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April 30, 2018

To Our Clients and Friends:

The Monthly Letter covers three topics this month. First, we provide our Quarterly Economic Overview. Global rebalancing came to center stage in Q1 2018, with the US pushing its trading partners to lower their trade surpluses with the US. While little is likely to transpire over the near term and the global economic cycle will dominate economic growth over the next few years, the seeds of a new world economic order have been planted that will disrupt and rearrange the global economic stage. Second, the markets returned to traditional volatility after a record number of days with no corrections. With the Federal Reserve withdrawing liquidity from the system and inflation increasing, things are unlikely to get any easier for investors. Third, the move by the United States to force a change in the Global Trading System likely stands as only Act One in a multi-act play. Awaiting backstage stands the Currency players who will star in Act Two, whereby the massive undervaluation of Developing Economy currencies will be challenged. This likely will precede a climatic Act Three wherein countries will fight outright for advantage to ensure a disproportionate share of Global Economic Growth. And Fourth, as always, we close with brief comments of interest to our readers.

A Wounded Dragon, The Setting Sun, Lumbering Elephant, Growing Tigers, Latin Rivals, The Old Man Slows, and Climbing To The Summit

> "*Tariffs give to a nation the advantages of economic diversification. This argument, unlike most of those described herein, is usually advanced in support of broad national purposes rather than for special interests. Briefly, the position is as follows: a nation should guide its productive activities so as to attain a balanced production and a high degree of self-sufficiency. Protective tariffs are means of encouraging industries that otherwise would not exist or that would not be able to attain the desired size because of foreign competition. The advantages of diversification are several from this point of view:*
> a. *Military Security. Many governments have protected industries essential for war purposes. ...*
> b. *Economic Stability: A wider and more diversified economy is believed to be less likely to experience a great degree of economic instability. ...*
> c. *Economic Nationalism: Closely allied to both these advantages is the desire of nations hitherto 'undeveloped' to become economically important. In part, this is a reaction against dependence upon the industrial nations for manufactured goods, i.e., against the 'colonial' status this dependence engenders. In recent years economic nationalism has become a crucial issue in some nations and has led to intensified 'five-year plans' designed to place the maximum of*

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national resources into building up industrial capacity. Political leaders in many of these countries enshrine industrialism itself as a national goal and measure national greatness in terms of pig-iron capacity – a criterion imported in part from the United States."

Chapter 36: International Economic Policy
Modern Economics
By Arthur Burns, Alfred Neal, D.S. Watson, and Howard Ellis
1948

The Global Economy continues its growth despite the noise over Global Rebalancing. Global economic growth hit its best level in five years in 2017 and stands poised to deliver another strong year of performance in 2018. A fundamental reacceleration in the US and Europe occupies the cornerstone of this change. This derives from the democratic political forces demanding that the average citizen participate in the bounty of a growing economy, which hitherto rewarded only a small slice of those at the top. And the most politically expeditious manner to deliver this outcome comes in the form of faster growth in a tight labor environment, fostering wage increases and encouraging investment for productivity. The alternative would be mandated redistribution, which is politically anathema to large slices of the political parties on both sides of the Atlantic. And while the US faces a Federal Reserve with a new Chairman determined to make his mark, the political consequences of slowing US growth too much and/or causing a recession, which would short circuit this dynamic, stands as a formidable impediment to overly restrictive monetary policy without clear evidence of significant economic excesses and high inflation.

Despite the noise over Global Rebalancing and standing at the epicenter of global imbalances, Chinese growth remains strong. China reported 6.8% year over year GDP growth for Q1. This growth came from the typical sources for China: increasing Fixed Asset Investment (FAI) by over 7%, Industrial Production growth of 6%, increased consumer incomes driving retail sales growth of 10%, running massive budget deficits to fund continued government investment, and managing its Balance of Trade surplus. This comes from the centralized government guiding the economy with a strong hand to ensure a rising standard of living for its populace as well as an improvement in the nation's global strategic position. As an example, as China "restructures" its economy by shuttering excess steel production and replacing it with modern technology plant, the country addresses domestic overcapacity, throws a bone to countries around the world complaining about excess capacity, and positions itself to compete at the leading edge of industrial growth for the future. While doing this, the government ensures that these companies are controlled by State Owned Enterprises (SOEs) that answer only to the central government. As another example of how China is restructuring its economy, the government proactively took steps to rein in Shadow Banking institutions to bring loans back to the state controlled banks. In order to forestall a credit crunch in the economy, the People's Bank of China (PBOC)

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continues to support economic growth by lowering Required Reserve Requirements (RRR), this time by 100 basis points (1%), allowing state controlled companies to lend more money and fill in the gap. This effectively offset any potential squeeze in financial conditions, supporting continued strong GDP growth in the economy, projected at almost 7% for 2018.

However, for China, the consequences of its mercantilist economic policy, driven by creating national champions, either direct SOEs or controlled by them, to compete around the world, appear to have come home to roost. The Trump Administration called out China on its patently mercantilistic policy coupled with the $300 billion subsidy from the government to undergird its "Made in China 2025" technology push. While foreign countries were willing to tolerate some trade surplus by China in lower value goods, the current actions appear to have overstepped the bounds as these investments target key leading edge industries that sell significant value added exports to China and stand at the core of Developed Country technology and manufacturing expertise. The industries at issue include semiconductors, healthcare equipment, fiber optics, high value industrial goods, robotics, ... China, in seeking to displace these imports through domestic "champions" that would then go on to dominate these industries globally, went A Bridge Too Far, as the Allies learned in World War II at Arnhem in The Netherlands. For China, this just would be similar to the economic policy it followed in building up its industrial, automotive, solar, wind, chemical, and other sectors, which went unopposed by any major government over the past 20 years. It would establish a company to grab global market share, using foreign components coupled with domestic assembly to grab end product market share, then displace the foreign components through a systemic program to backward integrate its whole product chain, licensing technology where it could and stealing technology where it could not license. And in creating the companies to produce the end product and the components, the government would explicitly subsidize the companies, then mandate that Chinese companies use Chinese components and inputs, creating an integrated supply chain in China shutting out foreign companies. Unfortunately for China, in going after critical leading edge industries in the Developed World, it provoked a response when none was expected. In other words, China just thought it could roll over these industries like Panzer Tanks rolled over the Allies in early World War II. Unfortunately for China, it ran into a modern day General George Patton in the form of President Trump. (For those who need a refresher course in history, Patton fought the Germans to a draw initially in North Africa before defeating them there. He then became one of the key generals formulating and executing the on-the-ground strategy to win in Europe.) Unlike the former US Presidents for the last 20 years, China faces a wildcard not bound to Corporate America and someone who is willing to get down in the mud with them. So, for example, when China announced $50 billion in retaliatory tariffs on US exports to China for the initial $50 billion in tariffed goods, the US announced an additional $100 billion in goods subject to tariffs. The Administration then banned US optical components from being sold to ZTE for the telecomm equipment it was selling, putting it out of business. ZTE's sales were 4x as big in the US as in China despite being a domestic Chinese manufacturer, consistent with the policy above of grabbing end market share then backward integrating.

