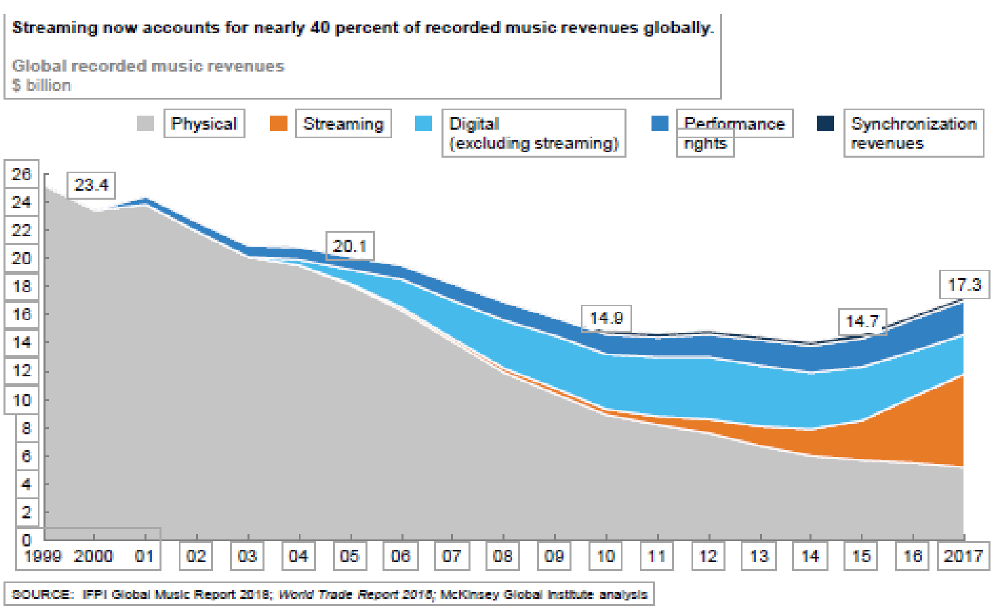
What is Really Happening with Global Trade

October 2019 – Q3 Exploration

I am currently listening to "I won't Back Down" by Tom Petty - a song whose lyrics will most likely always resonate but especially in today's environment for a multitude of reasons. The first time I listened to this song it was via a CD played on a stereo. If my memory serves me right it was Sony-produced (Japan). I am not sure where the CD was manufactured. Back in 1989, when the song was produced, the global trade ledger resulting from my decision to listen to music was rather straight forward (e.g. 2 physical goods: Stereo and CD). If some kid in Japan was listening to the same song as I back in 1989 they purchased the necessary physical goods highlighted above as well (namely a stereo and CD).

I am now listening to that song via Spotify streaming on my iPhone. There is no longer a physical component associated with the music. The iPhone has significant added physical value emanating from multiple countries as well as a material portion of its value due to intangibles such as IP and brand. If we focus solely on physical goods within global trade measurements we are missing a big portion of what is actually occurring in trade between nations.

Music is perhaps an extreme example of where we may be going. The graphic below represents global revenue by music medium between 1999 and 2017. Physical revenue has dropped nearly 75% and now comprises well less than 50% of overall revenue. Streaming is not captured in global trade data. My doppelganger in Japan no longer has to go to a store and hope Tom Petty's *Full Moon Fever* album is available. He can simply listen to the individual song digitally, always available, and delivered immediately.



