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May 31, 2019

The Monthly Letter covers three topics this month. First, we return to our Great Game of Power Series. With the massive changes in the global economy over the past 30 years, the new global economic order continues to exert pressure on existing international political configurations. Over time, this will force a political realignment. Second, we take a look at the Agricultural sector and the potential impact of the record rainfall this year. And Third, as always, we close with brief comments of interest to our readers.

# The Great Game of Power: Fracturing Alliances & The Coming Global Realignment

"*Preamble:*

*The Parties to this Treaty reaffirm their faith in the purposes and principles of the Charter of the United Nations and their desire to live in peace with all peoples and all governments.*
*They are determined to safeguard the freedom, common heritage and civilization of their peoples, founded on the principles of democracy, individual liberty and the rule of law.*
*They seek to promote stability and well-being in the North Atlantic area.*
*They are resolved to unite their efforts for collective defense and for the preservation of peace and security.*
*They therefore agree to this North Atlantic Treaty:*
*…*

*Article 3*

*In order more effectively to achieve the objectives of this Treaty, the Parties, separately and jointly, by means of continuous and effective self-help and mutual aid, will maintain and develop their individual and collective capacity to resist armed attack.*
*…*

*Article 5*

*The Parties agree that an armed attack against one or more of them in Europe or North America shall be considered an attack against them all; and consequently they agree that, if such an armed attack occurs, each of them, in exercise of the right of individual or collective self-defense recognized by Article 51 of the Charter of the United Nations, will assist the Party or Parties so*

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*attacked by taking forthwith, individually and in concert with the other Parties, such action as it deems necessary, including the use of armed force, to restore and maintain the security of the North Atlantic area.*

*…*

*Article 13*

*After the Treaty has been in force for twenty years, any Party may cease to be a party one year after its notice of denunciation has been given to the Government of the United States of America, which will inform the Governments of the other Parties of the deposit of each notice of denunciation.*"

The North Atlantic Treaty
Signed April 4, 1949
In Washington, D.C.

For those unfamiliar with the true changes in the global economic order, the following data should make clear just how much the global economy is set to change by 2030. According to the IMF (International Monetary Fund), the following tables show the ranking of the Top 10 Economies that existed in 2000 as well as the projected economic order in the year 2030:

| *Global Rank* | *2000A* | *2030E* |
|---|---|---|
| *1.* | *United States* | *China* |
| *2.* | *Japan* | *United States* |
| *3.* | *Germany* | *India* |
| *4.* | *United Kingdom* | *Japan* |
| *5.* | *France* | *Germany* |
| *6.* | *China* | *France* |
| *7.* | *Italy* | *United Kingdom* |
| *8.* | *Canada* | *Brazil* |
| *9.* | *Brazil* | *Canada* |
| *10.* | *Mexico* | *South Korea* |

