NOTES FROM THE NORTH: MARKET OUTLOOK

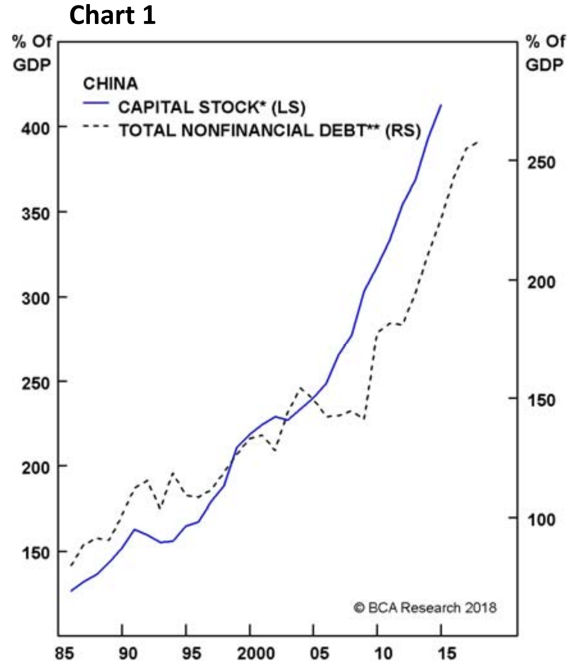
April, 2018

President Trump's proposed tariffs have upset the markets because they could slow global growth and increase costs for U.S. consumers. Trump's primary target is China, whose exports to the U.S. in 2017 outweighed their imports from the U.S. by a factor of 4.

While the negative trade balance makes an attention-grabbing headline, the trade balance alone would not be an issue. However, trade frictions with China have been building for some time. China's most obvious competitive strategy has been low labor costs as vast numbers of workers have shifted from subsistence labor in rural fields to more value-added work in manufacturing. Another simmering issue is China's lax enforcement of piracy and copyright law. Perhaps the most problematic issue is the least obvious: China strictly enforces a policy that in order to do business within China, a foreign businesses must take on a Chinese partner. This policy results in the Chinese partner gaining access to foreign technologies and trade secrets. Because of the vastness of the Chinese market and the pace of its growth, firms felt that they could not afford to *not* be in China, even if it required transferring trade secrets.

China's economic growth has indeed been remarkable. China has gained tens of millions of jobs over the last two decades. Their economy is now twice as large as Japan's and three times the size of Germany's. Between 2008 and 2017, China's nominal GDP expanded at an annualized rate of 11.2%. It is generally thought that China's economy will eventually be bigger than ours.

Chart 1



Growth has not been problem-free, however. Chart 1 (right) shows the debt China has assumed in order to maintain its growth. Xi Jinping understands that taking on more debt to build unnecessary cement and steel plants no longer makes sense. He has been removing the incentives for over-building infrastructure and attempting to spur more spending by consumers. The IMF estimates that Chinese gross national savings reached 46% of GDP in 2017! Unfortunately, China's citizens have few safe and profitable ways to invest their savings.

The nearer term result of Xi's new policies has been a slowdown in Chinese growth. BCA, the Bank Credit Analyst, thinks growth is likely to decelerate further over the next few quarters as authorities restrain credit growth and the property market continues to cool. Needless to say, from China's viewpoint, this is not a good time for the U.S. to impose tariffs on its imports from China.

China is not without weapons to fight back against tariffs. They could, for instance:

- Impose their own tariffs, especially on U.S. foodstuffs
- Sell some of their U.S. Treasury bonds, which would hurt the U.S. dollar and increase our interest rates

Notes From the North: Market Outlook, cont'd

- Devalue their currency, making their exports more attractive to buyers throughout the world
- Continue attempts to make the Yuan a reserve currency so they can pay for imports such as oil in their own currency rather than in dollars
- Limit sales of rare earth materials which are used in everything from cell phones and computers to jets and cruise missiles. (China produces 92% of the world's rare earth materials).

Both China and the U.S. have strong incentives to reach a mutually-satisfying agreement over trade. BCA expects an agreement to be reached, probably before U.S. elections in November. This would allow world-wide growth to stabilize at an above-average trend rate.

Even should an agreement be reached, Louis-Vincent Gave of Gavekal Capital, who has lived in China for the last 20 years, warns that investors must continue to monitor China closely. He believes Xi Jinping's goal is a paradigm shift in China, one that will affect all investors. Essentially China is attempting to secure a larger role in global affairs while making the Chinese economy more sustainable. More attention will be placed on the environment, healthcare and education. Huge investments are being made in Western Asia, Africa and even Afghanistan in order to create more connectivity and cooperation between China and Eurasian countries.

Mr. Gave thinks the Chinese currency will eventually become the "Deutschmark of Asia," putting downward pressure on the value of the dollar. As China reduces its pace of new manufacturing construction, the world-wide over-capacity situation will gradually be rebalanced. Ultimately, that will cause an end to the 30-year era of deflationary pressure and inflation will again become a concern. Central banks will no longer be able to keep interest rates at the incredibly low rates that exist today, especially in Europe and Japan. In an inflationary environment, gold might be more attractive than bonds. Asian equities might outperform U.S. stocks, particularly over-priced tech stocks and interest sensitive issues such as utilities, REITS and telecoms. These themes will likely take a long time to play out, but they deserve monitoring.

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