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Fiscal Policy

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The Truth about Trade War

This is the second installment of a special report on global trade. The specifics of President Trump's policies have been written about ad nauseam but there is widespread confusion on the implications of these actions. This report is intended to provide our readers with an explanation of the global trade and capital flow system, which is necessary to properly access the implications of trade policy.

Balance of Payments

Most analysis of cross-border transactions is focused 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 – what we refer to as the flow of capital (ex. 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 actually 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 I am using "trade account" in place of the "capital account" for simplicity. However, it should be noted that the current account differs slightly from trade account – a fact we can ignore for our discussion

The Balance of Payments equation tells us that any transaction that impacts one account will have an equal and opposite effect on the other. Movements in the trade account can just as easily be the result of a transaction on the capital account, and vice versa. As an example, if RSA invests $1 billion in the Brazilian stock market, all else equal, US net exports of goods and services will increase by $1 billion and Brazilian net exports will decrease by $1 billion despite the transaction having no connection to trade. Any analysis that fails to account for how a trade policy is impacting the capital account is flawed at best. Yet, the lack of understanding of this unintuitive, yet fundamental, connection between international trade and capital flows is pervasive in the investment community and it has led to a general misunderstanding of the trade issues now dominating the financial headlines.

Myth #1: The Chinese can retaliate against US tariffs by selling Treasuries

One of the most common misunderstandings is that China could retaliate against the US by selling US Treasuries. The idea is that by selling US Treasuries, the Chinese would cause US interest rates to rise and threaten the US economy. At face value, this looks like a solid argument. Yet, as we will show, this logic is completely wrong. In fact, selling US Treasuries is exactly the action that the US wants China to take. We will take a closer look to explain why.

US dollars, or any sovereign currency, can mainly be used for two things: purchasing 1) US financial assets - (ex. US Treasuries) a capital flow or 2) US goods and services – a trade flow. This fact explains why the capital account = the trade account. There are only two options, thus increasing capital flows means automatically decreasing imports of goods and services – i.e. the trade account, and vice versa.

Whatever happens to one side of the equation has the exact inverse impact on the other side. If a US entity purchases a good from China, for example, the US entity will get the good and the Chinese entity will receive dollars. If the Chinese entity uses their dollars to buy a US financial asset it will increase the US capital account and reduce the trade account by an equivalent amount. This understanding makes it obvious why it is good for the Chinese to sell US Treasuries. Selling US Treasuries must be matched by an equivalent purchase of US goods and services – reducing the US trade deficit. This is the crux of our argument: foreign countries are using their dollars to disproportionately buy US financial assets, such as Treasuries, and not enough US goods and services (elsewhere in the report we explain why countries have chosen this action and why it is harmful to the US and the world).

If the world sells US financial assets they must instead buy US goods and services. This action will increase US economic growth as US firms increase production as to meet the rising demand for net exports. In this case US interest rates are likely to rise, but only because US economic growth is increasing. The net impact of stronger US economic growth and higher interest rates is decidedly positive for the US economy.

Notice that the rise in interest rates is not a result of the selling of Treasuries, but instead the result of the stronger US economic growth that comes from rising net exports. This is a fact that can be difficult for some to swallow but we will address it in the detailed explanation.

<u>The detailed explanation</u>

China Selling Treasuries will Force an Improvement in the US Trade Deficit

We stated that there are only two options that China, or any country, has with their foreign currency: 1) a financial asset from that foreign country or 2) goods and services from that country. However, it is actually a little more complicated than that. Eagle-eyed readers might reject that claim because China can, for example, take their dollars and buy commodities priced in dollars. That would technically be a correct statement, but the end result is unchanged. The dollars are only transferred to the seller of those commodities, Saudi Arabia for example, who would then have to decide whether to use those dollars to buy either: 1) a US financial asset or 2) US goods and services.

There is never a net flow of currency out of a country. It does not matter how many intermediary transactions take place, the end result will be an entity deciding the ratio of foreign assets to foreign goods and services it wishes to exchange for that foreign currency.

Below we state all of the ways that China could sell US government bonds (i.e. Treasuries) and explain the impact in each case:

I. Beijing could buy fewer Treasuries and other US financial assets, but other Chinese entities could then buy more US assets so that net capital flows from China to the US would stay unchanged.
    a. No impact.
II. Beijing and other Chinese entities could buy fewer US financial assets and replace them with an equivalent amount of assets from other countries (German government bonds – Bunds - for example), so that net capital flows from China to the US would be reduced, and net capital flows from China to other countries would increase by the same amount.
    a. In this case, the entity selling the German Bunds to the Chinese would receive US dollars and then determine whether to use those dollars to buy either 1) US financial assets or 2) US goods and services.
        i. If they buy US financial assets then US current account and rates will not change but the Euro would likely appreciate relative to the dollar.
        ii. If they buy US goods and services then the US current account deficit shrinks – US net exports increase - and US interest rates and the US dollar likely rise because of higher US relative economic growth.
III. Chinese entities sell US financial assets and purchase commodities with those dollars so that net capital flows from China to the US would be reduced.
    a. In this case, the impact on the US is dependent on the decision of the entity selling the commodity and they have the same set of options as China with the dollars they receive. They can buy:
        i. German Bunds, for ex, which will raise the Euro relative to the Dollar.
        ii. US financial assets
        iii. US goods and services.
IV. Beijing and other Chinese entities could buy fewer US financial assets and not replace them by purchasing an equivalent amount of financial assets from other countries. Rather than financial assets, China would buy more goods and services from the US.

a. This would result in an increase in net exports, which would shrink the trade deficit, and cause an increase in US growth which would result in rising interest rates.

Regardless of how many steps it takes, in the end, dollars must either: 1) buy US fi assets or 2) buy US goods and services. <u>If China sells US Treasuries the US trade balance will improve</u> - unless 100% of the dollars China receives from the sale of those financial assets are used to buy an asset from another foreign entity who turns around and uses 100% of those dollars to buy US Treasuries – in which case there would be no impact on the trade deficit because the Treasuries sold by China will be bought by another foreign entity.

Myth #2: The US runs a trade deficit because it's cheaper to produce goods in countries with lower wages

The United States has run a persistent trade deficit for 36 years, at its peak reducing US GDP by 6% per year. The common explanation for the US trade deficit is that it is cheaper to produce goods and services elsewhere. Fund manager and finance blogger, Cullen Roche explains,

"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. US 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 US 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."

Cullen's argument seems logically sound, yet, as we will show, his conclusions are terribly confused.

This mode of thinking is pervasive among the finance community. Even highly intelligent individuals with extensive experience in finance fail to understand how the global trading system operates.

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 US worker is over 525% more productive than their Chinese counterpart.

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 his explanation fails to explain why a country, such as the United States, has run persistent trade deficits for almost 40 years, while other countries, such as China, have run persistent trade surpluses for over 50 years. In fact, most investors do not even realize that the large and persistent trade imbalances of the last 25 years are historically unprecedented. The truth is that large and persistent trade surpluses or deficits are unnatural, unhealthy, and unsustainable. The imbalances in the global trading system are the root cause of the global economic malaise and financial crises of the last two decades.

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. In other words, 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 - surplus or deficit. Persistent trade imbalances are always the result of significant policy distortions which necessarily impedes on the efficient allocation of resources and reduces global economic growth.

We will take a look at the economic feedback mechanisms which cause a reversal in a trade imbalance and explain how policy distortions have mitigated their effect so that the past 20 years have seen the largest buildup of trading and capital imbalances in history.

The trade account receives the bulk of focus; however, recall that the balance of payments bookkeeping tells us that the capital account = the trade account.

Any action should be viewed by its impact on both the trade account and the capital account. A lack of doing so is the result of much confusion around trade.

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, reduce the availability of credit, and reducing domestic demand.

If domestic production > domestic demand a country will run a trade surplus. So any policy that reduces domestic demand will tend to increase production relative to demand and improve 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. 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.

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 would ravage 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 their gold inflows to fully flow through to their money supply, which would increase inflation and raise the surplus countries 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. Ben Bernanke explains,

"The gold standard in the period prior to the Great Depression, the United States, and France ran large current account surpluses [i.e. trade surpluses] *accompanied by large inflows of gold. However, in defiance of the so-called rules of the game of*

the international gold standard, neither country allowed the higher gold reserves to feed through to their domestic money supplies and price levels…These policies created deflationary pressures in deficit countries that were losing gold, which helped bring on the Great Depression.”

In other words, the US was “sterilizing” the gold inflows in order to prevent inflation, which was necessary in order to reduce the US trade surplus and the rest of the world’s deficit. As a result, relative production costs were forced to adjust through deflation in the rest of the world and this led to the Great Depression, which eventually spread to the US economy.

In 1944, the Allies met at Bretton Woods in New Hampshire in order to design a new global monetary and trade 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 US dollar – with only the dollar pegged to gold. The final vestiges of the gold standard were erased in 1971, when President Nixon unpegged the US dollar to gold. The current trading and capital trading regime, with a free-floating US 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. This 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 increase 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 through 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 > 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 systems 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, financial crises, ect. It is a natural and expected consequence of persistent imbalances in global trade and capital flows.

Where did it all go wrong?

How has the United States run a persistent trade deficit for 36 years, despite the economic feedback mechanisms that are supposed to reverse imbalances? We will examine the reasons.

1) No more gold hard limit

When a US company imports goods from China, the US company receives the product and the Chinese company receives US dollars. We previously stated that US dollars, or any sovereign currency, can only be used for two things: purchasing 1) US financial assets (ex. US Treasuries) or 2) US goods and services. If China uses their dollars to buy financial assets rather than goods and services, then it will push the US into a trade deficit with China.

Under the gold standard, gold was, largely, the only financial asset available for foreigners to purchase with their foreign currency. Once a country ran out of gold to exchange for net imports they were forced to contract the purchase of imports and the trade deficit was forced to move into a trade surplus.

Even if trade surplus countries refused to follow the rules of the game and resisted adjustment, by preventing gold inflows from increasing domestic prices that would reversal in the country's trade surplus, a country's finite gold reserves placed a hard limit on the country's ability to run a trade deficit.

However, in today's fiat currency regime there is no such mechanism to place a maximum limit on the trade deficit. Today, debt, in the form of bonds, has replaced gold as the dominate financial asset purchased by foreigners with their foreign currency – equities (i.e. stocks) are another common financial asset available for capital flows.

There is no theoretical limit to the amount of debt a country can generate the way there was with gold. Instead, the size of the accumulated trade deficits a country can run is dependent on the amount of debt – ex US Treasury bonds - foreigners are willing to own in exchange for their net exports.

Which brings us to another feedback mechanism which will automatically reverse trade and capital imbalances: Expected return on financial assets.

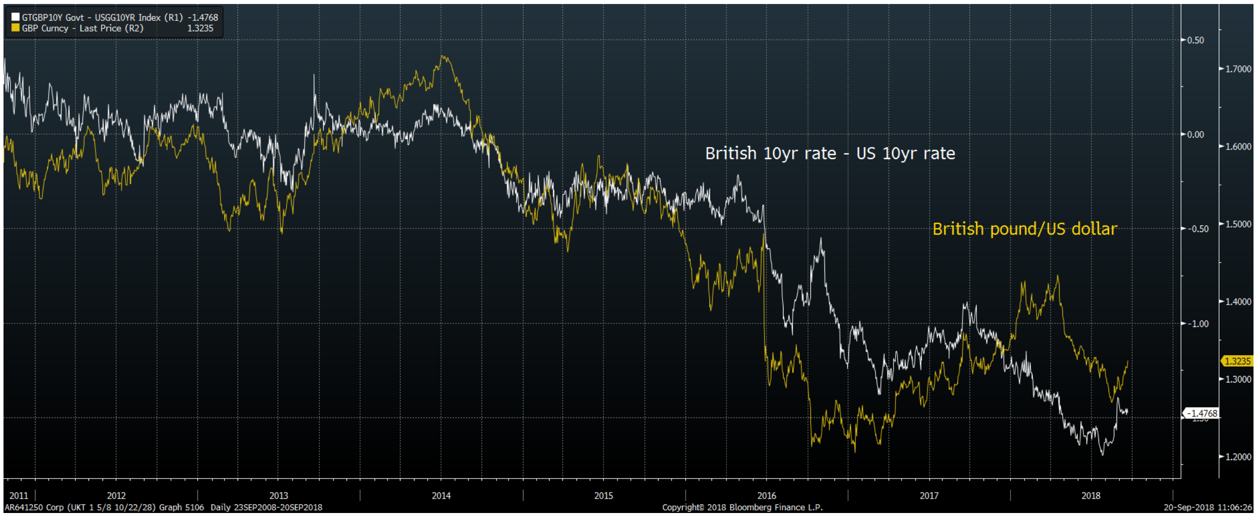
Expected return on financial assets

Recall that when an economic agent receives foreign currency as a result of global trade, they have two options: 1) purchase goods and services from that foreign country or 2) purchase financial assets from that foreign country.

The decision is not only the costs of those foreign goods relative to domestic goods but also the expected return of the foreign financial asset relative to domestic financial assets. Therefore, a drop in the expected return on foreign financial assets relative to domestic returns should cause the foreign economic agent to purchase fewer foreign financial assets, which automatically means purchasing more foreign goods and services.

A trade deficit means that domestic production is less than domestic demand; therefore, foreign production is replacing domestic production to serve that demand. Thus, net exports (trade deficit) are a drag on domestic Gross Domestic Production, while net imports (trade surplus) increase GDP. Slowing economic growth in the trade deficit country relative to the trade surplus country will, typically, lead to the trade deficit country's interest rates (the interest rate is your rate of return on a debt security such as a bond) and expected equity returns falling relative to the trade surplus country. As a result, less capital is invested in the trade deficit country and more capital invested in the trade surplus country. Less capital means more goods and services so that the trade deficit reverses, and vice versa for the trade surplus. This is a gross oversimplification of the way expected financial returns react to trade imbalances but it suffices for the purpose of our report.

Another way to think about the impact changing expected returns – interest rates – have on reversing a trade imbalance is the relationship between interest rates and exchange rates. When a country's interest rates fall relative to another country their currency tends to fall as well. The chart below shows the correlation between relative British and US 10 year bond yields (white) and the British pound to US dollar exchange rate (yellow):



The chart shows that when British 10 year interest rates fall relative to US 10 year interest rates, the British pound depreciates relative to the US dollar. A drop in relative interest rates causes the exchange rate to fall, which makes the goods from the country with a depreciating currency relatively cheaper and goods in the appreciating currency more expensive. In this way changes in relative returns on financial assets – impacting the capital account - has a tendency to move in the same direction as the relative production prices of goods and services – impacting the trade account; however, that is not always the case.

2) Exponential growth in cross-border capital flows

The Balance of Payments equation (Trade Account = Capital Account) tells us that changes in one account will have a proportionally inverse effect of the other account but makes no assumption as to which side is dominating and which side is being forced to adjust.

Up until the early 1900s trade finance accounted for 90% of all international financial transactions. As a result, changing conditions in the global trade of goods and services would cause changes in international financial markets. In other words, the capital account was forced to adjust to whatever changes were occurring in the trade account. As a result, the trade imbalances were usually the result of policies that distorted relative production costs between countries. Thus, policy tools aimed at reversing an imbalance were focused on the trade account and adjusting relative prices - tariffs on imported goods for example.

However, today capital flows dwarf trade flows. The daily trading volume of foreign exchange is now 100x larger than the daily volume in international merchandise trade. Therefore, capital flows now dominate and it's the trade account that is forced to balance. For this reason, global imbalances are far more likely to be the result of capital flow distortions than distortions in relative production costs and trade.

3) Countries manipulating the rules of the game: Accumulate Excess Foreign Currency Reserves

One of the largest sources of capital flow distortions of the past 20 years is a result of the unprecedented buildup of foreign currency reserves by foreign central banks. Foreign currency reserves are the foreign financial assets held by central governments. In our balance of payments equation, we can break the capital account into private capital flows and government capital flows.