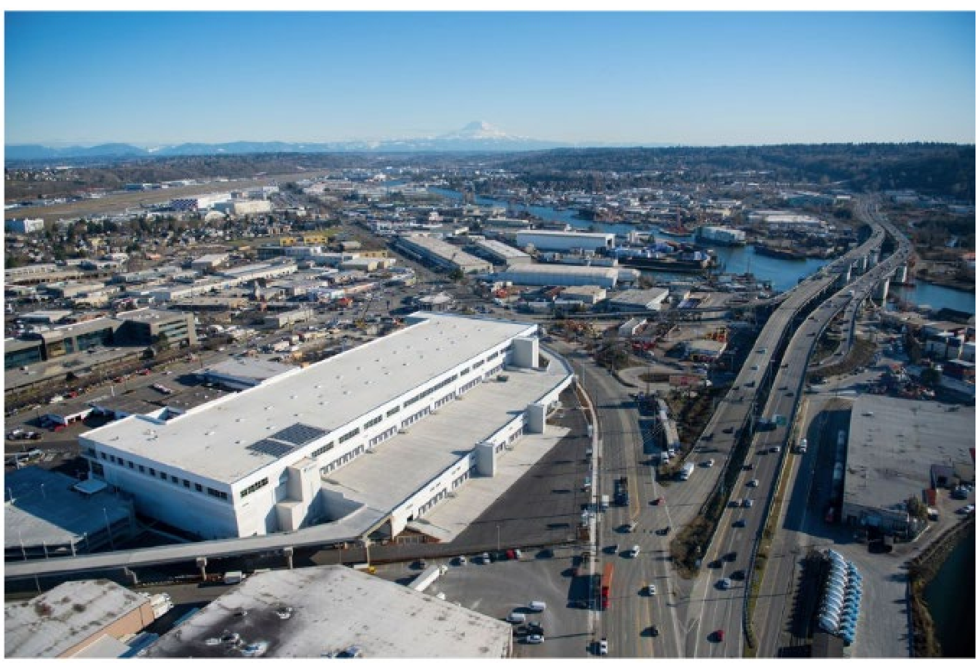
FOUNTAINHEAD INSIGHTS

Let's explore how sneakers may go the way of music.

Sneakers have come a long way. When I was a kid there was limited choice. Air Jordan's in a few varieties and a handful of other choices. If the sneaker was no longer available in the store closest to me I can venture to further shops. No store employee had the capacity to tell me with any confidence when that unavailable sneaker may come in. If I purchased an Adidas sneaker it may have come from Germany which means they (Germany) would get the credit for the physical good transaction.

My son meanwhile goes online and fully customizes his sneaker purchase with name knitted on, custom soles and the like for a similar price point to mine 30 years ago. Upon ordering he is positive he will receive it. Components of his sneaker may be made all over the world with added-value via the "bling" elements done locally.

The next generation sneaker is most likely customized and created by printer. Nike is already doing it - check out the Nike Flyprint. God forbid this generation wait more than a day to get their sneaker. Amazon is starting to stick their warehouses right next to or in cities - they are going vertical. The warehouse shown below has just-in-time manufacturing on the third floor where conceivably a Nike printer can reside. Due to land constraints there are two floors of freight loading (as opposed to the standard one). The physical goods traded internationally are now solely the raw material - which we believe is where it is going long term. The value is primarily captured in the country in which it is sold rather than in the international trade numbers. Intangibles make up most of the cost.



Prologis Georgetown Crossroads, a three-floor 590,000 square-foot industrial warehouse in Seattle. PHOTO: WOODY WELCH/PROLOGIS

