GREEN DRAKE
ADVISORS

Green Drake™ Advisors, LLC
175 Strafford Avenue, Suite One
Wayne, PA 19087
(610) 687-7766 Voice
(610) 300-3211 Fax

www.greendrakeadvisors.com

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The Monthly Letter covers three topics this month. First, we examine a series of policy actions the U.S. Government took over the past 2 ½ years. While discrete in and of themselves, when put together, they offer glimpses into a potential U.S. National Economic Strategy in the making. Second, with the U.S. moving aggressively to source technology and other goods outside of China, this possesses multiple implications for the global economy. The infamous J Curve will make its impact known, creating company and country winners and losers. And Third, as always, we close with brief comments of interest to our readers.

Watching Sausage Being Made: The Creation of a U.S. National Economic Strategy

> "*It is not easy to give a precise treatment of trade based on scale economies. The difficulties relate to the market structure under which such trade will occur. Perfect competition is in general incompatible with economies of scale, so some form of imperfect competition will prevail. For descriptive purposes, one must then choose among the numerous alternative ways in which imperfect competition cam be modelled; and the conclusions one arrives at will in general depend on the particular specification chosen. To arrive at a general theory of trade with imperfect competition is therefore impossible; the most one can hope for is a catalogue of special models. The same goes for welfare assessments. Because of imperfect competition, the gains from trade may not materialize; conceivably there could even be a loss from trade due to an increase in certain distortions. Again, whether trade will be beneficial depends on the market structure under which trade occurs.*"

Chapter 9: Scale Economies and Imperfect Competition
Theory of International Trade
By A.K. Dixit and V. Norman, 1980

For those watching the changes in Washington, D.C., there appears no order to them. One day the Presidential Administration addresses one item, such as Chinese trade. And the next, it addresses another seemingly unrelated item, such as NATO spending. Then it heads off in a third direction, creating a Quantum Computing initiative. Then the next day it returns to trade in autos, badgering Japan and Germany. Then the following day there is a focus on vocational education. This is followed by an Executive Order to establish the President's Advisory Commission on Asian Americans and Pacific Islanders. One might almost think there existed no overarching strategy behind these seemingly random

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actions. It might remind one of Watching Sausage Made. In the process, it looks like a mess. But somehow, when the product comes out the other end of the manufacturing line, it is a complete, finished product, ready to eat.

However, hidden behind these seemingly haphazard actions in Washington, there appears to be an emerging strategy that binds them all together. This unspoken strategy appears under the rubric of preparing the United States for the world of tomorrow. One might almost call it a National Economic Strategy, a strategy to grow the US economy at a faster rate and to position the country for a Great Power rivalry with China. The policies can be broken down into two parts. The first deals with the United States economy directly and key industries of the future:

National Electric Vehicle Supply Chain Initiative
National Focus on Advanced Manufacturing, AI, and Robotics
National Focus on STEM Education
National Focus on Vocational Education

And the second deals with those related to national security:

National Quantum Computing Initiative
National Hypersonics Initiative
Satellite Launch R&D Funding
National Focus on Balance of Trade
National Security Strategy for Space

These initiatives, when viewed as a whole, create an integrated strategy to position the U.S. economy to participate in the key industries of the future. They enable globally competitive companies producing leading edge products and protect these industries from actions to undermine them. This represents a sea change in policy after 20 years of allowing critical industries to move large portions of their supply chains abroad. In addition, these policies focus on creating the labor force of the future that will need different skills than the labor force of today. Unlike Europe, the United States does not formally train the workforce with vocational skills. Given the need for labor to fill many jobs for which a traditional college education will not provide the job skills, the government must now involve itself with reshaping the educational system. And lastly, they will seek to ensure certain industries locate in the United States physically in order to undergird the country's industrial base and defense capabilities. These will likely include technology focused industries as well as critical manufacturing industries such as parts manufactured using 3D Additive Manufacturing and the special powder metals and purified chemicals needed as well as Robotics and Industrial Automation for the factory of the future.

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As the above analysis makes clear, while appearing haphazard, these policies represent an integrated whole focused on driving economic growth for the United States over the next two decades. They simultaneously provide key manufacturing capabilities to undergird the U.S. industrial base and support U.S. defense capabilities. While large corporations over the past 20 years have focused on locating plants across the world and optimizing their well being, this change in government policy orientation coupled with an emerging Great Power rivalry will change the rules of the game, forcing companies to optimize U.S. economic well being over their own. While government policy making will continue to appear haphazard and look like chaos, much like an impressionist painting from Monet, a step back from the canvas provides a different perspective. It shows the whole picture. With the U.S. Government as artist and the rest of the world Watching Sausage Being Made, the finalized picture has begun to come into focus. And while numerous brush strokes remain to complete the canvas, the artist clearly outlined the overall landscape as The Creation of a U.S. National Economic Strategy. (Publicly available data from Office of the U.S. President, U.S. Department of Defense, U.S National Intelligence Council, U.S. Trade Representative, U.S. Congress, and company reports coupled with Green Drake Advisors analysis.)