Trade Surplus = Capital Account Deficit

Pivate Capital + Gov Capital

Private capital flows represent all non-government entities that are purchasing financial assets – investing in stocks, bonds, etc. When government capital flows out of the country they are accumulating foreign financial assets, referred to as foreign currency reserves (usually dollars – i.e. US Treasuries).

As an example, let's assume China runs a $100 billion **trade** surplus and a $40 billion private **capital** surplus (the private sector is investing $40 billion more outside of China than inside). In this case, the government **capital** deficit must equal $60 billion ($100b = $40b + $60). The increase in China's foreign currency reserves is equal to the $60 billion government capital deficit.

In the United States, a $40 billion private **capital** surplus would mean the US would run a $40 billion **trade** deficit because the United States does not have a "government capital account" that can purchase foreign financial assets (i.e. foreign currency reserves).

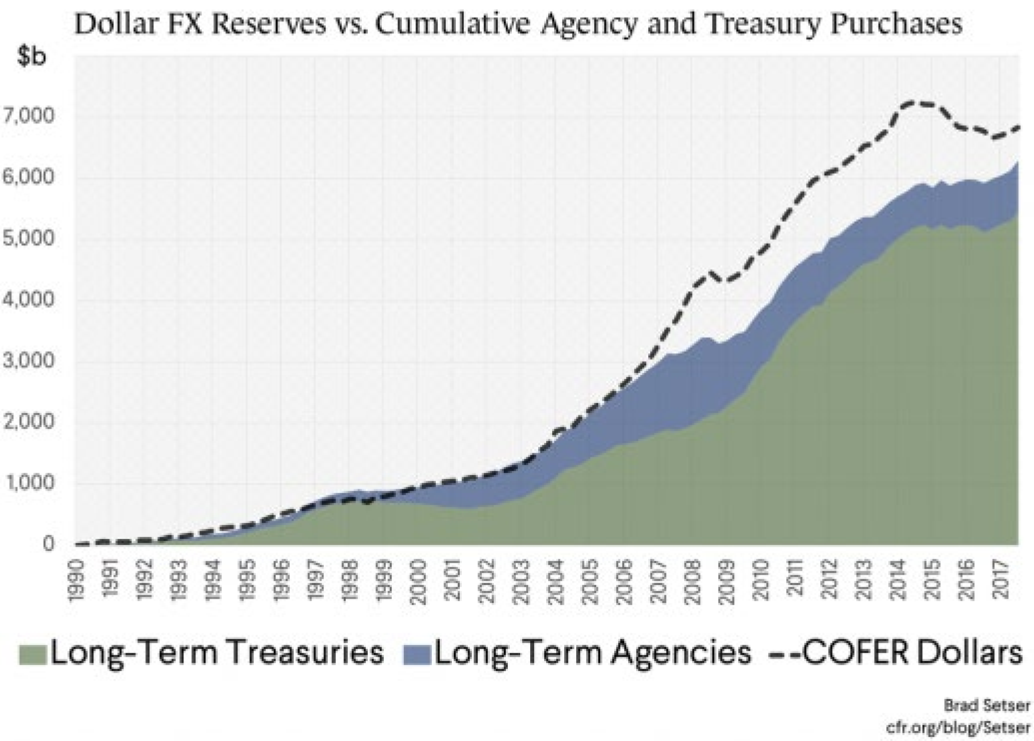
However, the Chinese government can mitigate the private capital flows, which would have forced the country into a **trade** deficit, by exporting an even greater amount of **capital**.

The current global monetary and trading system requires non-reserve countries to hold some level of foreign currency reserves to settle global trade and protect their currencies from devaluation in the case of a crisis. However, the unprecedented accumulation of foreign currency reserves (mostly US dollars) over that past 20 years is orders of magnitude greater than what can be justified by trade settlement or macro-prudential reasons.

Under the current Bretton Woods system, countries have used the buildup of currency reserves to ensure they run a capital account deficit, which results in a trade surplus. More specifically, governments are exporting capital in order to increase their country's net exports.

We previously stated that a trade surplus should reduce the supply of your currency and cause the currency to appreciate. However, under the current system, the trade surplus country can resist currency appreciation by purchasing foreign currency reserves, which is equivalent to increasing the supply of the trade surplus currency and decreasing the supply of the reserve currency (usually the US dollar). The US dollar should have responded to large trade surpluses by depreciating, making US exports more competitive, until the deficit was reversed. However, since the US is the global reserve currency, foreign governments' accumulating US dollar foreign currency reserves has prevented the dollar from depreciating enough to reverse the trade deficit.

In less than two decades, foreign governments, have purchased $6.5 trillion in US foreign currency reserves, an increase of over 700%.



The disturbing problem is that when the PBOC (Chinese Central Bank) is investing this capital – foreign currency reserves - into countries, such as the US, they are not doing so because they believe the returns are higher, which is supposed to be the sole economic reason for determining where capital flows. Instead, their decision to increase their foreign currency reserves (i.e. buy US Treasuries) is entirely driven by their desire to maintain their trade surplus.

Globally, governments now hold over $11 trillion of foreign currency reserves. The indiscriminate flow of capital by central governments represents one of most widespread misallocations of capital in history. It is no coincidence that the period of foreign currency reserve growth has coincided with a host of the most infamous financial bubbles in history (Japanese stock and property bubble, Tech Bubble, Global Property Bubbles).

Unfortunately, the trade and capital flow distortions caused by central bank purchases of foreign exchange reserves pale in comparison to the distortions that have resulted from the domestic policy decisions in some of the largest economies in the world.

Domestic Imbalances lead to global imbalances

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.

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.

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

The Chinese “investment growth model”, which we have written about in the past, is a classic example of this strategy. The Chinese investment growth model is a set of policies that taxed consumption and subsidized production in order to increase the competitiveness of Chinese industry. As a result of these policies, the Chinese economy has become the most unbalanced in history. In 2011, Chinese consumption as a percentage of GDP reached the lowest level ever recorded, in any economy, at 34% (the global average is 65%). Chinese consumption is not low because of high household savings rates, it is low because it has the lowest income share of the economy ever recorded. The low-income share of the economy is a direct result of policies which effectively taxes workers income and subsidizes producers.

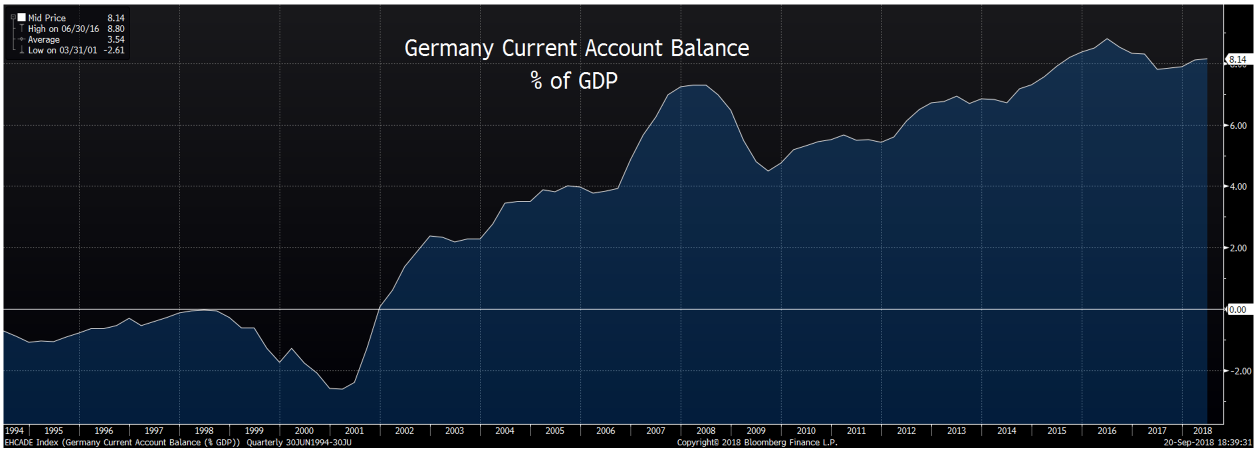
Germany currently has one of the largest trade surpluses, as a percentage of GDP, ever recorded from a major economy at over 8%. Germany’s trade surplus is a result of this beggar-thy-neighbor strategy which redistributes income from workers to producers. Germany accomplished this redistribution with the 2004 Hart Labor reforms, as well as having an undervalued and fixed currency relative to their trading partners – in Southern Europe.

A recent report from Breugel, a Belgian economic think tank, showed that the real difference in competitiveness between Germany and Southern European countries, like Italy, was not in what we think of as labor costs but in the share of national income going to the corporate sector.

The fact is that countries that run large trade surpluses almost always do so because of domestic distortions in the distribution of income.

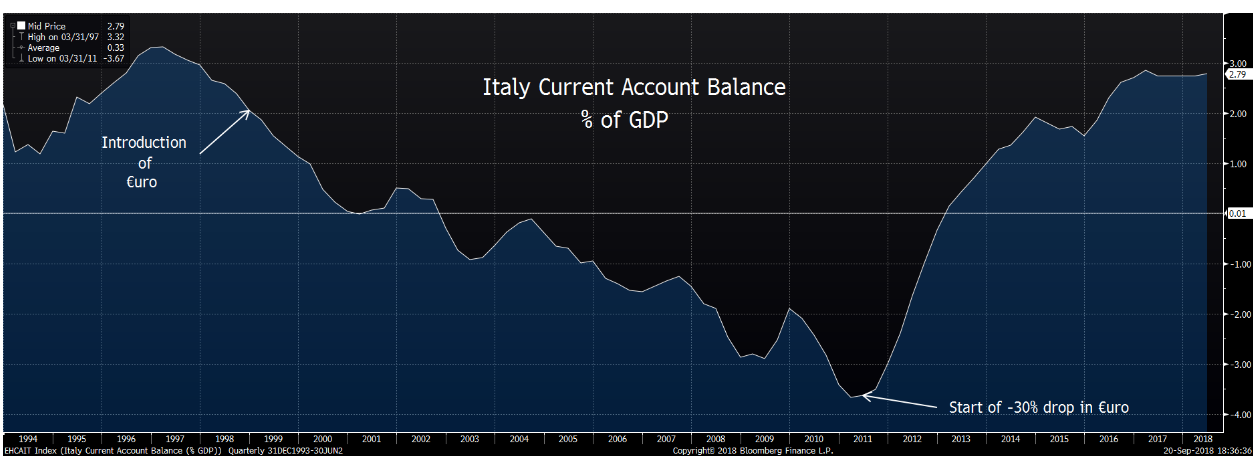
Strategies that tax consumption and subsidize production would not work in a closed economy because production would exceed demand. However, in a globalized economy countries can export their excess capacity by stealing demand from other countries. This strategy is especially effective in today's global trading regime because it is possible to mitigate the automatic feedback mechanisms that would normally reverse the trade surplus.

Beggar-thy-neighbor to resolve domestic imbalances



The chart above shows that Germany was running persistent trade deficits throughout the 90's. However, almost immediately after the introduction of the Euro Germany's trade balance moved from a deficit to an increasingly higher surplus (note that the chart shows the current account balance, which we have been using interchangeably with the trade balance for simplicity).

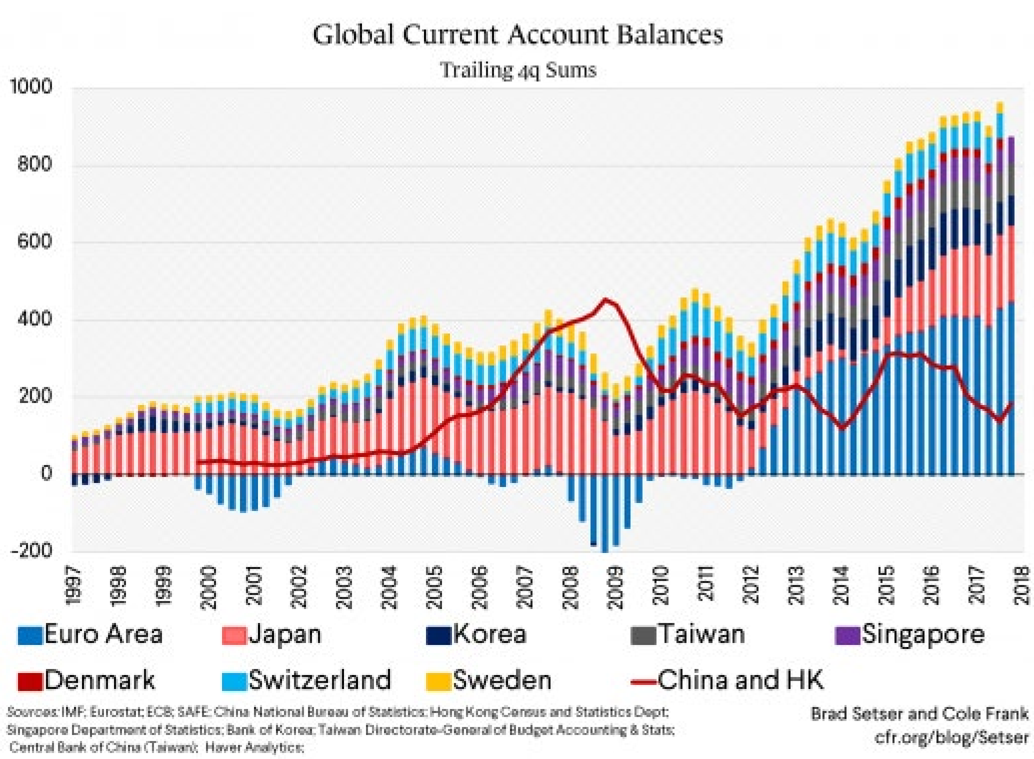
In contrast, Italy was running a trade surplus prior to the introduction of the Euro. However, Italy's trade balance consistently deteriorated over the next decade. From 2000 – 2011, Italy's trade balance was a near mirror opposite to Germany's trade balance – no coincidence. The other countries of Southern Europe shared a similar experience to Italy.



The combination of the common Euro currency and the domestic policies which redistributed income from workers to business, allowed Germany to grow at the expense of their trading partners – mostly Southern European countries.

However, since 2011, Italy, along with every trade deficit country of southern Europe, has seen a dramatic improvement in their trade balance. Yet, notice in the charts above, this improvement did not come at the expense of Germany - which would have represented a proper rebalancing. In fact, Germany's trade surplus actually increased over this time. Instead, the improvement in the trade balance of every European country, since 2011, came at the expense of the rest of the world – particularly the United States, as the Euro depreciated by 30% from 2011-2015.

As a result, Europe now has the largest trade surplus in the world – double that of the next largest, China.



Why persistent imbalances are harmful

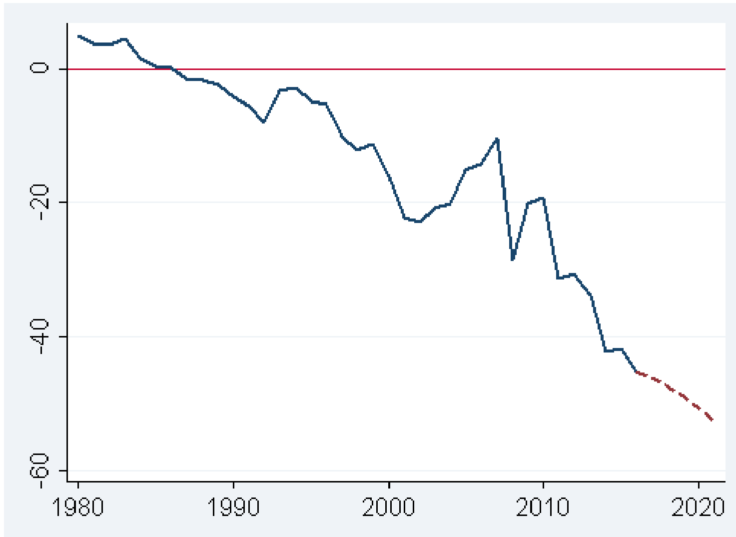
There are two main reasons why global trade imbalances are harmful.