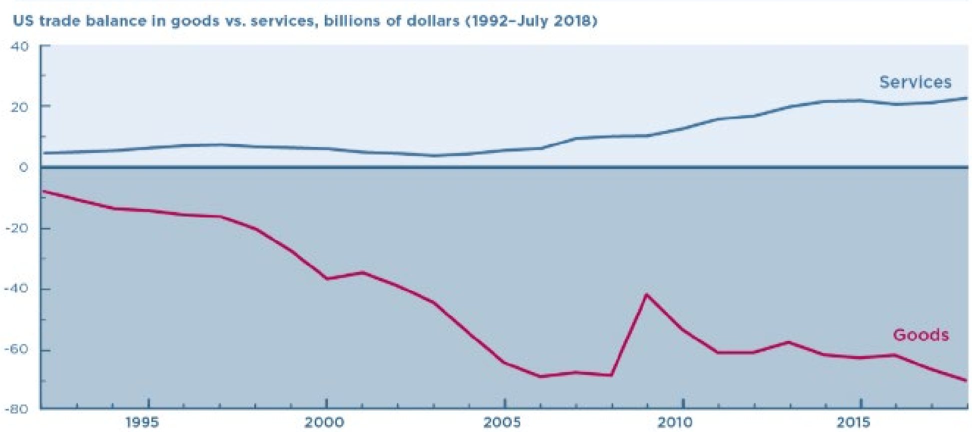
It is not inconceivable that the generation after will simply print their sneakers at home, which gets us back to music and the piracy occurring in the first part of this century. How easy will it be for someone to copy the CAD design and simply pay for the raw material?

Another item to note in the sneaker exercise is that in the past physical labor was a material cost in constructing the sneaker. This labor arbitrage is quickly disappearing due technology (e.g., AI, robotics). As we race towards simply needing the raw material in construction, globalization, at least from a physical standpoint, will most likely turn to "regionalization" as hauling finished product long distances becomes more expensive and slow as compared to simply producing the product as close to the end consumer as possible.

This trend is tremendously beneficial to the US market in our opinion. Another favorable trend is the increased growth and importance of services, digitization, and intangibles such as brand and know-how on a global level. Bringing it back to today and our current trade wars, the focus on physical goods is simply antiquated. Trade is way more complex and nuanced than what was occurring even a decade ago. Beyond digitization, services, and intangibles, there is the complex math involved with multi-nationals. For example, the Starbucks coffee purchased in China is not captured, to our knowledge, in any trade ledger. Yet Starbucks, which is an American company, captures profit generated by its brand and know-how, both of which are American born.

Trade in services is growing exponentially quicker than the trade in goods. And the US has a large surplus in this area.

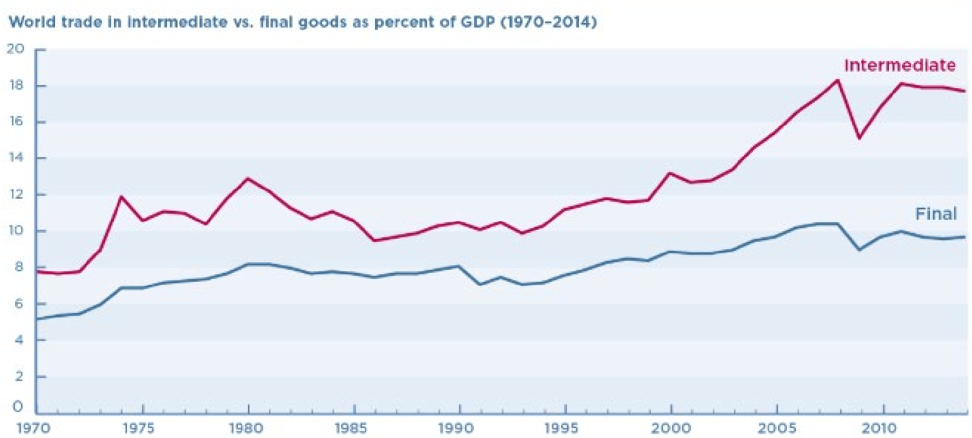
United States has growing trade surplus in services and deficit in goods



Note: Annual values are averages of monthly values.
Sources: US Bureau of Economic Analysis and US Bureau of the Census, "Trade Balance: Goods, Balance of Payments Basis [BOPGTB]" and "Trade Balance: Services, Balance of Payments Basis [BOPSTB]," retrieved from FRED, Federal Reserve Bank of St. Louis, on September 12, 2018 (https://fred.stlouisfed.org/series/BOPGTB).

