2017 2nd Quarter Stock Market Commentary

ZETETIC ECONOMICS

"House Speaker Jim Wright and I agree that there are three things we must do to balance the trade deficit. We can't remember what they are."
-President Ronald Reagan, speaking at the White House Correspondents Dinner

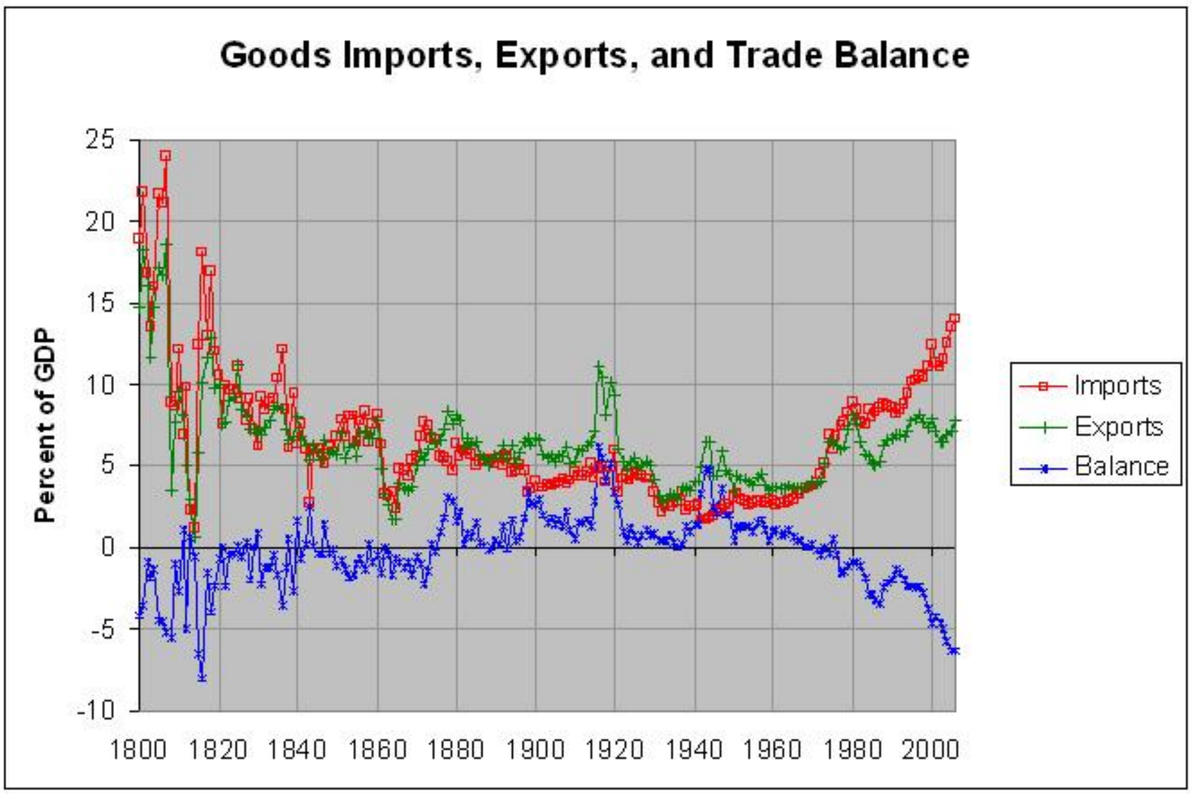
In the mid-1800s, Samuel Birley Rowbotham, using the pseudonym "Parallax," traveled the English countryside to promote his belief that the earth is flat. He codified his theory in a sixteen page pamphlet published in 1849, which he later expanded into a 221 page book entitled *Zetetic Astronomy: Earth Is Not A Globe*. Rowbotham maintained that the Earth is a flat disc centered at the North Pole and bounded along its southern edge by a wall of ice, Antarctica, with the Sun and Moon 3,000 miles and the "cosmos" 3,100 miles above the Earth. The word zetetic derives from the Greek and means "proceeding by inquiry." Apparently Rowbotham understood that by engaging in a bit of verbal obscurantism his oddball theory would appear to be based upon scientific principles.