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The Administration sent a further warning shot to China with the investigation of Huawei for selling goods to Iran. If found guilty, it would effectively ban the use of American technology in its products, such as the Android operating system. Furthermore, the tightening of US monetary policy with other major central banks not tightening, at least in the short term, will keep the dollar from depreciating and could potentially increase the value of the dollar, putting additional pressure on China's export oriented economy. Given the focus on its exports, any attempt to depreciate its way out of trouble would produce significant retaliation around the globe, not just from the US. Lastly, both the EU and US became highly critical of China's Belt and Road Initiative (BRI) over the past year, as it became apparent it was only a veiled method to export Chinese goods and services. The statistics demonstrate that over 90% of any project funded through BRI and the Asian Infrastructure Investment Bank goes to Chinese companies with less than 10% to the host country. This contrast with the World Bank where only 30% goes to the sponsoring country with over 40% going to the host country and another 30% going to other countries. Despite the bravado of the country's leaders who expect to "win" any trade war and see themselves emerging as the globally dominant country, China faces a rapidly coalescing group of countries poised to thwart its global ambitions, just as Germany faced from 1890 through 1914. And given this reality, it is A Wounded Dragon that will need to compromise in order to avoid serious damage to its economy.

For Japan, life continues to be good. Unemployment stands at 2.5%, its lowest since 1993. Job growth remains strong. Core machinery orders grew double digits in Q1, supporting strong capex numbers for the economy. But Inventories have risen sharply for the manufacturing sector and export order growth slowed. In addition, Retail Sales have been stagnant and Prime Minister Abe appears in political trouble due to a widening scandal. Furthermore, while it did not make the front page of the newspaper, Japan's steel exports did not get an exemption from US tariffs. Similar to the 1980s, Japan's export surplus to the US drew the attention of the US government, as it had grown to almost $70 billion per year. And while not as large as Germany or China, it is not a rounding error either. In addition, the tailwind from the massive depreciation of the Yen appears over, as the lagged positive impact of the depreciation fades coupled with political limits on the ability to depreciate the currency against the US Dollar further. Lastly, the Bank of Japan finally appears ready to raise rates later this year as Developed Market central banks exit QE and end rate repression. While global growth should continue to support Japan, given its export sectors large role in the economy, it is late in the day with The Setting Sun ahead.

India appears finally to have shaken off the disastrous impact of its demonetization. Commercial vehicle sales grew over 30% year-over-year over the past 3 months. Capital Goods imports are up 8% - 9% over the past quarter compared to the fourth quarter. Investment accelerated to 12% year-over-year in Q4 and remained strong in Q1. Bank Credit growth returned to a 10% - 11% year-over-year growth rate, which was the norm for the two years prior to demonetization. Export growth remained steady at ~6% for FY18 ended March 2018. And Industrial Production growth held above 7%. For India, the

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country seems back on track. This has not gone unnoticed by India's Central Bank, the Royal Bank of India (RBI). In the notes from their April meeting, the RBI noted that monetary policy was "likely to shift decisively to vote for a beginning of withdrawal of accommodation in the next MPC (Monetary Policy Committee) meeting in June. Reinforcement of inflation-targeting credibility that such a shift would signal is crucial". Translating this monetary speak to ordinary language for the RBI would go as follows: in order to maintain our credibility now that economic growth is back on track, the MPC needs to focus on keeping inflation from getting out of hand. So, expect us to raise rates. While this does not mean putting in place restrictive monetary policy, as inflation is only 4%+, it does mean the removal of accommodation and the potential for getting tight at some point in the future. So, for India, economic growth should continue at a strong pace, as the Lumbering Elephant moves its way through the economic jungle.

For Southeast Asia, the economic cohesion of the countries is beginning to have a reinforcing impact. With over 600 million people, nominal GDP of ~$3 trillion, PPP GDP of almost $9 trillion (Purchasing Power Parity), and a growth rate of 6% or better, this area is becoming an economic force in its own right. While the countries are diverse and include Malaysia, Indonesia, The Philippines, Thailand, Singapore, Vietnam, Laos, Myanmar, and Cambodia, the recent free trade agreement should bring them closer together while undergirding their economic ambitions. Furthermore, with the infrastructure planned over the next 20 years, there should be increasing integration of these economies. For the rest of the world, these Growing Tigers bear close watch as they grow into true adulthood.

Across the Pacific, South America stands as a testament to what can go wrong. While these economies showed much promise, they hitched themselves to commodities as a major driver of their economies, which ran into issues when China, the major source for commodity demand over the last 20 years, ran up against natural limits for its industrial economy. While some economies, such as Chile, have moved down the diversification path away from commodities and Chile benefits from being the world's largest producer of lithium, others, such as Brazil, took it in the chin when commodities rolled over. Brazil saw its economy shrink over 10% due to the collapse in iron ore, soybean, and crude oil prices. While its economy has stabilized and begun to grow again at a rate of 2% to 3%, it has yet to recover to the level of a few years ago. In addition, with it standing as the largest economy in South America, there exist significant feedback effects across the region. This dragged down economic growth across the region in countries such as Argentina, which only over the last six months benefitted from the turn up in Brazil. And while Brazil will continue to benefit from aggressive monetary easing as well as massive currency depreciation, which led to an explosion in FDI (Foreign Direct Investment), it will take some time to diversify its economy away from its core commodity drivers of the past two decades. In addition, Brazil faces competition from Bolivia and other lower wage countries for manufacturing investment. So, even though Brazil will remain the largest economy in South America, these Latin Rivals will give it a run for its money on future economic growth.

