Market Commentary: Globalization, War, and Inflation

November 2023

There has always been "international" trade of physical goods, knowledge, and concepts. Just two famous examples are the great library of Alexandria, with its goal of collecting books from around the world,[1] and the Silk Road, a route that extended from the tips of China to Spain and England.

Great empires of the past that controlled broad swaths of land, such as the Roman, Abbasid, and Mongol empires, allowed for controlled trade within their borders. This resulted in lower costs for all involved, despite a tax by those in control in return for safe passage.

Eventually, we conquered the oceans, greatly expanding our abilities for cheap trade through increased speed and reach. Empires were no longer contiguous land masses, resulting in increased complexities in return for tremendous opportunities for wealth. Drake's (British) adventures in the Atlantic and Pacific Oceans began the end of Spanish dominion of the New World. The Barbary wars were the United States' first foray (and first post-revolution war) into securing passage on behalf of its merchants on the way to its own eventual dominance of the globe.

Fighting over the riches and scant resources of the world has always been in vogue. With size comes power, but also scalability and wealth. For example, the US dollar as the global currency reserve and a consumer-led economy[2] has its privileges for us Americans.

With the end of WW II came a new world order with America patrolling global waters while attempting to spread democracy and liberal concepts – exporting Western ideology. It felt like "we" won with the dissolving of the Soviet Union. The US was as powerful as ever. However, the world is a dynamic place and power is always shifting.

Wars in Ukraine and Israel are creating clear lines around allied groups globally. China has grown at the benefit of our world order and is now seemingly seeking to challenge the United States' dominance. Previously, China has been material in keeping a lid on inflation by exporting cheap goods and buying our debt as part of their efforts to manage trade. Following is an analysis of global trade with a focus on American vs Chinese positioning:

<u>Energy</u>

China is energy hungry. The war in Ukraine had Russia focus its energy supply East as Europe quickly shifted its purchases elsewhere. This was a win for China. Meanwhile, Saudi Arabia has traditionally been a swing producer of oil. However, they have lost some of their price control due to dramatic energy growth in the US over the last few decades courtesy of the Shale Revolution.[3]

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[1] Library of Alexandria | Description, Facts, & Destruction | Britannica

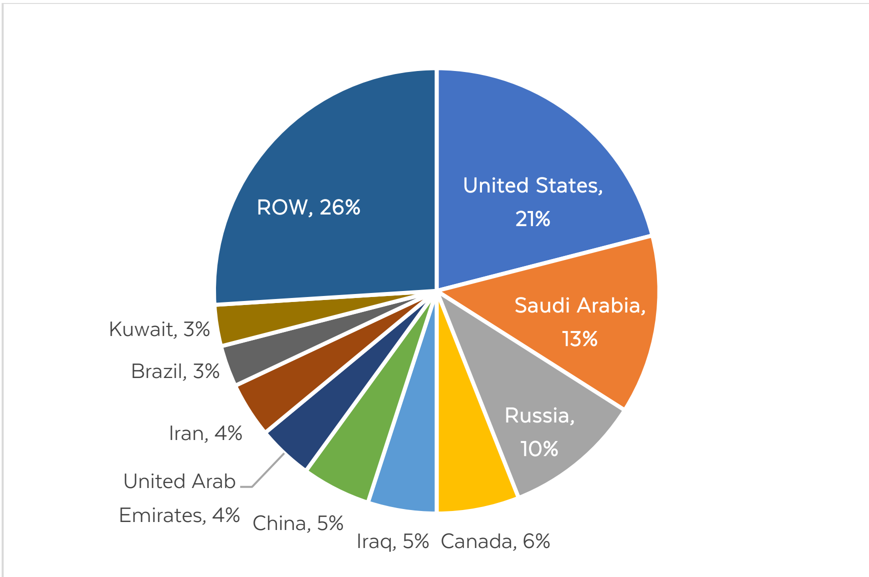
[2] Meaning we have a wealthy citizenship that purchases many things which accrues benefits to the US.

[3] One can draw a loose line to the inflation of the '70s, which was partly due to the 1973 Yom Kippur war as the US and other Western countries were punished for selling weapons to Israel via an oil embargo led by Saudi Arabia (yes, the world is complex). Based on the high cost of oil there was added incentive to find other means of extracting local energy – basic economic theory at work! American ingenuity eventually resulted in the ability to drill horizontally (rather than vertically which is much easier) as well as into tight rock formations and profitably extract oil. It is yet another case of American creativity, capability, and optimism!