1) A country running a trade deficit is trading financial assets in exchange for imports. Therefore, large and persistent trade deficits run by countries, like the US, means that the US must continually sell assets or increase their debt obligations to the rest of the world, which puts the US and the global economy at risk.

According to the Bureau of Economic Analysis (BEA) estimates, foreign financial claims on US residents and institutions exceeded US claims on foreign residents and institutions by $8.4 trillion, implying a negative Net International Investment

Position (NIIP) of -45% of GDP. <u>Never in history has one country owed so much to the rest of the world.</u>

US Net International Investment Position, 1980-2021 (percent of GDP)



Note: Dashed line is forecast starting in 2017.

Sources: External Wealth of Nations database, IMF World Economic Outlook database, US Bureau of Economic Analysis, Cline (2016), and author's calculations.

2) A persistent imbalance is a sign that there are significant policy distortions which are impeding the ability of the market from operating efficiently, with capital going to fund investment in areas with the highest expected return on capital and goods being produced in places with comparative advantage. A persistent imbalance is a sure sign of capital misallocation.

There is one startling fact that highlights the sheer scale of the capital that is being misallocated as a result of the policy distortions that have led to the persistent global imbalances: **<u>The US reports higher earnings on its foreign assets than it pays on its foreign liabilities despite its foreign liabilities exceeding its foreign assets by $8.4 trillion.</u>** Why are US investors so much better at investing their foreign capital than the rest of the world? Because the rest of the world isn't investing their capital based on where they think it will have the highest return. They're investing it where they can steal the most GDP.

The Inevitable Balance of Payments Crisis

The European crises is a classic balance of payment crises. Starting with the introduction of the Euro, the countries of Southern Europe began running increasingly large and persistent trade deficits with the countries in Northern Europe. The natural feedback mechanisms, such as falling relative interest rates or a depreciating currency, were absent because the growing deficits in Southern Europe were almost exactly matched by the growing surpluses in Northern Europe. As a result, the trade balance of the Eurozone in aggregate was stable.

As any 19th or 20th- century economist would have known, these persistent imbalances were a recipe for disaster. Beginning in 2010, interest rate spreads (a measure of default risk) in the Southern European countries began widening until reaching its nadir in mid-2012.

The automatic consequence of the persistent trade deficits in Southern Europe were a rapid buildup of debt. Importantly, the reason that the European trade imbalances turned into a crisis while the persistent trade deficits in the United States have not, is due to the fact the European countries effectively borrow in foreign currency due to the workings of the common Euro currency (it is a monetary union but not a fiscal union). The United States, on the other hand, borrows in its own sovereign currency and thus will not default on its debt. However, that is not necessarily good news.

Default risk has caused foreigners to avoid buying financial assets- debt - of the Southern periphery. Fewer purchases of financial assets results in more purchases of goods and services. As a result, the trade balances of the Southern Euro periphery have improved.

Rather than a crisis forcing a rebalancing of the US trade deficit, countries are likely to continue sending the US capital flows, dragging US growth lower through continued trade deficits. Until President Trump, the United States has sat by idly allowing countries to resolve their own domestic imbalances by stealing demand from the US.

Europe has only averted an economic depression because the global trading system has allowed Europe to replace their lack of domestic demand by taking demand away from the rest of the world. With the introduction of negative interest rates, the European Central Bank was able to orchestrate a 25% deprecation in their currency relative to the US dollar. As a result, despite a sharp drop in European demand, European production has actually increased, with the gap filled by foreign demand.

Below is a step by step guide of how you effectively force the rest of the world to resolve your own domestic economic issues.

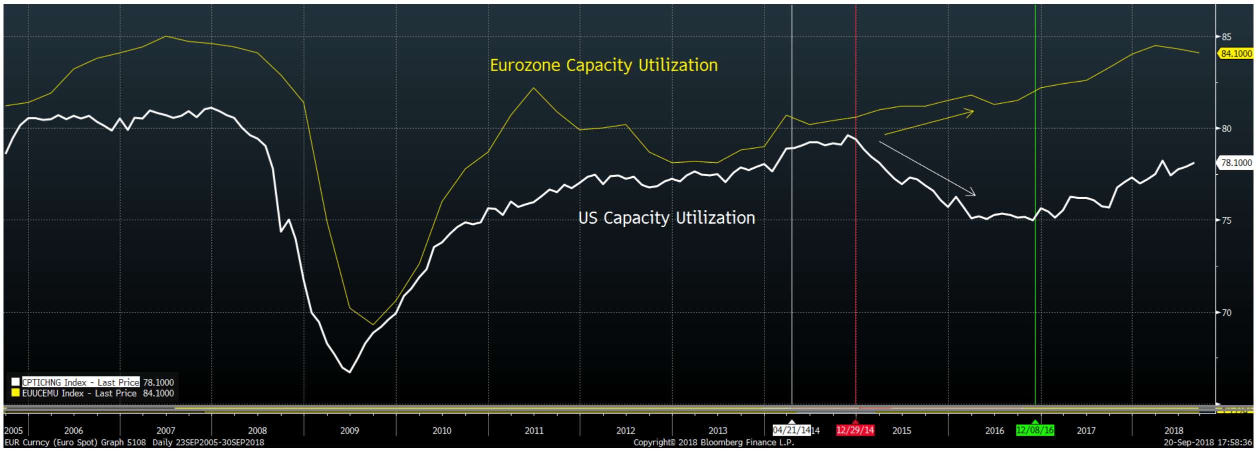
The anatomy of a beggar-thy-neighbor strategy

Beginning in 2014, Europe began engineering a depreciation in their currency to increase the competitiveness of their exports and steal demand from the rest of the world.

Step 1) European interest rates diverge from the US. Notice that interest rates didn't even diverge during the 2011-2012 debt crises but they did with the ECB's unprecedented quantitative easing and negative interest rates:

Step 2) Negative interest rates on European bonds resulted in a 25% drop in the Euro exchange rate with the US dollar in less than a year:

Step 3) Falling currency made European exports cheaper for the rest of the world. While an appreciating US dollar led to a drop in demand for US goods and services. Beginning in 2015, European manufacturing capacity utilization improves despite weakening European and global demand. However, US manufacturing was not immune to weakening global demand. US capacity utilization dropped meaningfully while Europe's improved despite US domestic demand being stronger than EU domestic demand.



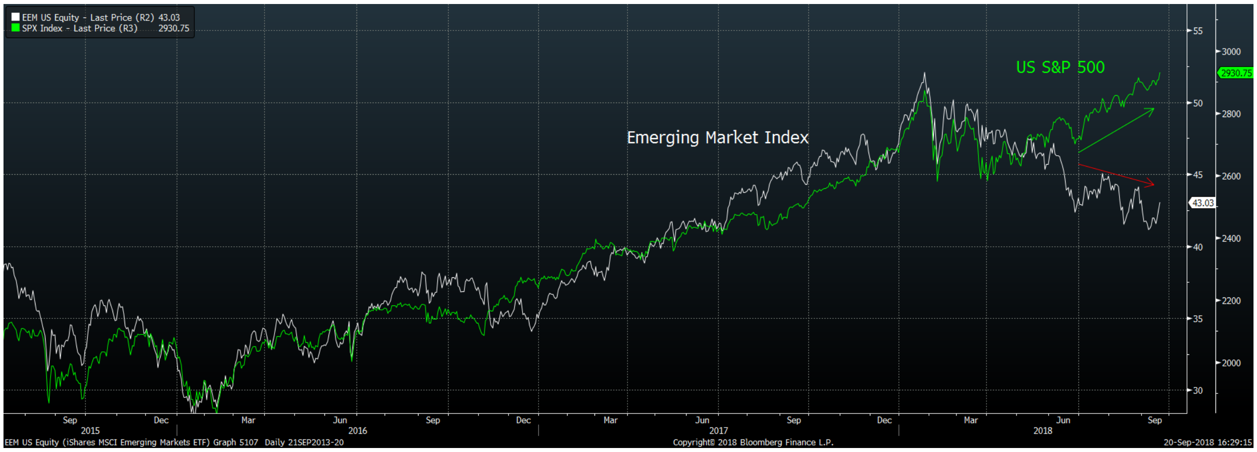
The source of Europe's manufacturing improvement and the US' decline was all a result of diverging trends in export demand. European exports increased by 6.5%, despite falling global industrial production during this time, while US exports declined by 7.3%

Myth #3: President Trump's tarrifs will help reverse the US trade deficit

Today, the volume of cross-border capital flows dwarf the volume of international merchandise trade. As a result, the global imbalances are a result of distortions on the capital account, not the trade account. However, President Trump's administration is viewing trade the way it was a hundred years ago. Restructuring trade deals and placing tariffs on our trading partner's exports will not reduce the US' trade deficit because the trade account is forced to adjust to whatever decisions investors and foreign governments are making in the financial markets and those decisions have little connection with trade. In other words, the trade account is just adjusting to the decisions being made in the capital account.

Tariffs can impact the economy, by reducing demand, but they will only impact the US trade balance to the extent that they affect capital flow decisions. Ironically, tariffs are more likely to increase the US trade deficit by increasing risk-aversion in the global financial system. When global risk-aversion rises, investors seek safety, which means moving capital out of places like Emerging Markets and into US markets. It appears that the President's tariffs have already caused an increase in global capital flows into the US seeking safety.

Note the divergence between the Emerging Market Index (white) and the US S&P 500 (green):



It is not rare for the S&P 500 to outperform the EM Index; however, the outperformance usually occurs with both indexes moving in the same direction – i.e. the S&P either increasing more or decreasing less. The complete decoupling, which began in May, is exceedingly rare. The first tariffs went into effect on June 1st. Over that time the S&P 500 is up almost 9% and Emerging Markets are down 6%.

Global risk could quickly subside and reverse the capital inflows of the last several months. Yet, the point remains: tariffs will only impact the trade deficit to the extent that it affects financial markets because the trade balance is simply adjusting to whatever decisions are being made in the capital markets and not to changes in production costs.

Economic Outlook

By Josh Husted

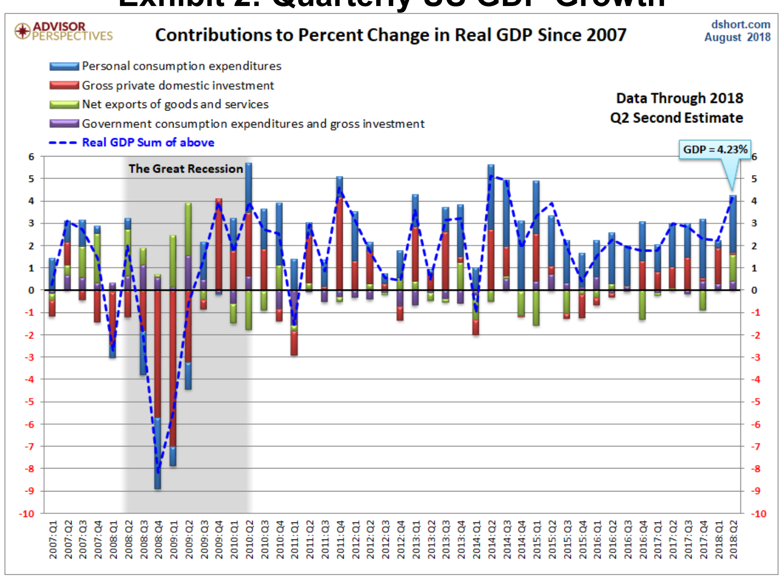
Age is a favored measuring tool of the discerning. Advice bears more weight from the experienced; wine is prized more as the vintage matures. However, relying solely on the age of the current economic cycle in order to determine its end will lead to false conclusions. We caution our readers to focus on the underlying drivers of a period of economic expansion, then analyze those in any attempt to form a conclusion. This report will serve to provide the reader an update on these drivers.

Source: Note: Real GDP drawdown are using annual per capita real GDP.
Source: NBER, Louis Johnston and Samuel H. Williamson "What Was the U.S. GDP Then?" MeasuringWorth 2018, Bernstein U.S. Economics analysis

GDP Growth

Q2 GDP growth accelerated sequentially with a strong 4.23% click (an upward revision from the initial estimate of 4.1%). Bolstered by high consumer confidence, tax cuts, and strong purchasing power, the US consumer led the charge, accounting for 60% of overall GDP growth.

Exhibit 2: Quarterly US GDP Growth



As cited in past outlooks, personal consumption as a percentage of GDP continues to loom large as its single biggest component. At 69.4% of GDP (just below its record high), PCE's outsized influence makes tracking the health of the US consumer of the utmost importance. The mid to late cycle state of wage inflation is dissimilar to past economic cycles as wage growth, while positive, has been rather anemic. Despite record low levels of unemployment, Main Street is just now starting to enjoy the benefits of this economic boom that Wall Street has been enjoying for quite a while. A unique blend of moderate inflation, low interest rates, a strong dollar, and the tax cuts have all contributed to the health and strength of the US consumer thus far. However, wages will need to continue to rise for this renewed health and strength to be sustainable. As a point of potential risk, we advise our readers to monitor overheating wage growth- wage inflation above 4% has historically represented a leading recession indicator.

Exhibit 3: PCE as a % of GDP

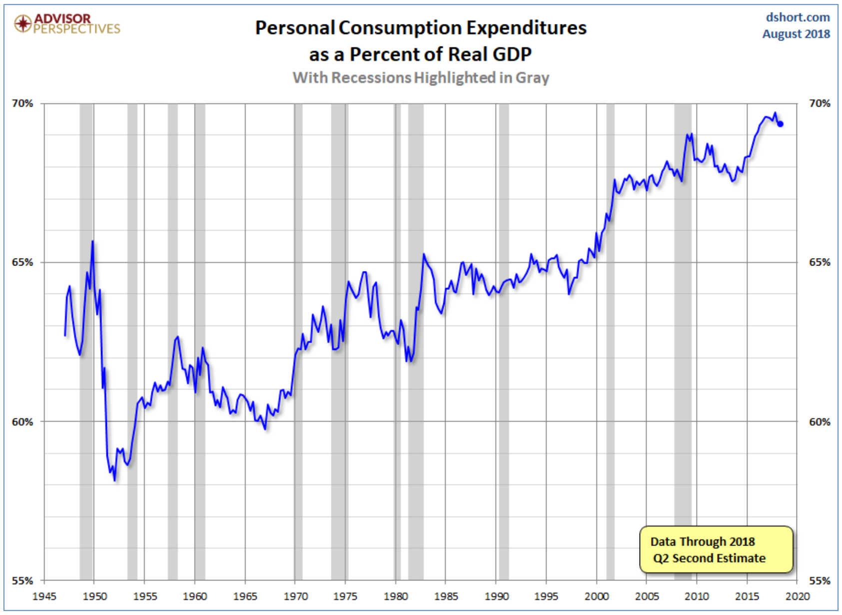
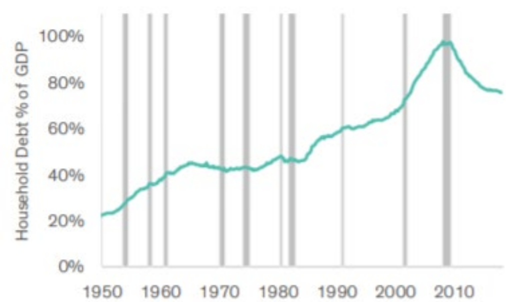


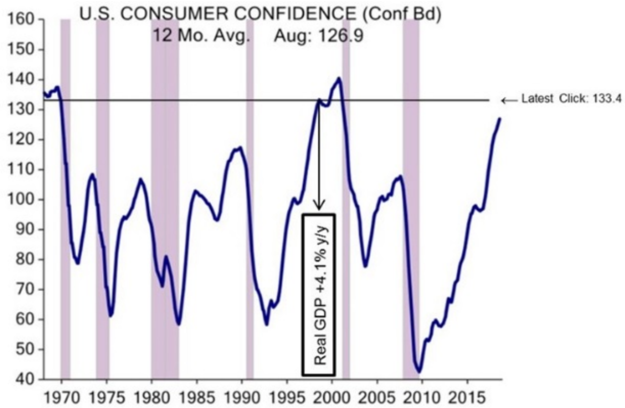
Exhibit 4: Household Debt

Consumer balance sheets have de-levered, with household debt as a % of GDP levels continuing to decelerate from their peak in 2008. Despite historically low interest rates, banks' willingness to lend, and rising employment numbers, the American consumer is hesitant to rack up debt, likely still wary of the Great Recession. Disaggregating household debt levels, we find student loans and auto loans are soaring; however, mortgage debt as a % of GDP continues to decelerate.



