1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

Dow Jones: 23932 YTD -2.62% | **S&P 500:** 2604 YTD -2.10% | **NASDAQ:** 6915 YTD +0.46% ***April 9, 2018***

Trade Dominates!

The markets continued to demonstrate extreme volatility this past week. All U.S. equity markets closed down. The Dow was down 0.71%, the S&P 500 down 1.38%, and NASDAQ down 2.10%. The economic releases during the week would not have suggested either the high volatility or a down market, but investors continued to concentrate on the belligerent trade talk between the U.S. and China. The New York Fed has a new president, John C. Williams, who will replace Bill Dudley on June 17th. President Dudley has a great reputation and will be missed, but there is no reason to be concerned about his successor. This appointment should reassure investors.

Market participants are trying to assess what the future holds for trade. During the next three weeks, we will try to look into the perceived or real problems related to trade and trade deficits. Three important areas must be researched: what are the likely results of the U.S. China trade battle, what causes a country to have a trade deficit, and is a trade deficit really bad? We have received quite a few questions on all of these. Since we received the most queries about China this week, we will discuss China first. Following is a brief history about what role domestic politics plays, China's unique economics and who has the most to lose.

It is our view China has far more to lose than the United States. This doesn't mean the U.S. won't be hurt by a trade war, but much less than China.

As we have written in the past, the U.S. has a real economic problem with China, but a trade deficit is not necessarily it. In our view and in the view of many analysts, the problem is China's theft of intellectual property, their insistence that U.S. companies operating in China share confidential industry information, and their restriction of U.S. companies from participating in many industries.

China has a romantic nostalgia of their historical narrative, as many countries do. The CCP (Chinese Communist Party) has promised to restore China to its rightful place in the world order. The promise has been repeated so often and so powerfully that it has become the reason for CCP's existence. This is an important and reoccurring theme. China clearly is a remarkable growth story. Its growth has brought many millions out of poverty. China now is the world's second largest economy behind the U.S., although its per capita income remains very low. The three most immediate economic problems facing China are: a slowing economic growth, high, unsustainable debt, and a rigid monetary regime. China had remarkable economic growth while playing catch up to the developed world, similar to Japan several decades ago. Now, China is in a position where playing economic catch up is over and they must innovate to grow, which is clearly a more difficult task. China is likely to continue to see economic growth slow. This affects job and wage growth which is very important for domestic stability. China has been propping up growth by making unprofitable loans to State Owned Enterprises (SOE) and building projects. This has fueled a rapid growth in unprofitable debt. At some point, China must face this problem. The most likely and efficient way to address this problem is through monetary policy, in other words, inflate their way out of the problem. China's central banking system is not conducive to solving this problem. There are four vital tenets to a strong monetary system: a strong and deep fixed income market, an independent central bank, no stringent capital controls, and a reliable store of value. China fails on all four. The Chinese are anxious for the Renminbi (RMB or Peoples' Currency) to be an important global currency, which it is not. As an aside, the currency is often referred to as the Yuan. The Yuan is a unit of currency, while RMB is the name of the currency. Any effort to inflate their way out will hurt their effort to make the RMB an important global currency.

While there is quite a bit of talk about U.S China trade, it is important to remember that China exports far more to the U.S. than the U.S. to China, about five times more. The United States is one of the least dependent countries on foreign trade, while China is one of the most. China clearly has the most to lose. We think, under the circumstances, a full blown trade war will not happen, but mistakes do occur.

We have received so many queries about China that we have added a bibliography:

BIBLIOGRAPHY

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China's Future, David Shambaugh, Policy Press, Cambridge Press, U.K. 2016

China Goes Global, A Partial Power, David Shambaugh, Oxford University Press, London, 2013

The Logic of the Market, Weiying Zhang, translated by Mathew Dale, CATO, 2015

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The Week Ahead:

- **MONDAY:** Japan Consumer Confidence Index expected at 44.5; EC Sentix Investor Confidence expected at 20.8; Canada Housing Starts expected at 218.0k
- **TUESDAY:** U.S. PPI Ex Food and Energy m/m expected at 0.20%; U.S. Wholesale Inventories m/m expected at 0.60%; China PPI y/y expected at 3.30%; China CPI y/y expected at 2.60%
- **WEDNESDAY:** U.K. Industrial Production expected at 0.40%; U.S. CPI ex Food and Energy m/m expected at 0.20%; U.S. FOMC Meeting Minutes; U.S. Monthly Budget Statement expected at -$185.0b
- **THURSDAY:** EC Industrial Production SA m/m expected at 0.10%; U.S. Import Price Index m/m expected at 0.10%; U.S. Initial Jobless Claims expected at 230k
- **FRIDAY:** U.S. U. of Mich. Sentiment expected at 100.6; EC Trade Balance SA expected at 20.1b; Germany CPI m/m expected at 0.40%