The end of strict collectivism in China and the Soviet Union beginning around 1990, increased the supply of industrialized labor from less than 800 million to nearly 2 billion over 20 years.

The effect on the marginal cost of labor was most pronounced in global tradeable goods.

The mercantilists are on the verge of a surge in dependency as their population ages. The US population is also aging; however, the rate of change is much slower.

In other words, the demographic dividend has been paid, it's about to turn into a tax for the global mercantilists.


"Demographics will reverse three multi-decade global trends", Charles Goodhart and Manoj Pradhan https://www.bis.org/publ/work656.pdf
MIT Economist David Autor’s analysis of the effect of China’s market share gains in global exports on US labor markets is evident in labor share of income.

US corporates capitalized on inexpensive Chinese labor; however, these trends appear to be bottoming.

Labor market turnover drives both wage growth and productivity.

Manufacturing sector measures of turnover, hiring, voluntary separations and wage growth are all accelerating for the first time since the JOLTS data was introduced in late 2000.
Globalization in Reverse – Global Rebalancing
Asian Exports Ex-China are Slowing

- Global trade grew ~3 times as fast as GDP in the ’00s as China grabbed market share.

- The slump in 2015-16 was the first occurrence of trade growing more slowly than GDP outside of a US recession, the catalyst was China’s heavy industry hard landing.

- We constructed this index of Asian exports as a leading indicator of global growth. Trade has recovered sharply since the early 2016 low. The biggest driver of this recovery is stabilization of Chinese demand. The drop mid-2014 to early 2016 came as Chinese ordinary imports (ex-commodities) fell sharply.

- The low in Feb 2016 was -16.6%; by March 2017 Asian trade had recovered to 15.2%. Asian trade is slowing again though it remains well above the 2016 low.

- While all of these countries show falling export dependency, they are integral to the global goods supply chain. As multi-nationals reduce this risk and increase reliance on automation (IIoT) their Mercantilist economic systems may become increasingly challenged.
In 2011 the Boston Consulting Group wrote a report titled “The Tipping Point” that concluded that productivity adjusted labor cost convergence, relative transportation and energy costs and increased exchange and supply chain risks would reduce Chinese manufacturing competitiveness to zero by 2015 across $2 trillion in US industrial production.

The differential in the growth in Chinese and US unit labor costs peaked above 20% in 2013. The subsequent collapse is likely related to the heavy industry hard landing, much as the decline in the late ‘90s followed the Chinese yuan devaluation and Asian Currency Crisis.

Core CPI goods prices fell sharply in the ’90s and ’00s as China and the emerging world’s export share surged.
Chinese Growth Without Creative Destruction

China’s GDP has been described as aspirational, a target, an input or output that includes products that never get sold and malinvestment.

Most measures are flawed, however, corporate sector sales growth has been a more reliable indicator than most.

Sales growth plunged from +15% in 2013 to -15% in 2015.

Sales and producer prices have been weakening but not nearly as much as the drop in share prices implies.

Chinese stock prices likely reflect policy maker credibility more so than fundamentals.
Globalization Benefits are Diffuse and the Costs are Acute
Chinese and oil exporter current account surpluses were recycled into U.S. assets

- China was the epicenter for the massive increase in the supply of labor in the global tradeable goods market from 1990-2008.¹
- During the '00s Chinese export revenues created a large excess pool of savings that was recycled into USD assets to maintain the hard peg until mid-2005 and crawling peg until the hard peg was reinstated during the global financial crisis.
- Chinese export market share is likely to fall in coming decades and their aging population will utilize the excess savings.

- The shale energy revolution led to a collapse in energy exporter revenues. Petrodollars get ‘recycled’ into U.S. financial assets either directly due to hard dollar currency pegs like the GCC nations or indirectly due to current account surpluses in Europe and Japan.²
- While the major drivers of the '00s savings glut are fading, a counter-trend recovery in global trade and developed world central banks filled the void in 2017.

Source: Haver Analytics, IMF Guggenheim Securities, LLC. Data as of 2017
Another Capital Spending Boom?
Intangibles, Equipment and Physical Investment

