses and deficits observed in the real world. Persistent trade surpluses, like China's, are not a product of comparative advantage but of structural imbalances and economic policies that distort the natural flow of trade.

Comparative advantage can't explain unbalanced trade—where one country consistently exports more than it imports, accumulating IOUs rather than goods and services. This creates a scenario where China floods global markets with its products while importing relatively little, a situation that comparative advantage theory does not account for.

The theory of comparative advantage assumes several conditions that often do not hold true in practice. It presupposes full employment and self-correcting trade imbalances through exchange rate adjustments, which should, in theory, eliminate surpluses and deficits.

As we will later discuss, trade surpluses are not caused by comparative advantage but by policies that artificially suppress domestic consumption and promote excessive saving and investment. In China's case, these include wage repression, undervaluation of the currency, and extensive state subsidies to export-oriented industries. These measures create an environment where China produces far more than it consumes, resulting in a large trade surplus.

Furthermore, the idea that technological convergence leads to trade surpluses is also misleading. While China has benefitted from technological advancements, this does not inherently lead to a trade surplus. The primary goal of technological progress should be to increase domestic welfare, not to accumulate foreign claims by maximizing exports and minimizing imports. This approach reflects a mercantilist mindset, contrary to the principles of comparative advantage and free trade.

China's persistent trade surplus is, therefore, not a natural outcome of comparative advantage or technological innovation. It is the result of deliberate economic policies that distort global trade. These policies force other countries to absorb China's surplus production, leading to economic imbalances and strained trade relations. The US's aggressive trade policies, often criticized by China, are responses to these distortions and an attempt to address the underlying imbalances in global trade.

The Cause of Persistent Global Trade Imbalances: The Chinese Economic Development Model

To recognize the true sources of China's consistent trade surplus, one must first understand China's economic development model. The Chinese development model is a version of the Asian development model, similar to those used by Japan in the 1960s and 70s, Brazil in the 1960s and 70s, the Soviet Union in the 1950s and 60s, and Germany in the 1930s. The foundation of this growth model lies in "taxing" households to subsidize producers, thereby significantly increasing the competitiveness of domestic industries and driving rapid growth in investment in real estate, infrastructure, and manufacturing capacity.

A version of this development model has been used numerous times throughout history and it has been extremely successful at generating rapid growth, but it always eventually runs into the same set of constraints: 1) the willingness of the rest of the world to absorb the trade imbalance and 2) an unsustainable build up in debt due to overinvestment and gross misallocation of capital.

There are four primary ways in which China taxes consumption and subsidizes production:

1. **Undervalued Currency**: An undervalued currency makes imports more expensive for its consumers and exports cheaper for other countries. This effectively taxes Chinese consumers and subsidizes Chinese producers.

2. **Government Control in Lending**: In China, the vast majority of credit is directed towards investment rather than consumer spending. This ensures that investment in production remains high, even at the expense of household consumption.

3. **Constraining Wage Growth**: Wage growth in China has consistently trailed productivity growth, which is an explicit tax on consumption. This has resulted in the lowest level of household income as a percentage of GDP in history, further subsidizing producers.

4. **Financial Repression**: This is the largest source of the transfer of wealth from households to the government and businesses. By keeping interest rates well below the natural level through government control over the banking system, China forces households to accept lower returns on their savings. Over the last decade, while China's nominal GDP grew by 15% annually, interest rates averaged just 6%. According to the IMF, this has led to an annual wealth transfer equivalent to 5% of GDP from the private sector to producers.

There are only three sources of aggregate demand in the economy: 1) domestic consumption, 2) domestic investment, and 3) net exports. The investment growth model is all about constraining domestic consumption and subsidizing production and investment. Therefore, it should not be a surprise that the hallmark of an economy employing a version of this investment growth model is extremely unbalanced growth.

The impact of these policies is that China's economy has become the most unbalanced in history. Consumption as a share of GDP is the lowest ever recorded, while investment as a share of GDP is the highest. In 2011, Chinese consumption was just 34% of GDP, compared to a global average of 65%. This low consumption is not due to high household savings rates but because of the low-income share of the economy, a direct result of policies taxing workers' income to subsidize producers.

This imbalance is important because of the impact that it has on the rest of the world. A natural consequence of China's investment growth model is that the economy tends to create far more production than it consumes. This excess production must be exported to foreigners for consumption. Therefore, China can only continue to grow investment as long as the rest of the world is willing to consume the excess production this investment eventually creates. Further, as China grew over the last several decades, the larger the gap between their production and their consumption became, and the more the rest of the world had to consume.

If China runs a trade surplus, by definition, an equal trade deficit must be run outside of China. A trade surplus adds to a country's GDP, while a trade deficit subtracts from a countries GDP. When China runs a trade surplus, they are capturing more than share of global GDP, which comes at the expense of lower GDP for the rest of the globe. In order for the rest of the world to absorb all of China's excess production (i.e., their net exports) it means that outside of China either production has to drop, which means slower GDP growth, or consumption has to boom through an increase in debt.