Source: Federal Reserve Board, BEA, NBER, and Bernstein U.S. Economics analysis

Exhibit 5: US Consumer Confidence



Consumer confidence continues to accelerate as rising housing prices have pushed household wealth above $100 trillion for the first time in history. This rise in sentiment has been coincident with continuous negative coverage of the administration's policies by the media and leading economic voices in the academic community. The divergence suggest that the US consumer is either skeptical of the prevailing wisdom, or unconcerned with its potential impact. Suffice it to say, a bullish consumer with the optionality to lever up is a positive tailwind for an economy largely fueled by personal consumption.

Employer Strength

According to the ISM, economic activity in the manufacturing sector expanded in August and the overall economy grew for the 112th consecutive month. August PMI registered at 61.3, an increase of 3.2 points from the July reading of 58.1. Demand remains strong, with the new orders index at 60 or above for the 16th straight month. Tariffs are pressuring input and commodity costs up, with the general consensus among survey respondents that uncertainty will rein until the trade wars are resolved.

Exhibit 6: US Small Business Optimism

US corporate profits (historically a 2.5 year leading recession indicator) are healthy and continue to make new highs with accelerating growth. Small business optimism hit a record high of 108.8 last month. Of note, we've never had a US recession with corporate profits doing well.

Critical to continued economic expansion is strong CAPEX investment. The administration's fiscal policies have given US corporations an influx of cash through tax cuts, repatriation, and deregulation. In turn, these corporations have deployed that capital. NFIB's latest report has the percentage of business owners planning CAPEX investment up from 30 to 33. We view CAPEX spending as an important component of continued length of the current economic cycle. CAPEX spend is critical to driving productivity gains and preventing wage inflation from derailing growth. This dynamic was evidenced in Q2 as US productivity rose a solid 1.3% y/y, an acceleration from 1% in Q1. The increase in productivity softens the unit labor cost increase to business, bringing the net effect down from 3.2% to 1.9%.

While so many of the data points we track are optimistic, we would be remiss not to point out some of the risks, namely the unpredictability of the executive branch. The growing brouhaha over trade, "winning & losing," and treatment of our traditional allies threatens to add volatility to a global economic system which has relied on American leadership for decades. While 80% of business owners have declared their capital spending plans will not be affected by the recently enacted tariffs, continued protectionism and increased restrictions on the flow of goods will drive up capital and input costs globally.

Exhibit 7: Repatriation

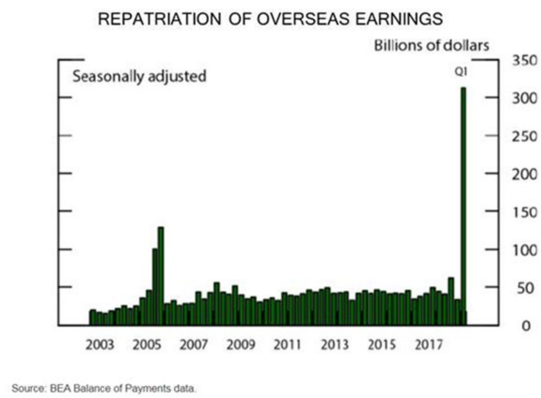
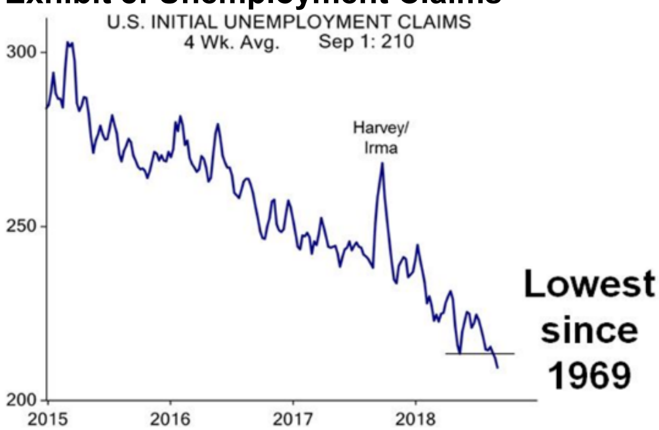


Exhibit 8: Unemployment Claims



Employment strength

Initial unemployment claims are within 1,000 of making a 50 year low and unemployment has dipped to 3.9%, a level traditionally associated with full employment. These data bode well for labor's claim on share of capital as a tight labor market pressures wage inflation up. There is a possibility of significant "participation reserves" wherein additional workers can be drawn back into the labor force, enticed by rising wages, agreeable opportunities, or the expiration of government programs. How large these reserves might be is uncertain; however, the labor force participation rate dropped by over 4% 2007 – 2015, leaving plenty of cushion for additional workers to return. If the reserves do provide sufficient to keep wage inflation tempered, this dynamic should combat the economy rising too far above its sustainable growth rate.

Exhibit 9: Disposable Income

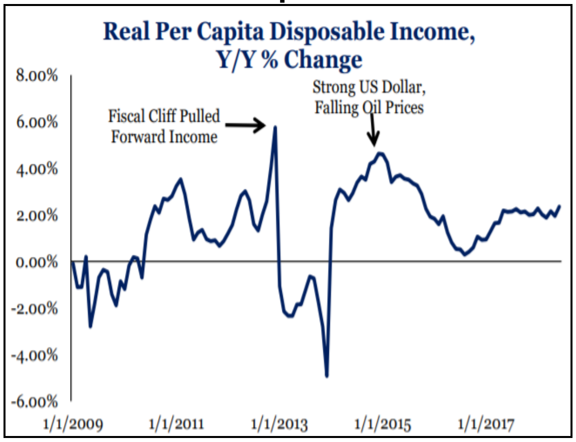


Exhibit 10: Average Hourly Earnings

While the tightening labor market has begun to pressure wages up, the wealth and income level recovery for hourly workers has lagged that of the broader market. Cyclical spending as a % of potential GDP sits at 24.8- well below prior cyclical highs of 28. From a cultural perspective, plenty of anecdotes exist to speak to the dissatisfaction of the working class. Politically, populism is more popular than ever, and the issue of income inequality is coming under much higher scrutiny. The old saying "something's gotta give" seems timely- that "something" is wage growth.

Exhibit 10 above illustrates how anemic the rate of wage growth has been since bottoming out in 2012. At its current rate, AHEs won't hit 4% (a 2 year leading recession indicator) for another 7 years. As a potential risk factor, we note that if this dislocation in wage growth is structural and not transitory, it could present a major headwind to consumer spending as inflation erodes consumer purchasing power.

Recession Risk

With the yield curve spread sitting at 25 bps at the time of this writing, any misstep by the Fed or shock to the economy could send the curve into inversion, triggering a key recession indicator that is considered by many to be settled law. We recommend a more nuanced view of the yield curve as some Fed members believe the flattening is technical in nature and inversion could be a false flag this time due to strong economic data.

While an inverted yield curve may not hold the predictive power it once did, its occurrence could still introduce increased volatility into the markets as participants are trained how to react to an event such as this. Event trading strategies, algos, and quants could all behave in such a way that ignores other data points and singularly focuses on this data point.

Exhibit 11: Recession Signals

Indicator	Years to Recession Signal
1. AHEs	7 years
2. Cyclical Sectors % GDP	6 years
3. LEI	5 years
4. Housing Starts	3.5 years
5. Fed Funds	2.5 years
AVERAGE	***~5 years***

Exhibit 12: Leading Recession Indicators

Indicator	Years from Peak to Recession
1. US Banks' Willingess to Make Loans	2 years
2. S&P Earnings	4.5 years
3. US Corporate Profits	2.5 years
4. Housing Starts	2.5 years
AVERAGE	***~3 years***

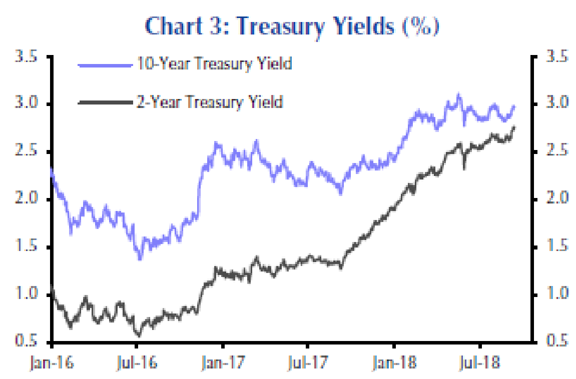
While we are closely monitoring risk factors, we remain constructive on the overall economy. Gauging the health and length of cycles must be an exercise that looks at multiple data points, taking historical patterns and filtering them through the lens of current constructs. We recommend our readers block out the headline noise that threatens to distract and focus on the underlying drivers of the economy.

RSA PORTFOLIO STRATEGY

Interest Rates and Fixed Income Strategy

By Lance Lachney

While the majority of us believe the earth to be round in shape, there are a few who swear that it is indeed flat. No need to worry, these observers have mistaken it for the yield curve. At the time of our last meeting, the treasury yield curve was quite flat. Today, it is flatter. For all the discussions, interpretations, and ramifications of this phenomenon, it is doing what it is supposed to do. Monetary policymakers raised the federal funds rate by 25 basis points in March and June. They will do so again this week and according to the market, another one in December is a virtual lock. For better or worse, these are the facts.



Source: Thomson Reuters

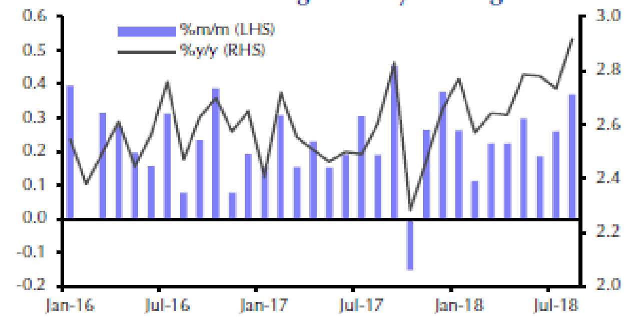
Through the end of August, credit markets have remained range-bound producing little to no return. Just as treasury yields began to recover from the political upheaval in Italy by mid-June, they were sent right back down to the low end of the range as trade tensions and emerging market weakness came into focus. Treasury market returns were essentially flat in June, while high grade corporates underperformed for the fifth consecutive month. Spreads gapped wider during the latter half of the month as supply accelerated within a risk-off move in financial assets.

Just like clockwork, risk assets rallied meaningfully during the first month of the third quarter. This move to the upside was helped by strong corporate earnings, healthy economic data, and plugging your ears with your fingers when the term “trade” was mentioned. Corporate debt provided an excess return of approximately 130bps, wiping out the losses from the previous three months. The technical backdrop also provided a lift as July produced the lightest amount of supply so far this year. Down in quality was still the trade to beat outside of equities, as high yield debt returned over 1.00% for the month. As one would expect given this environment, treasury yields rose and flattened along the way.

While equities enjoyed the month of August on the back of a trade agreement with Mexico, the fixed income market was more of a mixed bag. Treasury yields fell across the curve as weakness in emerging market currencies, like those in Turkey and Argentina, stoked fear of EM contagion. Corporate spreads widened at the margin due to heavy supply concerns after the Labor Day holiday. The Federal Open Market Committee took no action in August, continuing a pattern of raising rates at every other meeting since last December.

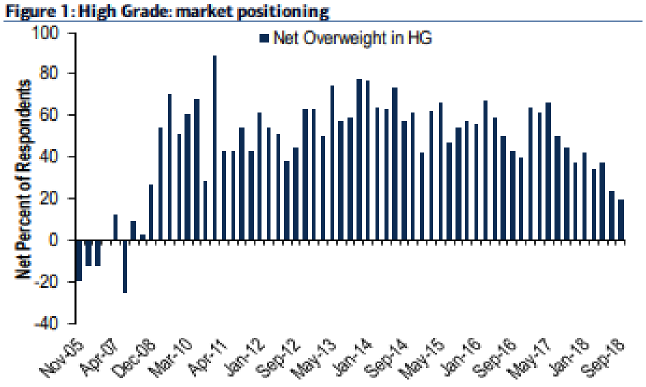
There has been a shift in sentiment over the last few weeks and the path of least resistance for rates has been higher. Fundamentally, the move towards the highs reached in May can easily be explained. The Fed has remained domestically-focused where economic growth and the labor market remain strong. Although tame, inflation is rising as wage growth has inched closer to 3.0%. While the cost of servicing government debt has been cheap, the budget deficit is widening and must be funded through new issuance. The Fed is also reducing the size of its balance sheet, albeit in a slow and reasonable manner. There is always a risk that the trade war spat with China evolves into something more that might affect its rather large presence within the treasury market. The recent pullback in the dollar and recovery in some of the emerging market currencies suggest the market is in the midst of another risk rally. Further evidence of this is being seen within sovereign bond markets as yields abroad are attempting to keep up with rates here at home.

Chart 5: Average Hourly Earnings



Source: Thomson Reuters

Figure 1: High Grade: market positioning



Source: BofA Merrill Lynch Global Research

While negative returns within fixed income are not desirable, the recent move has been beneficial to the fund at the margin. The fund remains underweight fixed income as a whole and is short duration relative to the index. During this time, we have been a reasonably active participant in the fixed income market. We have executed some trades that tighten up our tracking error within the mortgage portfolio and picked up additional yield within the agency space. In the corporate sector, we have continued to selectively add names in the shorter part of the curve that allow us to sleep easy at night. Cognizant of where we are within the credit cycle, our approach is to take advantage of what the market is bearing and not extending ourselves out the curve.

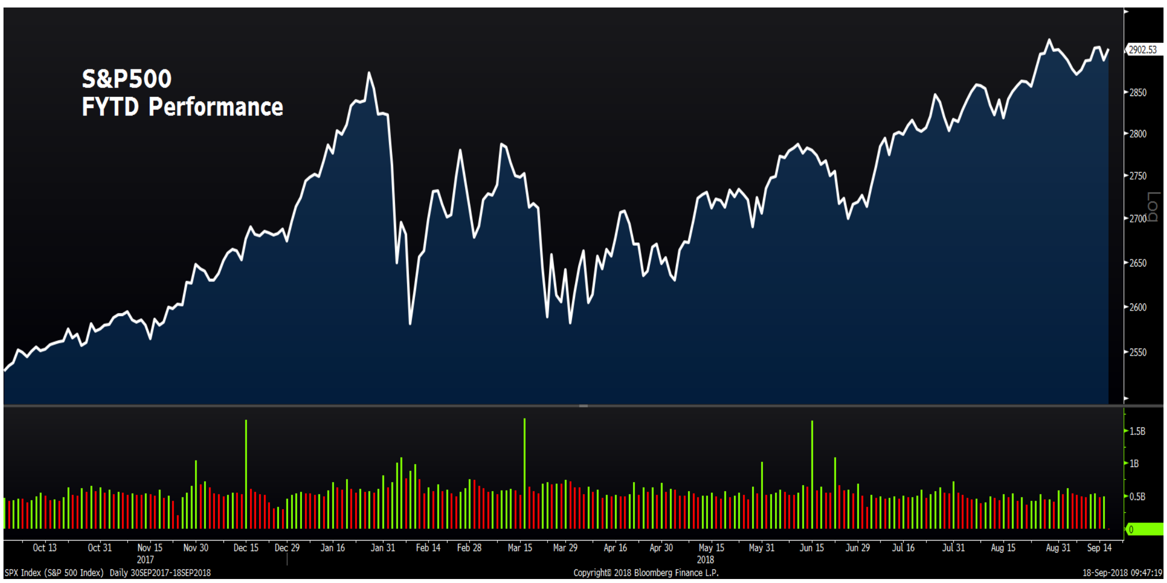
As previously stated, Federal Reserve Chairman Jay Powell and other monetary officials will raise short term rates this week to 2.25% at the upper end with another move highly likely to come at its December meeting. Things can definitely change as the Fed always leaves some wiggle room by being “data dependent”. Looking out into 2019, it is anyone’s guess on how things will shake out. However, as we move closer to the neutral policy rate, one which neither stimulates nor hinders the economy, Chairman Powell’s job is going to become more difficult. At the moment, the Federal Reserve is the only central bank that is shrinking its balance sheet. The European Central Bank is tapering its bond purchases and hopes to end this process by year-end. However, the ECB recently lowered its economic forecast for this year and next, with core inflation stuck around 1.0%. The rate differential between German Bunds and US Treasuries has now breached the 260bp level. The Bank of Japan is maintaining its 10yr target range and asset purchases for the foreseeable future. So while the recent emerging market hiccup appears to be in the rear-view mirror, the question remains how global risk assets will respond to further rate increases. The Federal Reserve holds a domestic-based mandate like most countries, but those countries do not carry the world's reserve currency. Intuitively, as the rate of return on safe assets rise, the global appetite for risk assets should fall. It will be a delicate balancing act for policymakers going forward after a decade of easy money.

