POLICY BASED INVESTING

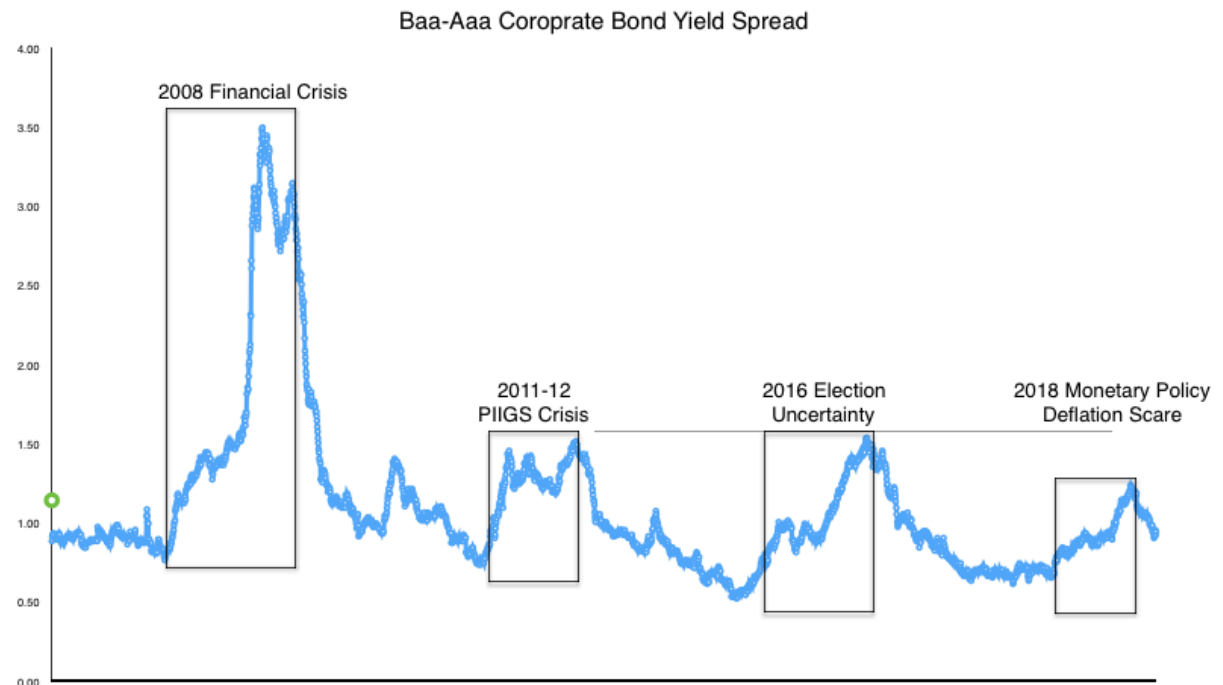
by Russell Redenbaugh & James Juliano

Monday, May 13, 2019

TRADE WAR FEAR

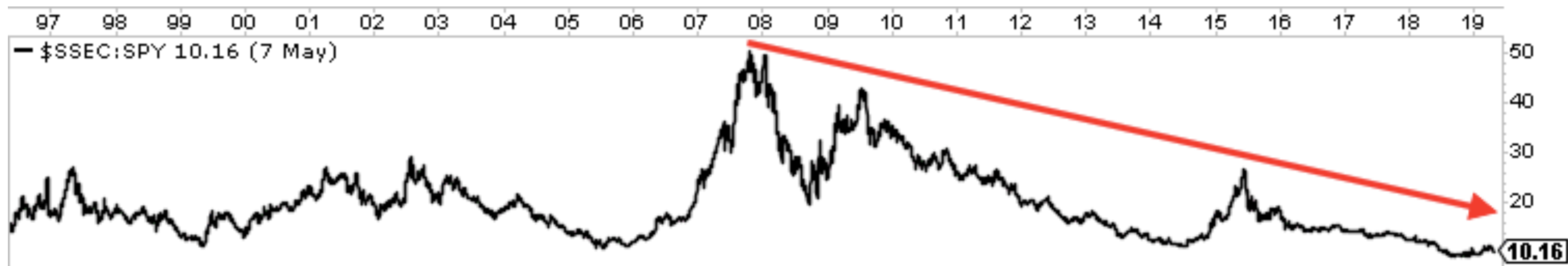
Trade war fears have again gripped financial markets. While it is certainly possible that current U.S./China trade negotiations could devolve into a full-fledged, 1929-style trade war, we don't think that outcome is likely. Let's begin with the data.