As the supplier of the world's reserve currency, the U.S. is forced to consistently run a trade deficit. As a result, most of the increase in China's GDP that has come from its trade deficit has come at the expense of U.S. GDP.

The U.S. Did Not Start the Trade War

As trade tensions with China have escalated, Beijing has attempted to reframe the narrative by casting the United States as the instigator and aggressor in instigating punitive trade actions. Chinese officials frequently accuse the U.S. of starting an unjustified "trade war" that has disrupted global stability and unfairly targeted China's interests.

However, such allegations bely the reality that the U.S. has actually been remarkably restrained and slow to react to China's mercantilist policies systematically undermining fair trade practices over the course of decades. Far from being the aggressor, America has patiently absorbed the severe economic impacts of China's strategies to gain trade advantages.

As Michael Pettis and other economists have exhaustively documented, China's policy arsenal - from currency undervaluation and financial repression to industrial subsidies - has amounted to a coordinated effort to suppress domestic consumption and turbocharge export growth. This "investment-led" economic model prioritizing surplus manufacturing for external markets is effectively a form of "beggar-thy-neighbor" policy by exporting unemployment and deficient demand onto trade partners.

Rather than operating as a free trade partner playing by mutually accepted rules, China has willfully distorted its economic environment to generate persistent trade surpluses on a massive scale. The resulting imbalances have impaired global rebalancing mechanisms like exchange rates and relative inflation from self-correcting as they should in an open trading system.

The U.S. has borne a disproportionate share of the burden from these policies. As the world's largest economy with an open capital system and reserve currency, it has been forced into persistent trade deficits to absorb China's surplus production and prevent broader global instability. This has come at immense cost in the form of manufacturing job losses, stagnant wages, and slower economic growth.

For decades, the U.S. responded with only limited trade actions, choosing instead to prioritize broader economic and geopolitical engagement with China. It was not until the Trump administration that more aggressive steps were taken to confront China's distortionary behavior through tariffs and other measures. However, even these came years or decades after most other leading economies would have acted to counter such violations of fair trade practices.

Characterizing the U.S. responses as an instigation of hostilities is an intentional obfuscation by Beijing. In reality, the evidence clearly shows it is China's mercantilist economic development model designed to systematically disadvantage trade partners that has been the true act of aggression. The U.S., if anything, has shown immense restraint in the face of such concerted actions that have violated the principles of free and fair trade.

Rather than recklessly disrupting global stability as Beijing claims, the U.S. trade actions should be viewed as a long-overdue recalibration after decades of domestic economic harm from China's growth achieved through profoundly distortionary policies. It is disingenuous for China to position itself as an innocent victim, when its own actions over many decades created the conditions for the current trade conflagration.

Two Ways to Increase Global Competitiveness

There are two ways for a country to increase competitiveness in international markets. The first is to invest in productivity increases, which lowers production costs by increasing the efficiency of the economy. The second strategy is to effectively tax domestic consumers and subsidize producers.

Whereas the first strategy increases the total pie (i.e., increases global growth) the second strategy works by increasing a country's slice of a shrinking pie. These are classic beggar-thy-neighbor policies.

The only way for the global economy to grow is through increases in productivity. Higher productivity leads to higher wages; however, in a globalized world, it is very difficult to raise wages because it is difficult to keep the benefits of higher wages – i.e., higher consumption – from bleeding out into the rest of the world in the form of a trade deficit.

For this reason, beggar-thy-neighbor policies have become an increasingly popular strategy as globalization has increased. It is also a major reason why global productivity growth has been on a downward trend over this time. The exact opposite result predicted by the conventional view of globalization.

Explanation of Balance of Payments (BoP)

Understanding China's trade surplus also requires an explanation of the balance of payments (BoP). Most analysis of cross-border transactions focuses on the global trade of goods and services. However, the international flow of money for the purchase of goods and services – international trade – is actually part of a larger system that includes the cross-border flow of money for the purchase of financial assets, known as the flow of capital (e.g., RSA buying Brazilian government bonds).

The balance of payments is a bookkeeping system that divides a country's cross-border financial transactions into the trade account and the capital account and allows us to see how these two seemingly unrelated activities are inseparably linked in a closed system. The balance of payments tells us that:

Trade Account* = Capital Account

*The technical BoP identity is: current account = capital account, but we are using "trade account" in place of the "capital account" for simplicity. It should be noted that the current account differs slightly from the trade account – a fact we can ignore for our discussion.

Importantly, whatever happens to one side of the equation has the exact inverse impact on the other side. Movements in the trade account can just as easily be the result of a transaction on the capital account, and vice versa. For example, if Korean life insurance companies invest $1 billion in the U.S. stock market, all else equal, U.S. net exports of goods and services will decrease by $1 billion and Korean net exports will increase by $1 billion despite the transaction having no connection to trade.