The following chart illustrates that more *incomplete* goods are being shipped globally with the final touches to the goods completed further in the supply chain. For example, a sneaker shipped from China to the US would be a Final good, while components of the sneaker shipped would be intermediate. It is difficult to illustrate the many intangibles that are now cropping up in actual trade within the data but this chart provides some indication of where we believe the world is going – that increased value add is being created either at headquarters or closer to point of delivery rather than internationally.

Global supply chains dominate world trade



Source: Agustin Carstens, "Global market structures and the high price of protectionism," remarks at the Federal Reserve Bank of Kansas City's 42nd Economic Policy Symposium, Jackson Hole, Wyoming, August 25, 2018 (https://www.bis.org/speeches/sp180825.pdf).

The focus on IP piracy and the like makes a lot of sense to us as increasing value is found in digital format, a medium which has been historically very easy to perfectly duplicate, as well as expertise in a process, brand, and similar capabilities - all areas that America excels in. In our Q1 Explorations we focused on global innovation. Gunpowder was thought to initially have been discovered by the Tang dynasty in the 9th century and “rapidly” spread to other regions. The first documented mention of gunpowder in Europe is in 1267 - a mere 400 years later. Today, ideas and innovation spread a bit more “rapidly,” which allows for huge amounts of brain power to quickly focus on further innovating for the (we hope) benefit, or at least overall increased wealth, of humankind.

In summary, we believe trade has been a net huge positive globally and for the US. And we expect it to continue to be so. Focusing on physical goods is missing the trade story. There is a natural progression of countries towards specialization of which the US has been a leader in creating cheaper goods in a faster fashion for US consumers while allowing for profit for multi-national firms that, once again are more often than not American in origin. A trade war focused on the wrong item can slow down or artificially manipulate the way in which we get to a logical endpoint[i].

Biases in favor of the US continue; Remain short duration in fixed income

Our general approach to investing on your behalf is to take a top-down approach in creating diversification of risks and returns in one's portfolio. Let's unpack that. A top-down approach means we start by viewing the high-level investing opportunities. Equities vs. Fixed Income exposure first. Then within equities, US, Developed Markets (e.g., Europe & Japan), and Emerging Markets (e.g., less- developed markets like China & India) and so forth. We continue on this path to actual strategy and manager selection. Diversification of risks and returns means we invest in multiple exposures on your behalf in order to increase the likelihood we'll have varied return streams as well as risk streams. Since we do not know with certainty (nor does anyone else to our knowledge) what investment will do best, we attempt to smooth out the experience. We do have biases though.

As has been the theme within our explorations this year our focus on global trade supports our bias in favor of the US. This has been purely coincidental - though we are happy to see it play out that way. While we expect the US to continue to have a deficit in physical goods traded, we believe it is more beneficial to be leading in services among other trade items not captured as well in trade ledger measurements as has been detailed above.

We also continue to remain a bit shorter in duration in our fixed income holdings. 10 year yields are currently at historical lows at roughly 1.5% as of this report. The risk-reward associated with a favorable move in yields seems skewed against the investor. No move in yields results in a scant 1.5% in annual interest payments, before tax. We have been barbelling our portfolio by holding some riskier products like high yield and shorter duration products which have similar yields to longer duration product but, in our mind, lower risk. We continue to actively monitor fixed income for opportunities within shorter duration strategies.

Concerns: Purchasers of negative yielding debt and Protests

Note that given our longer term focus, these concerns will not change dramatically from quarter to quarter. As such, when content does adjust we will make sure to point it out. Year to date we have had two rather positive big pictures focusing on the benefits of innovation and global trade with one partially negative one - demographics. These big picture subjects did not focus on the growing strife between citizens and their governments. Language on our first two headline concerns have been updated to reflect our increasing concern.

