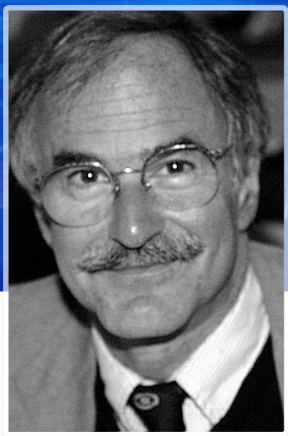
The PAD System Report



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TRADE WAR POKER

Your editor enjoys his monthly game of very low-stakes poker with friends. It is what economists call a "zero-sum" game, with the winners making exactly as much in total as the losers lose. Often the best hand wins the pot, but sometimes a clever bluff can drive out the best hand.

International trade is not a zero-sum game, but is a "positive-sum" game in which all countries can gain. Economists (with very few exceptions) have understood these "gains from trade" as far back as David Ricardo in the early 1800s. In his theory of comparative advantage, every country can gain by selling what they are relatively good at making to other countries, while importing what they are relatively worse at. Nonetheless, not everyone in a trading country will gain: producers of higher-cost goods and services will often see profits (and likely employment) eroded by cheap imports from countries with a comparative advantage in their product or service. Many countries will have trade deficits (an excess of imports over exports) with some of their trading partners. Often, but not always, these bilateral deficits will be offset by surpluses with other countries.

Historically, those industries faced with low-cost imports ask the government for protection to save jobs. This protection, which is often granted, usually takes the form of tariffs or quotas (a numerical restriction) on imports, sometimes on just some trading partners, sometimes on all. Invariably these barriers to trade, which impose higher prices on consumers, often end up costing more than $100,000 for each job "saved." Economists have long suggested that a direct subsidy for the impacted industry would be less expensive, but this of course looks like corporate welfare, while a tariff or quota can look like it does not cost the taxpayers anything (as long as they don't consume the product.)

Even more dangerously, the long-discredited doctrine of mercantilism, which argued that exports are "good" and imports are "bad," implies that a trade surplus is good and a trade deficit is bad. And a persistent trade deficit, particularly if it is largely tied to trade with a specific country, is really "bad," and means that we are "losing" and they must be "gaining," just like in poker.

Unfortunately, President Trump is a mercantilist who views trade as a zero-sum game. Believing that he holds the best cards in trade poker, he is willing to up the bet by imposing tariffs on steel and aluminum (very little of which is actually imported from China), and is now threatening to impose tariffs on most of what China exports to the US, and perhaps most vehicle imports from all countries. Yet, so far, China and the EU, and Canada and Mexico, have reluctantly called the President's bluff by imposing barriers to US exports.

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Saddest of all, the world has gone down this road before. The US imposed the Smoot-Hawley tariff in 1930, as the world spiraled downward into the Great Depression. This misguided policy certainly made the economic collapse worse, as world trade almost completely dried up.

After World War II, the victorious Allies realized that one good way to help restore world prosperity would be to create a system of rules, and regular multilateral negotiations, to reduce high trade barriers around the world simultaneously. Thus, at the same time that cheap imports would force some industries to shrink, export-industries would be expanding, and thus the pain of opening up to trade would be reduced. At the same time, it was also imperative that all countries played by the same set of rules, that is, did not try to gain advantages over trading partners by secretly subsidizing their exporters (to gain jobs) or unilaterally imposing new barriers (either openly or in disguise) to protect their firms facing cheap imports. Hence the GATT, and later the WTO, was created to monitor trade, enforce the rules, and provide a dispute resolution mechanism for all members. All of this was destined to promote world trade and the gains that come with it, and overall, was fairly successful.

Much as it is impossible to completely eliminate cheating in poker, it is impossible to eliminate cheating in trade. The Chinese certainly violate the rules of the WTO (especially intellectual property (IP) theft), although almost all countries have been known to bend or break the rules. (The US has long had a quota on imports of sugar, which is a clear violation of WTO rules.) But what President Trump is now doing is conflating a WTO violation (IP theft) with a non-violation (a bilateral trade deficit with China), and then adding his own violation, which is unilateral imposition of tariffs without regard for WTO procedures. Retaliation is inevitable. See you and raise you.

The risks in this high-stakes game: damage to the WTO and the world trade system, the end of NAFTA, and rising trade barriers around the world which could, if the bets and bluffs get big enough, cause a recession.

Even the Fed is beginning to worry about this, since a trade war would be an example of what economists call an "adverse supply shock," which makes the Fed's two jobs (maximum employment growth and price stability) both harder to achieve. The Fed has also begun worrying about the impact of Trump's tax cuts and spending increases, which could also make the Fed's price stability goal harder to achieve, and impel them to raise interest rate faster. The Fed also might worry that the economy is overheating already, with second-quarter real GDP likely to show an increase of 4% or more, which is very strong for an economy which is approaching its production potential.

Meanwhile, market valuations are still stretched, with the VL MAP at a low level of 40%. Even worse, Mark Hulbert reports that equity holdings of US households are close to an all-time high, which has in the past resulted in poor equity performance over the subsequent 10 years. Richly-priced stocks may thus have trouble weathering a trade war and rising interest rates.

PORTFOLIO NEWS: Our portfolio still has an above average weighted-average year-ahead performance rating: 2.53. It also has an excellent safety rank: 2.03. Our portfolio MAP now stands at 49%, a bit above the VL MAP of 40%.

RECOMMENDATION: VL MAP is still low at 40%. We are making no changes in the Model Portfolio which has 65% cash, among the highest in PAD history. Hold cash reserves of at least 65%. (6/24/2018 8:00 PM PT)