Domestic Equity Strategy

By Adam Rogers

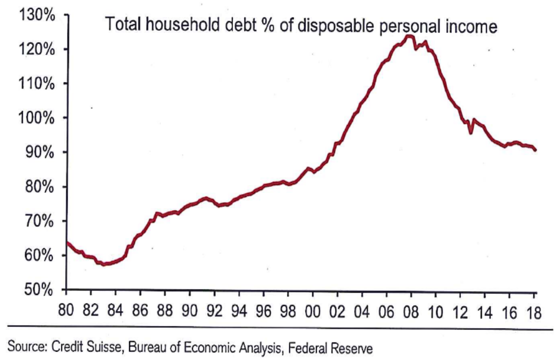
In June, when we last met, Allan Carr described the rollercoaster first half of 2018 where we witnessed multiple big market swings. The remaining summer months have been more like a lazy river for the equity indices, uneventfully trending and tacking on an additional 4.84% for large cap stocks (5.2% including dividends). This brings the total return for the calendar year to 10% and 17.3% for our fiscal year. On the following pages, we will aim to clarify the backdrop we see for US equities, beginning with a bird's eye view of the economy, earnings, and valuations, and then moving into market sentiment and addressing the primary concerns making the rounds this quarter.

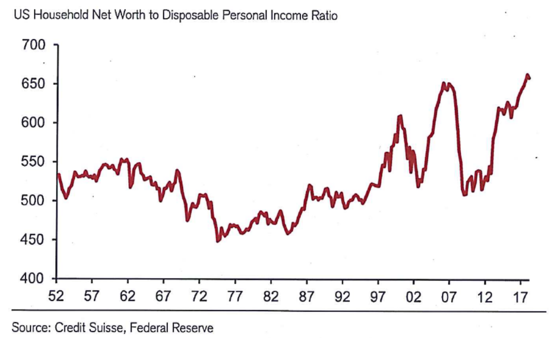
Exhibit 1



Beginning with a quick look at the health of the consumer, favorable trends continued through the second quarter. Confidence is high, unemployment is low, and consumer debt levels continue to paint a picture of restraint when judged by income. As a share of income, total household debt burdens have been declining continuously over the past 10 years. Most importantly, consumers have also shifted much of their borrowings to longer maturity, fixed rate products, mitigating (not eliminating) their sensitivity to higher rates (Exhibit 2, Credit Suisse).

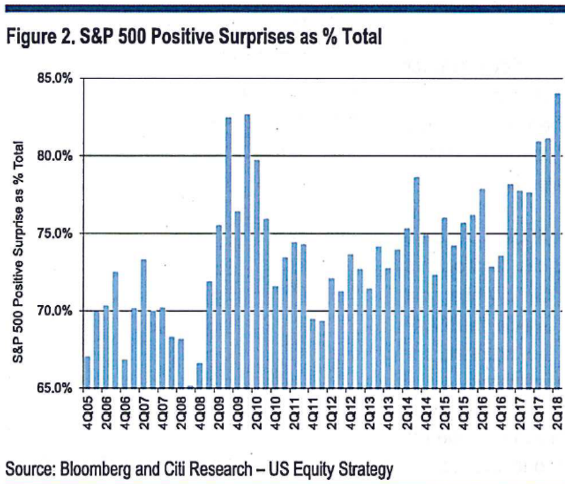
Exhibit 2





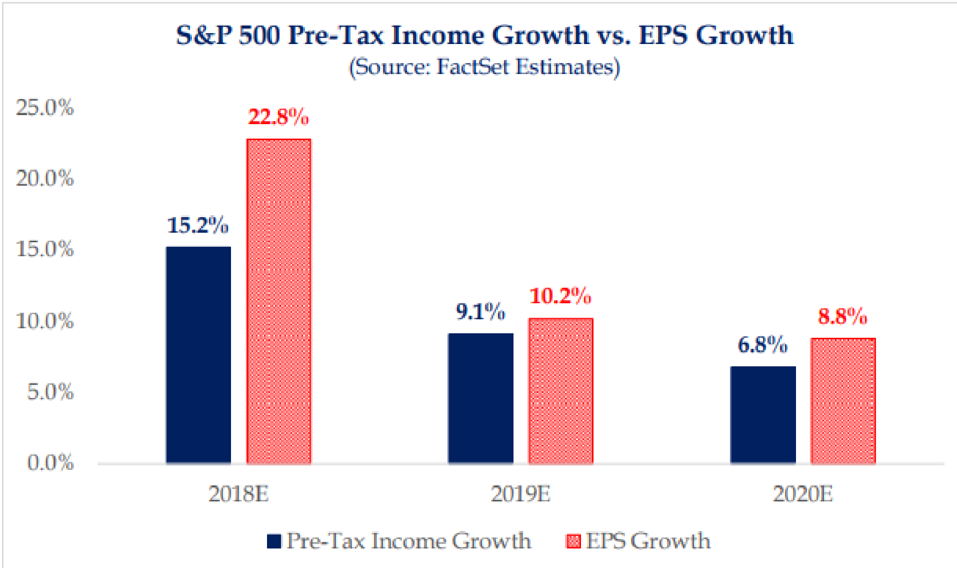
The corporate side also continues to impress. The second quarter marked the highest percentage of companies reporting earnings above the consensus we have seen in quite some time (Exhibit 3, Citi).

Exhibit 3



Indeed, earnings have been nothing short of amazing. The consistency across the market during the second quarter of beat and raise reports is the most I can remember in my 13 years here. What's driving it? Obviously, the decrease in the corporate tax rate played a significant role, though it is difficult to quantify the exact market-wide impact. The benefits of the change in treatment of overseas income, a 21% domestic tax rate rather than 35%, and 100% first-year depreciation write-offs for cap-ex boosted earnings somewhere in the range of 35-45%. The effect of the tax cuts has led many to discount the quarter as an aberration, though we would point out that for the year, topline numbers grew 10% and pretax earnings grew 15% (Exhibit 4, Strategas).

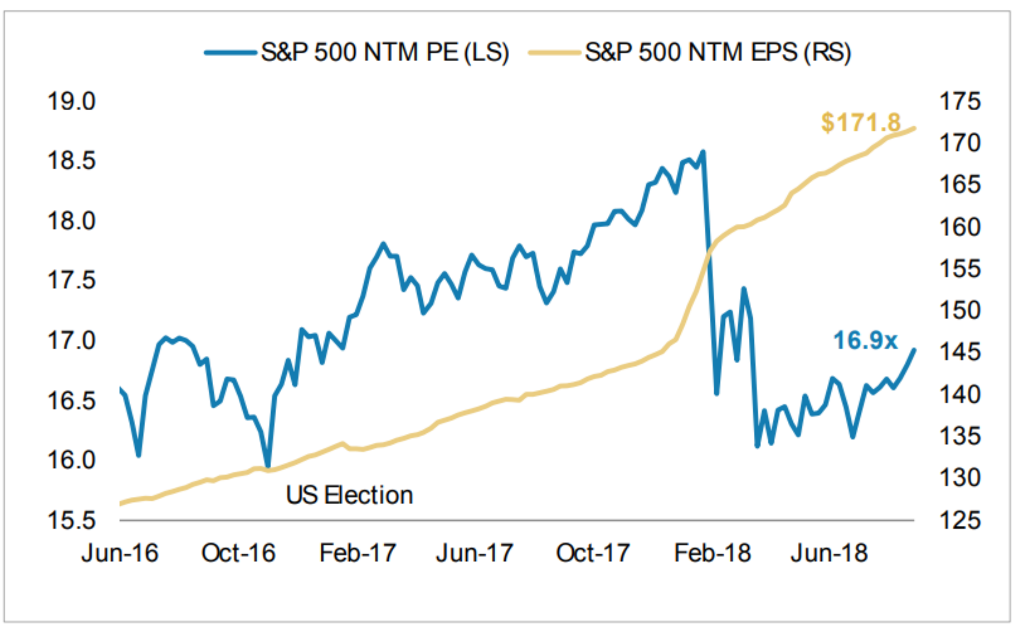
Exhibit 4



The jolt from tax reform has the investment community concerned about the second derivative, meaning a slow down in the growth rate next year. Understandably, the mulitple on next years earnings has dropped as the growth rate is indeed expected to slow, though it will still be positive. The important take here is that recent returns have been driven by earnings, not rampant speculation and mulitple expansion (Exhibit 5, Morgan Stanley).

Exhibit 5

NTM EPS Has Risen Parabolically While PE Has Dropped



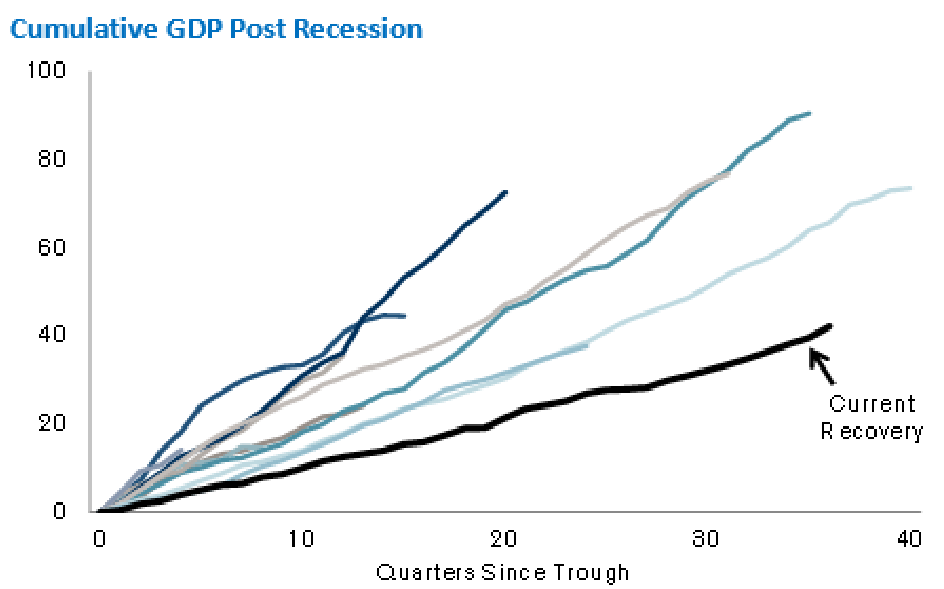
Source: FactSet, Morgan Stanley Research as of August 31, 2018

Sentiment

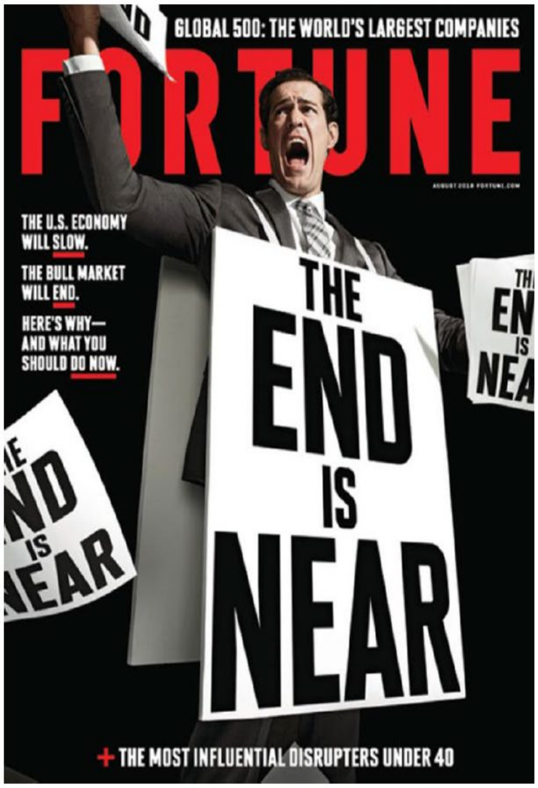
With good economic news, strong earnings, and reasonable valuation, one would think sentiment would be getting stretched. Instead, the prevailing rhetoric circling this bull market are references to its incredible duration, and with that the repeating question, “How much longer?” Much like kids in the backseat of a car, there is an unsettled impatience and a peering over the horizon, desperately searching for the answer to “Are we there yet?” Each new high or positive economic development is met with skepticism and warning, rather than peace and confidence.

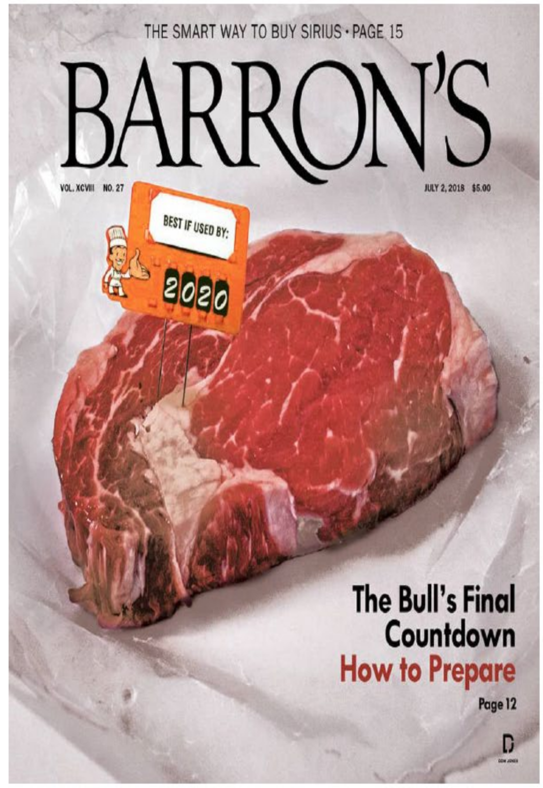
We have said many times bull markets do not die of old age. This one has indeed been long by historical standards, but we must remember how shallow and slow much of it has been compared to past expansions. A long period of low inflation and interest rates followed the financial crisis. Given the modest growth shown during much of the early recovery period, it is less surprising it has lasted this long without generating the excesses normally seen after this amount of time has passed (Exhibit 6, Credit Suisse).

Exhibit 6



Nevertheless, it seems no amount of price performance or earnings strength is enough to change investor's jittery disposition and create some excitement. Today, it appears the trusty wall of worry is still intact as the news stays ominous and the market keeps climbing. Part of this is due to the nature of "news." Bad news makes a headline while gradual improvement is a less interesting topic.





Speaking of news, we realize that magazine covers are hardly empirical evidence, but the sober and cautious sentiment in the August issue of *Fortune* sums up consensus quite well. Not exactly a celebration of all-time highs. Below are a few more headlines we have seen recently.