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Across the Atlantic, European growth abruptly slowed in Q1. This appears a function of slowing Net Export Growth as well as changes in ECB (European Central Bank) monetary policy. For the EU, Net Export Growth accounted for 50% of 2017 GDP Growth of 2.6%. In other words, if net exports did not expand, EU GDP Growth would only have registered 1.3%. This contrasts with the US, where 2017 GDP Growth would have approached 4% if not for the drag from net imports. Net Exports slowed in Europe for three fundamental reasons. First, the Euro moved from an undervalued level of $1.10 - $1.12, on average, in 2015 through H1 2017 to closer to fair value, averaging of $1.20 - $1.22 in H2 2017 and 2018 to date. This made Europe's exports less competitive globally. This stands in contrast to the Years 2015 – H1 2017 which benefitted from the massive drop in the Euro in 2015 and then its continued undervaluation. Second, while Eastern European wage rates still stand significantly below those in France and Germany, they are closing the gap. Due to the low levels of unemployment in countries like Poland, Czechoslovakia, Hungary, and Romania, real wages grew significantly over the past several years and now stand at 55% of those in Western Europe. This closing of the gap will continue to gradually erode the export competitiveness of these economies in supplying the remainder of the EU and in exporting outside the European Common Market. Third, China and the rest of Asia continue to build up their indigenous manufacturing infrastructure, including the ability to supply their own capital goods and consumer goods. As these countries continue down the path of self-sufficiency, this will create a long term drag on high value, European exports.

For Europe, Monetary Policy appears headed in the same direction as the US. The ECB plans to end QE later this year followed by interest rate increases in 2019. Not only does this relate to the position of the EU economic cycle, but it directly foreshadows typical central bank preparations for a new head. Mario Draghi's term ends in 2019. At the ECB, just like the Fed, the prior Chairman is preparing for institutional transition. In doing so, Mario Draghi will end QE and start raising interest rates to provide the new Chairman degrees of freedom in his or her actions, once he or she takes over. As a result, monetary policy will move from accommodative to neutral over the next year, with the US Federal Reserve running interference by leading the charge and keeping the Euro from appreciating sharply. With these export and monetary changes in place, it is no surprise that The Old Man Slows.

The United States stands in contrast to Europe and much of the rest of the world. The country underinvested for much of the past 20 years and allowed its trade deficit to explode. The reversal of these two factors can provide the foundation for strong, fundamental economic growth over the next decade as the country addresses these shortcomings. That is not to say it won't be a bumpy ride. But the US finds itself positioned to drive its economy at growth rates not seen over the past decade. In addition, with the rising conflict with China over trade and the emergence of Cold War II, there will arise a uniting theme of The National Interest to drive the reversal of these negative factors.

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However, until the promised land is reached, the US must deal with the balance of pluses and minuses in the current economic situation. On the liability side of the ledger, there stand a number of issues for the country to address. The Real Trade Deficit stands at over $800 billion or over 4% of GDP. US Capacity Utilization stands at 78% down from the 80% - 85% range in a normal recovery, with certain international oriented industries, such as chemicals, running at a mere 75%. Government Investment stands $800 - $950 billion below trend, depending on the assumptions. And the government's Debt to GDP could skyrocket unless Nominal GDP Growth accelerates. On the asset side of the ledger, the traditional early cycle industries, Autos and Housing, remain strong. Consumer demand for Autos remains above 17 million units at a Statistically Adjusted Annual Rate (SAAR). New Home Sales grew 8.8% year-over-year in the latest statistics and New Home Prices continue upward, rising ~6%. The rise in home prices means less than 5% of all mortgages are under water today. And as sales remain below mid-cycle levels, New Home Starts and Home Prices should continue to rise. For the Consumer, each change of 1% in Home Prices adds $280 billion to Consumer Net Worth. In addition, Consumer Savings Deposits stand at over $9 trillion. This means that each 1% increase in interest rates provides the Consumer with over $90 billion in additional income. Capital Goods Orders have recovered back to their 2012 – 2014 levels and appear headed higher. Companies now just are beginning their 2019 capital spending plans with numerous new plants on the drawing board. Government spending is rising after a long period of stagnation, focused on investment, defense, and R&D. With this plethora of positive factors in play, US economic growth should continue despite the Federal Reserve's plans to raise rates. And unless the Federal Reserve chokes off growth through a series of aggressive rate rises, the US should continue Climbing to the Summit over the next few years. (Data from the Federal Reserve, US Census Bureau, company reports, JP Morgan, Jefferies, and Raymond James coupled with Green Drake Advisors analysis.)

<u>The Markets: Slip Slidin' Away- The Revenge of Main Street</u>

> "*Slip slidin' away*
> *Slip slidin' away*
> *You know the nearer your destination*
> *The more you're slip slidin' away.*"
>
> Lyrics and Music by Paul Simon, 1977

> "*It should be pointed out that the experience of bond investors as a class had been relatively unsatisfactory throughout the period since our entry into World War, so that for the years prior to 1928 there had been developing a realization that bonds did not afford sufficient protection*

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against loss to compensate for the surrender of the profit element. The years 1917 – 1920 were marked by a tremendous decline in all bond prices as the result of war financing followed by the postwar inflation and collapse. The later recovery was not without its many individual disappointments, chiefly because the bulk of bond investment had previously been made in the railroad field and the credit of the carriers had on the whole been declining during most of the period in which numerous industrial companies had been showing extraordinary improvement. Even public utility bonds had been adversely affected from 1919 to 1922 by the postwar increase in operating costs, as against relatively inelastic rates."

Introduction
Security Analysis
By Benjamin Graham and David L. Dodd, 1934

"*In the 1920s, a prime market influence was a book by Edgar Smith called 'Common Stocks for Long Term Investment'. It was a brilliant and important book. Mr. Smith's main point was to advocate the benefit to corporate growth of the application of retained earnings and depreciation. Thus capital appreciates. The book was perhaps influential in changing accepted multiples of 10 times earnings to higher multiples of 20 to 30 times earnings.*

But people have often paid too much for assumed persistent growth, only to find out that a general economic decline, an act of war, or a series of government controls will change either the appraisal of the growth rate or change the growth rate itself. Rarely can securities be valued correctly at over 15 times earnings, because rarely is there any clear prospect that a company's earnings will grow sufficiently in the future to make it worth that price. We know that there are exceptions, but they account for perhaps 1% of the cases. So the odds are against you when you pay a very high multiple."

