Loss avoidance is a key to long term investment success. We deem certain risks profitable, to be exploited with sound research, while other risks are inherently unprofitable and should be avoided.

**OUR RISK MANAGEMENT TENETS**

- We believe in extensive asset class diversification
- We actively manage tactical asset allocation policy
- Our stock selection process emphasizes intrinsic value, earnings growth, innovation, and durable competitive advantages
- We believe excess returns are achievable due to market inefficiencies that persist over time
- We seek to build diversified portfolios of stocks with attractive valuations, quality balance sheets and above-average earnings growth
- We closely monitor valuation measures to limit downside risk
- We carefully control portfolio average capitalization and beta

**AS THE GLOBALIZATION TIDE RECEDES, CHINA IS EXPOSED TO INSTABILITY**

Paul Teten, CFA, Chief Investment Officer

World trade growth has slowed dramatically in recent years and has actually contracted by about 1% in the year ending in July\(^1\). A myriad of factors, policies and technologies are contributing to the evolving dynamics of global trade and we anticipate these developments will continue to dominate global growth in the years immediately ahead, much as they have in recent history. There are layers of complexity in the ever more efficient production, distribution and consumption of goods in world markets, with a substantial global bureaucracy in place to monitor and police fair trading practices. We expect to write further and more in depth on trade developments in the months ahead, and start here with an overview of the international efforts to foster a global trading system after World War II. Global integration accelerated following the collapse of the Soviet Union in 1991 and facilitated the emergence of China as a global manufacturing power. However, the wake of the Great Recession has revealed imbalances that have resulted from China’s success and opposition to its trade practices. This article reviews the resistance that has emerged to China’s aggressive trade agenda and the limits to globalization that are becoming evident.

At the International Monetary Fund’s (IMF) annual meeting in Washington D.C. earlier this month, managing director Christine Lagarde warned that global growth continues to slow and that the single biggest threat to growth is spreading protectionism\(^2\). It is easy to see the winds of change blowing against the previously bipartisan consensus favoring free trade agreements in the U.S. Presidential campaign. Both candidates are competing to posture as most hawkish and vigilant in protecting American workers from the encroachments of foreign competitors. But the broader canvas is that international efforts to prevent unfair trading practices and promote freer world trade have been ineffective for at least a decade. Consensus in the developed economies that attractive benefits are available to all through economic integration with developing nations is dissipating. The failure of the World Trade Organization’s (WTO) dispute resolution process is the primary cause of the rise of protectionist sentiment and bodes poorly for global stability as large trade imbalances are likely to find resolution by other means.

The WTO is an intergovernmental organization that regulates international trade, launched in 1995 as the successor to the General Agreement on Tariffs and Trade (GATT), which was the international effort begun in 1948 to assist in rebuilding the

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\(^1\) Ned Davis Research, July 31, 2016

global economy after World War II\(^3\). Signatories to the WTO charter include 164 countries which have agreed in principle to a set of broad rules governing behavior in international trade. The main elements of agreement include a pledge to treat all WTO members equally (non-discrimination), that any benefits granted to a trading partner are reciprocal, that agreements are binding and enforceable, that all internal trade regulations are transparent and accessible to trading partners, and that disputes will be resolved through the WTO’s resolution process rather than unilateral action. After a lengthy lobbying campaign and pledges to abide by WTO principles, China was admitted to the WTO in 2001.

A series of agreements known as rounds, referring to multi-year negotiations, under the auspices of the GATT and largely focused on trade between developed economies, were completed between the GATT’s inception and the Uruguay Round in 1986, in which the WTO was created. The subsequent Doha Round convened in 2001 was projected to focus on emerging markets’ interests and incorporate their particular concerns into the global trading order. However, the Doha Round has been notably unsuccessful, hobbled largely by disagreement over protection of developing agricultural interests. It did produce the Bali Package in 2013, which attempted to codify what common ground there was between developed and developing interests, in a salvage effort designed to create a sense of forward movement and obscure the collapsing consensus on globalization. The reality however is that little has been accomplished since 2001 and the WTO’s dispute resolution process has devolved into a thicket of bureaucracy and litigation that enables intransigence in settling disputes among the members.