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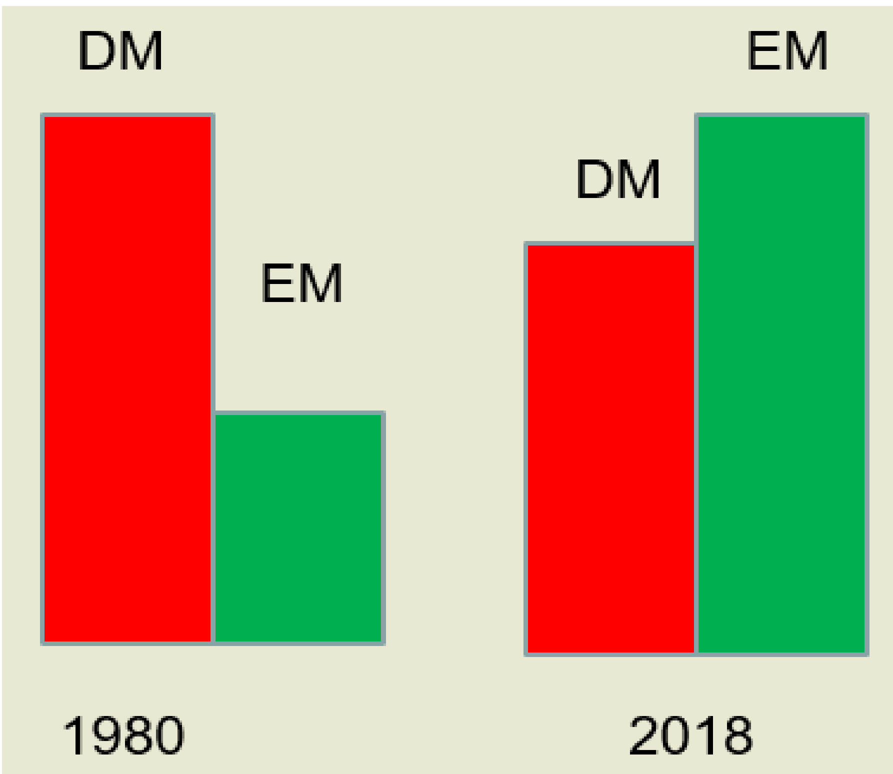
For much of the Western public and the Western media, the world they know today is the World of 2000. However, for the 195 countries across the globe, the reality of this new emerging Global Economic Order of 2030 stands front and center. As this reality comes closer and closer over the next decade, relations with countries such as China and India will become as important for countries as relations with the United States, with tremendous implications for how countries interact with each other both economically and politically.

For the Western economies, the implications of 50 years of aiding economies like China, India, Malaysia, and Ghana, to grow faster than their economies, have come home to roost. Western economies now represent a minority of the global economy on a PPP basis, as the following chart shows.




*Data from International Monetary Fund*

Furthermore, their economies continue to lose global share under the institutions and policies they erected in the 1950s and 1960s. In order to put an end to this share loss and maintain their relevance over the next few decades, they need to recapture their share of international growth and enable their

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economies to grow at a more rapid rate. In order to accomplish this, the rules of engagement between countries must change and the key economic policies must adapt to these new rules. As a result, international institutions constructed over the past 40 years, like the WTO, will continue to fall by the wayside as Western economies move to change the rules of engagement so as not to be left behind.

Of course, the first country to recognize this reality is the United States. With it clear that the rules no longer enabled its economy to grow at its traditional rate and stood as an impediment to its ability to maintain its global economic share, the US unilaterally acted over the past two years to protect its position in the global economy. This meant voiding rules that held its growth back and forcing changes to open up more opportunity for its economy to participate on a global basis. And when these changes would not find themselves accommodated by other countries, the country acted to put the interests of its citizens ahead of other countries. While this offended and will continue to offend many entrenched interests, who find their vested stakes in the existing system at risk, the initial result for the U.S., as a country, appears positive, despite the noise in the media. Productivity Growth, the bedrock of economic growth and higher real incomes, recovered to over 2%, potentially enabling faster economic growth over the long term. And, as a side benefit, casualties overseas in other nations industries will slow their GDP growth. In fact, some recent data indicate that the Emerging Economies, as a whole excluding China, now grow at a rate similar to the United States. Simply put, through a willingness to upend the status quo, the U.S. appears to have forced a change in the global equilibrium that will allow it to grow at the rate of Global GDP once more.

Other Western nations have not missed this result. The internal political pressures to produce faster economic growth continue to build. For example, Italy returned to the potential issuance of BOT to pay its citizens and companies for the work they do for the government. The BOT will act, in essence, as a second, parallel currency in place of the Euro, whereby Italians could pay the government any taxes or other payments due in BOT. They could also use this to pay local governments and each other. While the Italian government will not call this the Lira, lest they offend the Germans, if it walks like a duck, looks like a duck, and quacks like a duck, it is a duck. Or, as the Marx Brothers would say, Why A Duck, as it acts like a viaduct between the Euro and a new currency. (For those wishing to view the famous Marx brothers Why A Duck? routine and the Cocoanuts movie, they can view it at https://www.youtube.com/watch?v=J5izciEMkvw .) With the Italians having invented modern banking, recreating their currency would enable them to reassert control over their economy and undo the damage from the Euro, allowing their manufacturing to recapture all the share it lost over the past 20 years to Germany.