The Roy Neuberger Almanac
By Roy R. Neuberger (Founder Neuberger & Berman) in
Classics: An Investor's Anthology
Edited by Charles D. Ellis, 1989

For investors, the Year 2018 looks very different than 2017 and 2016. For those two years, markets went straight up with no interruptions, a highly unusual event. In fact, markets performing like that have occurred less than 5% of the time over the past 150 years. However, investors poured more and more money into the markets via ETFs and Index Funds, assuming that this was the norm. In addition, they added significantly to their fixed income holdings of bonds at a point in time when long term interest rates stood below levels that occurred during most of the Great Depression. With this as a backdrop,

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2018 came as bit of a shock. Through April 30, the S&P 500 performance is down ~1% and daily swings of 2% or more have become commonplace. In addition, 10 Year Treasury yields have risen from 2.40% at Year End 2017 to 2.95% currently. For the typical 60/40 stock-bond allocation, there has been nowhere to hide in the public markets. And overseas investing performed no better: the Shanghai Composite fell over 6%, the FTSE 100 fell almost 2%, and the Mexican Bolsa fell almost 4%. Foreign bonds have seen pressure as well. For example, German 10 Year Bund yields have risen from 0.42% to 0.56%, Philippine 10 Year Bond yields increased from 5.70% to 6.22%, and Indian Bond yields rose from 7.33% to 7.74%. The only markets delivering positive returns were those in Latin America, as Brazil's economy finally began to have traction for the region. Unless the public investor miraculously allocated funds to Chilean Bonds and the Brazilian Bovespa solely and hedged any currency risk, the First Quarter produced a less than desirable outcome.

Interest Rates coupled with the actions of the Federal Reserve comprise the fundamental issues facing investors. For the past few years, spreads between the interest rates corporations pay and those on government bonds have compressed. This benefitted companies as they could issue debt at extremely low levels to fund massive stock buybacks. So, even though US 10 Year Bond Yields rose from 2.25% in January 2016 to 2.95% currently, BAA interest rates fell from 5.45% to 4.65%.

However, spreads bottomed earlier this year, as the following chart demonstrates:

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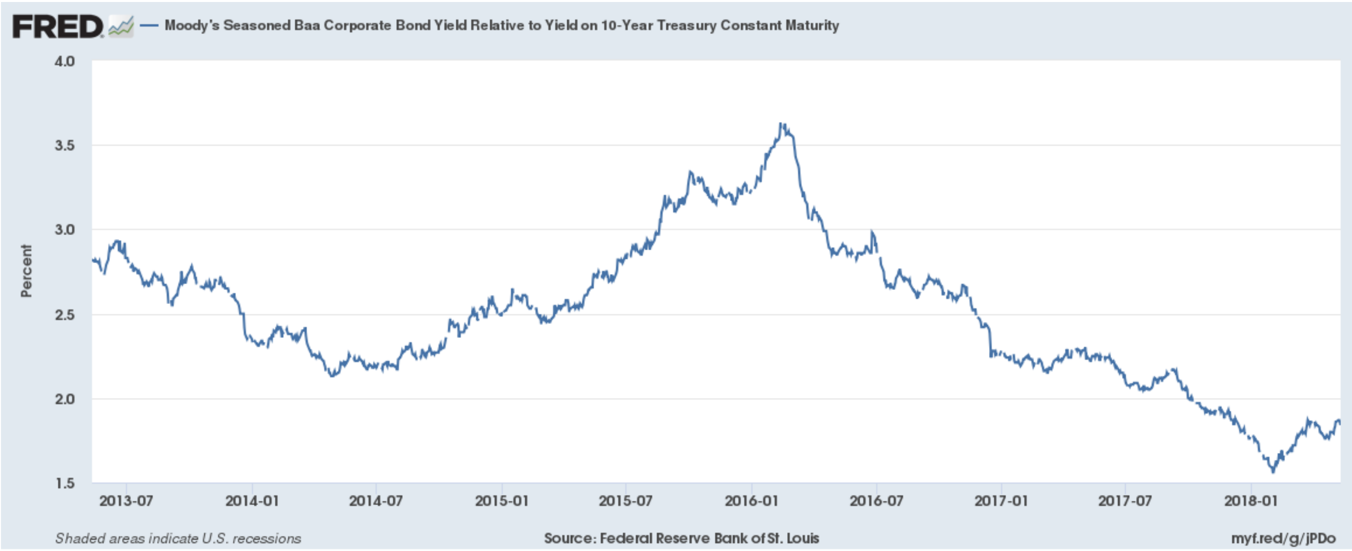
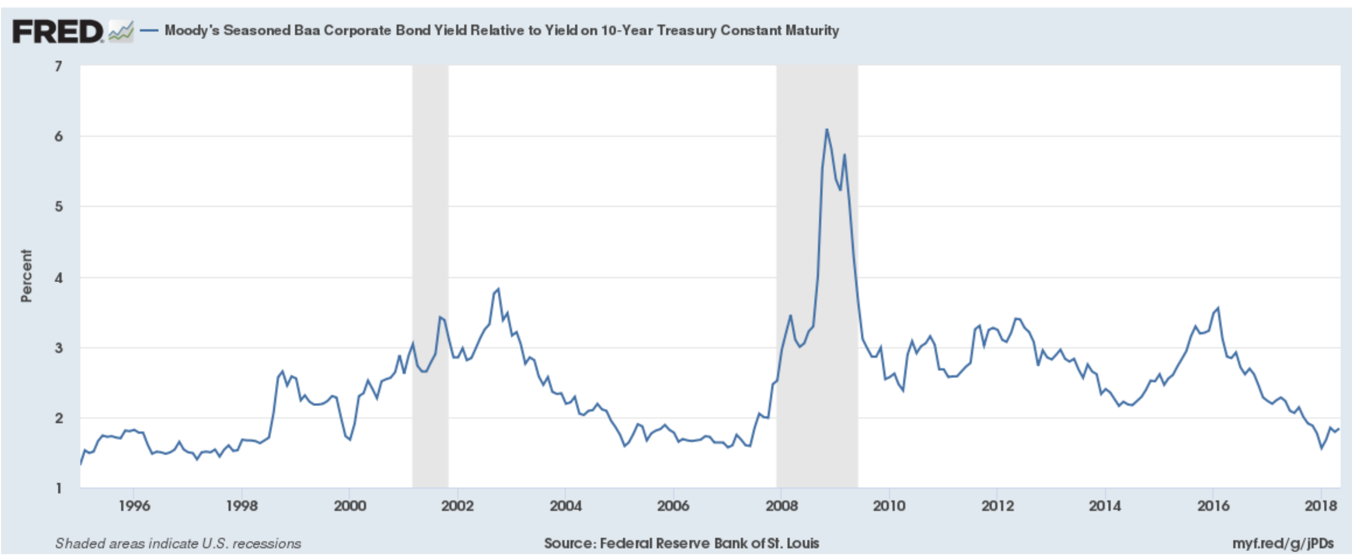