Stocks' Return to Records Paves Way for Volatile Autumn

Fears of broader contagion from EM sell-off

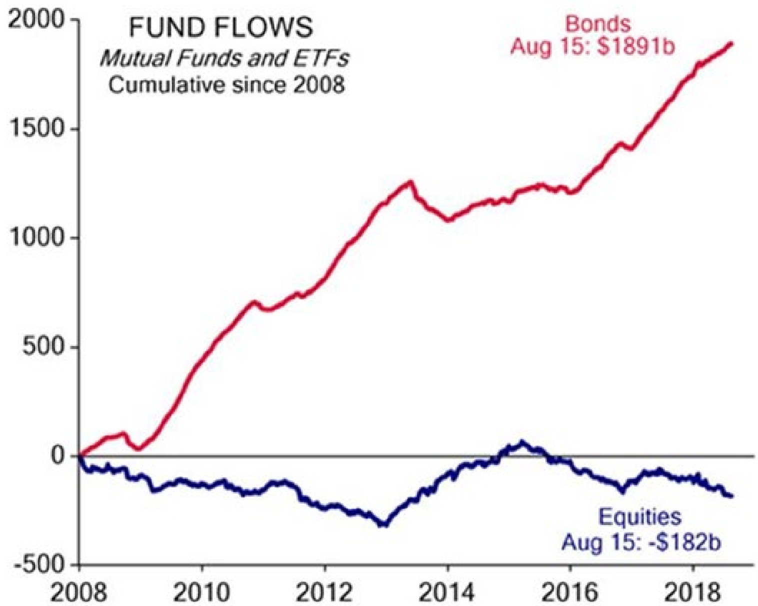
It's Beginning to Look a Lot Like a Crisis

Enjoy Labor Day Because September Could Bring 'Carnage' to the Stock Market

JP Morgan's top quant warns next crisis to have flash crashes and social unrest not seen in 50 years

Fund flows line up with the headlines, providing empirical evidence of sentiment. Net redemptions of domestic equity mutual funds and ETFs is $70.2 billion YTD. As we mentioned last quarter, individual investors and young investors in particular are sitting this one out. In an attempt to quantify this, Vanguard published a white paper this summer examining the different risk appetites across generations. Most of their findings were fairly boiler plate but the most interesting revelation is that, "*Millennials who started investing at Vanguard after the global financial crisis are more than twice as likely to hold zero-equity portfolios as those who started investing before.*" Cumulatively, since 2008, Equity ETF and Mutual Funds have seen $182 billion of outflows, hardly euphoric behavior (Exhibit 7, ISI).

<u>Exhibit 7</u>



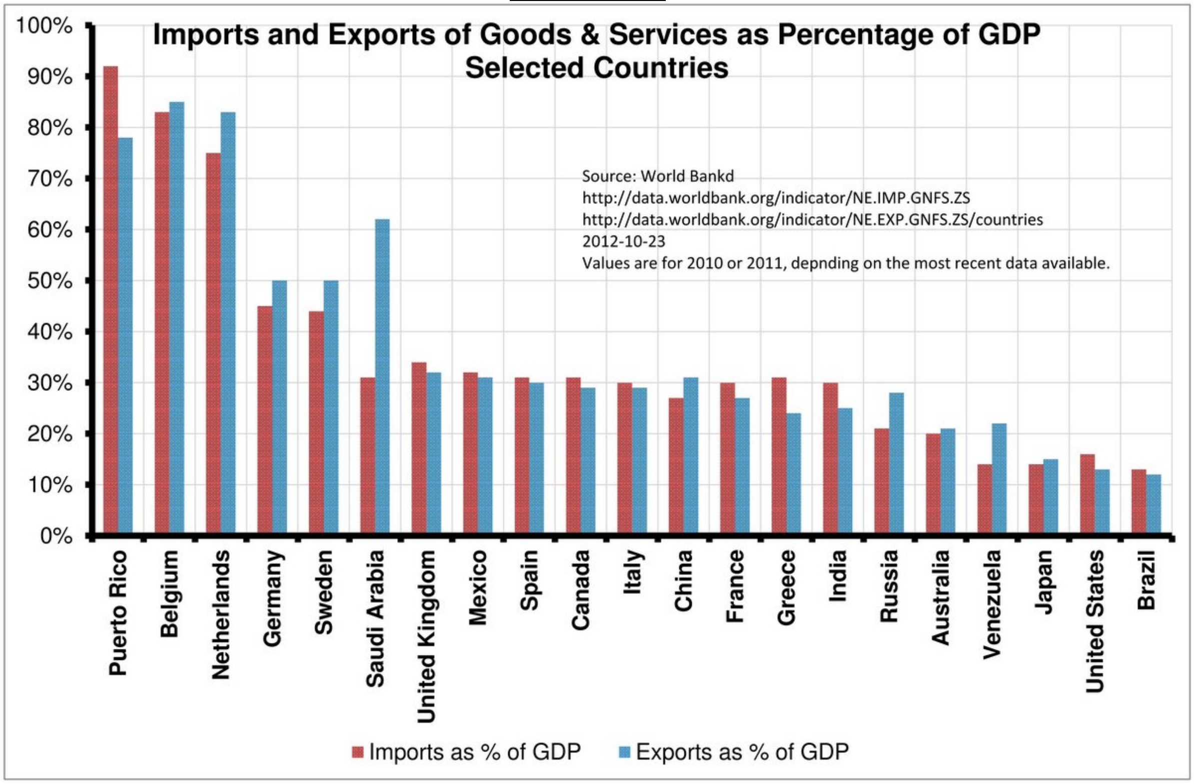
So obviously there is a nervous tension in the market. What is everyone so scared of? On the following pages we will take a look at the pressing issues of the moment, specifically trade wars, mid-term elections, and the yield curve.

<u>Trade Wars</u>

We will be the first to admit we have no idea what the President will tweet next on this topic and are completely unable to predict how the market will react in the short term to his announcements. What we can do is put the issue in context.

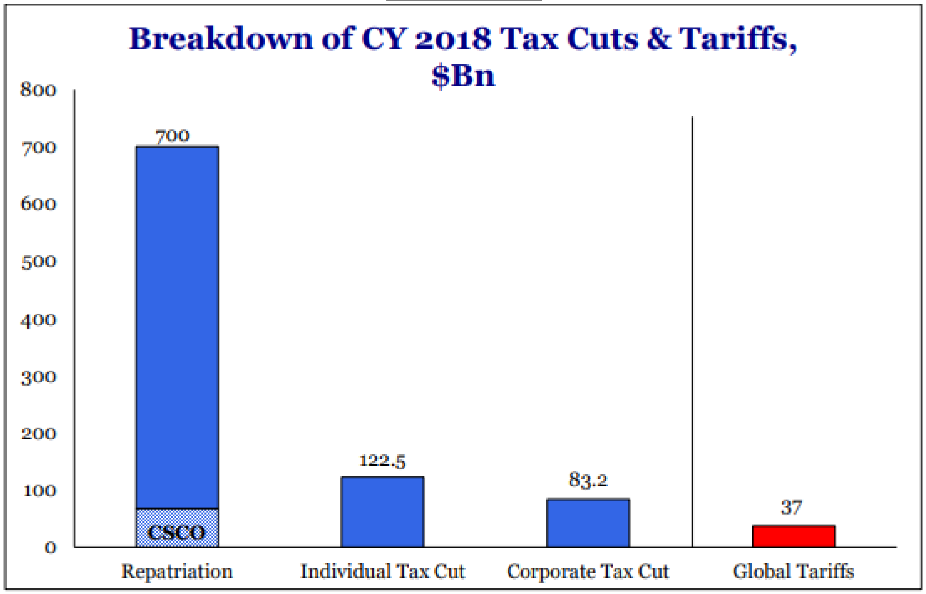
First of all, the US is one of the world's least trade dependent countries and not incredibly vulnerable to trade disputes. In the chart below, keep in mind that one-third of the import bar for the US is energy, a reality that is changing drastically with shale and horizontal drilling technologies. The relationship between surplus and deficit nations is complex and we encourage readers to check out the fiscal policy section of this report for a more thorough breakdown of this subject.

Exhibit 8



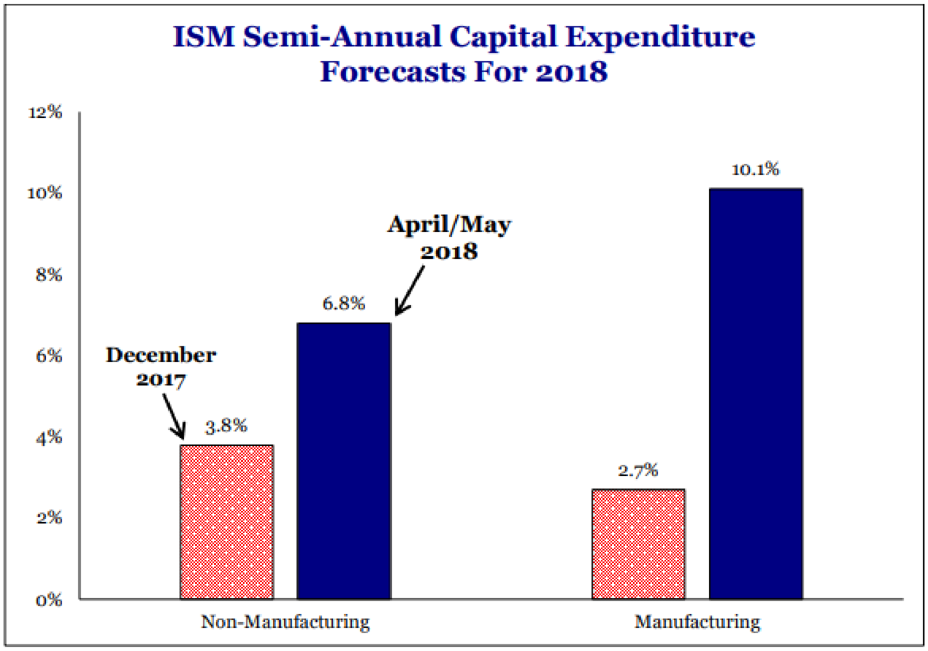
Second, now that we've established who holds the cards, let us put the size of the proposed tariffs in context. To briefly summarize, it is likely that total repatriation of cash back to the United States this year will be somewhere near $700bn. This is in addition to $120bn of tax cuts for consumers, $80bn for companies, and $100bn of new federal spending in 2018. Add it all up and we are looking at roughly $1 trillion of fiscal policy stimulus compounded by growing after-tax corporate profits. Cisco alone repatriated $67bn this year, nearly the size of the entire corporate tax cut. Meanwhile, if you flip on the news, all you will learn is that trade disputes and tariffs are destroying our economy. The total amount of global tariffs set to be implemented in 2018 is $37bn, a little more than half of what one company repatriated this year (Exhibit 9, Strategas).

Exhibit 9



There is still plenty of cash on its way back. US companies accumulated $2.6 trillion of unremitted foreign earnings prior to tax reform. The last repatriation tax holiday was in 2005 and companies returned $300bn of the $600bn held overseas at the time. This time there is even more incentive for companies to bring cash back. We expect most of it will be remitted over the coming years as companies decide how to allocate. We speculate much of it to this point has been used to shore up pension obligations as the tax bill specifically gave companies a 35% deduction through September for pension contributions. Going forward, repatriations will be used for buybacks/dividends, paying down debt, m&a, and capex. The important takeaway from this is that suggested tariffs and grandstanding by politicians captures our attention more than it should. This is not to say an all-out trade war would not be bad – it would create some noise, but we are not there yet. There are more important developments happening on the fiscal side right now that will have a much bigger impact on growth going forward. Take a look at how much business capital expenditure plans changed following the tax bill (Exhibit 10, Strategas).

Exhibit 10



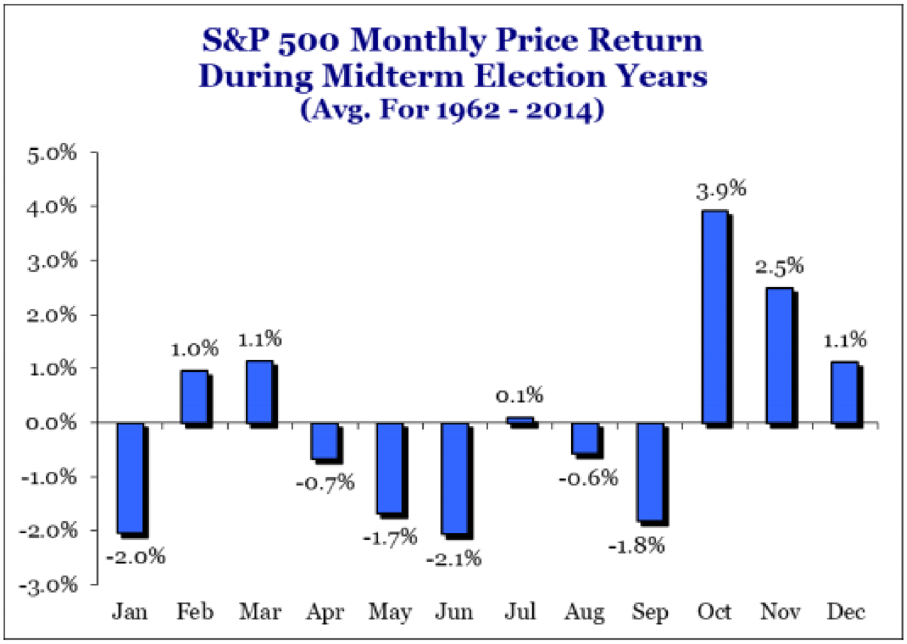
Mid-term Elections

The second worry on our list is the outcome of the mid-term elections, and the resultant policies or legislative actions which could arise. Voters have removed the party in power in five of the last six federal elections. This is elevated political volatility running concurrently with a growth rate that has been running under a long-term trend since 2008. As of this writing, betting odds place a 70% probability of Democrats taking over the House, making the sixth time in the last seven mid-term elections (Exhibit 11, Strategas).

Exhibit 11

As for what this means for stocks, there is no way to know what this year will bring. Historically, the market has traded sideways to down during mid-term election years, right up until the fourth quarter where the average return is 7.5%. The election is usually an inflection point and it does not matter which party wins, simply getting it out-of-the way has been a catalyst.

Exhibit 12

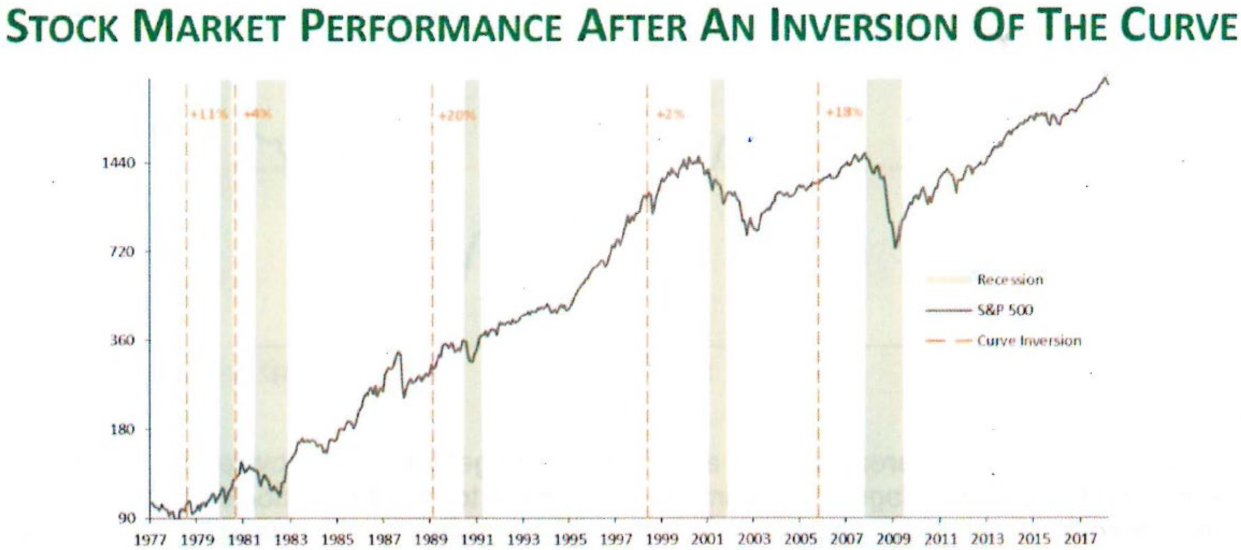


As for the actual policies, we are keeping an eye on any attempt to repeal portions of the tax bill, trade escalation/resolution, and impeachment are the three most impactful we see affecting the short term. One thing to keep in mind, though it is probably bad luck to mention, the S&P500 has not declined in the year following a midterm election since 1946. Markets enjoy certainty.