For Australia and Germany, a different issue awaits. While the U.S. stands a traditional ally due to the outcome of World War II and their allegiance during the Cold War, economic reality dictates a reconsideration of this relationship. For Australia, trade with China stood at almost $75 billion in 2018,

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representing over 5% of its GDP, compared with less than $10 billion in trade with the United States. As a result, although the country maintains a political and defense relationship with the United States, its economy depends much more on China. This change in economic relationship shows in its internal politics, whereby the party not in power would engage with China in a way that would lessen the influence of the United States. Should they come to power, the alliance between the U.S. and Australia could come under some strain. Germany presents a different facet of the changing world economy. While the U.S. still maintains its role as Germany's top export destination, China now stands not far behind, as #3. In addition, the United States continues to pressure Germany on its export policies, on its defense spending as part of NATO, and on its plans to import more Russian natural gas. Germany has pushed back, fighting against a rearrangement of the trade relationships, refusing to bend on defense spending, and attempting to reassert its traditional role in Central Europe, from its past during the 1800s. While not sufficient to change its alliance with the U.S. yet, the strain between the two countries continues to grow creating a Fracturing Alliance.

For Emerging Asia, with the Chinese economy ascendant, risks abound on every side. Asia, excluding China and India, exports 32% of its GDP. Of these exports, over 70% end up in the United States and Western Europe as finished goods. With China and the United States having a disagreement on trade coupled with China becoming the largest economy in Asia, the jury is out on the outcome for Emerging Asia. For some items like shoes, these countries will benefit. While China saw its U.S. import share of shoes drop below 50% for the first time in years, Vietnam gladly took its place, representing a clear boost to its economy. For the U.S. and Vietnam, this stands as a good outcome. However, in the areas of technology or other high value manufactured goods that China targets, such a positive, mutually beneficial outcome might or might not occur. For national security reasons, the U.S. easily could justify insourcing production of many technology and industrial goods to service its economy and its military. To the extent countries wish to benefit from China's growth and from exports to the U.S., they could get caught in the middle, forced to choose sides. As China's exports slowly but surely drop to the U.S., the actual source of much of the value in those exports will become apparent. As a result, new countries will come under scrutiny. To the extent they stand with the U.S. in opposing China's rise, the U.S. might turn a blind eye to these imports. However, should they try to play both sides against the middle, the U.S. might use the club of access to its markets as a way to force choice between the two sides. With one third of their economies dependent on these exports, these countries will have no choice but to play ball or see the ramifications of trying to ignore a major customer.

As these snippets make clear, the change in the global economic order over the past 30 years will change the global dynamic. With economic relationships changing, countries that hitherto were allies may find themselves on the opposite side of the table. Countries that were formerly pitted against each other might find themselves allying against a common foe. For those used to a stable dynamic, this may come

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as a shock. But as The Great Game of Power continues to play out, The Coming Global Realignment should surprise no one. (Data from public sources coupled with Green Drake Advisors analysis.)

**The Corn Is Not As High As An Elephant's Eye**

"*There's a bright golden haze on the meadow,*
*There's a bright golden haze on the meadow,*
*The corn is as high as an elephant's eye,*
*An' it looks like its climbin' clear up to the sky.*
*Oh what a beautiful morning,*
*Oh what a beautiful day,*
*I've got a wonderful feeling,*
*Everything's going my way.*"

Oh, What A Beautiful Morning
Oklahoma!, 1943
Music and Lyrics by Richard Rodgers and Oscar Hammerstein II

For the farmer, weather can play an outsize role in the outcome. Some years are perfect, with just the right amount of sun and rain. In those years, the farmer produces bumper crops. Other years are hot and dry, withering the crops in the field no matter how much the farmer waters. And in yet other years, the heavens unload, dropping copious amounts of rain on the fields, interfering with planting and literally raining disaster down on the farmer. The Year 2019 appears ready to shape up as the latter for the US farmer.