Corporate bond spreads continue to tighten. This is not a sign of systemic risk in the economy. As you see in the chart below, spreads widened significantly before and during every major crisis. The last widening happened during Q3 and Q4 last year when the Fed threatened a deflationary monetary policy mistake. In 2019 spreads have tightened from 124 to 90 basis points - not a move consistent with an emerging global trade war scenario.



Since making new, nominal highs two weeks the S&P500 has declined 4.7%. The Shanghai Stock Exchange index has fallen 11.8% over the same time period. These returns suggest China is suffering far more than the U.S. from lack of a trade deal. As we've said for some time, China has far more to lose in a "trade war." But China's underperformance is nothing new. As seen in the chart below, after a decade of outperformance in the 90s Chinese stocks have since been underperforming the S&500 for the

majority of the last decade. They have decisively underperforming since the U.S. pro-growth policy shift resulting from Election 2016.



Our good friend and excellent economist Scott Grannis grounds our recent China trade assessments well in his latest article titled, "U.S. and China play Trade Chicken, and both are likely to win." We strongly encourage you to read the entire piece and use it as a base to frame how much you "fear" current China trade headlines.

U.S. and China play Trade Chicken, and both are likely to win by Scott Grannis

Global markets are in the midst of another panic attack that appears to be the direct result of an escalating game of trade-war chicken between the US and China. Who's likely to win? I believe the odds are in favor of the U.S. winning, especially since a trade deal with China to Trump's liking is likely to end up being a win-win for all concerned.

The vast majority of economists would agree that the best trade policy is free trade, with no tariffs, barriers to entry, or subsidies. Free markets and global trade have proven to be the best way to promote global prosperity. Tariffs are best viewed as a tax on imports, with the cost being paid by the consumer, not by the producer. Taxes serve only to reduce private consumption in order to fund public consumption, which in the end is less efficient. The country that taxes its imports least is therefore the country that will benefit most

from trade. By the same logic, countries that subsidize their exports only hurt themselves while benefiting those who buy their subsidized goods and services. (We should welcome any country's subsidies!)

The vast majority of economists would also agree that there are second-order effects that stem from tariffs. By making imported goods more expensive, countries that impose tariffs on imported goods give domestic producers a degree of "protection" to the extent domestic producers can charge higher prices and still compete with imports. But this only reinforces the argument that at least part of the cost of tariffs is born by consumers. Protectionists also argue that tariffs save jobs—and to some extent they do, in the "protected" industries—but only at the expense of consumers. Tariffs, in short, benefit a relative few at the expense of the many.

Trump understands this, and said so at the G7 summit meeting last year: "That's the way it should be, no tariffs, no barriers … and no subsidies. ... that would be the ultimate thing." The only way to understand Trump's apparent love for tariffs today is that they are, as Larry Kudlow noted a few months ago, "a negotiating tool. They are part of his quiver." And tariffs are a policy tool over which Trump has direct control. That makes tariffs irresistible to deal-maker Trump.

A war of escalating tariffs between the US and China would be damaging to both countries. If carried to an extreme, a tariff war with China would most likely endanger the global economy by weakening both the huge U.S. and Chinese economies. Bad! And in that sense Trump is crazy to be engaging in a tariff war with China. Worse, he falsely argues that his tariffs are paid by the Chinese and that the money goes straight to the federal government's coffers. To his credit, Trump's economic advisor (and my good friend) Larry Kudlow yesterday correctly admitted that tariffs are in fact paid by U.S. consumers, not the Chinese. But he also correctly added that higher U.S. tariffs will hurt the Chinese as well. So the question then becomes, Who will suffer the most? Who will likely back off from this game of chicken the first?