It is hard to believe, but this unusual world view has modern-day adherents. In 1956 Englishman Samuel Shelton founded the International Flat Earth Research Society (the inclusion of the word "research" is a nice touch, don't you think), which was later moved to Lancaster, California by American Charles K. Johnson. The organization has several thousand members, and apparently many non-member believers. Cleveland Cavaliers guard Kyrie Irving made headlines recently when he stated in an interview that the Earth is flat. He received support for this unorthodox view from noted astronomer (and Hall-of-Fame basketball player) Shaquille O'Neal who said "I drive from coast to coast, and this s**t is flat to me. I'm just saying. I drive from Florida to California all the time, and it's flat to me. I do not go up and down at a 360-degree angle." So there you go!

Obviously, a belief that the Earth is flat is amusing, but there are no real-world consequences to a few athletes holding such beliefs. But it is quite a different story when beliefs unsupported by the facts are held by government officials in policy making positions. A case in point involves Peter Navarro, President Trump's trade policy adviser, who has written extensively about the drain on economic growth caused by America's trade deficits, and the negative consequences for the country of the capital surpluses that result from them. The truth is considerably more complicated.

Consider the chart below as a starting point for our discussion. It shows the value of imports, exports, and the difference between them, referred to as the "trade balance" or the "current account." When the trade balance is above zero the U.S. is running a trade surplus; when it is below the horizontal axis the U.S. has a trade deficit. If you look at the right-hand side of the graph you can see that the country has run trade deficits for 41 straight years. And yet this period was one of considerable prosperity. Gross domestic product tripled after adjusting for inflation, manufacturing quadrupled, and the size of the workforce doubled.

By contrast, consider the decade of the 1930s, the era of the Great Depression. During the 120 months of that period, the United States ran a trade surplus for 102 of those months. If a trade surplus was a sign of success, that would not be remembered as the darkest period in our nation's history.



Contrary to political rhetoric, a trade deficit is most often the byproduct of a healthy economy, where consumers are prosperous and optimistic enough to spend freely. In and of itself, it does not represent a problem that needs to be solved.

But more fundamentally, reducing our trade deficit would have the effect of decreasing our capital surplus. Given our massive accumulated government debt of nearly $20 trillion, any large decrease in foreign purchases of U.S. treasury securities would have the potential to drive interest rates (and our budget deficit) sharply higher. To understand this, consider the three basic sources of investment capital in the economy.

The first is private savings. It is what is left over after paying for goods and services, as well as taxes. This is currently about 5% of income, less than half the savings rate that prevailed from the mid-1950s until the early 1980s. By comparison, the Japanese savings rate has averaged nearly 12% for the past fifty years.

The second source of investment capital is government savings. It is what is left over from tax receipts after paying the expenses incurred to run the country. Unfortunately, since the United States has run a budget deficit every year for the past two decades, this is currently negative.

The third source of investment capital is from overseas, in the form of savings which foreigners choose to re-invest into U.S. stocks, bonds, property or businesses. It is the amount by which the country needs to borrow from foreigners to finance our purchase of things made abroad. It is called the "capital account surplus." By definition, it is the exact same amount as the trade deficit. When we buy French wine, German cars, Japanese electronics, or Chinese sneakers, the sellers are paid in dollars which they then need to recycle into U.S. stuff.* The whole world is more prosperous when the level of trade is higher. Focusing on a trade deficit with one country, like China, creates a false narrative.