Yield Curve

Saving the best for last, the threat of yield curve inversion remains everyone's favorite boogeyman. We covered this topic fairly extensively last quarter so there is no need to retell the story as it has not changed. The curve is still flattening but has yet to invert, and the facts remain that flat does not equal inverted and inverted does not equal imminent danger. Here is a simple explanation of what is at work. In order to snuff out inflationary pressures, the Fed raises short term rates. Anticipating this, the market sells off short-duration securities pushing the yield up and eventually above longer-dated yields. Banks, which borrow short to lend long, become discouraged as their margins are squeezed. Loan growth slows and money creation through credit halts, usually triggering a recession. So when we look at the threat posed by the yield curve, we must also look deeper and more directly into banking margin and loan growth, which presently reveal a cycle more akin to mid-cycle than late cycle. Do not take this as dismissal, as we monitor the yield curve every day. But even something as drastic as inversion still provides ample opportunity to take action. As far as the yield curve is concerned, we still have time (Exhibit 13, Cornerstone Macro).

<u>Exhibit 13</u>



To summarize, we believe we are a touch closer to the middle innings of this expansion. There is a hint of some short-term froth, which a little time or a small correction should take care of, but the prevailing sentiment is cautious. This simply is not what you see at bull market tops. There have not been heavy inflows into equities, IPO activity is average, real interest rates, while rising, are still low and the hikes have been gradual. Earnings revisions are positive, the leadership in the market is fairly broad with the right sectors leading, and credit spreads are compressed. The big risks and sources of anxiety are a more aggressive Fed, mid-term elections, inflation, trade wars, and an inverted yield curve. We recognize all of these and do not completely discount their ability to cause some problems, but the investor base remains hyper-aware of these threats. We will continue to layer on protection on a portion of our index exposure, buffering downside while still leaving room for additional upside. We have also taken some profits and raised cash following strong recent returns.

International Equity Strategy

By Steve Lambdin

The global equity markets outside of the U.S. posted another round of weak results in the second quarter of 2018. The combination of U.S. Federal Reserve actions, growing uncertainty with regards to trade, and shaky political rhetoric in Europe all served to push international equity markets lower. Emerging markets were punished much more severely than the more developed markets. All of this led to a much stronger U.S. dollar and stripped nearly -5% from local market returns in the period. Needless to say, the movement in the U.S. dollar has been quite vicious on returns. Fueling this move has been the diverging policies of central banks around the world. The U.S. Federal Reserve (FED) seems to be firmly in tightening mode as investors see several interest rate hikes on the horizon from a strengthening economy. On the other end of the spectrum, the Bank of Japan (BOJ) seems comfortable being in the accommodative mode as they remain committed to bringing inflation up to the 2% level, which is still far reach from current levels. Somewhere between the FED and the BOJ lies the European Central Bank (ECB) and the Bank of England (BOE). Both are somewhat accommodative at present, but see curtailment of these policies taking place in the months and quarters ahead in an effort to follow the FED. However, we are not too sure this will work out as economic growth begins to wane and will be much slower than what we will see in the U.S. But perhaps the biggest issue investors are grappling with at the moment are the rising trade tensions between the U.S. and the rest of the world, especially China. Thus far, we only see modest progress with Mexico, while little progress has been made with China and tensions are rising by each passing week. The ultimate outcome of talks with China remain a wildcard, as both sides are hard to read and actions can take a multitude of different directions. Outside of this on the economic front, growth has probably peaked outside of the U.S. but still remains healthy enough to keep investors interested. Corporate earnings are healthy even as the growth rate cools in 2019. On the Brexit front, we still see little progress to speak about as both sides seem to be "miles" apart at the moment in their attempt to come to an agreement. Surprisingly, China's economic climate remains decent even with the potential trade war looming. How long this remains is anybody's guess at this point.

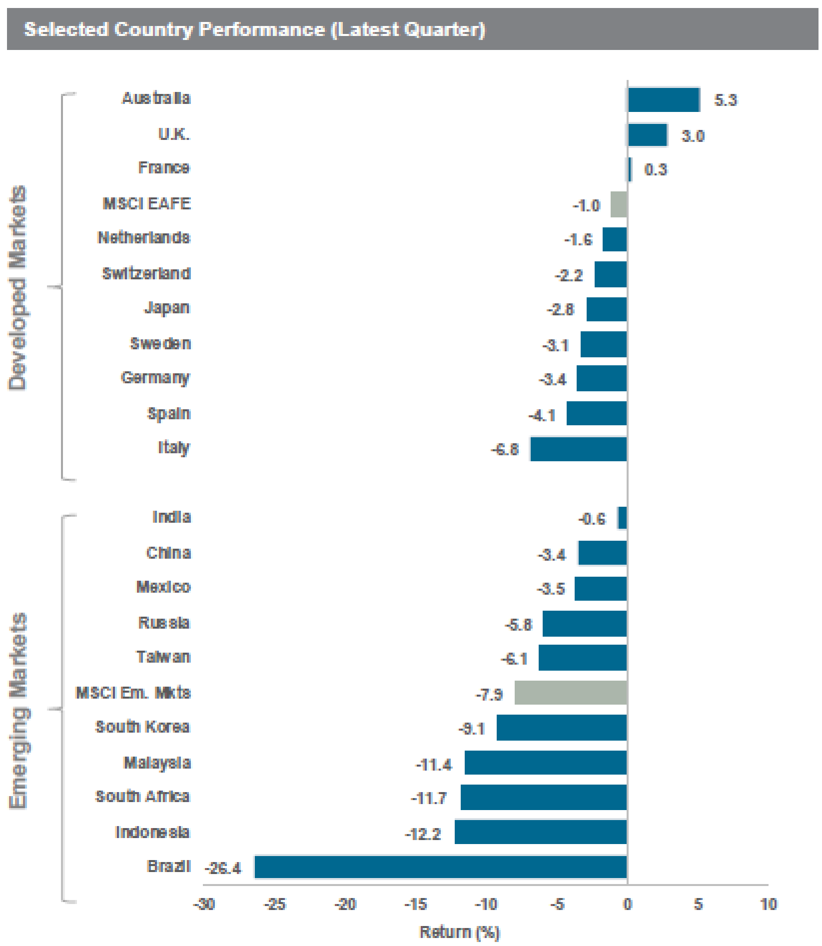
International Market Benchmarks

Equities	Representative	Q2 Return	YTD Return
Developed	MSCI EAFE	-1.2%	-2.7%
Europe	MSCI Europe	-0.9%	-2.7%
Japan	MSCI Japan	-2.8%	-1.8%
Asia	MSCI Pacific ex-Japan	1.8%	-2.0%
Emerging	MSCI Emerging Mkts	-8.0%	-6.7%

Performance returns as of 6/30/2018

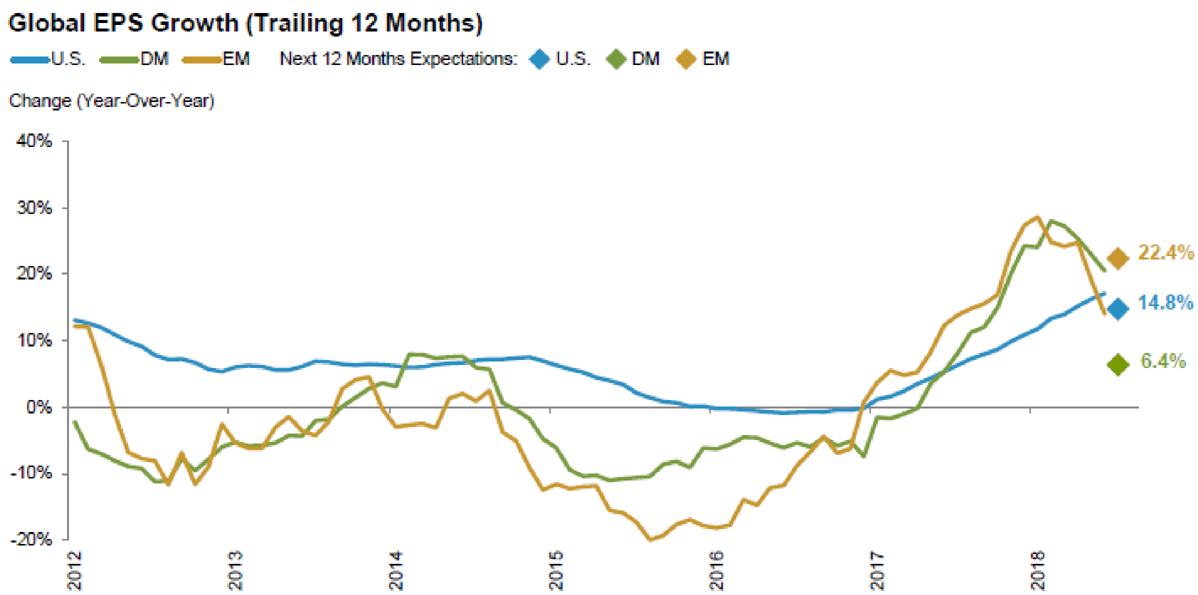
Source: Baird Market Update Q2 2018 Review and Outlook

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned -1.2% and -8.0% respectively during the second quarter of 2018 vs. +3.4% for the S&P 500 Index. The U.S. dollar slammed returns in the second quarter for unhedged U.S. investors as mentioned earlier. Had it not been for the -4.7% movement in the U.S. dollar in the period, developed market returns would have basically matched large cap U.S. stocks in the quarter. For the second quarter in a row, the Pacific region was a bit stronger than the European region, as Australian equities were very strong and helped overcome a weak Japanese equity market. From an economic sector standpoint, Energy and Health Care shares finished positive, while all other sectors finished in negative territory. Crude oil had a very strong rally in the last couple of weeks of the quarter, rising +14% in the period. Crude oil remains above the $70/barrel level for the first time since November 2014.



Source: Baird Market Chartbook; Morningstar Direct; MSCI

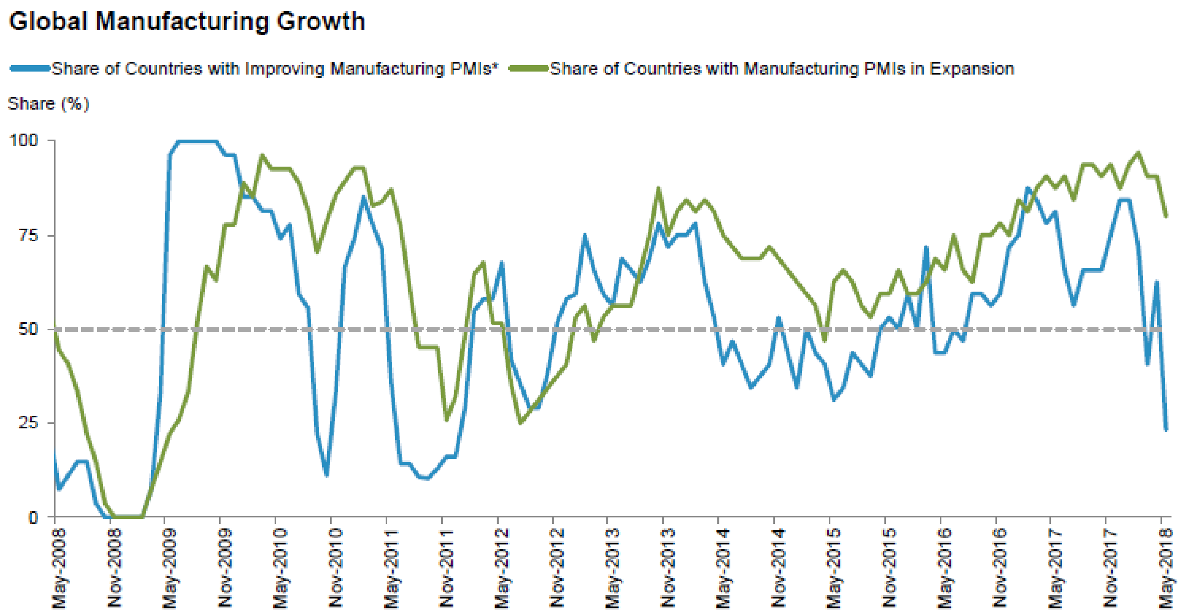
So far into the third quarter of 2018, global equities have been a mixed bag. U.S. stocks have been on a roll and have responded well to trade rhetoric and strong economic reports, while developed markets outside of the U.S. have surprisingly been relatively flat. Weakening growth trends in economic data points, a tense political climate in Europe, and a weak inflation outlook in Japan have come into play outside of the U.S. to put a lid on any potential equity rally thus far in the quarter. However, emerging market equities continue to be trounced on FED interest rate policy, political corruption in Brazil, possible expanding trade war, and policy problems in Turkey. These are a few issues that investors are grappling with at the moment. Even though the economic picture outside of the U.S. might be slowing a bit, we still see it as fairly healthy at the moment, which is subject to change of course. The MSCI EAFE Index is about flat, and the MSCI Emerging Markets Index is down approximately -3% through mid-September, vs. +7% for the S&P 500 Index. Investors simply cannot ignore the U.S. economic growth engine that has developed and equities have been quite good in this environment.



Source: Fidelity Q3 2018 Market Update; MSCI; Factset

Asia Update

For the second straight quarter, investors were met with dismal returns in this region. The MSCI Pacific region fell -1.4% in the second quarter, as currency movements masked better returns on a local basis. However, returns were quite different among countries in the region as the Australian and New Zealand equity markets where quite strong as exports really picked up due to currency movements. On the other hand, the Japanese equity market weakened a bit from the seesaw trade battle between the U.S. and China, falling -2.8% on a U.S. dollar basis. Defensive sectors performed much better than the cyclical sectors, as we would expect in a climate of trade turmoil. Chinese equities fell -3.4% in the quarter, but actually fared much better than the overall emerging markets index, as many other countries had a multitude of serious issues affecting their respective countries. We were a little surprised by this, but we believe it shows investors are trying not to overreact to the daily news on tariffs via tweets by President Trump. Overall we would characterize the economic climate as slowing a bit from previous quarters, but still healthy enough to foster further growth. All eyes are on trade relations between the U.S. and China at this point. Developments on this front will guide the equity markets over the near term.



Source: Markit, ISM, Haver Analytics, Fidelity Investments (AART)

The Chinese economy was relatively stable in the second quarter as GDP rose +6.7% from a year earlier, virtually identical from the previous quarter. This was a bit of a positive surprise to many investors as early jabbing between China and the U.S. over trade tariffs had yet to show up in any meaningful way. However, we could see the effects of this starting in the third and fourth quarters of the year. To what degree, we just do not know. Chinese leaders continued to make references to new growth initiatives in the quarter, especially targeting the technology, aerospace, and health care industries. As we know, these all are critical areas where the U.S. is well ahead of anyone around the globe. This is not by accident as we believe China is directly targeting these higher growth and higher technology laden areas. No doubt, this will pressure an already contentious relationship with the U.S. Peering further into some key economic data points in the period, industrial production continued to slip slightly in the second quarter and rose +6.6%, which was a slight deceleration from the previous quarter. This was about what most were expecting, as output may have peaked in some parts of the world. Fixed asset growth continued to slow as the year over year growth rate fell to just +6% in the first six months of 2018. This is probably what needs to happen as China slices excessive spending on needless projects. Exports and imports continued to grow rather robustly in the quarter as the trade surplus with the U.S. was the highest in any month going all the way back to 1999. Perhaps we are seeing robust activity take place before scheduled tariffs take place in July. We would expect Chinese export growth to slow down for the balance of 2018 as the trade war escalates. Retail sales growth was relatively steady as second quarter sales were up +9.0% from a year earlier, as the consumer seems somewhat healthy and engaged in the growth going on here. Inflation has been inching up lately as August consumer prices rose +2.3% from the year earlier period. Rising fuel and food prices were the main culprits. This still remains below acceptable targeted levels and should not be any real issue. At this point, everyone is watching what will happen on the trade front with many levels of tariffs scheduled to take place in the coming weeks and months. We believe as these transpire, the economic growth in China could be shaved by 0.3% to 0.4%, which would put growth in 2018 below the key target level of +6.5%. How the equity markets take this is somewhat of a wildcard. But we could be in store for a higher level of volatility going forward.

