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THEME
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Forced De-Globalization (Part I): Benefits And Costs Of Trade

Global export demand growth has downshifted materially in recent years, reflecting the unwinding of the Commodity Supercycle, cresting in emerging Asia industrialization, and shifting consumption trends[1]. This adjustment process has created strains for many economies, working to dampen growth and encouraging competitive currency devaluation. However, much more worrying is that there is escalating populist pressure on politicians in several advanced economies to forcefully curtail global trade.

Countries forged ahead with global trade deals over the past couple of decades. These have been tremendously rewarding for their aggregate economies, in terms of increased GDP, disinflation and lower borrowing rates. However, the gains in the developed world have been highly concentrated among capital owners and skilled workers. Under-educated and lower-skilled workers have been forced to compete within the global arena against their lower-cost emerging market counterparts.

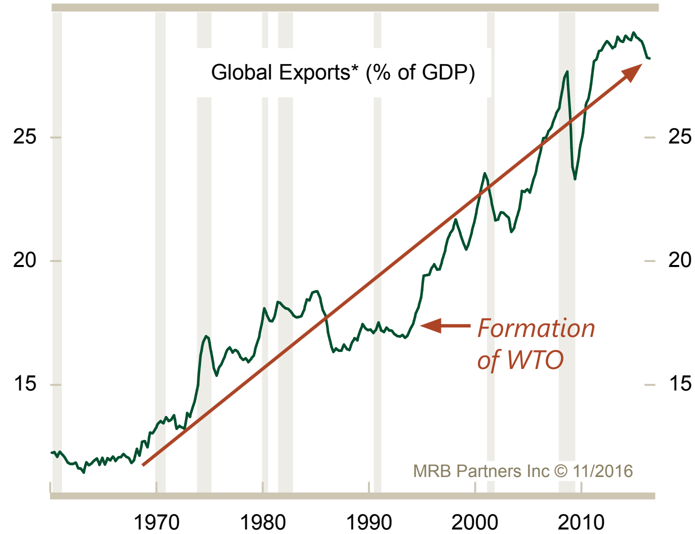
Policymakers failed to recognize the magnitude of the labor displacement that would ultimately occur and inability for these workers to transition into other industries. Openness to global trade was appropriate, but the process needed to be effectively managed, including efforts to redistribute gains, as well as educate and retool their domestic workforce. Neglecting to do so has brewed social

- Increased global trade has created tremendous benefits in recent decades, in terms of economic/profit growth, disinflation and lower borrowing rates. Still, the adjustment process associated with globalization was poorly managed, and has sown the seeds for its possible demise.
- Gains have not been equitably distributed and low-skilled workers in the developed world face chronically poor job prospects. This has fueled social unrest.
- However, politicians that fixate on the negatives and believe the answer is in adopting protectionist policies are naïve. Efforts to curb global trade give up the net benefits associated with it and risk creating a self-reinforcing downward economic cycle.
- Protecting uncompetitive domestic industries comes at a hefty and persistent cost to taxpayers and/or consumers. Also, retaliation from trading partners could crush corporate profits in domestic industries that are competitive, costing more wealth and job losses than those salvaged by anti-trade policies.
- Instead, the focus needs to be on enhancing and creating domestic comparative advantages to effectively compete in a globalized world. If such steps were taken, globalization would not be something to fear, but rather embrace.
- For the developed countries, this means educating their workforce and moving a greater proportion up the global value chain, rather than competing in the production of low-skilled products. The focus needs to be on producing higher-skilled goods and services as well as leading innovation in various industries.
- Investors should look to ***structurally*** underweight/ short risk assets of any country implementing anti-trade policies. If the world adopts protectionism on any meaningful scale, it would be quite negative for global equities and other pro-growth assets.

[1] **MRB** ***Theme Report***, "***Global Trade Cycle: Structurally Impaired?***", October 1, 2015

unrest and now threatens the foundations of many developed economies as voters revolt and push for extreme policy changes.

Chart 1 Global Trade Has Boomed Over The Past Few Decades



Note: Shaded for NBER-designated U.S. recession

Today's report is the first of a two-part **MRB *Theme Report*** on the consequences of forced de-globalization from politicians succumbing to protectionism pressures. ***Part I*** outlines the major economic benefit and consequences of increased global trade. Although some politicians are appealing to the populous by fixating on the negatives, adopting anti-trade policies would also unwind the positives and lead to a painful economic adjustment process. Instead, the focus needs to be on enhancing and creating domestic comparative advantages to effectively compete in a globalized world. In other words, reinforce the positives of global trade, while minimizing the adverse consequences.

Part II of this report (which will be published on November 10) notes that technology advancements have also contributed to the displacement of low-skilled labor over the past few decades, particularly in the manufacturing sector. Although global trade has been criticized, much of the blame is misplaced.