The reason that the capital account equals the trade account is that U.S. dollars can only be used for two things: purchasing 1) U.S. financial assets (e.g., U.S. Treasuries), a capital flow, or 2) U.S. goods and services, a trade flow. There are only two options; therefore, when foreigners use their dollars to buy more U.S. stocks or bonds, it automatically reduces U.S. exports of goods and services and vice versa. Technically, China can take their dollars and buy commodities priced in dollars, but those dollars are only transferred to the seller of those commodities, who then faces the same decision: buy either a U.S. financial asset or U.S. goods and services.

Persistent Trade Surpluses and Deficits are Unnatural, Unhealthy, and Unsustainable

Large and persistent trade imbalances are not natural because trade deficits and surpluses alter economic conditions in ways that cause them to automatically reverse. Without major distortions, the global trade and capital system is highly self-organizing, with natural feedback mechanisms that cause a reversal in the buildup of a trade imbalance—whether surplus or deficit. Persistent trade imbalances are always the result of significant policy distortions, which necessarily impede the efficient allocation of resources and reduce global economic growth.

In a properly functioning global trading system, excess demand for goods causes either the trade surplus country's currency to appreciate or its relative inflation rate to increase until the relative production cost advantage of the trade surplus country levels out and the balance of payments rebalances. For example, imagine a new country, Newtopia, enters the global trading system with a currency value that makes its production costs much cheaper than the rest of the world. Newtopia will initially run a trade surplus. However, the excess demand for Newtopian goods will either cause Newtopia's currency exchange rate to appreciate or its relative inflation rate to increase, thus leveling out the production cost advantage and balancing trade.

Feedback Mechanisms which Rebalance Trade

The trade account receives the bulk of focus; however, recall that the balance of payments bookkeeping tells us that the capital account equals the trade account. Any action should be viewed by its impact on both the trade account and the capital account.

Any transaction that impacts one account will have an equal and opposite effect on the other. This tells us that movements in the trade account can just as easily be a result of a transaction on the capital account. Therefore, the economic mechanisms that cause a reversal of a balance of payments imbalance can occur through the trade account or the capital account.

Under the gold standard there were two main mechanisms that adjusted to create negative feedback and rebalance the global economy and reverse surpluses and deficits in the trade and capital account: 1) changes in interest rates and 2) changes in relative prices (i.e., inflation).

Adjusting the Bank Rate

The first policy prescription for a government in a country suffering a balance of payments crises – losing gold from persistent trade deficits – was to raise the Bank rate (the short-term interest rate similar to today's Fed Funds rate). A rising Bank rate would make trade finance more expensive, reducing the demand for exports, reducing the availability of credit, and reducing domestic demand.

If domestic production is greater than domestic demand, a country will run a trade surplus. Thus, any policy that reduces domestic demand will tend to increase production relative to demand, which improves the trade balance.

Changes in Relative Prices

Previously we stated that if you receive foreign currency as a result of exporting goods to a foreign country the exporting country only has two options with their foreign currency: 1) buy a foreign financial asset or 2) buy goods and services. Under the gold standard, gold was the financial asset that foreigners bought to settle cross border trade.[1] Since gold was used to pay for exports, a country running a trade deficit would exchange gold, equivalent in price to the net exports, to the trade surplus country. In other words, a trade deficit country would lose gold and the trade surplus country would accumulate gold.

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[1] Technically there were two primary financial assets were used to settle international trade: gold and trade finance letters of credit. Trade settled in gold was straight forward. An importer would receive foreign goods and the exporter received gold (a financial asset).

One problem with international trade (especially during the gold standard) was the time lag between the time of purchase and delivery. If an importer paid upon purchase the exporter might not ship and if they paid upon delivery the importer might not pay. Trade finance was developed to remove settlement risk in international trade.

A third party (typically a bank) pays the exporter upfront for their goods, while issuing a short-term line of credit to the importer which would be paid back upon delivery of the goods. Thus, the importer received goods and in exchange the bank received short-term debt of the importer – a financial asset. The essential point is that these capital flows were directly related to trade flows.

In the gold standard days, a country's money supply was directly linked with the quantity of gold held domestically. Therefore, a trade deficit country, losing gold, would undergo a contraction in their money supply, which would cause deflation. The trade surplus country, accumulating gold, would experience an expansion in their money supply, which resulted in inflation. Consequently, relative prices would fall in the deficit country and rise in the surplus country, reversing the production cost advantage of the surplus country and reversing the trade imbalance.