China and Exports: Capital Mobility, The J Curve, and Slowing Growth Ahead

> "*We have no historical criteria by which to judge the efficiency with which investment responds to the shifting demands of our manufacturing industries. If we accept – or better, define – the dispersion of industry rates of return as the measure of the disequilibrium in any year, we can at least make several comparative statements. Dispersion is relatively greater in years of depressions: industries cannot adapt to sudden decreases in demand as well as they can to expansions – in part, perhaps, because fixed capital is easier to increase than to decrease in the short run. Dispersion is larger (as well as more stable) in concentrated industries: whether because of monopoly power (of which we find no reflection in average rates of return) or because of lesser flexibility of response to changing conditions, the industries dominated by relatively few firms are somewhat less efficient in adjusting their capital stock.*"

Chapter 1: Introduction
Capital and Rates of Return in Manufacturing Industries
By George J. Stigler, 1963

China continues to grow at a rapid pace. According to the latest economic data released by the country, the economy grew over 6% year over year in the first half of the year. This growth occurred despite the noise on trade. Propelling Chinese growth was consumption and government spending, with consumer

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spending growing almost 10%, and infrastructure Fixed Asset Investment increasing over 6%. In addition, other economic data points, such as steel production growing 10% year over year, confirm this top level data. This seemingly unstoppable combination appears to have taken over from investment to drive its economy.

However, all does not appear as it seems. Auto sales dropped 12.4% year over year in the first half of 2019. In most countries, a double digit decline in auto sales would be called a recession. The Government deficit exceeds 10% of GDP, as the government moves to stimulate the economy. The Central Bank continues to increase the amount of monetary stimulus, whether through outright monetary growth or through lowering Required Reserve Requirements. All of these are classic actions to fight a recession. But, in China, that word does not exist.

If this were a normal recession, with the accompanying economic pain, and the government applied this traditional stimulus, a true recovery would ensue with economic growth accelerating to well above average coming out of the recession. But this is not a normal slowdown. China stands in the midst of a trade fight with the United States, its largest trading partner. With the ability of corporations to move capital around the world, what economists call Capital Mobility, companies have begun to reorder their supply chains. And instead of building their next plant or product in China, other countries, such as Vietnam, Malaysia, and Singapore, have become the objects of affection. For example, Vietnam's exports to the United States rose over 36% in the first 5 months of the year to over $25 billion.

With foreign companies investing less in China, while near term exports will see only a limited impact, longer term effects could become quite substantial. This shock to the system comes from something called the J Curve. Traditionally, this is used by economists in understanding the impacts of currency movements. For example, if a currency appreciates 10% on a trade weighted basis, initially a country's trade balance improves, as existing contracts continue. But because a country's currency rose, its companies are less competitive in the global marketplace and foreign goods are relatively more attractive. This typically leads to lower exports and higher imports after 12 months. A country's trade surplus, in nominal terms, initially improves and then deteriorates as time goes on, looking like the letter J, but in this case upside down. And the more the currency appreciation, the larger the downside over a period of years, potentially making the descending side of the J quite large. For China, this extended J Curve likely stands as the outcome of the dynamic of plants being moved abroad. Initially, exports continue as contracts exist and plant construction takes time. A typical plant can take 2 years or more to build along with all the planning necessary on the logistics side to move goods to market. However, as contracts expire and these plants outside China come online and ramp their output, production will exit China, impacting its exports and capacity utilization of its manufacturing capacity. And with no new products to replace the products moving abroad, investment will come under pressure and plants will face closure. Already, foreign companies have moved to resource their production to other countries.

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And, on top of this, in a surprise move, select Chinese companies started to invest abroad instead of inside the country in order to maintain their global market share. Both of these actions will impact investment in the short term and the long term. And while plants don't face closure issues today, the future continues to rush forward. For China, this likely stands as a 2021 or 2022 issue. (How much domestic Chinese companies can move production abroad stands in question as the government exerts significant control over these actions and much of the country's industry falls under the control of State Owned Enterprises.)

While China continues to report growth over 6%, this growth stands suspect given the auto data and as numerous countries move to limit the role of Chinese imports. In addition, recent academic studies demonstrate Chinese real economic growth 1.8% or more below that reported over the past five years. In other words, the economy only grew at 4.5% or less per year. Furthermore, other Asian economic competitors to China have moved to limit Chinese goods in their economies even more than the U.S. For example, India slapped tariffs on Chinese chemicals such as MPDA to protect its domestic producers. (MPDA is a critical intermediate chemical for dyes and photographic chemicals.) This stands as just another in a long list of goods India has tariffed out of its markets. And while China can maintain its growth over the short term, as fiscal and monetary stimulus moves to offset export pressures, longer term these pressures will mount at an accelerating rate. And with China's Productivity Growth negative for the past 4 years, according to the Conference Board, coupled with a shrinking labor force, offsetting these pressures with fundamental growth looks difficult at best. Given Export pressures coupled with Capital Mobility, from both foreign and Chinese companies, China likely faces the consequences of the J Curve and Slowing Growth Ahead with all its messy consequences for the country. For companies and investors who have come to depend on China's steady 6%+ growth rate, a new landscape stands ahead much different than that over the past 20 years. (Data from public sources coupled with Green Drake Advisors analysis.)

Real Interest, Rest Stops, and There They Go Again

Finally, we close with brief comments on Real Interest, Rest Stops, and There They Go Again. First, the drop in interest rates appears to be having a salutary effect on home purchases. According to the latest data from the Mortgage Bankers Association, New Home Purchase Applications rose 17.9% compared to a year ago and Existing Home Purchase Applications rose 7.0%. We see the consumer having Real Interest in purchasing a home again. Second, according to data from truck companies such as JB Hunt and Covenant Transportation, truck volumes fell 7% or more in Q2 as the Global Inventory Correction roared along. For trucking companies, we see their drivers taking extended Rest Stops. And third, large club stores began to raise prices aggressively to offset higher costs and to ensure their profit continues to grow at a rapid rate. This is similar to what occurred in 2005 – 2008. Examples of products with large

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price increases recently include parmesan cheese up 14%, hot dogs up 11%, office paper up 10%, tuna fish up 18%, and guacamole up 33% to 54% (as the lower cost packaging size disappeared from the store). For the consumer, it is There They Go Again.

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

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