Government data indicate this year, to date, stands as the wettest on record, since records began to be kept in 1895. The following picture from NOAA demonstrates in pictorial form just how wet this year has been:

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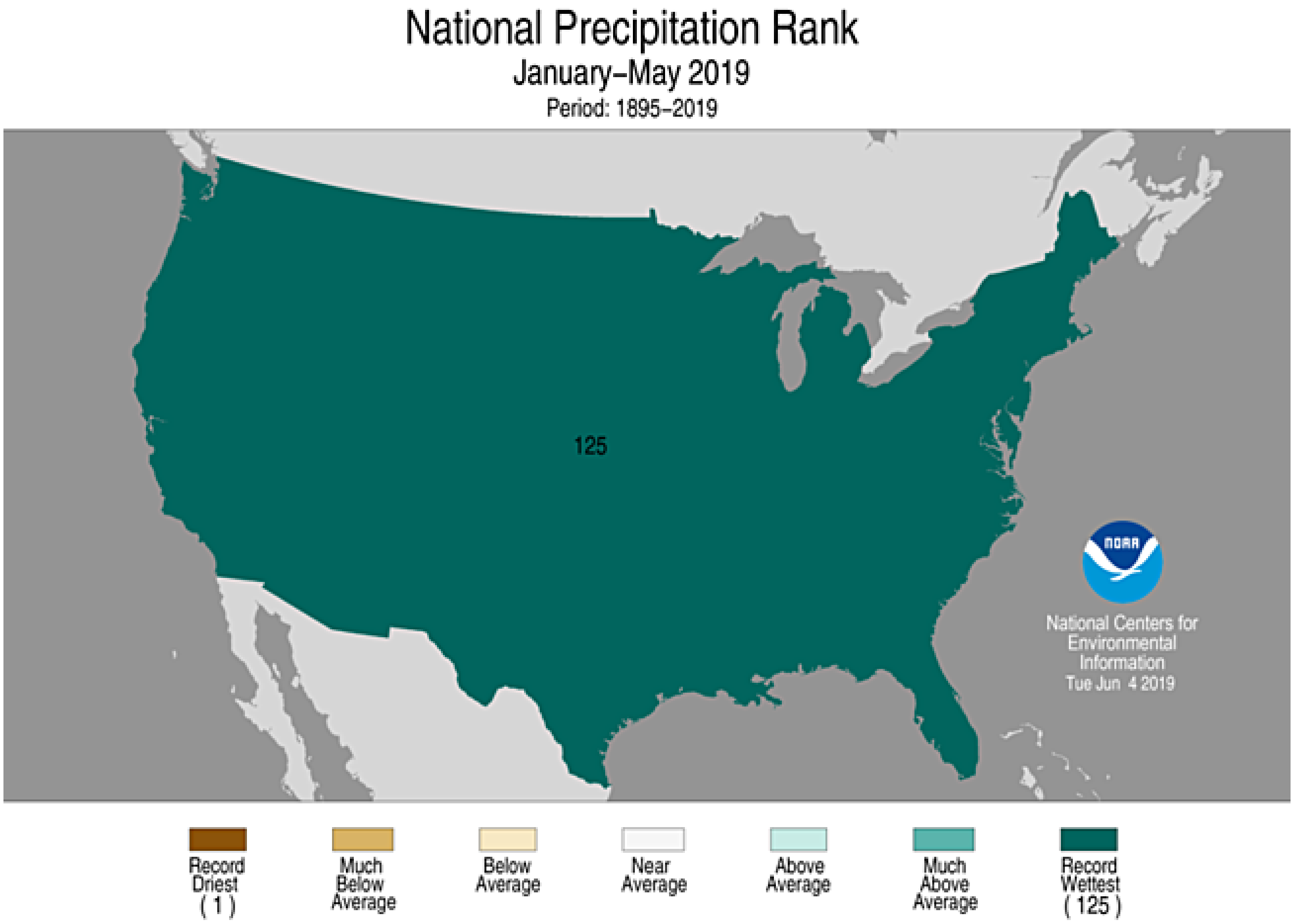


As the picture demonstrates, should precipitation continue at this rate, 2019 would become the record year for rainfall for the US as a whole. And for the farmer in the Midwest focused on planting corn and soybeans, this year will rank in one of the Top 5 in the Upper Midwest and in the Top 10 for the rest of the farm belt:

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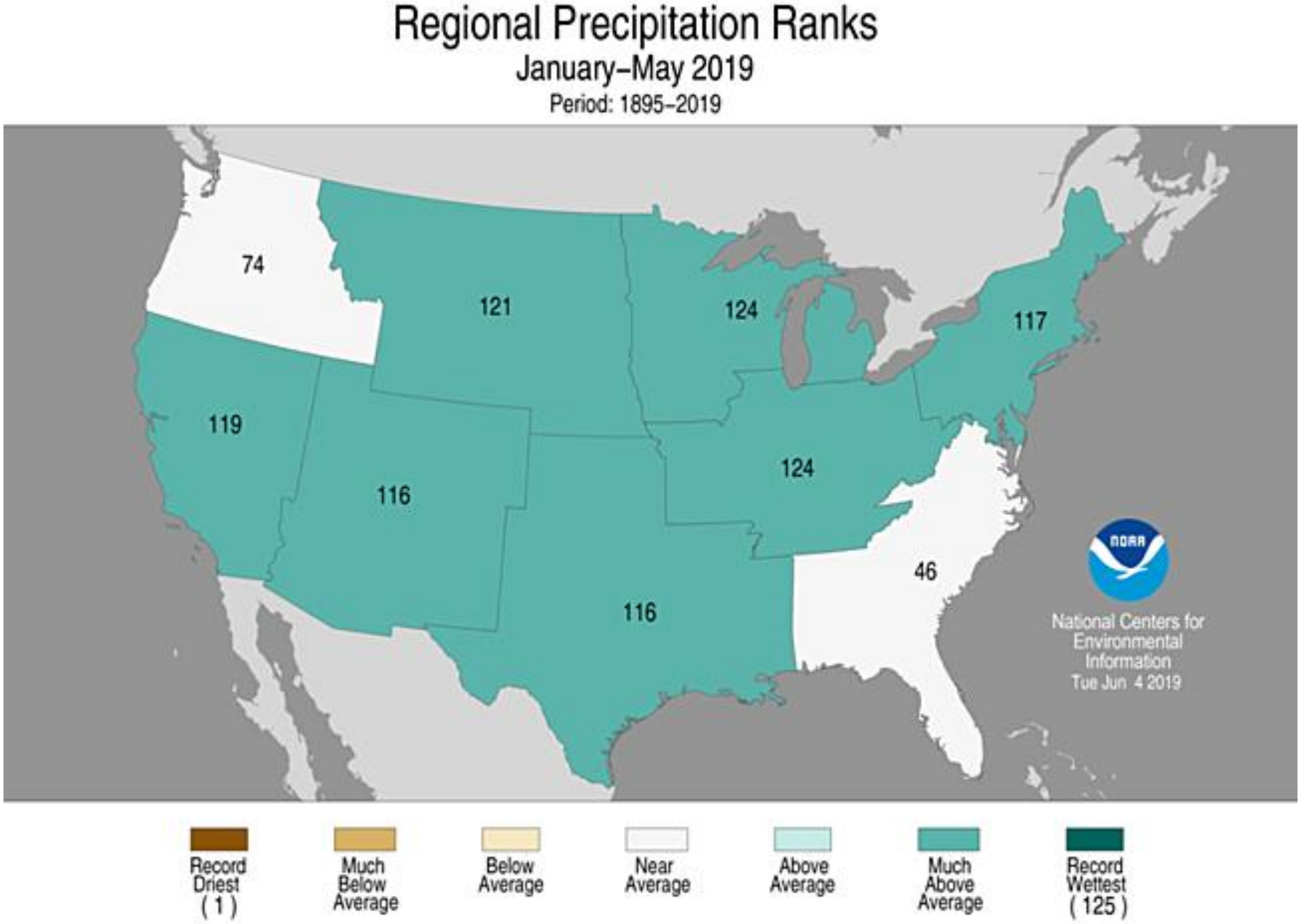