The relative price change mechanism is a particularly brutal means to reverse trade imbalances because wages, the main variable available to reduce production costs (productivity cannot be adjusted so easily), are "sticky" – they tend not to adjust downward except through drastic increases in unemployment. As a result, the deflation needed to lower production costs in the trade deficit country ravaged the economy and made depressions a common occurrence during the gold standard. However, the deflation necessary from the trade deficit country could be alleviated if the trade surplus countries allowed its gold inflows to fully flow through to their money supply, which would increase inflation and raise the surplus country's production costs.

The important point is that the gold standard trading regime required global coordination and countries adherence to the "rules of the game". During the pre-war period, global coordination was high and the global trading system operated smoothly. However, during the inter-war period, global coordination broke down and the system collapsed.

In 1944, the Allies met at Bretton Woods, in New Hampshire, in order to design a new global monetary and trading system to replace the failed gold standard. Under the gold standard, all currencies were fixed to the price of gold; however, under the new regime, commonly referred to as the Bretton Woods monetary system, currencies would be allowed to float relative to the U.S. dollar – with only the dollar pegged to gold. The final vestiges of the gold standard were erased in 1971, when President Nixon unpegged the U.S. dollar to gold. The current trading and capital trading regime, with a free-floating U.S. dollar, is often referred to as the Bretton Woods II system.

The significance of Bretton Woods is that it created a new mechanism to reverse global trade imbalances. The Bretton Woods system has the two adjustment mechanisms of the gold standard 1) changing relative interest and 2) changing relative inflation, but added a third: flexible currency exchange rates (Exchange rates are the relative prices of two currencies. Flexible exchange rates allow currencies to appreciate and depreciate relative to each other).

Flexible Currency Exchange Rates

A trade deficit leads to an excess supply of the trade deficit country's currency, while a trade surplus has the opposite effect. All things equal, an excess supply of the trade deficit currency, and reduced supply of the surplus currency, will cause the surplus currency to appreciate relative to the deficit country. Prices of goods produced in the trade surplus currency increase, while prices decrease in the trade deficit country until the trade imbalance is reversed. The adjusting exchange rate mechanism differs from the gold standard, fixed exchange rate regime, in that it is changes in the relative currency values that change the relative prices rather than the flow of gold, which increases the money supply and sets off inflation. Flexible exchange rates have the advantage of allowing relative prices to adjust much quicker. A trade deficit country need not go throw the process of lowering wages to adjust. A falling exchange rate automatically lowers real wages within the country and the citizens are largely unaware of the fact that their dollar of income can purchase fewer goods and services.

A falling currency represents a shift in resources from domestic consumers to domestic producers. Recall that a country will run a trade surplus if domestic production is greater than domestic demand. A depreciating currency reduces the purchasing power of domestic incomes - reducing domestic demand – while decreasing the price of the country's exports – increasing production. Thus, a depreciating currency helps reverse a trade deficit because it increases domestic production relative to domestic demand.

Since the global trading system's natural feedback mechanisms will serve to reverse trade imbalances, persistent trade surpluses and deficits can only occur because of large policy distortions that prevent their reversal. The Bretton Woods system of floating exchange rates was supposed to increase order to the global trading system. Instead, the global trading system has never been more unbalanced than it has in the last 20 years. It is no coincidence that the historic imbalances of the last 20 years have coincided with declining global economic growth, housing bubbles, stock bubbles, and financial crises. It is a natural and expected consequence of persistent imbalances in global trade and capital flows.

Under the gold standard global imbalances could not persist because the system contained a natural feedback loop to reverse the imbalances.

In today's trading regime countries can resist the appreciation of their real exchange values and prevent the reversal of their trade surplus. Rather than trading gold, countries trade financial assets (mostly debt). Therefore, a trade imbalance can continue for as long as one side is willing to continue trading financial assets for goods and services.[2]

Former Fed Chairman Ben Bernanke explains that "As currently constituted, the international monetary system has a structural flaw: It lacks a mechanism, market-based or otherwise, to induce needed adjustments by surplus countries, which can result in persistent imbalances."

As a result, the mercantilist/beggar-thy-neighbor strategy is especially effective in today's global trading regime. As more countries implement these policies the global economy

[2] We are not making an argument in favor of going back to the gold standard. The gold standard was a brutal system with its own set of flaws. We are only stating that the strength of the gold standard was its ability to reverse global trade imbalances in a self-organizing manner, while today's system lacks such a mechanism.

becomes even more distorted. Without global coordination, countries are likely to follow strategies that increase their share of the pie without increasing the size of the pie.

These feedback mechanisms explain why arguments that attribute China's persistent trade surplus and the U.S.'s persistent deficit (over 50 years) to relative production costs or lower wages are so flawed. Fund manager and finance blogger. Cullen Roche provides an example of this misguided logic stating, *"The main reason the USA runs a trade deficit with countries like China is because it's much cheaper to make stuff in China than it is in the USA.* A factory worker in China commands just $3.60 per hour, versus $23 in the USA. U.S. workers command higher wages because there are fewer workers, and those workers demand higher wages to meet their higher living standards. The inverse is true in China, where living standards are lower and there is an abundance of labor.