Geopolitical climate: Daily protests in China, impeachment proceedings in the US, newer protests in Egypt and Russia. Need we scare you more?
Artificial market support by governments: Is it possible that the government is purchasing negative yielding bonds from the government? Yes it is. We are not sure of the implications or how this potentially even ends (negatively or not) if it does but we are actively analyzing.
Shorter-term volatility and risks: The geopolitical climate (note first point) should result in an increased potential for volatile moves in the market. A good example was the weekend in which our government squeezed Mexico via trade threats in return for further border controls.

To be clear, there are and always will be concerns in the market and in the world. We explore them to obviously give us the best chance to navigate them effectively. It is worth noting though that the reason we diversify both risks and returns is that the future is simply unknown.

General Market Review: Sideways market, uncertainty prevails
There are three main themes coursing through the markets: Trade, Fed Policy & the Economy. Let's discuss one at a time:

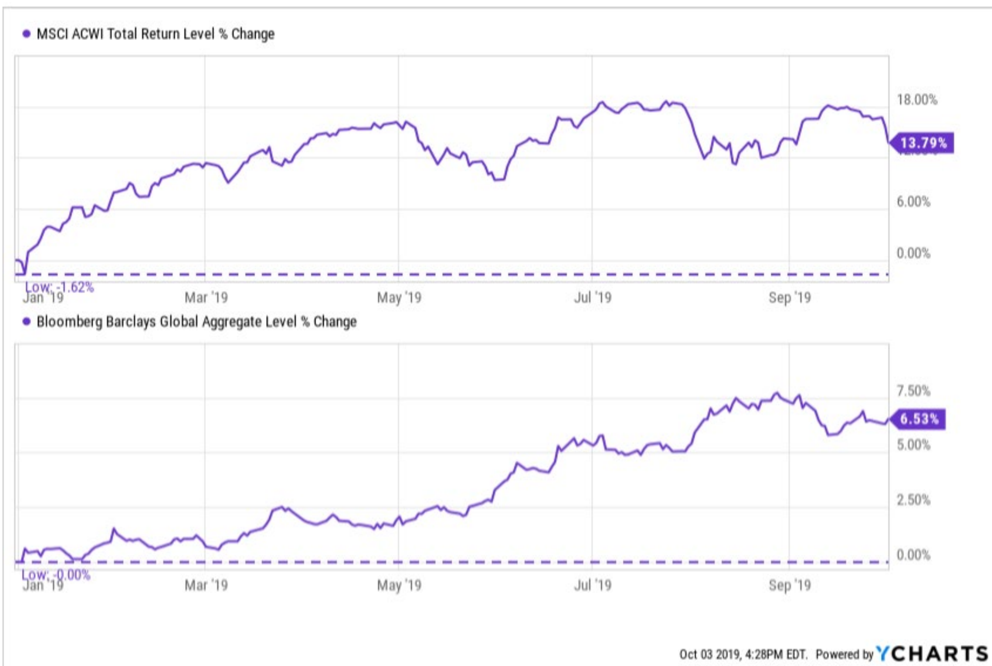
Trade wars continue to catch headlines and for good reason. The two largest economies in the world are at loggerheads, with a true, all-encompassing deal seeming more and more unlikely. The temperature of this war oscillates dramatically, fanned by today's media apparatus allowing for immediate official reactions. We believe the Achilles heel, at least for US negotiation, is the upcoming election. While at one point trade wars seemed to have played politically positive, markets seem to trump all else. At the end of the day, the lack of resolution definitively weakens global growth due to the inability to accurately forecast longer term costs associated with cap-ex. That means less corporate long term spending and economic confidence.

Unlike Q4 2018, the Fed has been very accommodative with expectations for further rate cuts in coming months. A significant portion of the equation conducted by business and consumer alike is debt servicing. With longer term rates at or near recent all-time lows and shorter term rates quickly dropping, aforementioned debt servicing and therefore debt fueled purchases become cheaper, effectively fueling market growth.