Benefits Of Global Trade

Increased global trade creates tremendous gains for the aggregate economy

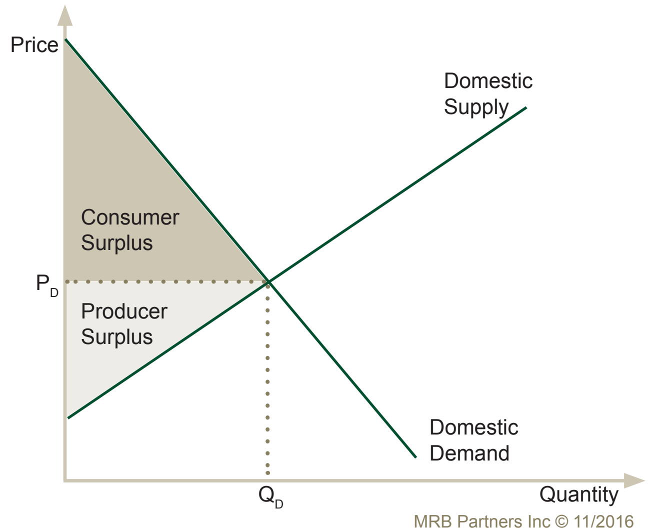
Global trade has been supported over the past two centuries by advancements in transportation (particularly shipping and rail) and communications. However, its growth nearly halted following WWI as most global economic powers adopted protectionist policies and introduced trade barriers. It was not until the second half of the 20th century that the political tide started to slowly shift. By January 1948, a total of 23 nations had entered in the General Agreement on Tariffs and Trade (GATT). This was later replaced by the establishment of the World Trade Organization (WTO) in January 1995, which included 123 nations. The WTO has since been broadened to 159 members, including China in December 2001. Both agreements made countries gradually cut trade barriers and open their current accounts and capital accounts, although it took until the 1970s for global trade to fully resume. Global exports have surged from 13% of GDP in 1970 to 28% currently (**chart 1**).

There is plenty of support in the economic literature for reduced barriers to trade. While there are several theoretical models, most are rooted in the comparative advantage framework laid out by David Ricardo in 1817[2]. Although his original work is arguably

[2] Ricardo, David. On the Principles of Political Economy and Taxation. London, England.: J. Milligan, 1817.

overly simplistic for a modern global economy with multiple products and international trade linkages, the conceptual rationale still proves useful. In short, Ricardo highlights that aggregate gains will be achieved if each nation specializes on providing goods and services where they have a comparative advantage[3], and then trade with one another.

Chart 2 **Without Global Trade: Determining Market Price And Quantity**



Although variations and other frameworks have been promoted over the past 200 years, nearly all economists agree with the principle that open world trade increases economic growth and raises living standards. It is probably easiest to explain why by using basic macroeconomics supply and demand diagrams. For those with an economics background, please excuse the brief refresher, but the conclusions derived from the analysis are critical to outline the macro and investment implications of policymakers in any country attempting to forcefully curtail global trade. We will explain the theory using the overly simplified but commonly accepted example that emerging markets largely trade cheap low-skilled labor for the technological/industrial advancements and higher-skilled processes of the developed world.

Without Global Trade

Nearly all economist agree that open world trade is a huge net benefit

To demonstrate the impact of global trade, we need to begin with a point of reference of an economy prior to opening its borders to exchange goods and services. **Chart 2** provides ***domestic*** supply and demand curves for a given product. For simplicity, we chose a linear downward sloping demand curve, i.e. quantity demanded steadily increases as the price drops. The supply curve is upward sloping to reflect that businesses will be willing to provide a greater quantity as the price rises. This is typically the case when businesses have a finite availability of inputs, causing costs to rise as they require more. For example, a developed economy may have a limited supply of low-cost laborers to work on manufacturing assembly lines. Businesses may be able to attract workers from other segments of the economy, but at a higher wage cost. In turn, they will only increase output if the market price for the manufactured product they produce increases.

The intersection of the ***domestic*** supply and demand curves determines the market price (PD) that is set and the quantity produced (QD). The darker shading represents the "consumer surplus", or the gain obtained by those able to purchase the product at a market price that is set below what they would have been willing to pay. The lighter