When multinational U.S. corporations decide where they're going to make their goods, they can either choose the $23 worker in the USA or the $3.60 worker in China. In the last 30 years, more and more companies are choosing the $3.60 worker in China."

The first area of confusion within Cullen's statement is that his analysis of comparative production costs only examines relative wages. However, the important factor is relative productivity and not relative wages. Productivity is a measure of the relative output per unit of input. For example, labor productivity measures GDP per hour of work. A country's relative wages are largely a result of the country's level of productivity. According to the Conference Board, a U.S. worker is over 525% more productive than their Chinese counterpart (the result of higher per capita capital stock, differences in organizational structure, etc. and not the result of the workers motivation).

Even a cursory examination of the facts would have led Cullen to a realization that his interpretation of global trade is flawed. First, Germany, with relatively high wages, has the largest trade surplus in the world. Secondly, countries with lower relative wages have historically been more likely to run a trade deficit.

Cullen's focus on relative wages was misguided but the biggest source of misunderstanding is that he fails to understand that trade imbalances alter economic conditions, so that relative production costs adjust via currency values, wages, or inflation.

The reason for the persistent global trade imbalances is due to policy distortions that have prevented their reversal. The fact is that countries that run large trade surplus almost always do so because of domestic distortions in the distribution of income. In China's case, these distortions are in the form of implicit taxes on consumers and subsidies to producers, leading to Chinese incomes as a percent of GDP being the lowest in the world. The result is that China consistently produces more than it consumes and it externalizes the costs by stealing demand from its trading partners in order to balance its domestic imbalances.

The Problem of Excess Savings vs. Overcapacity

While debates around China's trade practices often focus on overcapacity in specific industrial sectors, Michael Pettis argues that the root cause of China's persistent trade surplus lies in its structurally high domestic savings rate, driven by policies that suppress household consumption. Addressing this excess savings issue is crucial for creating a well-functioning global trading system.

Pettis distinguishes between the issues of overcapacity and excess savings, which are often conflated. Overcapacity in targeted sectors like electric vehicles and solar panels, while contentious, is not unique to China. Most major economies implement policies to support strategically important industries, aiming to foster comparative advantages. However, such policies alone do not inherently lead to persistent trade imbalances.

The crux of the problem, according to Pettis, is China's decades-long development strategy of transferring income from households to subsidize the production side of the economy. This approach involves explicit and implicit subsidies, such as directed credit, currency undervaluation, labor restrictions, weak social safety nets, and overinvestment in infrastructure. These policies collectively suppress household consumption, forcing up domestic savings rates.

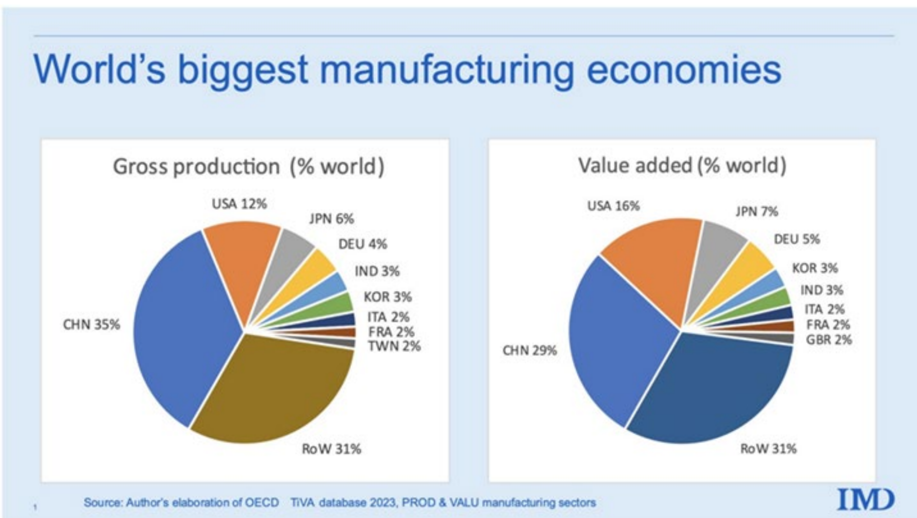
As a result, growth in household income has consistently lagged behind productivity growth, leaving Chinese households unable to consume a significant portion of what they produce. The high savings rate leads to an overproduction of goods, which must be exported, externalizing the deficiency in domestic demand.

Pettis argues that while China's dominance in certain manufacturing sectors is consistent with comparative advantage and free trade principles, it is the excess savings, representing suppressed domestic wages and demand, that creates a problem for the global economy. By running large trade surpluses, China effectively exports the consequences of its deficient domestic demand, such as higher unemployment, to its trade partners. These surpluses must be absorbed by trade partners through higher unemployment, increased fiscal deficits, or rising household debt, destabilizing global economic stability and growth.

