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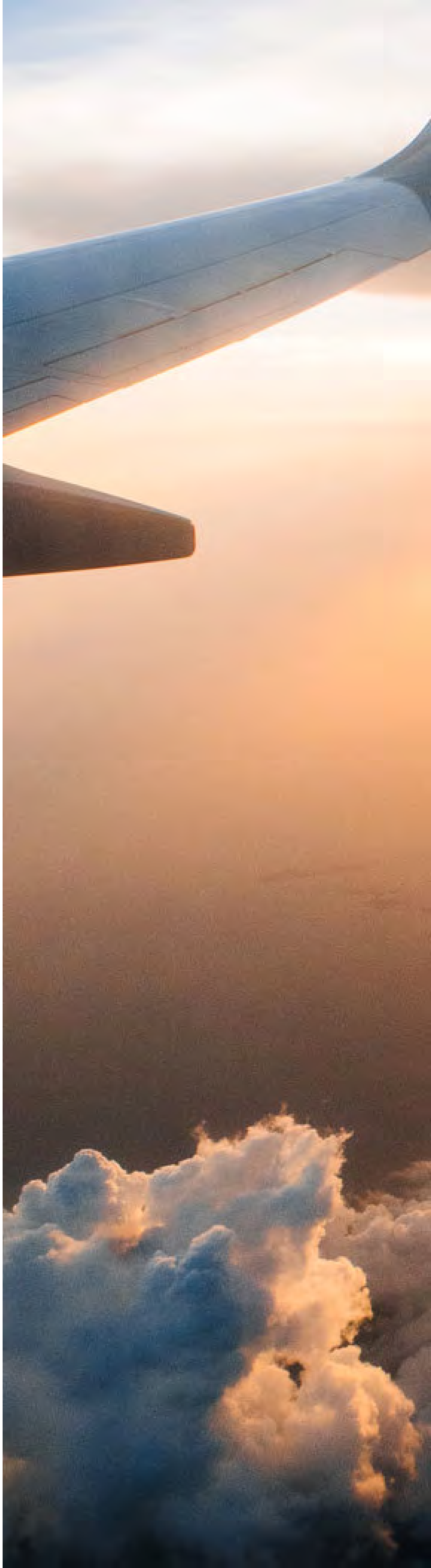
Trading the Goods

How Important is Global Trade?

Trade has been in the headlines a lot in the last couple of years. While our trade disputes with China may be resolved eventually, it appears the sights may be set on next reconsidering our trade with Europe.



Talk of trade and tariffs is a constant, even though it has seldom made headline news in the past. We thought it would make sense to put trade into perspective and what it means for the future of your investments.

Global trade volume (in dollar terms) today is about 30 times what it was in 1950[1]. The improvements trade has made on worldwide standards of living are vast, providing citizens of most countries with efficiently produced goods while providing much-needed employment for developing countries. Trading relationships, however, have also been abused with some countries forcing their advantages by providing government subsidies, dumping products in competitive markets, and displacing workers in long-established regional industries. It is a complicated world.

China and Beyond

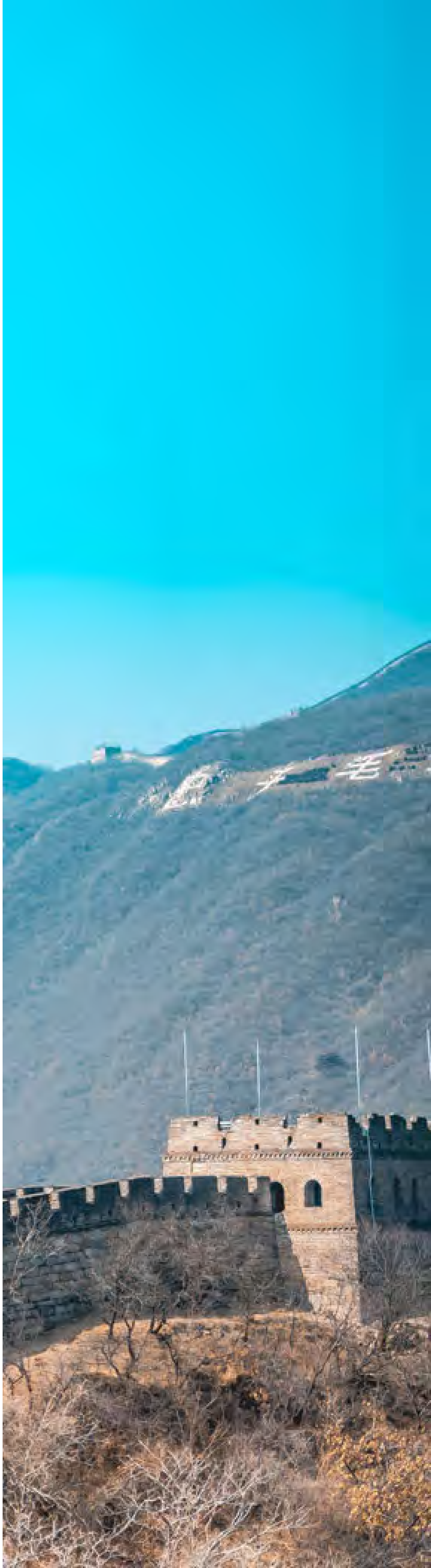
Some countries depend on trade more than others. The United States, for example, is generally considered a “closed” economy, meaning that we tend to produce most of what we consume.

