COMMENTARY

August 4, 2017

Dear clients and colleagues,

Congratulations to Mr. Sain Godil, a member of our Global Alpha team, on the celebration of his wedding last weekend. Sain's family and friends, travelling across the globe to attend, gave the wedding a distinct Indian flavour, but not too spicy as his wonderful bride, Susannah, is an Anglophone Canadian. The ceremony was held in Longueuil, the most French speaking suburb of Montreal with dinner at Damas, a highly renowned Syrian restaurant on Van Horne Street, nestled between little Italy and Cotes-des-Neiges, an area that 25,000 Filipinos call home.

No longer an anomaly, multi-cultural events such as these serve to remind us how and why immigration can successfully contribute to society. Furthermore, without immigration, the population of working-age individuals in the US would start to decline by 2035, a drastic change from its momentum-building years. Since 1945 the US has consistently increased immigration thereby creating a healthy workforce and, no doubt, plenty of international weddings.

A mobile multi-cultural workforce along with technological advances in communication support long-term globalization trends as products are becoming increasingly standardized through geographies as well as easier to ship and sell. However, we do live in a new era in which protectionism is now the current headline.

With no urgent need to attract labor until 2035, US officials are addressing international trade imbalances as they attempt to re-invigorate local production. The largest gap comes from trade with China, as the US goods trade deficit reached $347 billion last year.

To reduce the US trade deficit with China, the US and Chinese governments are currently designing a 100-day action plan. Negotiations, which began in April, have reopened China's market to US beef, after a 14-year absence, and prompted Chinese pledges to buy US liquefied natural gas. American firms have also been given access to some parts of China's financial services sector.

There has been little progress in soothing some of the biggest trade irritants, such as: US demands that China cut excess capacity in steel and aluminum production, lack of access for US firms to China's services market, and US national security curbs on high-tech exports to China.

The Trump administration is considering broad tariffs or quotas on steel and aluminum, partly in response to what it views as a glut of Chinese production, which is driving down prices by flooding international markets.

China is set to produce 825 million metric tons of crude steel next year, a 0.5 percentage point increase from 2016—yet it will consume 87 percent of this production. Its steel capacity stands at 1200 million metric tons, so it has already begun to put many of its facilities on idle. According to a recent report by BMI Research, the Chinese domestic demand will narrow the global steel market surplus to 3.2 million tons in 2017 from 10.9 million tons in 2016. However, this will do little to offset the US trade deficit with China as the US receives the majority of its steel imports from Canada. As shown in the table below, broad tariffs and quotas with China would have to be applied through machinery, electronic equipment and vehicle product imports if a bilateral deal is to be sufficient to change the imbalance. It is hard to see how China, and not the US consumer, loses on broad quotas and tariffs. A 2016 review tells us that well-supported commodity prices through intervention did not hinder the Chinese economy.

US Imports from China	US Exports to China
1. Electronic equipment: $131.7 billion	1. Soybeans: $15 billion
2. Machinery: $100 billion	2. Civilian aircraft: $8.4 billion
3. Furniture, lighting, signs: $31.6 billion	3. Cotton: $3.4 billion
4. Toys, games: $24.9 billion	4. Copper materials: $3 billion
5. Plastics: $15.6 billion	5. Passenger vehicles (small engines): $3 billion
6. Footwear: $15.4 billion	6. Aluminum materials: $2.4 billion
7. Knit or crochet clothing: $15.1 billion	7. Passenger vehicles (large engines): $2.2 billion
8. Vehicles: $14.3 billion	8. Electronic integrated circuits: $1.7 billion
9. Clothing (not knit or crochet): $14.2 billion	9. Corn: $1.3 billion
10. Medical, technical equipment: $11.7 billion	10. Coal: $1.2 billion

The application of tariffs and quotas on machinery could benefit non-Chinese industrial companies in the short term. However, US consumers will ultimately foot the bill.

Global Alpha portfolio holdings include companies that may benefit from US quota and tariff escalation with China. Companies in the materials and industrials sectors such as:

- Alumina – an alumina producer with core activities in Australia, the support of alumina prices would not drastically affect the demand curve. The company holds long-term supply contracts with large smelters and operates on a global basis.
- Titan Machinery – an agricultural equipment distributor aligned with Case New Holland, a company that manufactures products in India and Belgium.

Tariffs on electronics, the largest component of the trade gap, could also help Global Alpha investments, in that, companies such as Solaredge, a US-based solar equipment manufacturer, may benefit as tariffs and quotas should curb the expected Chinese competition for its solar inverters. However, some markets remain sensitive to pricing, tariffs and quotas such as solar panels and these could prove quite inelastic on volumes as most panels are imports from China. Each industry therefore has its price-volume particularities. Overall, as evidenced by President Trump's direct approach with Apple and other companies, the lack of US electronic infrastructure is pushing his administration towards using subsidies in place of tariffs.

In conclusion, we will continue to follow the China-Trump negotiations with a diligent eye and attempt to bring corrective actions in the event that changes in policy materially affect companies in the portfolio.

Have a good weekend.

The Global Alpha Team