Tyler Cowen is a well-respected economist at George Mason University who has a reputation for not having a partisan bias. Today he wrote a column for Bloomberg (which certainly does have a strong liberal bias) in which he argues persuasively that China stands to lose more from a trade war than the U.S. does, even though it is clear that Trump's higher tariffs on Chinese imports impose burdens on U.S. producers and consumers.

Here's Cowen's conclusion (read the whole thing for the important details):

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In my numerous visits to China, I've found that the Chinese think of themselves as much more vulnerable than Americans to a trade war. I think they are basically correct, mostly because China is a much poorer country with more fragile political institutions.
My argument isn't about whether Trump's policy toward China is correct. I am only trying to get the basic economics straight. Next time you hear that the costs of the trade war are simply being borne by Americans, be suspicious. In their zeal to make Trump look completely wrong, on tariffs or other issues, too many commentators pick and choose their arguments. A more fair and complete economic analysis indicates that China is also a big loser from a trade war. Trump's threats are exerting some very real pressure on the country.

Markets are usually efficient at discounting the future, if only because they reflect the consensus of millions of participants with skin in the game. Right now they are saying that although both the U.S. and Chinese economies are hurting, the Chinese are hurting more.

Chart #1

Chart #1 compares the value of yuan vis a vis the dollar (blue) with the level of China's foreign exchange reserves (red). Here we see that since the beginning of the U.S.-China tariff war (March-April 2018) the yuan has fallen by about 8% vs. the dollar. That means that the amount of yuan that Chinese producers receive for each dollar of sales to the U.S. has fallen by 8%. This chart also shows that China's foreign exchange reserves have been relatively stable for the past 30 months, at just over $3 trillion. China's central bank is apparently targeting a stable level of reserves, and allowing the yuan to fluctuate in value as capital attempts to enter or leave the country (this is a legitimate monetary policy, though one not often used). The weaker yuan thus directly reflects weaker net investment in China and a loss of Chinese purchasing power. Bad!

As Cowen notes in his column, China's lack of "guarantees against espionage, intellectual property theft and unfair legal treatment ... makes investing in China less desirable for many multinationals, not just U.S. ones." If China were to agree to Trump's demands in these regards, its economy would almost certainly benefit from increased investment and a stronger yuan. Good!

Chart #2

Chart #2 compares the value of the MSCI China Index (in HK dollars) to the value of the S&P 500. Chinese equities have greatly underperformed their US counterparts since China's "opening" to the world in 1995. Moreover, since the US/China tariff war started last year, Chinese equities have fallen by almost 18% relative to US equities. Equity markets are clearly saying that *China will be the biggest loser*.

Chart #3

Chart #3 shows that Chinese exports to the US and imports from the US have both fallen since the beginning of Trump's tariff war (in dollar terms). This is the result not only of a reduced volume of trade but also the yuan's reduced value. US/China trade represents a far greater share of China's economy than it does of the US economy: China's exports to the US are roughly 4 times greater than China's imports from the US, while the US economy is roughly half again as large as China's. China thus stands to lose much more from any trade disruptions.

Chart #4

Chart #4 quantifies the market's renewed sense of unease over trade relations. Though not yet as acute as what we saw late last year, it's a similar pattern. Rising fears are driving down the value of equities.

Meanwhile, swap spreads and credit spreads remain relatively low. Liquidity conditions have not deteriorated, the Fed is not too tight, the dollar is not collapsing, and the US economy is likely to continue growing. What we see in the markets today is another panic attack which will likely be assuaged once the Chinese figure out a face-saving way of capitulating to Trump's demands. That shouldn't be too hard, since it ultimately will lead to a positive result for both the US and Chinese economies.

ALLOCATOR

Fixed Income

Bonds are an asset class that does well in a deflationary policy environment (Low Growth & Strong Currency)

We have long said the Treasury bond bubble will pop again as it did from May2013-Jan2014 when long term Treasury bonds fell 18%. With voters choosing Trump's pro-growth agenda to ignite growth, we believe the this is even more likely. Treasury bond prices are at risk to fall 30-50%, and we expect any moves higher in bond prices (lower in yields) to be short-lived. Since most other bonds price off of Treasury yields, fixed income in general is a risky asset class.

