CONWAY • JARVIS

Quarterly Investment Outlook

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China: Trading Partner or Co-Dependent?

In our previous issue we began a discussion of what could upset the "just right" conditions of the "Goldilocks Economy" we enjoy today. Despite the downturn in US real estate, we viewed recession as only a remote possibility. With another quarter under our belt, we believe that odds of a recession have lengthened even further. In this issue we'll examine the role of China, our largest creditor and, some say, the heir apparent to the top spot in the global economy. How China manages its growth will have a tangible effect on US economic policy. With an election year looming, we're concerned that politics could unduly influence fiscal policy as it relates to China. What would that mean for the US economy, its businesses, and its markets?

In our March Outlook, we offered our opinion that two things were sure to present risks to the continued expansion of the US economy: the downturn in residential real estate; and the anticipated slowdown in the Chinese economy. We predicted that the imbalance in residential real estate market would be absorbed through the abundance of liquidity in the system and that there would be few, if any, significant negative effects on the broader economy. So far this has proven correct and our opinion has strengthened during the just-ended quarter. As we approach the end of the first half of 2007, we are seeing the contraction of the US real estate market run its course. Yes, there have been the defaults, foreclosures, and the failure of a number of sub-prime lenders that many thought would trigger a recession in the US. What we haven't seen is the precipitous drop in consumer spending that many predicted and what small decline there is has been offset by an increase in business spending as the global expansion picks up the slack. The net result? A continuing "Goldilocks Economy" in the US, still growing at a respectable pace with inflation remaining under control.

While still waiting to see if the worst of the real estate downturn is behind us, we now turn our attention to Asia, specifically China. In our March installment we stated the obvious: China must rein in its economy to avoid a speculative overheating that could create imbalances affecting the global and US economies. In this issue we'll examine some potential problems that could arise. First and foremost among those is a resurgence of inflation. Since 2004, the central banks of our major trading partners, including China, have steadily raised key interest rates, following the Fed's lead in attempting to preempt such an occurrence. The net effect has been a reduction in global liquidity designed to offset inflationary pressures. In addition, China has focused internally on implementing measures designed to slow the speculative segments within its economy. Recent examples are newly imposed restrictions and taxes on real estate and stock transactions. Aside from the occasional sharp downdraft in the Shanghai Composite, there have been very few side effects accompanying these measures. That's the good news.

The bad news is that China has done very little toward allowing its currency to reflect a more realistic value relative to the currencies of its trading partners. With the Yuan loosely pegged to the dollar, China enjoys a significant advantage in the price of its goods exported to countries with more valuable currencies. Recent adjustments to the Yuan have been viewed as mere token gestures while they enjoy a trade surplus that has recently surged 73% over that of 2006 to a record $22.45 billion. Understandably, this has triggered a hue and cry from most, if not all, of China's major trading partners with some asserting that the Yuan is undervalued by as much as 40%. They are demanding that the Chinese government expand the range within which the currency is allowed to float in order to more accurately reflect its relative value. So far, the Chinese response has been muted.

Cooperation or Aggravation?

In our previous installment, we cautioned that a failure by China and the US to resolve their trade/currency imbalance could result in the legislative enactment of protectionist trade policy by the latter. This week, the Democratic-led Congress will once again introduce legislation designed to compel China, through the imposition of tariffs, to recalibrate the Yuan versus the dollar. If history has taught us anything, it's that tariffs don't correct trade imbalances, they instead have a chilling effect on trade that the equities markets don't take kindly to. We're also left wondering how our biggest creditor might react. Retaliatory trade restrictions are a possibility. So too, is the diversion of China's surplus capital away from the US. In our view, neither is likely to occur. We see China and the US as symbiotic partners, each of whose success is vested in that of the other.

China is our largest creditor, holding approximately $1 trillion of our treasury securities while we, as their largest customer, are responsible for the lion's share of that burgeoning trade surplus that has offended so many. China has few alternatives as to where they can park their huge surplus of capital. The size of our dollar denominated markets offers them the only safe haven with a requisite amount of liquidity. We, in turn, have found their excess capital to be a cheap source of financing for our shrinking budget deficit and the US consumers' spending binge. In addition, US multinational corporations have found China to be a cheap source of labor while creating jobs and the genesis of what will someday become the world's largest consumer market. Simply put, we need each other for now. For that reason, and the fact that any tariff driven legislation protection will meet a quick death at the business end of the president's veto pen, we see no major trade policy revisions through the end of next year. The US and other developed nations will continue to express their outrage and China will acquiesce with a minimal response. The dance will continue for now but next year's election could drastically alter the regulatory environment.

Mixing Politics with Economics

The Fed looks at capital flows, trade balances, currency values and inflation expectations as guides to forming monetary policy. They serve no electoral constituency. Congress, on the other hand, has shown the propensity to craft fiscal policy driven by considerations other than the pursuit of sound economic policy. Currently, the global expansion is a tide that is raising all boats, including ours. We're seeing record personal and corporate tax revenues shrinking our budget deficit to the point of where a surplus is on the distant horizon and the trade deficit registered a rare decline last month. We see little reason to change the competitive trade landscape other than to secure more routine currency concessions from China.

For now, business as usual will continue to drive the US economy and its markets in the right direction. Unfortunately, we see the potential for a significant change in fiscal policy that could have a dramatic affect on trade, taxes, and the markets beyond 2009. Our hope is that we're simply bearing witness to a good amount of pre-election bluster from a newly empowered Congress and that cooler, moderate heads will prevail in the post-election environment. We would hate to see the Goldilocks Economy go the way of the Peacetime Economy. In our next installment we'll discuss possible outcomes for the '08 election and what those might mean for the markets.

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