And from a historical perspective, stand well below levels reached during periods of slowing growth and/or recession:



As the above graph makes clear, Spreads of 2.50% - 3.50% are not unusual. And should spreads return to 3.00%, the midpoint of the above range, with US Treasuries yielding 3.00% or more, BAA Bond Yields easily could head up to 6%+, a level seen as recently as 2011.

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While, on the surface, this provides a headwind for bonds only, as a growing economy should produce rising earnings for most companies, BAA Interest Rates stand as the critical discount rate with which to value equities. So, as earnings turned upward over the past two years and BAA interest rates fell, not only did the value of a company increase due to earnings, but multiples expanded as the discount rate fell. On top of that, investors benefitted from a large corporate tax cut. A simple example will make this clear:

	2016	*2017*	*2018*	*2018 with Tax Cut*
Earnings	*$10.00*	*$11.00*	*$12.10*	*$13.31*
Interest Rate	*5.5%*	*5.5%*	*5.5%*	*5.5%*
Value	*$181.82*	*$200.00*	*$220.00*	*$242.00*
Interest Rate	*4.5%*	*4.5%*	*4.5%*	*4.5%*
Value	*$222.22*	*$244.44*	*$268.89*	*$295.78*

Note: Computation of Value assumes Earnings as a Perpetuity.

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As the above Table makes clear, not only did investors benefit from rising earnings, but from a significant uplift in valuation due to the drop in BAA interest rates. And to finish off the Ice Cream Sunday with a cherry on top, the Congress provided large corporate tax cuts. While the real world is not quite so neat, directionally the table explains much of the moves of the past two years.

However, for investors, this uplifting, feel good movie appears in the rearview mirror. What shows through the front window, hurtling at them at 60 miles per hour, is a thriller with rising rates and the prospect of decelerating earnings growth. Suppose, earnings rise at 10% per year over the next two years but rates rise 0.5% per year as spreads return to normal. Then investors might experience the following results:

	2018	*2019*	*2020*
Earnings	*$13.31*	*$14.64*	*$16.11*
Interest Rate	*4.5%*	*5.0%*	*5.5%*
Valuation	*$295.78*	*$292.80*	*$292.91*

Note: Computation of Valuation assumes Earnings as a Perpetuity.

In other words, Earnings could grow, but valuation would not. On top of this, the markets would likely produce a normal amount of volatility. So, at the end of two years, investors would experience an unbelievable rollercoaster, fitting of Six Flags, leaving them right back where they started, but with a queasy feeling in their stomachs. In other words, they would see those returns, Slip Slidin' Away.

And, if investors were to cry: "Say it ain't so!", history would laugh at them. In January 1960, after a similar rise during the 1950s, the S&P 500 stood at 58 and the Dow Jones stood at 685. And while they both increased nicely over the next two decades in nominal terms, when adjusted for inflation, both indices fell significantly in real value between 1960 and 1980. This is similar to what occurred from 1930 to 1950 and from 1900 to 1920. During all these time frames, the economy grew and corporate earnings rose meaningfully. For the average American, living standards grew significantly alongside the economy. But stocks fell in real terms.

For the past decade, Wall Street massively outperformed Main Street, producing a historic bull market, similar in magnitude to those during the 1950s and 1990s. However, for the average American, living standards barely stand above where they stood in 1999, almost two decades ago. And while Wall Street

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profited handsomely over the past decade, Main Street did not. However, the sands of time are shifting. Policies to aid Main Street stand front and center, as politicians respond to voters demanding their share of the pie. As a result, economic growth is now approaching historic rates with the average American seeing their living standards rise once again. And with the US government needing faster growth to fund all the promises made to citizens, faster growth will follow, further helping the ordinary citizen. For the country, this will stand as a return to normal and a positive. For the average American, she or he can look forward to finally participating in the fruits of economic growth over the next decade to bequeath a better place for her or his children. However, with these forces in ascent, this could look like a return to the 1960s for Wall Street, a decade Wall Street does not extol, which was followed by the 1970s, a decade Wall Street would like to forget. And for the average investor loaded up on Index Funds and Indexed ETFs, taught that indexing stands as the optimal investment choice, life could turn out very differently than they expect. They could face a decade or two of flat performance, similar to what investors faced in 1910, 1960, and 2000. And instead of enjoying the fruits of the Eisenhower years, this could look like The Revenge of Main Street starring the Average American who overcomes adversity to triumph, leaving equity investors to cry over their beer as the economy outperforms the markets. (Data from Federal Reserve of St. Louis, Bureau of Labor Statistics, and US Census Bureau coupled with Green Drake Advisors analysis.)