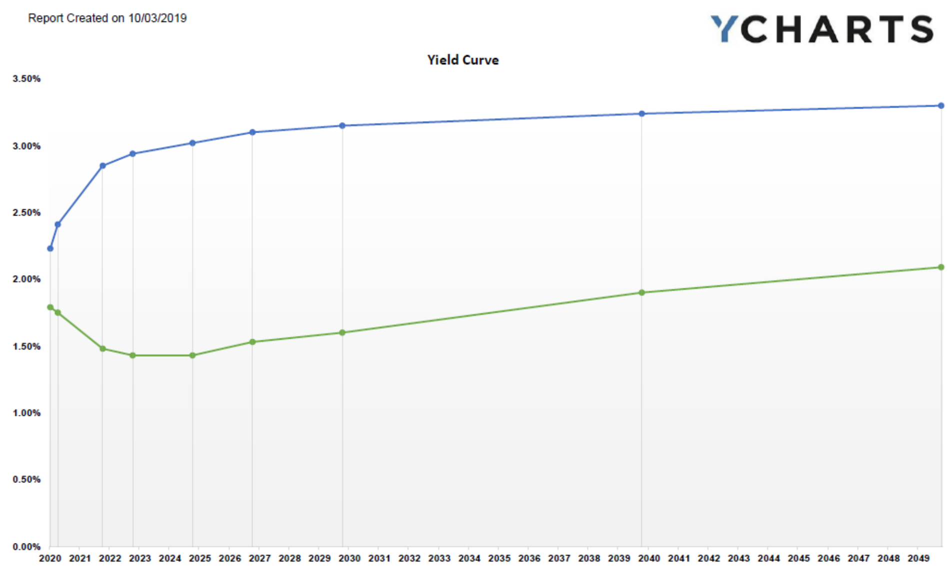
Caught in this tug of war between the uncertainty created by trade wars and an accommodative Fed is the actual health of the economy. While portions of the economy, like manufacturing, have been slumping as of late, employment, inflation, and other indicators, especially consumer-related ones, continue to remain mostly stable.

FOUNTAINHEAD INSIGHTS

After a quick bounce back in Q1, markets have been relatively sideways. As can be seen from the chart below, the sideways action in equities (top chart which reflects global equity performance) has been nicely supported by a drop in yields, represented by the upward move in the bottom chart which reflects global fixed income performance.



While the shortest part of the yield curve is still inverted, the two year – ten year spread looks better than it did a year ago and Fed rate expectations are for at least another 75 basis points in cuts which will drop the front end significantly, resulting in what is traditionally viewed as a healthy looking yield curve.



	1/3/2020	4/3/2020	10/3/2021	10/3/2022	10/3/2024	10/3/2026	10/3/2029	10/3/2039	10/3/2049
Today	1.79%	1.75%	1.48%	1.43%	1.43%	1.53%	1.60%	1.90%	2.09%
Last Year	2.23%	2.41%	2.85%	2.94%	3.02%	3.10%	3.15%	3.24%	3.30%

In closing, we continue to monitor markets closely and look for opportunity on your behalf.

The information contained in this report is informational and intended to provide background to clients of Fountainhead AM and Fountainhead Capital Management about our thinking concerning investing. Our opinions are only that, and we make no guarantee about future investment results or the impact of global and domestic events on investments. Nothing in this letter should be construed as investment advice; we provide advice on an individualized basis after understanding your own circumstances and needs. Indices shown are used to illustrate broad market movements related to the themes of this article and are not reflective of any actual portfolio advised by Fountainhead. Indices are unmanaged and it is not possible to invest directly in an index. Accordingly, index returns do not reflect the deduction of any trading costs or investment management fees.

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[i] The topics discussed here were largely motivated by a report published by McKinsey Global Institute in January 2019 titled "Globalization in Transition: The Future of Trade and Value Chains. McKinsey Global Institute is the business and economics research arm of McKinsey, focusing on developing a better understanding of the global economy and equipping leaders with insights and analytics to help make informed business and policy decisions.