Moreover, Pettis highlights China's recent shift of investment from the property sector towards manufacturing, potentially exacerbating the imbalance. With China's manufacturing share of GDP already at 27% (compared to the global average of 16%), a continued reliance on manufacturing-driven growth could overwhelm the rest of the world's ability to absorb the increased Chinese output, unless other countries are willing to significantly reduce their own manufacturing sectors.

Pettis concludes that without a major restructuring of its growth model away from investment and manufacturing, and towards greater reliance on domestic consumption, China's ability to raise its share of global GDP becomes increasingly constrained. The global economy would find it extremely difficult to absorb further Chinese growth without a contentious accommodation from the rest of the world.

In essence, Pettis argues that China's persistent trade surplus is not a natural outcome of comparative advantage or technological progress, but rather the result of deliberate policies that distort global trade and capital flows. Resolving the issue of excess savings, rather than overcapacity in specific sectors, is fundamental to achieving balanced and sustainable global economic growth.



Should the U.S. Respond with Protectionist Measures?

The question of whether the U.S. should respond to China's trade practices with protectionist measures requires an examination of the broader implications. While it might seem that cheaper imports from China benefit American consumers, this perspective ignores the fact that consumers are also producers. Subsidized foreign goods, often perceived as a gift, actually impose significant costs on the U.S. economy. The supposed benefits of lower prices are overshadowed by the detrimental impacts on domestic production, employment, and overall economic stability.

Michael Pettis argues that the inflow of cheap goods from China, driven by extensive subsidies, does not result in a net gain for the US. Instead, it undermines domestic industries by creating unfair competition. This leads to a decline in domestic manufacturing, which has broader economic implications. When American producers cannot compete with subsidized foreign goods, they are forced to reduce production, lay off workers, or shut down entirely. This results in higher unemployment and decreased economic activity within the US, which offsets the initial consumer savings from cheaper imports.

Furthermore, the persistent trade imbalances caused by China's policies lead to financial instability and rising debt levels. As domestic production declines, the U.S. economy becomes more dependent on foreign goods, increasing the trade deficit. To sustain consumption levels amidst declining production and rising unemployment, households and the government often resort to borrowing. This creates a cycle of increasing debt and economic vulnerability.

How Should the U.S. Respond?

"The debate is not about choosing free trade or choosing protection. It is about how each economy should position itself in a highly distorted trade environment driven heavily by beggar-thy-neighbor policies among major economies." – Noah Smith

Thus far, the U.S. has responded with tariffs against Chinese goods. Is this the right policy?

In our 2018 report in response to the Trump tariffs, we predicted that the tariffs would have the opposite of their intended effect. We stated that "*Tariffs can impact the economy, by reducing demand, but they will only impact the U.S. trade balance to the extent that they affect capital flow decisions. Ironically,* ***tariffs are more likely to increase the U.S. trade deficit by increasing risk-aversion in the global financial system****. When global risk-aversion rises, investors seek safety, which means moving capital out places like Emerging Markets and into U.S. markets.*

Restructuring trade deals and placing tariffs on our trading partner's exports will not reduce the U.S.'s trade deficit as long as those countries are exporting capital to the US. Only policy prescriptions that focus on the capital account, such as limiting foreign central banks purchases of U.S. foreign currency reserves, will ensure a reduction in the U.S. trade deficit."

To understand why tariffs will not reduce the U.S. trade deficit, we must look at the underlying dynamics of global capital flows. We previously explained that the balance of payments bookkeeping system divides a country's cross-border financial transactions into the trade account and the capital account. These two accounts must balance each other, meaning any change in one will result in an equal and opposite change in the other. Thus, an increase in capital inflows into the U.S. results in a corresponding increase in the trade deficit.

Historically, tariffs have been used to reduce trade deficits by making foreign goods more expensive. However, tariffs alone do not address the capital flows that drive trade imbalances. When the U.S. imposed tariffs on Chinese goods in 2018, the overall trade deficit widened instead of shrinking. This counterintuitive result occurred because tariffs increased global risk aversion, leading to an influx of foreign capital into the US. The increased capital inflows resulted in a larger trade deficit, illustrating that tariffs can have the opposite of their intended effect.

Our 2018 prediction that the Trump's tariffs were more likely to cause the U.S. trade deficit to widen than contract – the opposite of its intended effect – was proven correct:

The point that we have been making for years is that the U.S. does not run a trade deficit because of higher relative production costs. The U.S. runs a trade deficit because it has been forced to absorb nearly 100% of the world excess savings (i.e., net capital flows) due to the fact that the U.S. is the only country that allows the free flow of capital and has a large enough financial system to absorb the capital flows. As long as the U.S. allows unrestricted foreign capital flows into the country it will continue to run a trade deficit. The solution to reducing the trade deficit lies in addressing these capital flows, not trade policies.