With Saudi Arabian GDP per capita flat for decades and oil power receding, the new generation of leadership has been looking to diversify. At the same time, they've been looking for military assistance in combating Iran and its proxies. As a reminder, Saudi Arabia has been at war on some level with the Houthis, an Iranian proxy, since 2015.[4]

Prior to the Hamas terrorist attack, the rumor was that Saudi Arabia and Israel were going to normalize ties. This would have been a big win for the US and Israel and a negative for Iran and, to a lesser extent, China. Israel fit the bill as a Saudi partner given their strong military and intelligence operations to assist in combatting Iran, and their world-class technology sector as an economic partner.

Top Producers of Oil via the EIA (referenced in footnote 5; ROW = Rest of World)



[5]

Recently, American relations with Saudi Arabia have been somewhat frosty. This has perhaps been heightened by the fact that the US has been moving assets out of the Middle East for the last 20 years. However, between potential normalization with Israel and the current US showing in the region, Saudi Arabia should hopefully become more aligned with the US.

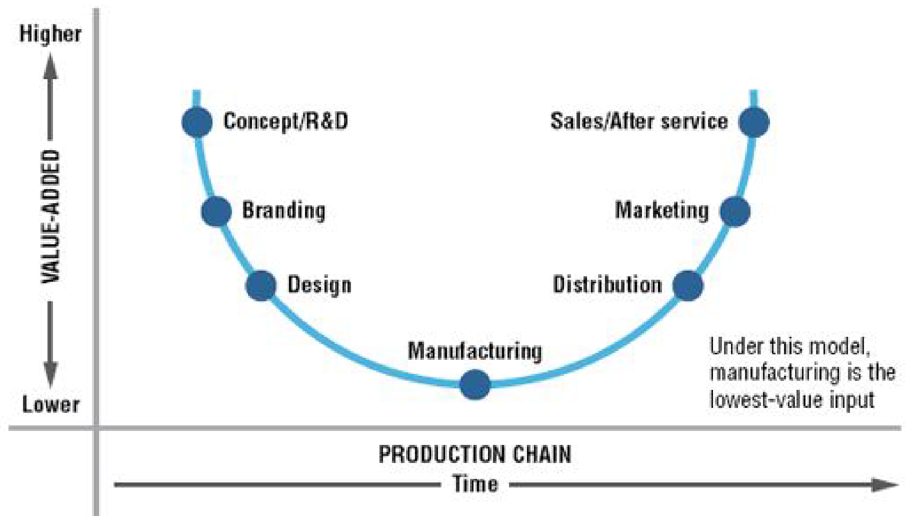
Ideally, this would spell less energy volatility for the US and the West with a cap on related inflation. That said, America has already helped itself in these areas with its Shale Revolution. Note America's share of total oil output vs. China. We are balanced in our energy use though unbalanced in terms of fuel mix (natural gas vs crude) while China consumes 16% of world oil resulting in a net negative 11% they have to import.[6]

[4] War in Yemen | Global Conflict Tracker (cfr.org)
[5] Frequently Asked Questions (FAQs) - U.S. Energy Information Administration (EIA)
[6] Frequently Asked Questions (FAQs) - U.S. Energy Information Administration (EIA)

Trade

As shown in the graphic below, globalized trade works according to a "smile." R&D and design are high-value inputs to a product, while the assembly is typically sent to a low-wage center. Higher-end value-add assembly then occurs in more sophisticated environments prior to being distributed.

The Smiling Curve



Source: The Smiling Curve: Stan Shih.

China began its economic ascent in the 1980s under the leadership of Premier Zaho Ziyang by focusing on becoming the world's manufacturer. Cheap labor costs and government price controls (e.g., currency controls) resulted in a level of exported deflation as our goods became cheaper despite overall demand increasing in our consumer-based economy. Over time, Chinese factories acquired ("borrowed"?) IP to move into higher value production inclusive of design and higher-end assembly. It takes time and education for this to occur. So, decoupling will not occur overnight. Currently, India is, for a variety of reasons, in a strong position to slowly take over manufacturing from China and then seek to move up the "smile" and further compete with China. Foxconn, which famously provides manufacturing capabilities for Apple, has significantly expanded in India.[7] Management is Chinese. This is similar to what occurred decades back when Japanese managers assisted in the initial setup and running of operations in mainland China. While China and the US have been decoupling for a while now, Covid definitely sped up this process due to the need to better risk-manage supply chains.[8]