Currency Wars, Trade Wars, The Fight For Economic Growth, & The New Cold War

> "*Branstetter and Feenstra (2002) suppose that the domestic industry is owned by the government, as with state-owned firms in China. The profits earned by these firms receive extra weight in the government's objective function. The presence of multinationals presents a potential threat to the state-owned enterprises through product market competition. This creates a conflict between the entry of foreign firms and the profits of state-owned firms that must be resolved through government policy towards entry of the multinationals.*
> …
> *For China, we find that state-owned enterprises have a weight that is between four and seven times greater than that given to consumers. The evidence of a political premium on state-owned industries diminishes over time, but the point estimates still indicate these firms are favored. Branstetter and Feenstra (2002) further investigate the impact on provincial objective functions of the changes in tariff structure that China has promised under WTO accession. They find that these changes could potentially lower welfare in some provinces, due to the exit of multinationals. This provides some quantitative backing for skepticism that China, given the current political equilibrium, will actually follow through with the promised liberalization in all sectors and regions under its entry into the WTO.*"

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Chapter 9: Political Economy of Trade Policy
Advanced International Trade: Theory and Evidence
By Robert Feenstra, 2003

For a hermit living in a cave for the past 150 years, Methuselah like, and poking his head out for the first time since then to see what was going on between countries, he would say nothing has changed. Now as then countries aided their domestic industry, tried to undermine other countries' industries, and moved to improve their global position. In 1878, it was the Great Power rivalry between the UK, France, Germany (Prussia), Russia, the US, and the Ottoman Empire. Today, it is the Great Power rivalry between Russia, the US, the EU, Japan, China, and India. "La plus ca change, la plus ca meme chose." he would murmur, shaking his head. (The more things change, the more they stay the same.) He then would return to his cave for the next 150 years secure in the knowledge that his view of the world needed little to no alteration. For what he saw today differed little from the world he left behind in the 19th Century.

For the past 20 years, the Emerging Economies (EM) played this game skillfully, leveraging the good will of the Developed Economies (DM) without needing to provide anything in return. They cratered their currencies in the late 1990s, just prior to the opening up of the DM markets to their products through the formation of the WTO (World Trade Organization). Since then, they leveraged this undervaluation to aid their economic growth. The following table lays out the difference in fair valuation of DM currencies to the US Dollar and compares them to the fair valuation of EM currencies to the US Dollar:

	May 2018 Exchange Rate	*2017 Year End OECD PPP*	*Appreciation to Fair Value*
Japanese Yen	*¥110.3 /US$*	*¥98.2 /US$*	*12.3%*
EU Euro	*$1.178 /€*	*$1.339/ US$*	*13.6%*
UK Pound	*$1.348 /£*	*$1.42/ £*	*5.3%*
Brazil Real	*R$3.686/ US$*	*R$2.06 /US$*	*78.9%*
Chinese Yuan	*¥6.372 /US$*	*¥3.55 /US$*	*79.5%*
Indian Rupee	*□67.8 /US$*	*□17.8 /US$*	*280.9%*

PPP Data from www.OECD.org. Exchange Rates actual current exchange rates.

As the above table makes clear, DM currencies are only slightly undervalued. However, EM currencies stand significantly below fair values, as they have since the late 1990s. With this type of

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undervaluation, the EM economies effectively practiced a Currency War for the past 20 years to give their domestic manufacturers and service companies significant competitive advantage on a global basis. And, as the economic results for this period demonstrate, this enabled them to grow at rates they could not envision prior to this gift of access to the DM economies.

However, as often occurs in life, all good things eventually come to an end. With the growth of EM economies to over 50% of the global economy, the DM countries, in particular the US, have begun to ask for something fair in return for access to their markets. The WTO documents were written with the assumption that as EM economies grew, they would open up their markets to DM companies and create a level playing field, no longer protecting their domestic companies. While this utopian vision of the world may occur on some distant planet in a galaxy far, far away, the real world is a harsh mistress. Countries that benefitted from the structure of the WTO possessed little incentive to change a document providing their economies structural advantage on a global basis. So, they did not open up their economies as expected, instead relying on that good export from Mexico: "Manyana." But, one can only say Manyana a certain number of times, before the translation becomes "No". And once it became apparent that countries such as China or India or Malaysia possessed no intent of opening up their economies, then rising trade friction becomes the logical outcome.

To understand this state capitalism, a Westerner must throw off their pre-conceived notions of how an economy should run and how capital should flow. There exist numerous choices out there to manage an economy of which "Liberal Capitalism" as practiced in Europe and the US represents but one alternative. Liberal Capitalism assumes that the economy efficiently allocates capital always without government interference. However, as data demonstrate, this assumption does not work in the real world. The recent financial crisis in the US stands as a testament to how capital can end up completely misallocated when the government abandons its role in limiting certain behaviors, allowing an asset bubble to develop which then collapses. On the other end of the spectrum, the lack of Investment in the US by multi-national corporations for the past 20 years provides another data point in how corporate capital allocation can end up harming a country by torpedoing productivity growth. Thus, when certain basic assumptions turn out incorrect, alternative methods of managing an economy become valid options, especially if they possess track records of success.

For the EM economies, the goals stood loud and clear in the late 1990s post the Asian Financial Crisis. Industrialize our economies to produce our own goods and raise our citizens' standard of living to global middle-class standards. At the same time, avoid trade deficits that create the potential for future financial crises when local debt is held in foreign currency. To follow the policies recommended by Western economic texts to optimize current "factors of production" where they possessed competitive advantage, which, in English, would mean to remain as commodity producers or providers of low value, high labor content goods, would not produce this result. To get there, these economies would need to

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create advanced manufacturing production that would provide the productivity and income for their workers. Thus, managing their economies to replicate the industries that DM economies possessed through utilizing a mercantilist economic policy, which has historical successful precedent, would generate a pathway to achieving their goals. There existed no miracle of Asian Growth. There existed instead a deliberate plan by governments to climb the economic ladder through replicating Western industry, with the ultimate goal to replace Western companies with domestic ones.

The gold standard for executing this policy, of course, is China. China continues to push the envelope on technology and high value, industrial goods. From Solar to OLEDs to Robots to Bioengineering, China's state directed capitalism produced results. Today, China stands as the largest producer of numerous advanced technology products, unseating the US and Europe. And to ensure its ability to create future industries, the government continues to pour money into the industries of the future. For example, the government will inject over $170 billion to state formed semiconductor companies to build domestic capacity to displace foreign imports. The government will invest over $100 billion to create a commercial aerospace industry. The list could go on and on and on. And when the US and Europe objected to this, the Premier of China, Li Keqiang stated in his annual address to the National People's Congress in 2017, "We will fully implement our plan for developing strategic emerging industries. We will accelerate R&D on and commercialization of new materials, artificial intelligence, integrated circuits, bio-pharmacy, 5G mobile communications and other technologies, and develop industrial clusters in these fields." In addition to the industries listed in his speech, the government's plan includes the following industries: aircraft, robots, electric cars, rail equipment, ships, and agricultural machinery. In sum, China told the DM countries to go pound sand.