Since China’s accession to the WTO in 2001 their trade surplus with the U.S. has grown almost 5-fold from $75 billion annually to $350 billion currently\(^4\), accounting for roughly 50% of the U.S. non-oil goods trade deficit (see chart below). The U.S. trade deficit with China alone represents about 2% of real GDP, so when we assess the factors that have depressed U.S. economic growth in recent years compared to prior cycles, our trade deficit with China has to be on that list. Contrary to popular belief, or at least a belief promoted by one of the presidential candidates, China has not been a currency manipulator in the last decade, opting instead for a loose peg against the Dollar over most of that time. It has become ever more clear in the last decade that China’s trade advantage owes more to deliberate and often informal trade barriers that essentially close their markets to U.S. producers.

Since China joined the WTO, the U.S. has filed 22 complaints with the WTO’s Dispute Settlement Body for adjudication, and the U.S. has won all 11 of those completed\(^5\). The remaining cases have dragged on for years, over a decade for some. The dispute resolution process awards no financial penalties for past practices deemed unfair, only that practices be corrected in the future, thus there is no downside to disputing claims and intransigence is rewarded. Many

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\(^3\) www.wto.org

\(^4\) Ned Davis Research, August 31, 2016

\(^5\) Richmond Times-Dispatch, June 18, 2016, Stuart S. Malawer; “Obama, Trade Enforcement and China”
have lamented the fact that the WTO’S dispute process fails to recognize or remedy the jobs lost due to unfair trade practices. By the time an illegal trade practice is adjudicated and sanctioned, the damage done to the complainant country is typically irreversible.

There is little evidence that WTO sanctions against China have resulted in any meaningful change in Chinese trade practices, resulting in continued friction over trade practices. The WTO cases decided against China have included illegal duties on U.S. high-tech steel exports, U.S. agricultural exports, dumping of Chinese tires into the U.S., restrictions on imports of autos and auto parts into China, restricted use of U.S. credit cards in China and restrictions on exports of rare earth elements and other raw materials from China. Outstanding cases predominantly include charges of dumping Chinese steel, aluminum and other manufactured goods onto world markets.

One of the most contentious issues in U.S.-China relations is the rampant theft of U.S. intellectual property by Chinese agents. Some of this is accomplished surreptitiously by requiring U.S. companies operating in China to have Chinese partners and more has been acquired by cyber espionage. This unacceptable behavior reached a boiling point last year and resulted in President Obama’s announcement that the U.S. would henceforth identify, target and sanction Chinese companies that benefit from IP theft. While the WTO has an elaborate process to protect intellectual property, the U.S. unilateral sanction threat is the clearest signal of the failure of the world body to protect member interests. The U.S. has also begun to develop plans to unilaterally sanction Chinese companies that refuse to honor their pledges against trade barriers, dumping and export controls.

The failure of the Doha Round resulted in efforts to craft other multi-lateral trade agreements where some consensus seemed possible. However, after years of work and ministerial gatherings to bless the process, both the Trans-Pacific Partnership (TPP) and the Trans-Atlantic Trade and Investment Partnership (TATIP) are on life-support, if not dead on arrival. The TPP’s demise is more a function of changing attitudes in the U.S. toward globalization, while the TATIP’s collapse is more related to Britain’s exit from the European Union, another signal of receding globalization. The important point is that the pendulum swing away from globalization is not just a function of the emergence of populist fervor in the U.S. and the U.K., although they are factors; but these currents have been in play for years and the Obama Administration has taken critical unilateral steps that underscore the inadequacy of the WTO.

5 Richmond Times-Dispatch, June 18, 2016, Stuart S. Malawer; “Obama, Trade Enforcement and China”
6 The Wall Street Journal, October 13, 2016; Wilber Ross, “Trump’s Right: NAFTA has been a Loser for U.S.”
7 Washington Post, August 30, 2015, Ellen Nakashima; “U.S. Developing Sanctions Against China Over Cyberthefts”
“China is now a threat to the United States not because it is strong but because it is fragile.” - Ruchir Sharma

World trade has slowed to a crawl in the aftermath of the Great Recession and China has struggled to adjust with its now enormous excess manufacturing capacity. China’s attempt to stabilize its economy and promote growth has resulted in an explosion of debt and an overheated property market. The prospects for a hard landing in China are clear enough, although they possess inherent advantages to cushion the transition that less controlled economies do not have. It seems inevitable though that political hostility to China’s gigantic trade surplus with the U.S. will continue to find traction, representing a major source of continuing instability for China. The risks to the global economy from continuing instability in China should not be underestimated. China’s aggressive military operations in the South China Sea may well be a portent of things to come if China finds a need to shift attention from its unsatisfactory economic performance.
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