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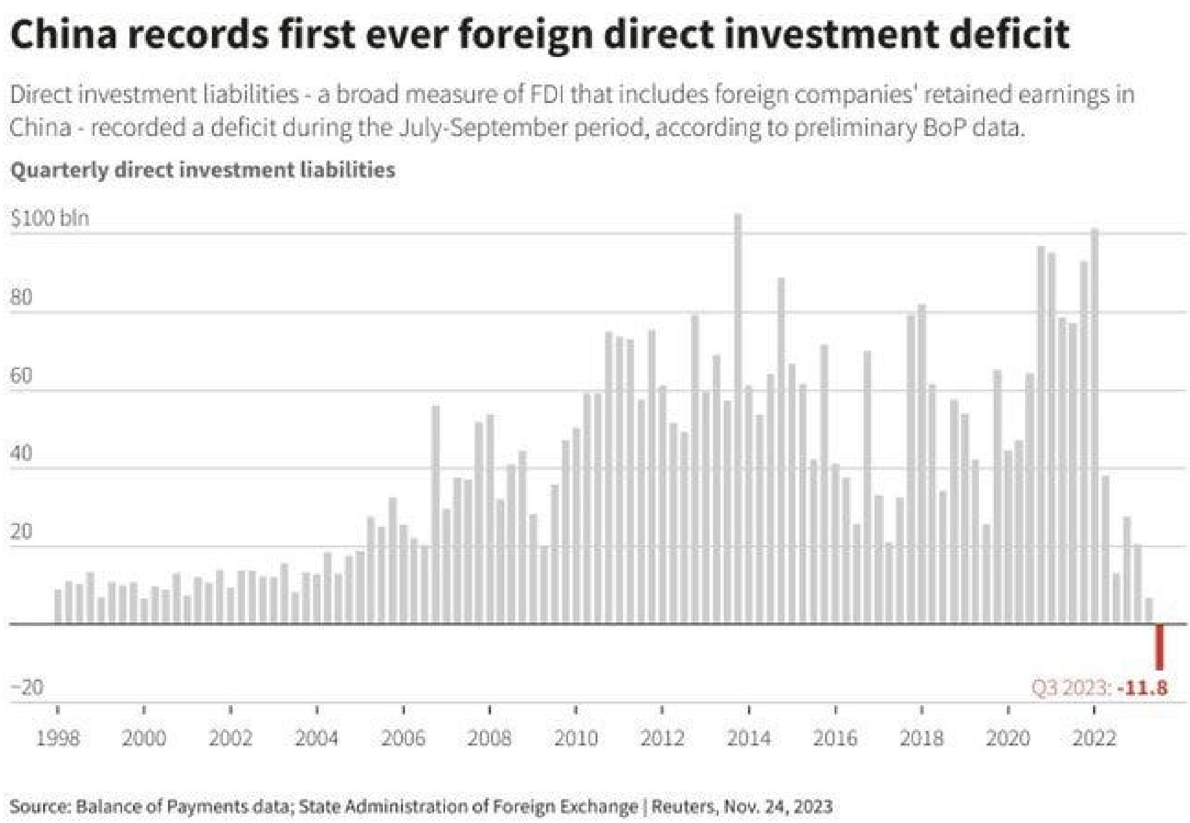
[7] Foxconn to invest $1.5 bln to expand India operations | Reuters

[8] Risk management and efficiency should not be at odds but they are. Having redundancies creates extra (small) costs that avert (much larger and potentially fatal) costs. It is like Life Insurance – you hope you never need it but if you do and you don't have it, it is no good.

The point is, any decoupling will take years, perhaps decades, to occur on any material level. However, the seeds of this decoupling can best be seen through net investment in China. This is highlighted in a great Substack read by Noah Smith.[9] The first step in a move away from a country is a pause in investments in that country. We previously noted a major decline in investments as illustrated in the following charts:



A Transition away from China seems likely for a variety of reasons, inclusive of global competition and proactive divestment by the West. Will China let this occur willingly as it tries to transform its own economy to a consumer-based one? How will the lower reliance by the West affect its decision-making within its own geography (yes, Taiwan but also the Far East, South Asia, and beyond)? The answers to these questions will be consequential in terms of both world security and inflationary pressures.