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Investment Grade	LQD	9/9/2016	$119.00	$118.86	-0.1%	
Aggregate Bond	AGG	9/9/2016	$109.00	$108.67	-0.3%	2017 rise in Treasury bond prices (decline in yields) due to inflation expectation falling while growth expectation flat. This is a positive combination for future economic growth. Bonds remain a risky asset class that could decline 30-50% as real growth normalizes higher.
Municipal	MUB	9/9/2016	$111.00	$111.89	0.8%	
TIPS	TIP	9/9/2016	$114.00	$113.27	-0.6%	
Extended Duration	EDV	9/9/2016	$128.00	$117.67	-8.1%	
US Treasury 3-7 yr	IEI	9/9/2016	$124.00	$122.88	-0.9%	
US Treasury 7-10 yr	IEF	9/9/2016	$109.00	$106.12	-2.6%	
US Treasury 20+ yr	TLT	9/9/2016	$133.00	$124.75	-6.2%	
International Total Bond	BNDX	9/9/2016	$54.40	$55.81	2.6%	
High Yield	HYG	4/12/2016	$77.00	$86.23	12.0%	Act more like equities than bonds, benefit from improving growth

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Commodities

A change in the price of gold is a change in the value of the currency. When gold rises, the currency's value falls and vice versa. Commodities are an asset class that does well when the currency is weak.

If growth is slowing while the currency weakens, there is stagflation. Own precious metals.

If growth is accelerating while the currency weakens, there is an inflationary expansion. Own agriculture, industrial and energy commodities.

Commodities suffered heavy losses in the strong US Dollar environment 2012-2015. In 2016 Dollar weakness was caused by election uncertainty and commodities rallied. That weak Dollar trend was reversed by Election2016. The demand for transactional and asset based Dollars will rise if Trump's pro-growth policies are implemented and fall if his policy agenda fails. Gold's recent decline back below $1,300/oz is a confirmation of better policy and rising growth rates. Capital is beginning to leave safe haven asset classes as policy uncertainty diminishes.

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Gold	GLD	10/2/2017	$120.77	$121.43	0.5%	
Silver	SLV	10/2/2017	$15.67	$13.84	-11.7%	
Energy	DBE	8/13/2014	$28.97	$15.01	-48.2%	
Oil	USO	7/30/2014	$37.00	$12.84	-65.3%	
Agriculture	DBA	9/13/2011	$32.50	$15.59	-52.0%	
Broad Comm. Index	GSG	8/5/2011	$33.00	$16.01	-51.5%	
Base Metals	DBB	6/17/2011	$23.00	$15.90	-30.9%	

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Real Estate

Real Estate is an asset class that performs well when growth is accelerating. When rising growth is coupled with a strong currency, own real estate tied to business activity (like commercial REITS). When rising growth is coupled with a weak currency, own real estate tied to commodities (farmland).

Commercial RE will be helped by improving real economic growth. RE properties leveraged to businesses & economic growth are preferred under pro-growth US policies.

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/ Loss	Policy Notes
Residential	REZ	12/21/2016	$61.00	$70.73	16.0%	Real estate assets have declined as higher interest rates expectations lower the perceived attractiveness of housing demand and real estate's dividend yield.
Building/Construction	ITB	12/21/2016	$28.00	$38.11	36.1%	
Mortgage REIT	REM	4/1/2016	$35.00	$43.35	23.9%	
REIT	VNQ	3/7/2016	$75.50	$86.86	15.0%	