Source: Evercore ISI

The Japanese economy is back in growth mode after a pause in the first quarter. Second quarter GDP rose +0.7% from the previous quarter, or +3% from a year earlier. Recent revisions were fairly significant for this figure. This is the fastest growth rate in over two years. As we expected, growth came back on the heels of strong business investment. Capital spending was strong in the quarter as automation continues due to the lack of skilled workers in many sectors of the economy. Private consumption was decent as well and contributed to this growth spurt in the economy. Exports were very strong in the second quarter on the strong global economy and the movement of the Yen. However, recent data seem to indicate a slowing of this trend as trade rhetoric heats up between the U.S. and many trading partners, including Japan. This will be crucial for the next few months as well as movements in the Yen. Also, we have witnessed Japan's leading economic index slip a little lately, perhaps indicating a somewhat tougher business climate ahead. At its September meeting, the BOJ kept its short term rate at -0.10% and is still targeting a 10-year government bond target yield at 0%.

The BOJ is expected to keep its monetary stimulus program in-tact for some time to come, with little deviation expected. Industrial production has rebounded a bit recently as July rose +2.2% from a year earlier. This continues to be a mixed bag from month to month with no clear direction. Consumer confidence remains rather weak as August's reading of 43.3 is the lowest level going back to last year. It's hard to get the consumer too excited as wage growth remains low and energy prices are rising. The labor market continues to tighten as the jobless rate fell to 2.4% in July, while the jobs-to-applicant ratio moved up to 1.62, the highest rate since the mid-1970's. Needless to say, the labor market remains tight. As we look out over the next few months, we see an uncertain outlook with this economy as trade issues dominate the landscape. Investors need to stay tuned in.

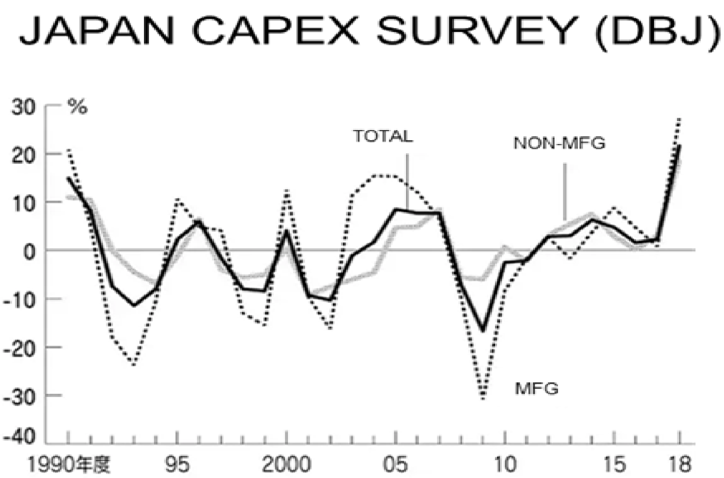


Chart courtesy Nikkei News

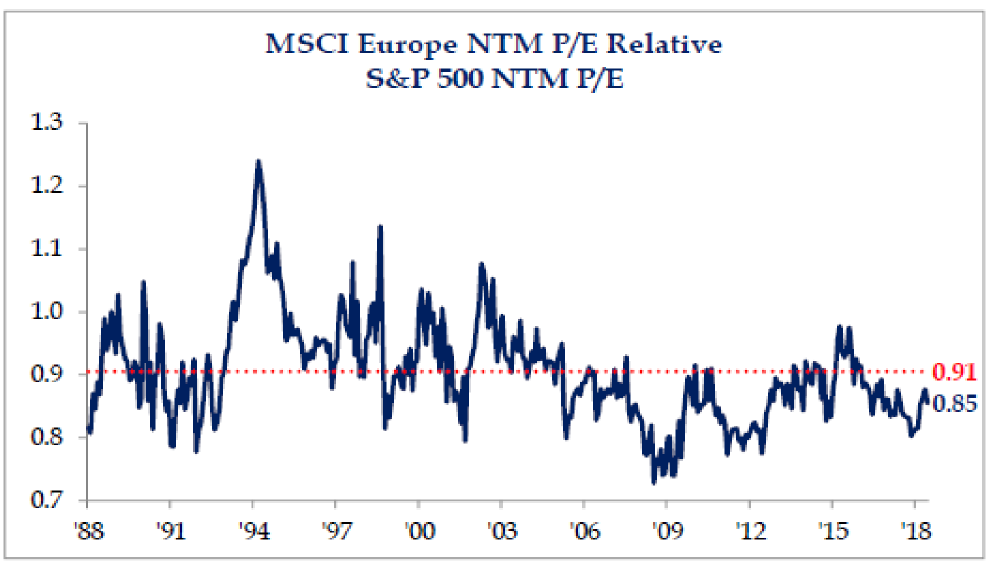
Source: Evercore ISI; Nikkei News

Europe Update

European equities took it on the chin again in the second quarter as the ECB shifted monetary policy which sent the Euro tumbling against the U.S. dollar. Also, we saw signs of a slowing in the Eurozone economy, continued political turmoil in a few countries, and increasing trade tensions with the U.S., which all came together to push the Euro lower and put returns into negative territory for U.S. investors. This pushed the MSCI European Index (ex. U.K.) down -2.9% in the quarter, even as local returns were positive. The Italian and Spanish equity markets led the downward movement as these two countries continued to suffer from political uncertainty. The German equity market was weak as well from the potential affect that tariffs will have on this country's strong export economy, especially the automobile industry. Lastly, the ECB will be winding down its bond buying program starting in September, but is not planning any interest rate increases well into the mid to later part of 2019, which rattled investors somewhat.

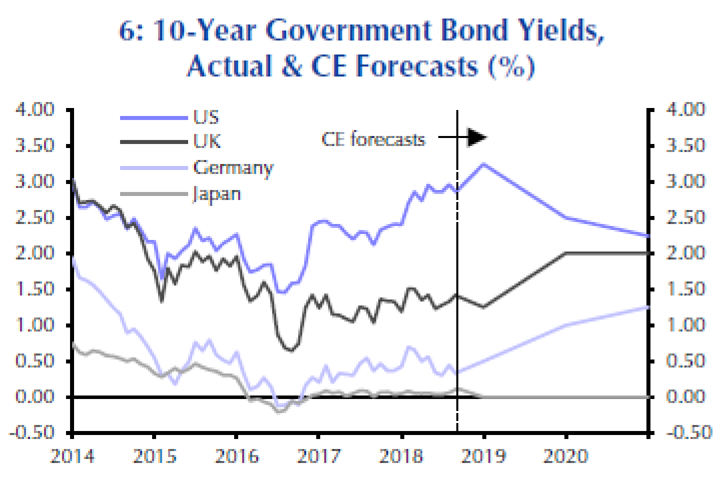
The European economy wound up being just slightly weaker than expected, as second quarter GDP rose +0.4% from the previous quarter, or +2.1% from the year earlier period. This is virtually the same growth rate from the previous period. The Italian and French economies were the weakest in the region as they suffered from political issues. Propelling the Eurozone region was strong capital spending that more than offset the negative drag from net trade in the quarter. Industrial production has been a little rough lately as July fell -0.8% from June, or -0.1% from a year earlier. We believe this is a signal of a slowing in the region's economy, as we have passed the peak. In another sign of weakness, the index of executive and consumer sentiment fell to 111.6 in August, which is the lowest reading in a year. This key statistic is certainly not going in the right direction. Retail sales seemed to be unimpressive lately in the region, as sales were only up +1.1% in July, which is the weakest reading this year. This goes right along with other weakening trends in the region. Core CPI hasn't moved very much lately, rising only +1.0% in August, about where it has been over the last year. We still see very little true pricing power across the region. The employment situation continued to improve lately, as the July unemployment rate fell to 8.2%, yet another fresh new low since the great recession. This remains one area in the Eurozone economy that is fundamentally improving with each passing period. Looking at the region now, we still see an economy that is clearly well off the highs reached a few quarters ago, but looks set to continue to grow at a slower pace over the next few months. But we all need to be weary of trade relations with the U.S. in the coming months, as this can change the outlook in either direction very quickly.

EUROPE APPROXIMATELY FAIRLY VALUED FOR NOW COMPARED TO THE U.S.



Source: Strategas

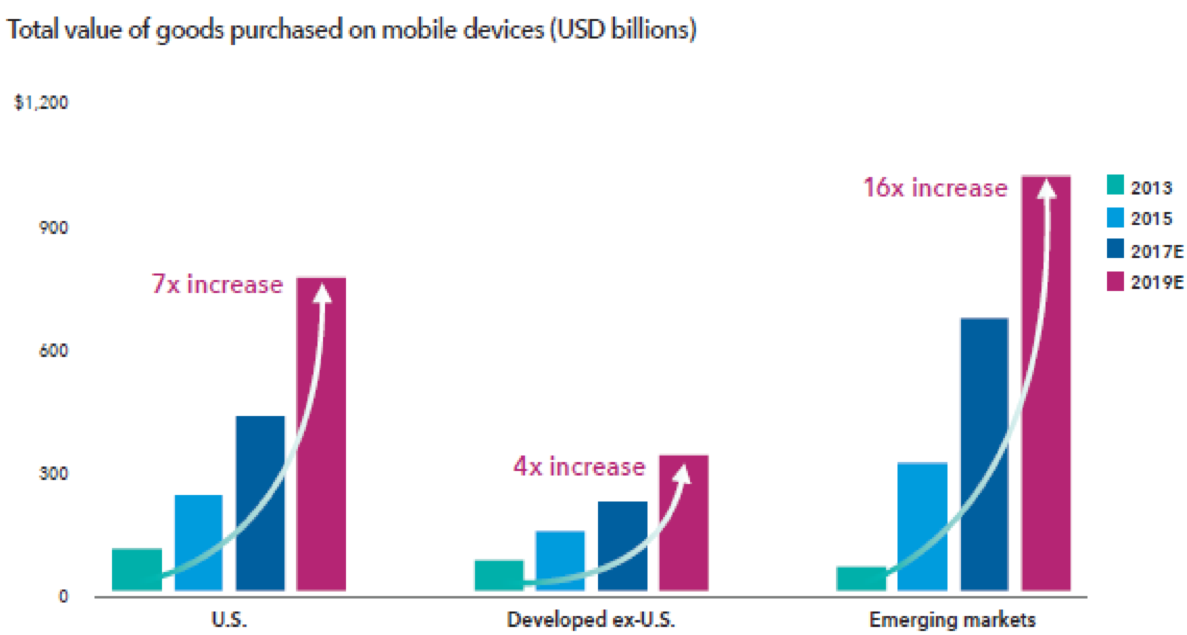
The U.K. equity market shrugged off a weak first quarter and wound up being one of the best performing equity markets in the MSCI EAFE Index. Even though there was little in the way of true Brexit progress, we did see falling inflation as well as a stronger business services environment, which was enough to push markets higher in this region. The MSCI U.K. Index returned +9.4% on a local currency basis, but only +3.0% on a U.S. dollar basis. As we saw in every other region around the world, the strong U.S. dollar zapped -6.4% from the local return. The economy rebounded a bit in the second quarter, as GDP grew by +0.4% from the first quarter, or +1.2% from the year earlier period. We view this as slow, but very stable at the moment. Capital spending and household consumption were the strong areas, while net trade was a large detractor of GDP growth. Industrial production continued its recent weak trend as July grew only +0.9% from the previous year, even though manufacturing was one of the bright spots within the broader industrial production picture. Retail sales staged a rebound recently as July sales rose +0.7% from the previous month, or +3.7% from a year earlier. This was well above expectation as warmer weather and the World Cup encouraged consumers to spend. Core CPI continued to fall as July's reading of +1.9% from a year earlier was a surprise and is right at the BOE's targeted rate of +2.0%. At this point, we would expect to maintain this level and don't expect a big move downward in the near future. At its recent August meeting, the Monetary Policy Committee (MPC) voted to increase its benchmark interest rate by 25 basis points to 0.75%, while maintaining its bond purchase target of 435 billion pounds, including 10 billion in corporate bonds. The MPC feels this is justified and in-line with its near term outlook given a pickup in economic activity in the second quarter vs. the previous quarter. We felt it was a 50/50 type of scenario, but in the end it wound up being a unanimous decision by the MPC. Following the recent trends in other regions around the globe, the employment situation continued to improve as the July unemployment rate fell to 4.0%, which is another multi-decade low. Employment increased by 3,000 workers with ending employment at a new record of 32.4 million workers. Wage growth continued to improve, as wages grew by +2.9% in the three month period ending in July.



Source: Capital Economics, Bloomberg, Thomson Reuters, WSJ, ACM

<u>**Emerging Markets**</u>

Emerging market equities experienced a significant turn in the second quarter as investors became very concerned over the strengthening U.S. dollar, widening problems in Latin America, turmoil in Turkey, and ever increasing trade tensions. All of these issues came together to form a fresh round of volatility and push these markets downward in the period. The MSCI Emerging Markets Index fell nearly -8% in the quarter and down almost -4% thus far in our current fiscal year. The political turmoil hit Brazil's equity market hard as the Brazilian index fell -26% in the quarter. In addition, the ongoing saga in Turkey was tough on this market too, as Turkish stocks fell about -26% as well in the period. Also, trade tensions between China and the U.S. continued to play havoc with China's other Asian trading partners, as several of these markets were down substantially as well. These issues led investors to sell off emerging market assets and move exposure to the U.S., which is what we normally see in times of crisis. Over the near term, we expect investors to proceed cautiously with regard to exposure until any of these issues begin to clear up. This could take some time. However, over the long term, we continue to have a positive stance toward this asset class as do many investors.



Source: Capital Group Mid-Year Outlook; Euromonitor

International Equity Activity/Strategy

No doubt, actions on the trade front by the Trump administration will play a key role in the equity markets in the coming weeks and months. Proposed tariffs and retaliatory tariffs have the potential to wreak havoc on many economies around the globe. Surprisingly enough, thus far, global growth has remained quite good. Most of the damage has been with emerging market stocks, with virtually no damage seen in U.S. stocks. Even taking trade actions into account, we still have a positive view on the global business cycle heading into late 2018. While we have probably passed the peak in economic fundamentals for this cycle, we still see the global economy expanding quite nicely over the next few quarters with more room to run. Global PMI's still look good to us, inflation still seems contained, and global employment continues to improve. Central banks remain committed to maintaining a stable environment where policy actions come as no surprise. This should foster an atmosphere where corporate earnings should be healthy and growing with further expansion of the business cycle. Investors should remain watchful with regard to further trade negotiations as this can be a source of volatility going forward. Perhaps we will see some type of agreement on trade with our trading counterparties, especially China in the coming months.

We continue to remain active with our put writing on EEM over the last few months and expect to continue to be going forward in an effort to bring in some current income and add further to this asset class after an extended period of under-performance lasting several years. Premiums for doing this strategy still look attractive in the current low interest rate environment. Our current allocation to Emerging Market equities is approximately 2.6% of total assets and approximately 10.5% for MSCI EAFE equities. *(Credit is given to the following entities for charts provided: Capital Group, Euromonitor, Capital Economics, Bloomberg, WSJ, ACM, Thomson Reuters, Haver Analytics, Nikkei News, Barclay Research, Strategas, Markit, Fidelity Investments (AART), ISM, Baird Market Update, MSCI, Factset, Evercore ISI, and Morningstar Direct)*