[9] Stop saying "there is no decoupling". There is! (noahpinion.blog)

Geographic Wranglings

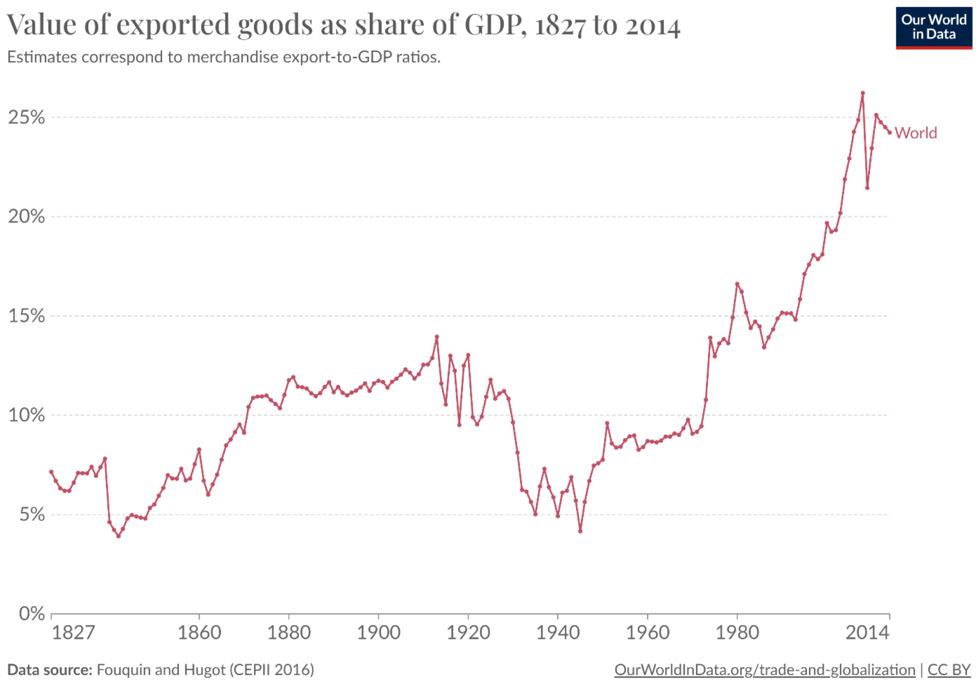
The Suez Canal was purposely built for speed and efficiency in delivering oil and other goods from as far away as China to Europe. Roughly 10% of global seaborne-traded oil goes through the Suez Canal. Part of these oil flows are via the SUMED pipeline in Saudi Arabia, while the rest is shipped up the Red Sea which puts it in the crosshairs of the Houthi rebels in Yemen. Currently, US warships are patrolling the Red Sea which is a cost to shipping that is not currently felt by consumers (thanks taxpayers and debt holders!).

China has a rather long shipping route to get to the Red Sea. Historically, China's troubles were from the Great Plains to its North-West, its location of the Great Wall: present-day Mongolia, Kazakhstan, and the like. But with that frontier calm over the last few decades, China has embarked on its belt-and-suspenders campaign. If China can send goods via high-speed train through Afghanistan / Pakistan to the Indian Ocean, they increase their shipping efficiency dramatically. This approach may also allow China to focus more efforts on aggressive tactics within the China Sea and neighboring countries (with Taiwan perhaps goal #1) with less adverse effect on their commercial shipping.

Conclusion

China does not have a monopoly on cheap labor or know-how. The deflation they exported through price controls and efficiencies (e.g., having whole districts working on a single product) may be exported from other countries. But it has taken China decades to achieve the efficiencies and know-how they have today. China is also a huge, centrally run country which further assisted its efficiencies. How goods production shifts to other countries will affect the import of inflation.

China has also become increasingly bellicose with designs to expand its footprint, while the world's shipping routes are becoming more dangerous as exhibited in the Red Sea. This affects costs of goods.



America has a history of flip-flopping between isolationist policies and a more active role in foreign diplomacy, but with global trade roughly 25% of GDP, and perhaps higher for the US, we really do not have a choice but to be present and active on the world stage, similar to what we are doing in the Middle East, in order to preserve our own best interest. The world is simply too interconnected to ignore. Given our positioning, we have the capability to potentially minimize war and local inflation, both of which we are attempting to do in the Middle East.