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US Equity

We have been waiting for a 1980s/90s type of policy driven equity bull market for sixteen years. The 2014 midterm House/Senate/gubernatorial election shifts put us on the path as pro-growth candidates propelled the GOP to majorities. It was a repudiation of anti-growth economic policies and a big step toward a Reagan/Clinton type of equity bull market. Despite the voters' growth signal, Obama doubled down on his tax/spend/regulatory (EPA) agendas in 2015 causing stocks to be range bound and volatile. As 2016 began, policy uncertainty ahead of November's elections became the biggest threat to equities. The ebb and flow of the presidential political season moved markets in both directions as investors waited to learn which policy theme would prevail in November – growth vs. redistribution. Voters decisively made their choice in Election2016, and growth won. Trump's pro-growth policy agenda beat Hillary's anti-growth policy agenda in landslide fashion. Republicans retained control of the Senate, House and increased their control of governorships by three. The policy stage is now set for Trump and Congress to keep delivering pro-growth tax, regulatory and monetary policies. As they do, a bull market in U.S. equities will ignite to rival the 1980s/90s

US Equity - Cap Size

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Micro	IWC	7/11/2016	$72.00	$94.58	31.4%	Most tied to domestic policy / growth
Total Market	IWV	5/19/2016	$117.00	$170.06	45.4%	
Large	IWB	5/19/2016	$111.00	$160.33	44.4%	Large caps should underperform smaller caps as domestic economic growth accelerates
Small Cap	IJR	5/19/2016	$54.00	$79.32	46.9%	Most tied to domestic policy / growth
Mid Cap	IWR	4/6/2016	$38.57	$54.99	42.6%	More tied to domestic policy / growth

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US Equity - Style

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Large Growth	IWF	7/11/2016	$101.00	$154.83	53.3%	Growth outperformed value in 2017 across all cap sizes. Trend will continue as tax cuts get implemented.
Small Growth	IWO	7/11/2016	$140.00	$199.79	42.7%	
Small Value	IWN	5/19/2016	$92.00	$123.37	34.1%	
Mid Growth	IWP	5/9/2016	$90.00	$139.02	54.5%	
Large Value	IWD	4/6/2016	$95.00	$125.32	31.9%	
Mid Value	IWS	4/6/2016	$68.00	$88.20	29.7%	

US Equity - Sector

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Staples	XLP	6/5/2017	$57.00	$57.31	0.5%	Defensive sector hurt by rising growth
Utilities	XLU	6/5/2017	$54.00	$57.96	7.3%	Defensive sector hurt by rising growth
Metals/Mining	XME	5/8/2017	$29.00	$28.12	-3.0%	Tied to commodity prices, hurt by strong Dollar
Energy	XLE	3/13/2017	$69.00	$64.05	-7.2%	Tied to commodity prices, hurt by strong Dollar
Healthcare	XLV	2/8/2017	$71.00	$88.91	25.2%	
Discretionary	XLY	11/14/2016	$79.00	$117.29	48.5%	Consumer strong w/ rising growth expectations
Financial	XLF	7/18/2016	$19.00	$27.48	44.6%	Helped by Trump deregulation (Dodd Frank) & rising interest rates
Materials	XLB	4/6/2016	$44.00	$55.14	25.3%	Global growth
Industrial	XLI	3/14/2016	$52.00	$76.27	46.7%	Global growth
Technology	XLK	3/7/2016	$41.00	$76.18	85.8%	Repatriation tax reform huge plus for tech companies

