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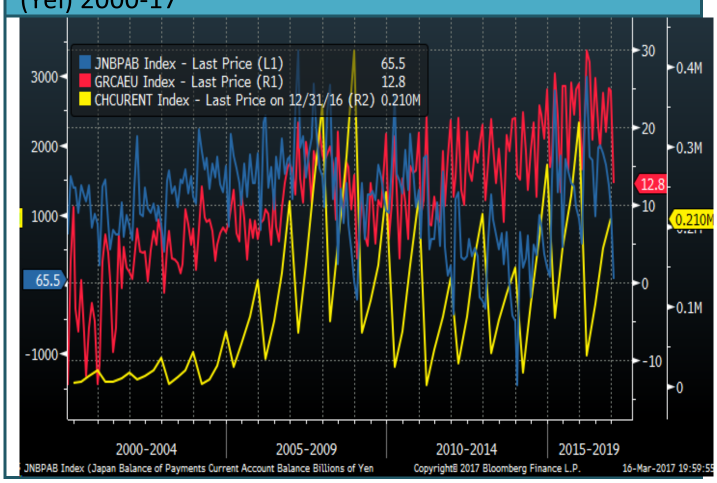
ECONOTE No. 59: Why facts matter: Heisenberg and quantum physics meet the US trade deficit 19/3/2017

Summary	Investment Conclusions
Criticizing Trump is now "démodé", as the French would say, and they know something about style, ask Mr. Fillon and his EUR 6,500 suits! However, the whole ambience of discussion on public policy has brought forth more than ever, the terrifying realization that we all look at the same facts but come to totally different conclusions. Clearly, the facts, as they are, are not the same for each observer. In Einstein's physics, time is relative to observers in relative motion. And so to quantum physics. Facts could be subject to a,wrongly attributed, version of Heisenberg's Uncertainty Principle, whereby the act of observing facts, changes them. Facts are relative to the observer, and nothing is what it seems to you is but, nonetheless, it is what I say it is.(Apologies to "Breaking Bad" and Lewis Carroll !)	There is just no evidence that the trade policies to be implemented by Trump will increase FDI and employment in the US, even in the long run. Hence stick to infrastructure and defense related stocks which will be the first to benefit from the fiscal plans, but not consumer-related.The Fed will be constrained to hike thrice in 2017 if the fiscal promises are implemented, that is less tax and more spending, as UST long yields will rise sharply. Asian short-term rates are decoupled from USD rates, and US trade policies, if implemented, will have modest impact on Asia. Hence Asian equities remain attractive, especially the smaller markets. Stay negative on UST and mildly positive on the EUR.

The EU and Asia, concerned and puzzled spectators ?

The Dutch injected a note of sanity with a large electoral turnout and a vote of confidence in the EU. The "leave Brits" received the first of several wake-up calls on the road to Perdition (oops sorry…Article 50) with the Scots threatening/promising a referendum on independence. Next the Northern Irish will be faced with a physical EU frontier thereby needing passports to cross the street to go to the pub.If the French follow the Dutch example, the Brits will be looking particularly forlorn in their anti-EU stance. Possibly the best thing which happened to the pro-global, pro-free trade etc. group, was Trump's election. Funnily enough in the welter of anti-Trump invective, as well as dire prophesies as what will happen to the world if the last bastion of multilateralism, the EU fell, no one bothered to mention China. For all its faults and authoritarian system, the "second biggest economy in the world" remains staunchly pro-trade being, be noted, among the biggest three importers in the world. And please, see the Fact Box and the attendant text before saying, "of course they would be, wouldn't they"? The rest of Asian economies, including India, remain sidelined spectators, as they should be as the main threat is to Mexico, Canada and possibly China, with a potentially modest spillover effect on Asia. (See Econote No. 58). As an introduction to the crux of the confusing bilateral and multilateral surpluses, Fig.1 shows the C/A balances of Japan, Germany and China from 2000 to date.All of them with surpluses except for a few years and, pressumably, all of them stealing jobs from the Americans.A similar picture is shown in Fig. 2 with the C/A balances of some Asians. (See the lines above zero or negatives).As the biggest bilateral deficits of the US are with Canada, Mexico and China, it is important to differentiate bilateral from macro balances. The US trade deficit reflects excess of US's investment over its savings. China has nothing to do with it.