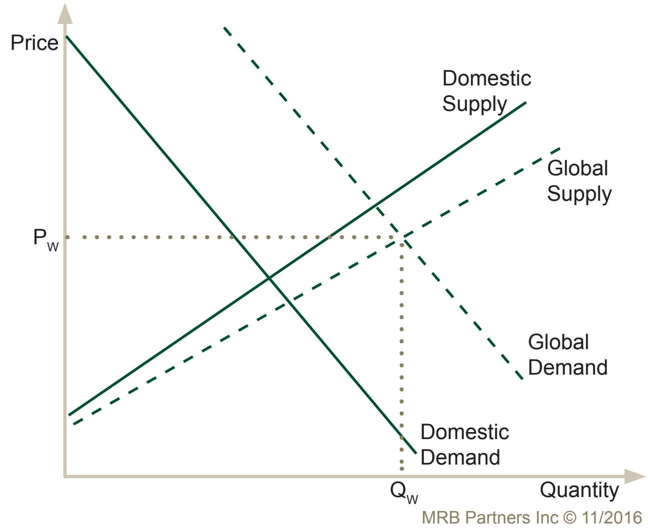
[3] A country has a comparative advantage over another in producing a good or service if it can do so at a lower relative opportunity cost.

shading is the "producer surplus", or the aggregate gain obtained by businesses willing to supply quantities of the product at a price below that set by the market. Together they reflect the total surplus or gain for the domestic economy.

With Global Trade – Domestic Producers Have Comparative Advantage

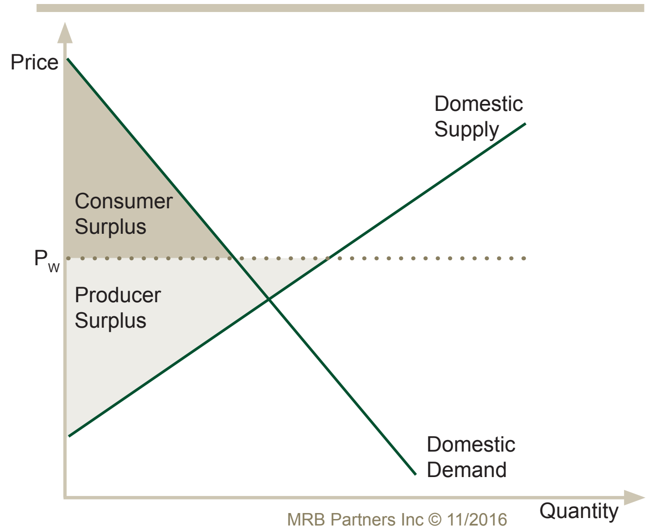
Now that we have a point of reference, we can outline what happens when a nation opens itself to global trade. We will begin with the case where the country has a comparative ***advantage*** in a good or service (i.e. the lowest cost of production). **Chart 3A** adds a ***global*** demand and supply curve to **chart 2** on page 3.

Chart 3A **With Global Trade And A Domestic Comparative Advantage**



For simplicity, we will assume that the global demand curve has the same linear downward slope. However, it is drawn to the right to signify that the world will demand a greater quantity (than the domestic economy alone) at any given price. The global supply curve also shifts to the right to reflect that there are some foreign producers that are also willing to provide some quantity of the product. However, the curve shifts marginally since domestic producers are much more efficient than their global peers (i.e. they have an extreme comparative advantage) and able to squeeze out most of their foreign competition. An example could be software sold by a U.S. provider that alleviates the need to have many people manually processes the same information. Only a few businesses in emerging economies with extremely low cost laborers may be able to compete utilizing a traditional manual process. Another example could be heavy industrial machinery able to handle the workload of what traditionally took a large number of manual laborers.

Chart 3B **Larger Aggregate Gain, But Benefits Are Greater For Producers**



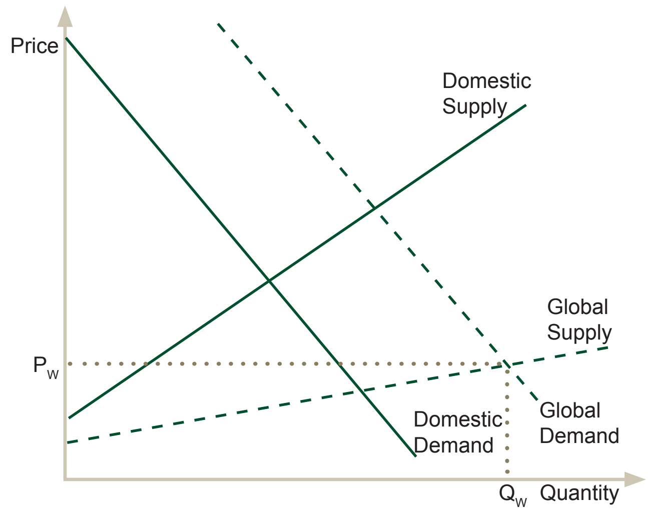
Competitive businesses gain from access to a much larger market

In the case of this product, the quantity produced (QW) and the market price set (PW) is determined by the interest of the ***world*** supply and demand curves. **Chart 3B** highlights that in this situation, the price of the product for ***domestic*** consumer rises modestly (i.e. PW > PD). However, output for domestic producers increases markedly, which creates domestic profits, wealth accumulation and increased labor demand for this industry. In other words, the consumer surplus shrinks somewhat, but the producer surplus rises substantially and encourages a positive multiplier effect, leading to a greater overall gain for the domestic economy.