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Foreign Equity

Country	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Mexico	EWW	10/1/2018	$51.23	$44.59	-12.96%	Freer and fairer trade agreements are pro-growth for all parties involved
Canada	EWC	10/1/2018	$28.78	$27.98	-2.78%	
Denmark	EDEN	7/2/2018	$63.89	$63.63	-0.41%	European polices not improvng despite anti-austerity movements across the Euro Zone. Capital is fleeing. A zero trariff trade deal with the U.S. would reverse course and be very pro-growth for European economies.
Switzerland	EWL	7/2/2018	$32.58	$35.74	9.70%	
Netherlands	EWN	7/2/2018	$30.51	$30.86	1.15%	
Sweden	EWD	7/2/2018	$30.51	$30.69	0.59%	
Eurozone	EZU	7/2/2018	$41.01	$39.43	-3.85%	
Spain	EWP	7/2/2018	$30.35	$28.89	-4.81%	
Poland	EPOL	7/2/2018	$21.78	$21.91	0.60%	
France	EWQ	7/2/2018	$30.52	$29.95	-1.87%	
Germany	EWG	7/2/2018	$29.98	$28.34	-5.47%	
Italy	EWI	7/2/2018	$28.89	$27.35	-5.33%	
Austria	EWO	7/2/2018	$22.65	$20.46	-9.67%	
Israel	EIS	2/26/2018	$52.41	$55.72	6.32%	
Vietnam	VNM	10/9/2017	$14.99	$16.29	8.67%	Demographic leverage to US economic growth policies
Indonesia	EIDO	7/24/2017	$26.78	$24.29	-9.30%	Demographic leverage to US economic growth policies
Ireland	EIRL	1/26/2017	$39.00	$42.95	10.13%	
Singapore	EWS	1/11/2017	$21.00	$24.39	16.14%	
China	FXI	1/6/2017	$35.50	$41.97	18.23%	Strong Dollar emerging market, tied to US growth
World Ex US	VEU	11/15/2016	$43.50	$50.20	15.40%	Global growth reset higher after US Election2016
Norway	ENOR	8/20/2016	$20.00	$24.98	24.90%	
UK	EWU	8/4/2016	$30.50	$33.00	8.20%	Brexit was a vote for growth
Finland	EFNL	7/26/2016	$33.00	$37.75	14.39%	

Japan	EWJ	7/15/2016	$47.00	$54.07	15.04%	
South Korea	EWY	7/13/2016	$52.00	$57.75	11.06%	
Hong Kong	EWH	7/6/2016	$19.00	$25.66	35.05%	
Frontier Mkts	FRN	7/5/2016	$10.50	$14.02	33.52%	Highly levered to Eurozone growth movement
Peru	EPU	6/29/2016	$30.50	$36.57	19.90%	
South Africa	EZA	6/29/2016	$51.00	$56.28	10.35%	
India	EPI	6/27/2016	$19.00	$24.76	30.32%	Strong Dollar emerging market, tied to US growth
Taiwan	EWT	6/21/2016	$27.00	$35.04	29.78%	
Thailand	THD	5/20/2016	$64.00	$89.45	39.77%	
Belgium	EWK	3/16/2016	$16.50	$18.34	11.15%	
New Zealand	ENZL	3/5/2016	$36.00	$51.95	44.31%	
Philippines	EPHE	8/5/2015	$37.00	$33.41	-9.70%	
Qatar	QAT	12/1/2014	$24.00	$18.09	-24.63%	
Malysia	EWM	10/3/2014	$41.00	$28.74	-29.90%	
Australia	EWA	9/16/2014	$22.50	$21.71	-3.51%	
Greece	GREK	7/14/2014	$20.00	$8.07	-59.65%	
Portugal	PGAL	6/4/2014	$15.00	$10.70	-28.67%	
Columbia	ICOL	6/27/2013	$21.00	$12.99	-38.14%	
Turkey	TUR	6/1/2013	$58.00	$21.85	-62.33%	
UAE	UAE	5/20/2013	$23.00	$14.56	-36.70%	
Russia	RSX	8/7/2011	$30.00	$19.97	-33.43%	Weak Dollar emerging market
Brazil	EWZ	7/14/2011	$60.00	$40.25	-32.92%	Weak Dollar emerging market
Chile	ECH	3/1/2011	$61.00	$41.06	-32.69%	
Egypt	EGPT	2/23/2004	$64.00	$30.77	-51.92%	