Fig.1 C/A Balances, Germany (red), Japan (blu), China (Yel) 2000-17



Source: Bloomberg

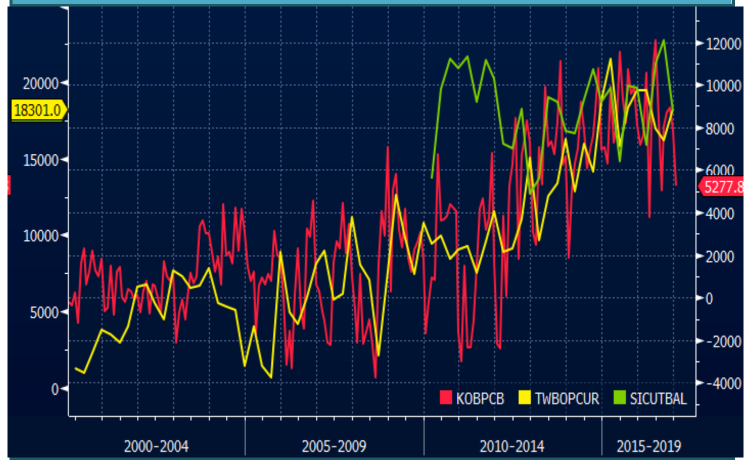
Politics and policies: A summary for the perplexed

Step 1: Cheap labour countries such as Mexico and China, the latter helped by "cheap RMB", sell more than they buy to the US creating large and seemigly permanent trade and curent account deficits.**Step 2**:These countries compete away local US production causing job losses even to the extent of the physical removal of factories outside the US.**Step 3**:The number of job losses "caused" by Mexico and China, the two main culprits, vary so widely as to make responsible discussion difficult.An extreme estimates puts the losses to 25 ml, a conservative one at 2.7 ml.**Step 4**: The Chinese sold on credit to the US as shown by their holding of USD 1.0 trillion of UST.These holding since 2008 yielded next to nothing, and now with rates rising will cause very large capital losses to the Chinese if they sold them.**Step 5**: The partial funding of the widening US fiscal deficit during the difficult period of 2008-2014 by China contributed to the recovery of the US economy, kept interest rates low, thus helping to keep taxes also low. The Chinese allowed the US to buy cheap goods thus keeping inflation down and standards of living up, helped to fund its fiscal deficit at near zero costs and helped to keep taxes down as well. **Step 6**: Reverse all this by restricting trade, and inflation will go up, standards of living down, cost of deficit up, taxes possibly up unless government spending goes down and no guarantee whatsoever that the jobs lost will come back. The Chinese will be left with a pile of UST with falling prices made worst in terms of RMB if the USD weakens versus the rest of the world. But then from the point of view of Asia, restrictions on the US-China trade may have a modest impact, as it will also have on China. The last argument is based on the fact that, historically, the trade surplus has made a very small contribution to China's GDP.

FACT BOX: You read the book, now watch the movie!

Peter Navarro, professor at U of Cal. Irvine, has been appointed director of the National Trade Council by Trump. He has produced a series of books and documentaries on the military and economic threat of China. His documentary, "Death by China" is available on YouTube:
https://www.youtube.com/watch?v=mMlmjXtnIXI
The title gives the game away, which is sleekly made propaganda supporting my point that we all look at the same data and come to different conclusions. The film points to the flooding of the US with Chinese goods in return for paper **USD IOUs**, yielding next to nothing, and that in order to produce cheaply the Chinese polluted massively **their** environment. All of which looks to me a bargain for the US! But not for Peter ….

Fig 2 C/A, S.Kor(Red),Taiwan(Yel),Sing (Gr) 2000-2017



Source: Bloomberg

So everything is relative, so what ?

The very modest aim of this report is to help our readers understand the economics of the world we live in and for investors to make some money. Pointing out that recent events have made life much more difficult in seeking out the "truth" and differentiating opinion from fact, is not particularly helpful.Our advice is simple. Stick to simple statistics which are available from official sources or from reputable research houses, all of them in the internet. Try to interpret these yourselves as third party interpretation (including this one, be noted !) can open the gate to Mr Heisenberg ,and we don't want that now, do we ? Stick to simple interpretations at the risk that oversimplification is a trap, too, and can lead away from the truth-such as it is.Simple approaches to investment decisions are also the most difficult to follow and understand, but they are more difficult to distort, while complex ones can hide a lot of sins under a carpet of facts. Stick also to simple investment solutions. Index funds confounded quants Ph.Ds and the success of ETF and low fee funds with no fancy research shows another trend (That's why Econotes will always be free !).We suggest smaller Asian equity markets which will not be affected by the US political turbulance and the EU existentialist crisis although ,once the French elections are over, this may leave only the poor Brits on the good ship "Titabrexit" complaining that "they asked for some icecubes, but this is ridiculous".We return in the next issue of Econote on more concrete, simple and straight forward investment suggestions against the background of the concerns and caveats raised in this issue. Andrew Freris (writing completed on 19/3/2017)