For the farmer praying for some sun to dry out his or her fields to plant crops, this stands as bad news. Crop plantings stand significantly behind normal:

| ***% of Crop Planted*** | ***2019*** | ***Normal*** |
|---|---|---|
| *Corn* | *83%* | *100%* |
| *Soybeans* | *60%* | *91%* |

*Data from USDA as of June 9, 2019*

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As the above data demonstrate, plantings stand well behind normal. For corn, if the crop is not in the ground by June 5, then the farmer cannot obtain crop insurance. So, the 17% of corn acreage not planted yet stand at risk of never being planted with corn this year. These acres likely will transition to soybeans, which have a latter planting deadline of June 10 to June 30, depending on the location. But with the fields so wet, planting soybeans by the date needed for crop insurance stands as no sure bet. Unless the sun shines soon, a large portion of US acreage stands at risk of lying fallow this year.

For the Global Supply-Demand Balance, this possesses significant implications. The U.S. produces the largest corn crop in the world and one of the top soybean crops as well. As a result, a shortfall in the US crops will impact the globe. According to the USDA World Agricultural Supply and Demand Report (WASDE), the US farmer produced 25% of the world's "Coarse Grains" in the 2018/2019 Crop Year, principally corn, and a little under 21% of Oilseeds, which are principally soybeans. Based on the latest USDA Yield Projections, the farmer will harvest just 166 bushels of corn per acre, the lowest since the 2013/2014 Crop Year. And if this year's rainfall continues at the pace that currently exists, that harvest yield could shrink considerably. Already, Corn Stocks to Use are projected to end the year below 12%. (The WASDE report is available at https://www.usda.gov/oce/commodity/wasde/wasde0619.pdf .)

And while the rainfall continues to impact the farmer's production, lower yields will meet higher prices leaving farm Corn cash receipts strong. In March, prior to the current run-up in Corn prices, the USDA forecast Corn crop receipts, as of March 6, 2019, at $50.8 billion this year compared to $48.3 billion last year. Since then, prices have gone from $3.50 to $4.50 per bushel, up 28%+, while harvested bushels are only forecast down 9%. Even should the actual harvest drop 15%, the farmer still stands 9% ahead due to the massive rise in prices. So, while pictures of soggy fields might make the evening news, corn farmers overall should do well. And even though soybean farmers are under pressure due to the dispute with China, the improvement in corn cash receipts should offset any impact on the soybean side, leaving the farm community close to the same income as last year. (Note: For this outcome, prices are assumed to stay where they are. Should the crop truly become a disaster, prices could revisit $6.00 or more, where they stood in 2011 and 2012 with a nice benefit to the farmer. And in this instance, soybean prices would recover.)

For the US farmer, the 2019/2020 crop year is shaping up to produce the most volatility in 6 or 7 years. And this volatility stands mostly as a good thing for the average farmer, assuming he or she can get their crops in the ground. And while one can picture Curly singing Oh, What A Beautiful Morning, that certainly does not fit what the torrential downpours the farmer faces this year. Instead of singing such a light and soaring song, the farmer will instead offer a serious lament titled: "The Corn Is Not As High As An Elephant's Eye". (Data from US Department of Agriculture coupled with Green Drake Advisors analysis.)

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**Hot Air, Two Faced, and The Bionic Human**

Finally, we close with brief comments on Hot Air, Two Faced, and The Bionic Human. First, manufacturers of HVAC equipment (Heating, Ventilation, and Air Conditioning) have announced price increases of 5% to 7%. This is very similar to what occurred from 2004 – 2006. For their customers, the cost of Hot Air just went up. Second, the Commerce Department announced that solar panels that collect electricity on both sides would be exempt from anti-dumping duties, unlike the one sided panels common today. Utility scale projects are expected to use this exemption to bring millions of kilowatts of panels into the country duty free. With this action, we see the US Government as Two Faced. And third, researchers from the University of Newcastle have developed a 3D Printed Artificial Cornea. In addition, scientists at the university have developed a self-assembling cornea from 4D Biomaterials. These 4D Biomaterials can change shape or function when exposed to specific external stimuli. We see this as another step on the road to 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
President
& Senior Advisor