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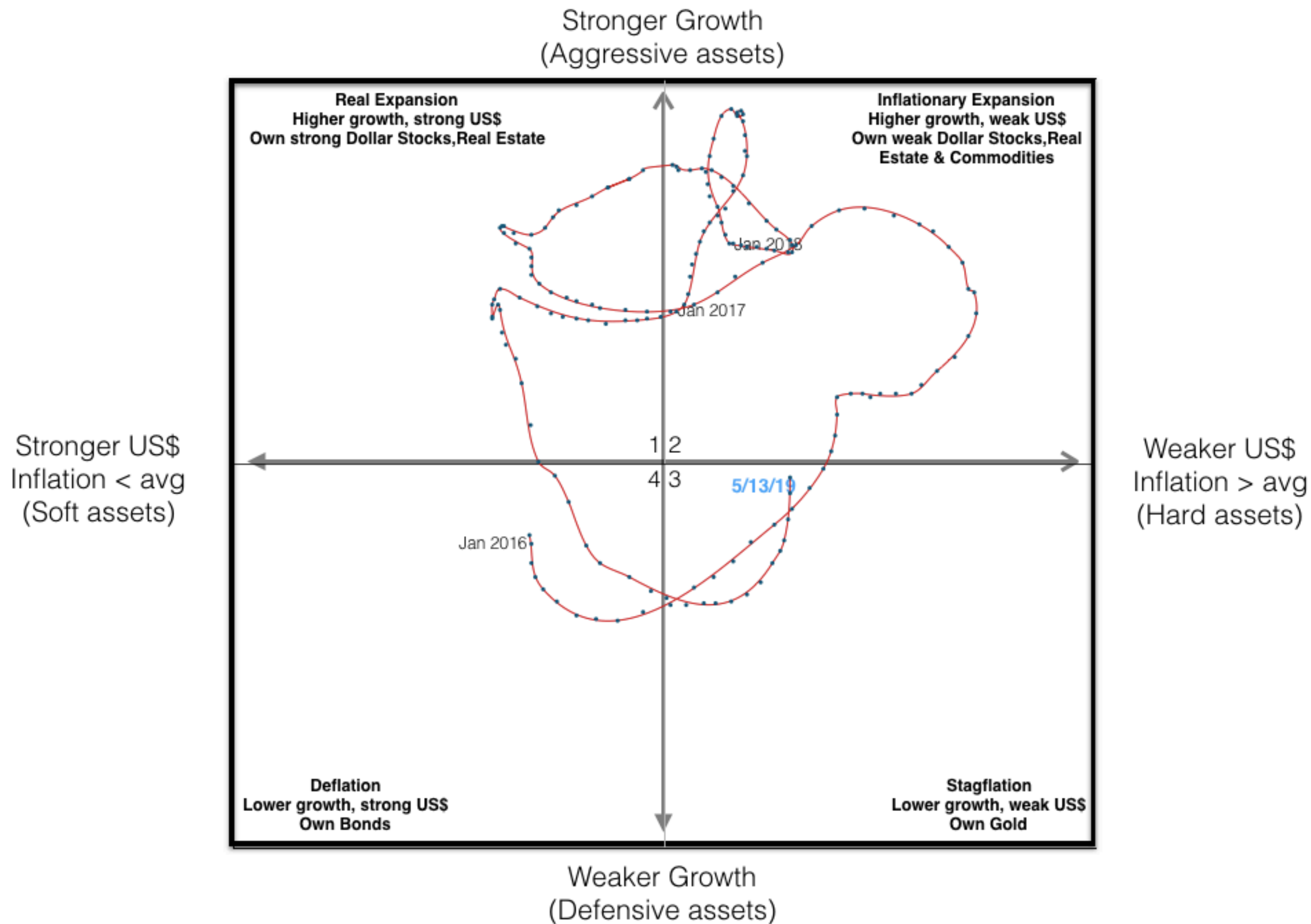
POLICY MAP

Growth increased versus last week (-..17 to -.08): Despite pro-growth tax and regulatory policy improvements since 2016, growth has tipped into negative territory over fears of a 2008-style, deflationary monetary policy mistake.

Value of US$ was unchanged versus last week (0.64 to 0.64): Dollar had been stable between gold $1,300-$1,375/oz, and recently strengthened to $1,230/oz. This strong Dollar signal gave the Fed room to pause rate hikes until economic and market data calm down.



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BOND YIELD COMPONENT ANALYSIS

Nominal Yield: 2.47% (-3%) **Inflation Expectation Component: 1.88%** (-2%) **Real Growth Component: 0.59%** (-6%)

Real growth exited the range of .30-.70 to the upside after 2017 tax cuts. In recent weeks growth expectations embedded in bond market have dislocated from equity markets. The collapse in real growth so far seems caused caused by global bond market dynamics, not a significant deterioration in U.S. policy outlook.