<table>
<thead>
<tr>
<th>Business Cycle Peak to Peak</th>
<th>Real GDP</th>
<th>PCE</th>
<th>NonRes Fixed Investment</th>
<th>Structures</th>
<th>Equipment</th>
<th>IPP</th>
<th>R&amp;D</th>
<th>Productivity</th>
<th>CPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q3-48 to Q2-53</td>
<td>5.5%</td>
<td>4.1%</td>
<td>3.0%</td>
<td>3.7%</td>
<td>1.6%</td>
<td>11.3%</td>
<td>16.5%</td>
<td>3.4%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Q2-53 to Q3-57</td>
<td>2.4%</td>
<td>3.5%</td>
<td>4.7%</td>
<td>5.1%</td>
<td>3.8%</td>
<td>8.7%</td>
<td>10.1%</td>
<td>2.1%</td>
<td>1.4%</td>
</tr>
<tr>
<td>Q3-57 to Q1-60</td>
<td>3.1%</td>
<td>3.0%</td>
<td>0.6%</td>
<td>0.9%</td>
<td>-0.6%</td>
<td>5.8%</td>
<td>8.2%</td>
<td>2.9%</td>
<td>2.0%</td>
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<tr>
<td>Q1-60 to Q3-69</td>
<td>5.3%</td>
<td>5.3%</td>
<td>9.2%</td>
<td>6.2%</td>
<td>10.7%</td>
<td>12.0%</td>
<td>12.2%</td>
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<tr>
<td>Q3-69 to Q4-73</td>
<td>3.6%</td>
<td>4.2%</td>
<td>5.4%</td>
<td>2.0%</td>
<td>8.2%</td>
<td>3.4%</td>
<td>2.9%</td>
<td>2.6%</td>
<td>5.0%</td>
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<tr>
<td>Q4-73 to Q1-80</td>
<td>3.0%</td>
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<td>5.4%</td>
<td>4.1%</td>
<td>5.5%</td>
<td>7.6%</td>
<td>5.1%</td>
<td>1.2%</td>
<td>8.8%</td>
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<tr>
<td>Q1-80 to Q3-81</td>
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<td>2.5%</td>
<td>4.3%</td>
<td>0.3%</td>
<td>7.4%</td>
<td>5.4%</td>
<td>0.9%</td>
<td>12.1%</td>
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<td>Q3-81 to Q2-90</td>
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<td>3.4%</td>
<td>-0.3%</td>
<td>3.8%</td>
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<td>4.2%</td>
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<td>Q2-90 to Q4-00</td>
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<td>9.9%</td>
<td>1.8%</td>
<td>13.8%</td>
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<td>6.7%</td>
<td>2.2%</td>
<td>3.0%</td>
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<tr>
<td>Q4-00 to Q4-07</td>
<td>2.6%</td>
<td>3.0%</td>
<td>3.3%</td>
<td>0.0%</td>
<td>4.0%</td>
<td>4.4%</td>
<td>2.9%</td>
<td>2.7%</td>
<td>2.7%</td>
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<tr>
<td>Q4-07 to Q2-18</td>
<td>1.6%</td>
<td>1.9%</td>
<td>3.1%</td>
<td>-0.8%</td>
<td>4.1%</td>
<td>5.5%</td>
<td>3.3%</td>
<td>1.3%</td>
<td>1.8%</td>
</tr>
<tr>
<td>Average</td>
<td>3.3%</td>
<td>3.4%</td>
<td>4.6%</td>
<td>2.5%</td>
<td>5.0%</td>
<td>8.1%</td>
<td>7.3%</td>
<td>2.2%</td>
<td>4.5%</td>
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<tr>
<td>1H18 Annualized</td>
<td>3.2%</td>
<td>2.2%</td>
<td>10.1%</td>
<td>14.2%</td>
<td>6.5%</td>
<td>12.3%</td>
<td>11.6%</td>
<td>1.6%</td>
<td>2.6%</td>
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<tr>
<td>2H98-1H08</td>
<td>3.0%</td>
<td>3.5%</td>
<td>5.1%</td>
<td>1.3%</td>
<td>5.8%</td>
<td>6.8%</td>
<td>4.5%</td>
<td>2.8%</td>
<td>2.7%</td>
</tr>
<tr>
<td>2H08-1H18</td>
<td>1.8%</td>
<td>2.1%</td>
<td>3.5%</td>
<td>-0.9%</td>
<td>5.2%</td>
<td>5.6%</td>
<td>3.5%</td>
<td>1.3%</td>
<td>1.6%</td>
</tr>
</tbody>
</table>

Source: Haver Analytics, Guggenheim Securities, LLC. Data as of 2Q18.

"Understanding Weak Capital Investment: the Role of Market Concentration and Intangibles", Nicolas Crouzet and Janice Eberly

• Most economists agree on one factor in the productivity conundrum: investment has been weak since the TMT bubble burst
• This is the 2nd weakest capex cycle since WWII.
• The 1958 recession capex collapse and tepid recovery set the stage for JFK’s supply-side tax cuts.
• The 1981 ITC-related surge in capex faded into a mediocre capex cycle.
• The 1986 Tax Reform cut corporate tax rates and expenditures and was followed by the strongest post-war cycle.
• Productivity improved in 2017 driven by innovation adoption, capital deepening is next.
• Intangible investment is highly concentrated and may be contributing to greater concentration in key economic sectors – consumer, technology, healthcare and industrial.
• Concentration can drive productivity or market power; the polar extremes are the consumer and healthcare sectors.
Labor Slack is not Influencing Consumer Prices
Globalization impaired the Fed Mandate (Phillips Curve)

The Post-GFC Phillips Curve

The Post-GFC Keynesian Curve - Shelter

The Post-GFC Phillips Curve - Globalization Effect Core Goods

- Only housing among the major expenditure categories for core CPI is responding to tightening domestic slack as a Phillips Curve model would predict.
- In a recent BIS paper; “Monetary policy in the grip of a pincer movement”¹ the authors conclude that monetary policy operating with a Phillips Curve framework should increase their weight on the financial cycle.
- In the intermediate term this implies the Fed is unlikely to accelerate the tightening process; particularly if we are correct about the investment driving growth in 2018.

Source: Haver Analytics/Bureau of Labor Statistics/Guggenheim Securities/Data as of September 2018

¹https://www.bis.org/publ/work706.pdf
Our premise in this analysis is that when correlation of the components of the consumer price index are high, endogenous macro factors like low labor slack, strong aggregate demand impacted goods and services prices broadly. When correlation is low, exogenous unrelated variables impact prices individually.

In the ’70s correlation was high, currently it is exceptionally low. Idiosyncratic factors including global excess goods capacity, technology, innovation and disruption are having disparate impact on prices.
Personal income was revised up by $468 billion in the 2018 comprehensive GDP revision

The savings rate revision from 3% to 7% was startling
Suggested Reading

- “Destined For War, Can America and China Escape Thucydides Trap?”, Graham Allison
- “A Great Leap Forward: 1930s Depression and U.S. Economic Growth”, Alexander Field

- Please see the footnotes in the earlier slides, all of these papers are informative.
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