And while China stands as the poster child, much as Arnold Schwarzenegger did when he won Mr. Universe, numerous other countries either followed its example directly by going down the pathway of state directed economic growth or implicitly did so by protecting domestic industry or forcing productive capacity to be built in country. These countries make up a virtual who's who of Emerging Economies and include such stalwarts as Singapore, Malaysia, Indonesia, Iran, Kenya, … For an example of the typical actions under such a regime, the following example will make clear how these policies act in practice. McDermott International, a US corporation, is a major international engineering and construction firm specializing in large, energy projects. In order to compete in Malaysia, the company needed to put in place a major engineering hub in which the majority of employees are Malaysian. Furthermore, the Malaysia Industry Development Authority set local content requirements for the actual fabrication of the projects as well as knowledge transfer requirements. The goal of the policy is to build up an indigenous capability in this area. The obvious result of this policy is that these jobs and the accompanying investment are created in Malaysia instead of the US or Europe, aiding Malaysia's growth and helping to build out its industrial economy. Other examples of this type of behavior abound. Iran built a major steel industry with the goal of supporting its domestic

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manufacturing as well as exporting steel to other countries. Iran now stands as the 12th largest net exporter of steel in the world. Vietnam built major cell phone manufacturing plant. For a country with significant low cost labor it can leverage, this step-up in its development represents an effort to leapfrog its economic status to compete in high-value industries despite its current state of its economy which would indicate a focus on high labor content goods. Kenya explicitly stated a national goal to become the technology hub for Africa. It created incentives for African companies to locate in Kenya. And with this productive capacity in place, they now are seeking to put in place infrastructure, such as the India-Myanmar-Thailand highway or the Mekong-India Economic Corridor, to integrate their economies and reinforce their growth rates with the potential to position them to take over global economic leadership.

With China's "Made in China 2025 Strategy", the DM countries no longer could ignore the reality of the EM strategy. And in doing so, an internal DM political battle began over the structures that enable this. Standing on one sideline, defending the status quo such as the WTO, are the current multi-nationals intent on benefiting from the ability to invest into these countries to capture market share in the local economies as well as the EM governments that benefit from this. Standing on the other sideline are the DM populations and governments intent on creating change to put an end to policies that hurt their countries' economic growth and the standard of living for their citizens. It will be a tough, hard fought game with neither side conceding ground easily. And there will be plenty of casualties along the way as each side plays for keeps. However, in a democracy, ultimately the side that delivers improvement to the citizens wins. And while the citizenry in the US and Europe was promised a pot of gold under the WTO, it turned into a pot of gold at the end of the rainbow, never attainable. Thus, the likely winners standing at the end of the game are the citizens who will stand victorious over the bodies of multi-national companies that did not get on board.

The easy way to understand the looming EM-DM conflict over the global economy is as follows. For a country, such as Mexico which benefits from NAFTA, there exist large incentives to fight tooth and nail to prevent change. Mexico's industrial economy related to exports make up 25% of its GDP today. In addition, another 25% of GDP relates to service industries that support this 25% of its economy. Thus, almost half its economy directly relates to the current trade structure, which accounted for the vast majority of its economic growth over the past 20 years. Furthermore, NAFTA enabled Mexico to grow the real standard of living for its population by 4% per annum for the past 20 years despite that in the US going nowhere since 1999. In other words, Mexico's population has seen its real wages more than double since 1999 due to the economic setup, mostly at the expense of US economic growth and the real wages of its population. With nothing to gain and much to lose, there exists little to no incentive for Mexico to agree to any changes. The likely outcome appears unilateral US actions to protect its economy at the expense of Mexico, forcing economic change. And while negotiations might sound like the optimal place to cut a deal as countries can come to "reasonable compromise", reality will likely intrude as one country's idea of compromise stands as another country's loss. One need only look at the

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Brazil-Mexico free trade in autos to see the outcome. When Mexico took advantage of the agreement and refused to alter the terms, Brazil imposed new terms that protected its economy. And this type of confrontation will replicate itself around the world as DM economies push to level the playing field in The Fight For Economic Growth. The likely result will be a Trade War, whether stated or not, as these economies move to recapture the economic growth they ceded over the past 20 years.

The other unpleasant reality, clearly shown from history, relates economic might to military might and global strategic capabilities. Every major economic power of the past 2,000 years developed a major military capability as well as the ability to buy influence to improve its strategic positions. Whether they deployed these capabilities to their advantage or not depended on the judgment of the leadership of the political entity and the abilities of its military leadership. With the rise of its economy, China set out to leverage this into its military as well as its strategic position around the world. The country reorganized its military into a force structure similar to that of the US and then began to deploy its military strategically around the world. For example, besides building advanced military fortifications in the South China Sea, which have made the front page of the newspaper, the country set up naval bases in Gwadar, Pakistan and in Djibouti. In addition, it took control of a key port in Columbo, Sri Lanka. For this port, China is building an underground road network. These bases are positioned to counter US forces in the region as well as threaten India by potentially cutting off its sea access through the Indian Ocean. At current levels of spending, China's Navy will exceed the size of the US Navy, the largest in the world, by 2035. China also set significant resources behind creating an edge in military technology. It invested $10 billion to create a Quantum Computing Research Center. It invested billions into creating Hypersonic Weapons. (For those unfamiliar with this concept, these are weapons that travel faster than Mach 5 and have the ability to maneuver and alter their trajectory in flight.) It set up a joint venture with Russia in rockets to create ballistic missiles designed as carrier killers. In addition, China continues to expand and upgrade its armor, tanks, and air force to create strategic superiority in the Asia Pacific region.

These aggressive moves by China did not go unnoticed around the world. Other countries are just beginning to react to increase their military capabilities significantly, while buying time through engaging China economically. While they will try to thread the needle in the short term by remaining neutral, the larger China's military becomes, the more Asian countries will need to ally with each other and bring in a partner from outside Asia to help protect them from China's likely attempt to dictate policy to their governments. The likely partner is the US, which is the only country that possesses a military that can go toe-to-toe with China. The alternative is to kowtow to the new emperor in China and become a vassal state.