Tariffs Likely to be Deflationary

In 2018, we made a highly non-consensus prediction that the tariffs were more likely to be deflationary. Today's economists can be forgiven for lacking the requisite knowledge of how tariffs impact the economy because they haven't played a major role in the global economy in their lifetime.

Most economists start with the a priori assumption that tariffs raise prices and never even consider the possibility that they would be deflationary. When forecasting how tariffs will increase inflation economists simply add up the cumulative cost increases that tariffs create. Economists often fall into the trap of using this type of reductionist approach to economics and only consider the first-order impact but fail to think deeply about the system as a whole.

A holistic examination of the system shows that tariffs might raise the price of some goods but it will cause the price of other goods to fall because it does not increase income in the economy - and by definition spending equals income. For example, if U.S. income is $14 trillion and $500 billion of taxes are placed on certain products, then consumers will buy $500 billion less of goods and services because they only have $14 trillion to spend. <u>Tariffs work by increasing a country's savings rate.</u> The savings rate = domestic production – domestic consumption.

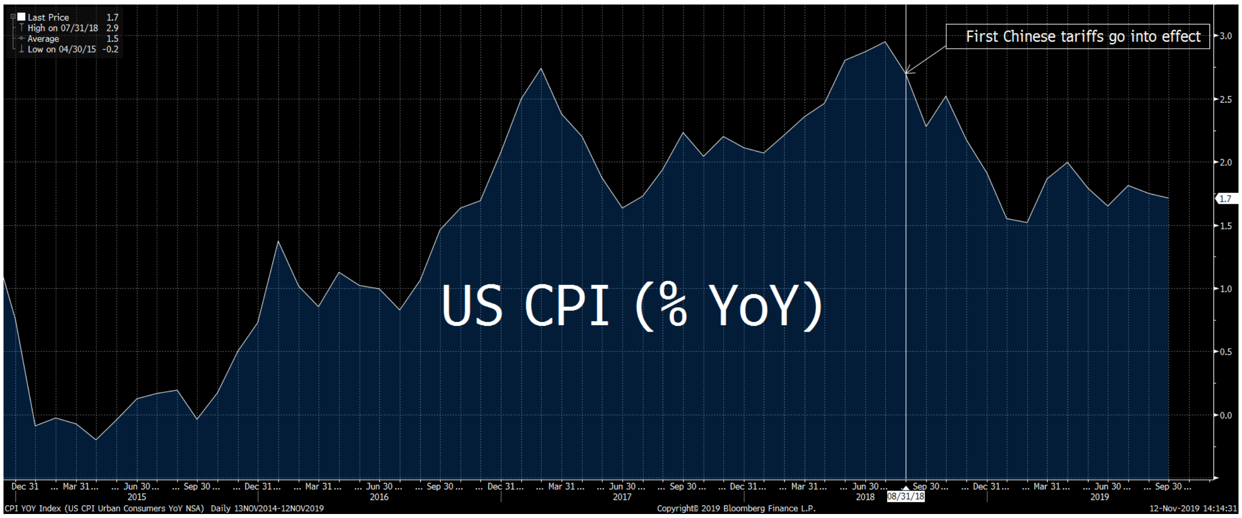
A tariff is effectively a tax on domestic consumers, whose real incomes decline, and a subsidy to domestic producers, whose prices fall relative to their foreign competition. A decrease in domestic consumer's real incomes and an increase in the competitiveness of domestic producers causes production to rise relative to consumption – in other words, a rise in the savings rate.

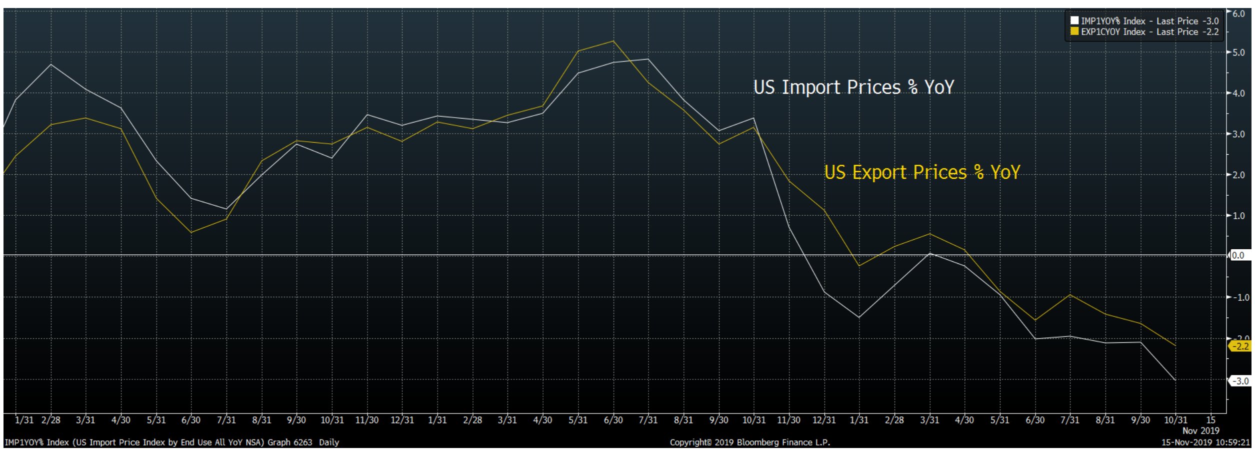
There are only two forms of demand: consumption and investment. If consumption declines, the economy can only grow if investment increases by a sufficient amount to offset the decline in consumption. Since tariffs reduce consumption, economic growth will only occur with a boom in investment.

