STORMY DATA

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It has often been said that US monetary policy is data dependent. That's a fancy way of saying the Federal Reserve governors wait and see what happens to a variety of economic indicators before changing the fed funds rate.

For much of the past two years, the focus of this data dependency has been on the US labor market and its implications for in!ation. As the pace of economic activity has quickened, investors wanted to know how low the unemployment rate could go without creating troublesome wage in!ation. Indeed, the recent stock market correction began in early February when the Labor Department reported that average hourly earnings in January had risen an unexpectedly "high" 2.9% year over year. This sparked concerns that the US economy might be overheating. Stock prices plunged 10% in a few days, before rallying later in the month when it became clear that in!ation was likely to only drift higher, not spike higher.

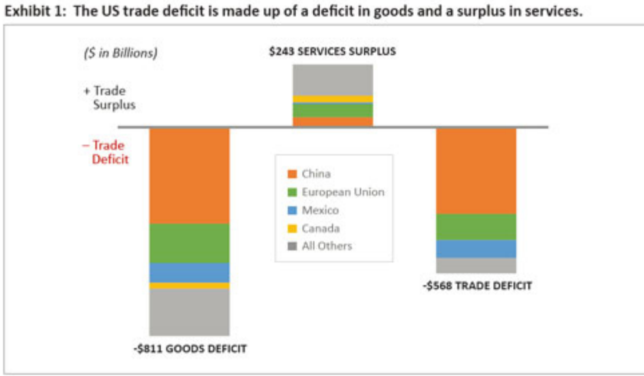
Of course, this rally was cut short in mid-March by news that the Trump Administration was imposing tari?s worldwide on steel and aluminum imports. Tari?s and fears of a trade war have replaced the labor market as the worry du jour. As well they should.

The US is the world's largest importer of goods and services. And, believe it or not, we are also the largest exporter of services and the second largest exporter of goods. China, of course, is the largest exporter of goods. According to the World Bank, global trade represents over half of global GDP. We live in a very interdependent world.

International trade policy is a serious issue. If mishandled, it could wreck the synchronized global economic expansion that has underpinned global stock markets for the past two years. Unfortunately, data regarding international trade — de?cits, tari?s, imports, exports, etc. — are more di?cult t interpret, less straight forward, more "cloudy," let's say, than data about employment and wages. For these reasons and their potential for mischief, I call the trade data stormy data.

What follows are my views on the key issues facing investors about trade, tari?s and trade wars.

Exhibit 1: The US trade deficit is made up of a deficit in goods and a surplus in services.

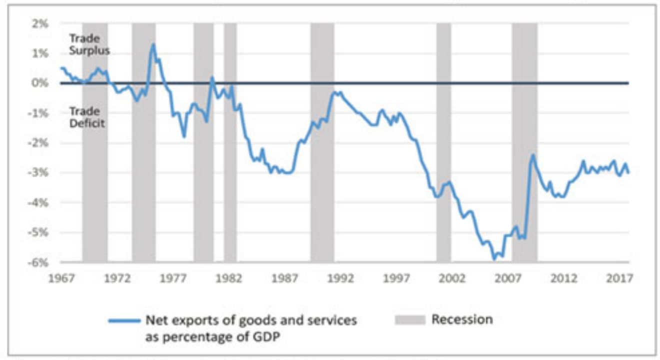


Source: Census Bureau, Atlanta Capital. 2017 data as of February 2018.

What are the trade de?cit and its various components?

A de?cit occurs when a country imports more than it exports. There are two basic components to imports and exports — goods (sometimes called merchandise) and services. (See Exhibit 1.) For the US, we export about $1.6 trillion of goods annually — Boeing aircraft, soybeans, SUVs made at the big BMW plant in South Carolina. We import $2.4 trillion of goods, mostly from China and Europe. Typical US imports include clothing, furniture, autos and household appliances. In 2017 we had a goods trade de?cit of $811 billion. This is the number that President Trump likes to focus on, but it's not the whole story. While the US had a de?cit in goods, we had a surplus in services. We are the world's leader in exporting services like insurance, ?nancial services, travel and education (think foreign students getting their PhDs at American universities.) Last year the US had a trade surplus in services of $243 billion. Combine the de?cit in goods with the surplus in services and you get an overall US trade de?cit of $568 billion. This de?cit represented 3%

Exhibit 2: The US trade balance, relative to the size of our economy, over the last 50 years.



Source: St. Louis Federal Reserve, Atlanta Capital. Quarterly data as of March 2018.

Yes, good factory jobs have been lost, but manufacturing's importance in our economy has changed very little. Competition, both foreign and domestic, has caused the decline of many individual companies and industries. Cheap labor in China, Vietnam and Bangladesh decimated the textile industry in the American South during the 70s and 80s. But the o?spring of many of those textile workers now build BMWs for $30 per hour at the plant in South Carolina. Now bankrupt Bethlehem Steel was once the nation's second largest steel producer and is often cited as a victim of foreign competition. But I suspect the main culprit was the American company Nucor, which perfected the mini-mill technology of steel making. It is now America's dominant steel maker. America's factories are still making lots of stu?, just doing it with fewer workers.

Will tari?s help solve our trade problems?

It's unlikely. A tari? is a tax or duty on a particular class of imports or exports. Most foreign countries impose higher tari?s on US goods than we impose on foreign goods. That may seem unfair, but it is one of the reasons Americans enjoy much higher living standards than other countries. Not only do we produce a higher GDP per capita than the rest of the world, but we tax personal incomes as well as imports at lower rates. As a tool of trade policy, tari?s are often imposed on goods that a country is accused of selling (dumping) at unpro?tably low prices. China dumps steel and aluminum on world markets because they have over-invested in these industries and are seeking to maintain employment to prevent social unrest. While American consumers in the aggregate bene?t from low steel and aluminum prices, tens of thousands of steel and aluminum workers do not. And for national security reasons, the US has an interest in maintaining a viable steel and aluminum industry. But, in dealing with trade issues, there are three problems with tari?s which limit their e?ectiveness: they are in!ationary, they invite retaliation, and because of the ?rst two, they reduce economic activity.

Trade de?cit not as bad as doomsayers portray

There's one more aspect of the trade situation that warrants discussion. I believe much of the data on imports and exports are at best imprecise. As a result, I doubt the US trade de?cit is as bad as the doomsayers portray. Collection methods for international trade data were developed decades ago, before the development of intricate global supply chains. What's more, multinational corporations have become increasingly adept at "pro?t-shifting" around the globe to maximize their tax advantages. All this has tended to distort the trade data.

An example will help clarify. Ireland has a trade surplus of 22% of its GDP, while its close neighbor the United Kingdom has a de?cit of about 4%. Why the big di?erence? Ireland isn't usually viewed as a manufacturing export powerhouse. The di?erence is probably related to Ireland's super-low corporate tax rate of 12.5%, which provides multinational companies, like Apple, a powerful incentive to locate "operations," particularly intellectual property, in Ireland. This tends to in!ate Irish exports at the expense of US exports. Indeed, Apple cites Ireland as one reason its tax rate in 2017 was only 18% versus the then US corporate rate of 35%. As most people know, much of the value of the Apple iPhone is in its design and engineering done

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