Over the past year, the US recognized the rising challenge to its global strategic and military position with the government explicitly stating in its 2018 National Defense Strategy a focus on the return to

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Great Power rivalry. Military spending increased 20% under the current budget and government R&D spending, through arms such as DARPA, exploded upward for key military technology to counter China's moves. In order to maintain its position, the US likely will need to rethink its allocation of military resources around the world and to reposition significant assets to the Pacific, including troops and supplies. In addition, it will need to rethink its economic arrangement with China, as outlined above, which has been one-sided in favor of China. Only time will tell if its actions are soon enough. On the other side of the globe, military spending is rising in Europe as well, given the reality of a resurgent Russia with expansionary tendencies and the rising military goals of China. With the rising military and economic rivalry between the US and China and Russia and Europe, the world looks more like the 1950s and 1960s when the Cold War between the US and Europe, on one side, and China and Russia, on the other side, dominated all thinking. It should come as no surprise that the words of Winston Churchill are echoing down the halls of history from his famous Sinews of Peace speech presented on March 5, 1946 at Westminster College in Fullerton, Missouri, "It is my duty however, for I am sure you would wish me to state the facts as I see them to you. It is my duty to place before you certain facts about the present position in Europe. From Stettin in the Baltic to Trieste in the Adriatic, an iron curtain has descended across the Continent." If he were alive today, he would replace certain words such as Europe with "Pacific" and the locations mentioned in Europe with those in Asia to read as thus: 'It is my duty to place before you certain facts about the present position in Asia. From Seoul in South Korea to Jakarta in Indonesia, an iron dragon has descended across the Continent.' Such a statement would reflect the reality of a rising rivalry between Great Powers and the inherent conflict it would engender. It would recognize the reality of the political situation and the incompatible goals of the two opposing forces. And it would clearly demark the increasing risk of military confrontation across a great front spanning a continent. The path the US and the rest of the world likely will follow, in this New Cold War, was laid out by President Dwight D. Eisenhower in his Annual Message to the Congress on the State of the Union on February 2, 1953:

> "*Our country has come through a painful period of trial and disillusionment since the victory of 1945. We anticipated a world of peace and cooperation. The calculated pressures of aggressive communism have forced us, instead, to live in a world of turmoil. From this costly experience we have learned one clear lesson. We have learned that the free world cannot indefinitely remain in a posture of paralyzed tension, leaving forever to the aggressor the choice of time and place and means to cause greatest hurt to us at least cost to himself.*
>
> *This administration has, therefore, begun the definition of a new, positive foreign policy. This policy will be governed by certain fixed ideas. They are these:*

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1. *Our foreign policy must be clear, consistent, and confident. This means that it must be the product of genuine, continuous cooperation between the executive and the legislative branches of this Government. It must be developed and directed in the spirit of true bipartisanship.*
2. *The policy we embrace must be a coherent global policy. The freedom we cherish and defend in Europe and in the Americas is no different from the freedom that is imperiled in Asia.*
3. *Our policy, dedicated to making the free world secure, will envision all peaceful methods and devices – except breaking faith with our friends. We shall never acquiesce in the enslavement of any people in order to purchase fancied gain for ourselves. I shall ask the Congress at a later date to join in an appropriate resolution making clear that this Government recognizes no kind of commitment contained in secret understandings of the past with foreign governments which permit this kind of enslavement.*
4. *The policy we pursue will recognize the truth that no single country, even one so powerful as ours, can alone defend the liberty of all nations threatened by Communist aggression from without or subversion within. Mutual security means effective mutual cooperation. For the United States, this means that, as a matter of common sense and national interest, we shall give help to other nations in the measure that they strive earnestly to do their full share of the common task. No wealth of aid could compensate for poverty of spirit. The heart of every free nation must be honestly dedicated to the preserving of its own independence and security.*
5. *Our policy will be designed to foster the advent of practical unity in Western Europe. The nations of that region have contributed notably to the effort of sustaining the security of the free world. From the jungles of Indochina and Malaya to the northern shores of Europe, they have vastly improved their defensive strength. Where called upon to do so, they have made costly and bitter sacrifices to hold the line of freedom…*
6. *Our foreign policy will recognize the importance of profitable and equitable world trade. A substantial beginning can and should be made by our friends themselves…*

In this case, the disillusionment would be over the outcome of the WTO with the hope China would adopt a more open economy and move towards some form of democracy. Both these hopes have been dashed on the rocks of reality. With a new global economic order, an emerging arms race, and the demands of a new rising power for "Our Place In The Sun", the world seems a more dangerous place, resembling the globe from 1850 – 1914 more than the post-World War II era. And with a New Cold War in place, the Great Game of Power stands once more in ascent. (Data from OECD, US Department of Defense, Office of the President, and public sources coupled with Green Drake Advisors analysis. See also *Germany 1897: Our Place In The Sun* from April 30, 2013.)

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Chicks Away, All Those Bits of Energy, Enjoy That Cup of Joe, and The Bionic Human

Finally, we close with brief comments on Chicks Away, Those Bits of Energy, Enjoy That Cup of Joe, and The Bionic Human. First, chicken processors are adding significant capacity to the industry. They plan to add over 7% by the end of 2019. This should put significant pressure on margins in the industry as they compete to fill up those plants. But for the growers, it will be Chicks Away. Second, crypto-currencies growth seems unstoppable. So, does their insatiable demand for energy. It is estimated that Bitcoin and Ethereum mining alone now consume almost 0.3% of total global electricity. This is almost 3x the electricity consumed by EVs across the globe. It appears that all those crypto-currencies are worth their use of All Those Bits of Energy. Third, the global coffee crop is on track for record production in Brazil. That has driven near term prices to lows last seen in 2015. However, coffee plants produce smaller crops every other year and futures prices reflect this, rising 6% by the end of 2018. For all those coffee lovers out there, make sure to Enjoy That Cup of Joe. And Fourth, a collaboration between Tel Aviv University in Israel and Linkoping University in Sweden is developing an artificial retina. The retina is manufactured using inexpensive organic pigments used in printing and cosmetics coupled with gold. This photo-active film converts light into electrical signals. While in early testing and development, it possesses the potential to restore sight to blind people. We see this as another step along the path to creating The Bionic Human.

In Closing

Should you have any questions on how the above issues or the items discussed in our accompanying cover letter impact your family's financial position or your business's future as well as the potential actions you could take in response, please do not hesitate to contact us. We welcome the opportunity to discuss this with you.

Yours Truly,

Paul L. Sloate
Chief Executive Officer
& Senior Advisor

Steve Rodia
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