However, the tariffs will not lead to an increase in U.S. investment under the current economic conditions. In our November 2018 Fiscal Policy Report, we stated that "*supply-side policies will fail in a world in which investment has not been constrained by a lack of savings. In this case, taxing consumption and subsidizing investment will only cause aggregate demand to decline. If supply is already sufficient to meet demand, then businesses will react to falling consumption by also reducing investment.*

For at least the past two decades, the world has been living in a savings glut. There have been no sufficiently profitable investments that have been prevented due to a lack of access to capital. It is just the opposite. Thus, in today's economy, Trump's supply-side policies will not only fail but lead to lower growth. ***We should expect tariffs to cause a drop in both consumption and investment…This is why, contrary to popular opinion, tariffs are more likely to be deflationary than inflationary."***

Our forecast that “under the current economic conditions we expect the tariffs to cause a decline in inflation” has proven correct. Just six months after tariffs went into effect, U.S. inflation (as measured by the consumer price index) was cut in half, from nearly 3% to 1.5%.





We believe that the recent tariffs by the Biden administration are also more likely to be deflationary and reduce U.S. investment and economic growth.

Tariffs are the wrong way to respond to China’s mercantilist policies. The only way to effectively reduce the U.S. trade deficit is to prevent unrestricted capital flows from coming into the US. Tariffs alone will not achieve this goal and are more likely to exacerbate the problem. Policymakers must focus on addressing capital imbalances to create a sustainable solution for the U.S. trade deficit. This requires implementing measures such as taxes on capital inflows or restrictions on foreign investments, which can help control the gap between U.S. savings and investment.

In conclusion, the U.S. must rethink its approach to trade policy. Tariffs are a blunt instrument that fails to address the underlying issue of capital flows. To achieve a sustainable trade balance, the U.S. needs to focus on policies that manage these capital flows effectively.

Conclusion

Many policymakers and analysts attempt to attribute China's massive trade surpluses to the country's lower wages and production costs compared to its trade partners. However, this conventional explanation fundamentally misunderstands the principles of comparative advantage and the self-correcting mechanisms inherent in a balanced global trading system.

Invoking comparative advantage to justify chronic trade imbalances is a misapplication of economic theory. Comparative advantage explains why countries specialize and engage in mutually beneficial trade based on their respective productivity advantages for certain goods. However, the theory assumes balanced trade flows where export and import values equalize over time.

Persistent, sizeable trade surpluses or deficits violate this balanced trade condition that enables the full realization of comparative advantage benefits.

In a properly functioning trading system, large trade imbalances initiate self-reinforcing feedback loops that ultimately restore balance.

China's ability to sustain such a staggering surplus over decades, accounting for nearly a third of global exports, represents a systemic departure from these assumptions. It is prima facie evidence of deep-rooted policy distortions that subvert global trade's self-equilibrating tendencies.

Simplistic explanations focusing only on China's wage or cost differentials miss the much more consequential roots of this imbalance.

Trade imbalances are not merely the outcome of China's lower wages or production costs outcompeting other nations, as some presume. Rather, they are an inevitable byproduct of Beijing's decades-old development model premised on restraining household income growth, repressing interest rates, and diverting income from consumption towards subsidizing production and exports.

By persistently producing more than it consumes, China forces an export of unemployment and deficient demand onto its trade partners. This "beggar-thy-neighbor" dynamic impairs global rebalancing mechanisms and strains the ability of other economies to absorb China's surplus production through their own investment and consumption.

Trade restrictions, like tariffs, are ineffectual remedies because they fail to address the underlying root causes in China's domestic economic distortions and imbalances. The world cannot resolve entrenched trade imbalances without China fundamentally restructuring its growth model towards greater reliance on consumption rather than excessive investment and exports.

Until the pernicious effects of Beijing's mercantilism are unwound, trade frictions will only intensify as the world strains to accommodate China's excess productive capacity.