Of our $21 trillion economy, exports represent approximately $1.6 trillion (about 8%) and imports about $2.4 trillion[2]. While not insignificant, trade represents a relatively small component of our overall economy.

What has been grabbing most of the headlines lately is our trade with China. Back in 2006, China’s exported goods to the U.S. equaled about 7.3% of China’s GDP. In the past 13 years, China’s economy has grown rapidly and its current exports to the U.S. are now only 3.4% of GDP. Again, not an insignificant amount, but not enough to break their economy if it was suddenly reduced.

Unlike China and the United States, some countries rely more heavily on exports. Germany, Sweden and South Korea’s exports each amount to well over 40% of their GDP. Mexico, Canada, and France each export over 30% of their production to other countries.[3] Trade talks between the U.S. or other partners tend to be even more heated than we’re seeing with China, and for good reason.

Americans do love German cars, French fashions, and Korean appliances, etc., so our consumer-driven economy is not one to blindly accept any new tariffs that significantly increase the costs of those goods.



Politicians can make a lot of noise about trade imbalances, but American consumers can literally vote with more than their pocketbooks. Pressure from politicians to protect national industries is offset by pressure from consumers to buy the best products at the lowest cost. It is the classic “workers vs. consumers” tension.

United States

The following charts show our major trading partners.

The charts show who our largest trading partners were in 2017. Our most important trading partners were Mexico, Canada and China, with Japan and Germany being far behind them.

Of course, American jobs are important. If we were able to turn off or significantly reduce imports, we could theoretically put more laborers to work. This would be the argument for increasing tariffs. The efficient/rational

economist, on the other hand, compares the price of the goods being sold to us against our cost to produce the same items. If we can buy things cheaper than what we would pay to produce them, we should import them and spend the savings on improving what we do produce. Consider Apple. Apple designs and sells its products in the U.S., but manufactures them in China. If Apple manufactured its products in the U.S., they would cost more to produce, hampering its ability to compete against rivals like Samsung, who have cheaper avenues of production.

What effect does this have on the United States? Where is Apple's wealth? It is not in China. China provides the hardware and assembly at very slim profit margins. The wealth that Apple creates is here in the U.S. with its stock price and highly-paid hardware and software engineers and designers.

However, it is important to remember that not all industries operate under the same logic. Clothing manufacturers, for example, were nearly shuttered with this argument. While consumers benefit from cheaper prices, workers suffer from job transitions. The worlds of consumers and manufacturers are in constant tension in a global economic system because cheaper labor is always seemingly available somewhere in the world. Not having any tariffs is just as damaging to economic systems as having too many or too high tariffs, hence the importance of negotiation.

Put another way: while globalization provides an engine for growth, that engine comes at a cost of the transitions caused by a global economy. The societal question on every leader's mind becomes: to what extent should we allow foreign goods to derail our own industries?

Investment Implications

What does this mean for investors? There are two broad answers:

Global investment capital is highly fluid. We can buy stock in a Korean company as easily as an American company. If a country's economy is suffering from an economic slowdown due to inadequate trade practices, capital will move to other countries. When we look at the global share of stock investments, the U.S. represents about 54% of capital invested in stock markets. We have seen that percentage change over the years, and we adjust the Vista portfolios when it changes enough to make a significant difference.

Monetary and fiscal policy are still more important to the future of economies than trade policy, especially in countries like the U.S. whose economies are large enough not to be highly dependent on exports. As the trade disputes have heightened here in the U.S., there has been more talk from the Fed and economists about keeping money loose by keeping interest rates low or reducing them. Many problems that arise from trade frictions can be alleviated by monetary or fiscal policy.

A Little More Perspective

Great Britain was at the heart of the Industrial Revolution about 150 years ago. In 1870 Britain was the "workshop of the world." It manufactured more, shipped more, and her banks financed more than any other country at the time.

In 1840 Britain removed all tariffs with the logic that if goods came there cheaply, they would use them to their own profit or to improve their standard of living. During the next 60 years, Germany and the U.S. became major steel producers while also increasing tariffs on steel imports to their countries to protect their industries. When Germany and the U.S. produced too much steel, they sold it to Britain at very cheap prices. By 1895, British steel production lagged far behind both Germany and the U.S. Britain eventually brought back tariffs on steel after World War I in order to re-establish and protect her steel production.

Today, about 50% of industrial goods (non-agricultural) enter the U.S. duty free and the U.S. has trade relations with about 75 countries.[4] Since the Tariff Act of 1789, placing a 50 cent per ton duty on goods coming off foreign ships, the U.S. has placed tariffs to protect domestic production. Today, virtually all countries employ tariffs and they probably won't be going away anytime soon. We should also note that when tariffs become too high, black markets usually become more popular.

As we said at the beginning, it is a complicated world with many competing countries and constantly shifting incentives. Where it all leads over the years of our investment horizons is inevitably to a place somewhere in the middle. Ignoring the exaggerations of politicians and the press is usually the best approach for long-term performance.

Thanks

We hope that this has shed a little more light on trade and tariffs and how these important topics can affect your investments. As always, we look forward to hearing your thoughts and questions.

Thank you for the trust you've placed in Vista.

Your Vista Wealth Management Team