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Weekly Market Insights

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The Budget, the Evolving Nature of Globalization and a Quick Word about Brexit!

This past week was an excellent one for U.S. equity markets.

The Dow Jones gained 1.57%, the S&P 500 2.89% and the NASDAQ gained 3.78%. Impressive indeed. The Dow may have gained more had it not been for the outsized affect Boeing's crisis had on the index.

Lots of interesting things occurred this past week: the president issued his first veto, BREXIT, as expected, needs a delay, and economic releases were reasonable but mediocre. But the on again off again tariff war with China still dominates investors' psyche and this past week, investors felt more at ease with the negotiations.

When any administration releases its budget, it is supposed to reflect the president's goals, hopes and aspirations for the country. Therefore, it is instructive to breakdown the 2020 budget and see if we can divine the envisioned future of this administration. Remembering that this is only a proposed budget and, like most budgets, will no doubt be revised. As in any budget, there are winners and losers; the important question is who wins and who loses. The first obvious point is it is very large - more about that later. It is important to break down the budget and look at the allocations to the various departments, because it helps us to get a better understanding of where the president thinks the country should be.

The winner of the lottery is the Defense Department. The bill adds $33 billion to the defense budget which, as the Washington Post points out, makes the total defense allocation 57% of the proposed discretionary budget. Interestingly it allocates $7 billion to "the wall." This is in addition to the almost $7 billion announced for the national emergency. The three other winners are in order of percentage increase: Veterans Affairs, Homeland Security and Commerce. The list of losers is also very interesting and informative: Environmental Protection, State and USAID, Housing and Urban Development, Agriculture, Interior, Health and Human Services, Education, Energy, Labor, Justice, and NASA. Interesting!

As we wrote earlier, the budget represents the hopes and aspirations of the president and his administration for the country's future.

Defense of the nation is, of course, paramount and the primary responsibility of any president! But it seems a stretch to think of many departments that are getting drastic cuts in funding not being vital to the nation's future. The trade-off in the budget appears to sacrifice an awful lot of potential future growth. Much of the cuts come in areas that increase consumer spendable income, education and a hard to measure cost like untreated health problems. Interestingly, even though more spending is often considered stimulative for the economy, in this case, due to the above mentioned problems complicated by the expanding budget deficit, it may wind up being a drag on the economy in the long and intermediate time frame.

Globalization has shifted over the years from being perceived as a great boon to society to a curse. It has led to unemployment or underemployment in economically developed countries and large trade deficits. Politicians in these developed countries have raised many concerns and hoped for solutions, including tariff reprisals along with other anti-trade actions.

Weekly Market Insights (cont'd)

Globalization is certainly not new. Humans have been expanding their opportunities since the first human walked out of Africa looking for a better life.

We wrote the other week about mismatches in timing. Globalization is a textbook example, but a bit more complicated. Globalization has helped all countries. The problem is it hurt specific parts of the labor force while benefitting the vast majority. We have written in the past how governments have missed the boat in preparing their countries' work forces and temporary stabilizers. Today, we point out some of the ways economically developed countries are changing.

We were fortunate to participate in an excellent panel with McKinsey & Company concerning the future of trade and value chains. This will be a very short part of it and we hope to write much more about this in the future. It appears that Adam Smith and David Ricardo were correct in their belief in comparative advantage.[1] One of the problems is, the modern world changes can take place so fast that the economy doesn't have time to adjust. This really does cause hardship on many. Is there now a light at the end of the tunnel? In some ways, yes and in others, no. Not a very satisfactory response, but the positives outweigh the negatives by a considerable amount. The biggest negative affects a small portion of the labor force in the developed economies. It is clear that over the past few years, labor has made a significant recovery. Unemployment rate is down dramatically, labor force is growing and wages are picking up.

The one segment of the population that is not benefitting at all is the poorly educated. The jobs they held, no matter how high tariffs may be, are highly unlikely to come back.

What encourages us to believe globalization has more to offer and the benefits will start to accrue to the economically advanced countries? The distribution between the trade of goods and services is changing. Although trade in goods is still growing, it is slowing, while the trade in services is expanding at a sixty percent faster rate than trade in goods. Economically advanced countries dominate services. Goods producing value chains are becoming less trade intensive. Less than twenty percent of goods traded is based on labor arbitrage.[2] Global value chains are becoming more knowledge-intensive and more reliant on highly skilled labor. An interesting statistic is that total private investment in the United States and Europe has moved from 12% tangible (goods producing) in 1995 to 11% in 2016, while intangible (service producing) has grown from 10.5% to slightly over 13% in 2016.[3]

Lots can and should be done to ease the plight of those who have been hurt. Globalization is not dead, only marking time.

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[1]The **law** or **principle of comparative advantage** holds that under free trade, an agent will produce more of and consume less of a good for which they have a comparative advantage. **Comparative advantage** is the economic reality describing the work gains from trade for individuals, firms, or nations, which arise from differences in their factor endowments or technological progress. In an economic model, agents have a comparative advantage over others in producing a particular good if they can produce that good at a lower relative opportunity cost or autarky price, i.e. at a lower relative marginal cost prior to trade. One does not compare the monetary costs of production or even the resource costs (labor needed per unit of output) of production. Instead, one must compare the opportunity costs of producing goods across countries.

[2]Labor arbitrage substitutes cheap labor for expensive and is usually associated with cross border manufacturing.

[3]Globalization in Transition: The Future of Trade and Value Chains.

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