Consider a domestic analogy. When you pay your doctor for a visit you have a bilateral trade deficit with your doctor. You do not expect him/her to purchase an equal amount of goods or services from you. But it is then understood that some of the money the doctor earns will be recycled into a haircut or lawn care. This specialization benefits all parties. Trade is not a zero-sum game. Without it, we would have a primitive society in which every individual would grow their own food and make their own clothing. It is the same for nations. Guatemala and Columbia will likely always sell coffee to the United States, and we need to buy manganese and platinum from South Africa. But those countries need to buy their airplanes either from Boeing in the U.S., or Airbus in Europe, since they lack a large enough domestic market to justify the huge costs to develop an aerospace industry. This theory of comparative advantage has been known for two hundred years, dating back to Ricardo, and it is well understood that voluntary trade boosts the well-being of all economic actors.

The problem, though, is that the negative effects of trade deficits are not borne solely by those who reap the benefits of the availability of lower cost, high quality goods. Instead, the negative effects fall disproportionally on factory workers in the Rust Belt. One frequently quoted study

* *For those of you who are comfortable with a bit of algebra, we can represent this discussion as a consequence of the GDP Identity taught in every basic macroeconomics course.*

$$Y = C + I + G + (X-M)$$

Here Y=GDP (gross domestic product), C=consumption, I=investment, G=government spending, X=exports and M=imports. If we rearrange these terms we obtain

$$I = Y-C-G-(X-M).$$

Adding and subtracting T=taxes on the right side (which changes nothing) gives

$$I = (Y-C-T) + (T-G) + (M-X)$$

where (Y-C-T) is private savings, (T-G) is government savings and (M-X) is the capital surplus.

estimated that imbalanced trade with China resulted in the loss of more than two million American jobs between 1991 and 2011, with half of those being in manufacturing. Low wage workers in emerging markets have cost workers without college degrees (which is two thirds of the American workforce) 5.5% of their annual earnings, according to a study by economist Josh Bivens.

Over the past quarter century, the United States has entered into a staggering number of trade agreements. We currently have agreements involving 162 different countries and bilateral trade agreements with 25 countries. American companies are quite competitive when trade is truly free. The United States actually runs a surplus with those countries with which it has trade agreements which are honored by both parties. Unfortunately, many of our trade partners consistently violate the spirit of the agreements through such means as manipulating their currency, creating licensing requirements, imposing local content requirements and quotas, and stealing intellectual property. The need to police our trade agreements is one of the few issues on which candidates Hillary Clinton and Donald Trump agreed.

Congress attempted to provide the executive branch with the tools to enforce trade agreements when it created the Office of the United States Trade Representative (USTR) as a part of the Trade Expansion Act of 1962. Twelve years later it expanded the bill by allowing American companies to petition the USTR to block imports from offending countries. Unfortunately, the agency, which has fewer than 300 professionals, does not have sufficient resources to accommodate the huge growth in the number of trade agreements and the volume of trade.

Given the current Administration's love of the use of media, perhaps they should try an unconventional means of correcting our trade imbalance. Send free copies of iconic movies such as Avatar, Erin Brockovich, China Syndrome and Chinatown to China. If we can turn an entire generation of Chinese youth into environmentalists, we should be able to restore a level playing field for American manufacturers.

Less facetiously, if the government is serious about restoring free trade, it should sharply increase the number of professionals examining unfair trade practices, and impose stiff penalties on violators. Simultaneously, much greater resources should be provided to educate and retrain workers whose jobs have been off-shored. Unfortunately, such measures are not nearly as flashy as a border tax adjustment, or the imposition of large tariffs on countries with which we run a large trade deficit. For example, President Trump recently imposed tariffs on Canadian timber, and is threatening similar measures for the Canadian dairy industry. This is likely to be met with retaliatory tariffs, dampening overall economic activity. Additionally, both tariffs and border tax adjustments are inflationary. Whatever policies are enacted will create industry winners and losers. More than is usually the case, politics will likely affect earnings estimates for huge swaths of corporate America. It seems likely that the current low volatility in financial markets is simply the calm before the storm.