With Global Trade – Domestic Producers Have Comparative Disadvantage

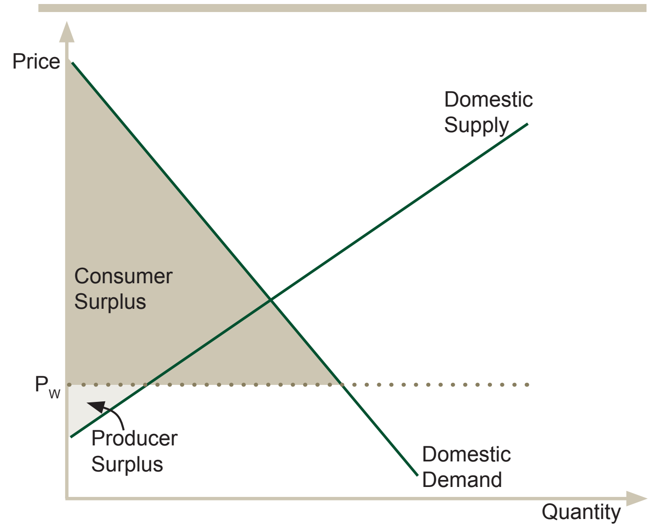
Chart 4A broadens **Chart 2** on page 3 to show the opposite case of when a country opens itself to global trade in a good or service that it has a comparative ***disadvantage*** (i.e. a higher cost of production). We made the global demand curve the same as the previous example. Increased demand would normally be good for domestic producers, but they are now forced to compete with global businesses that have a comparative advantage. As such, the global supply curve shifts significantly to the right and flattens to highlight that more efficient foreign producers with ample low cost inputs are willing to provide much greater supply of the product at a lower price. An example of this would be basic manufacturing, where emerging markets have an almost limitless supply of cheap laborers compared with the developed world.

Chart 4A With Global Trade And A Domestic Comparative Disadvantage



Again, the quantity produced (QW) and the market price (PW) is set by the intersection of ***world*** supply and demand. **Chart 4B** highlights that in this situation, the price of this product for domestic consumer falls materially (i.e. PW < PD). This ***increases the consumer surplus*** in the local economy substantially. However, output for domestic producers falls since they are unable/unwilling to produce much at the price set in the global marketplace. This leads to a ***smaller producer surplus*** and reduced labor demand for the industry. Still, the larger consumer surplus more than offsets the reduction in the producer surplus, leading to a greater overall gain for the domestic economy.

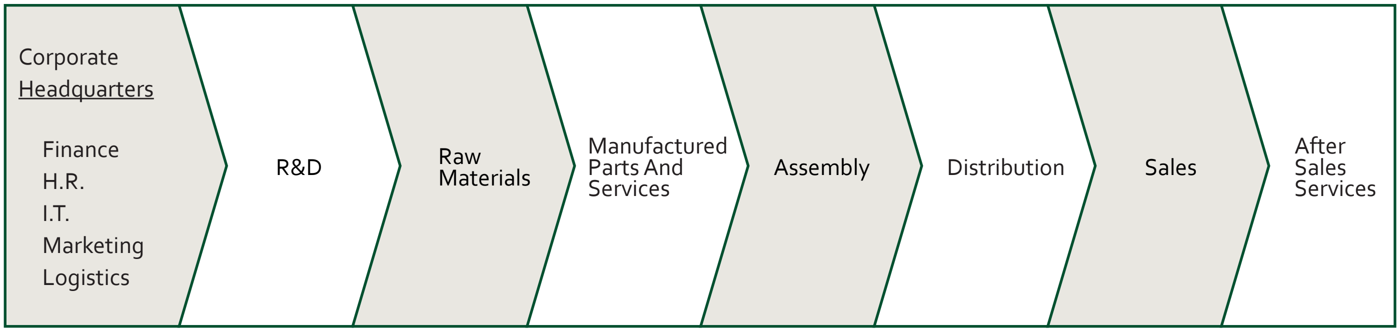
Chart 4B Larger Aggregate Gain, But Benefits Are Greater For Consumers



Consumer benefit from disinflation, lower borrowing rates and higher asset values

It is worth noting that the comparative advantage framework can be broadened beyond merely trading finished products. In the modern world, it is often applied to the ***value chain*** for individual goods or services, where businesses in different countries specialize in supplying various segments (**chart 5**). There are many cases where companies in developed markets outsource elements of the value chain (often manufacturing,

Chart 5 **Simple Value Chain**



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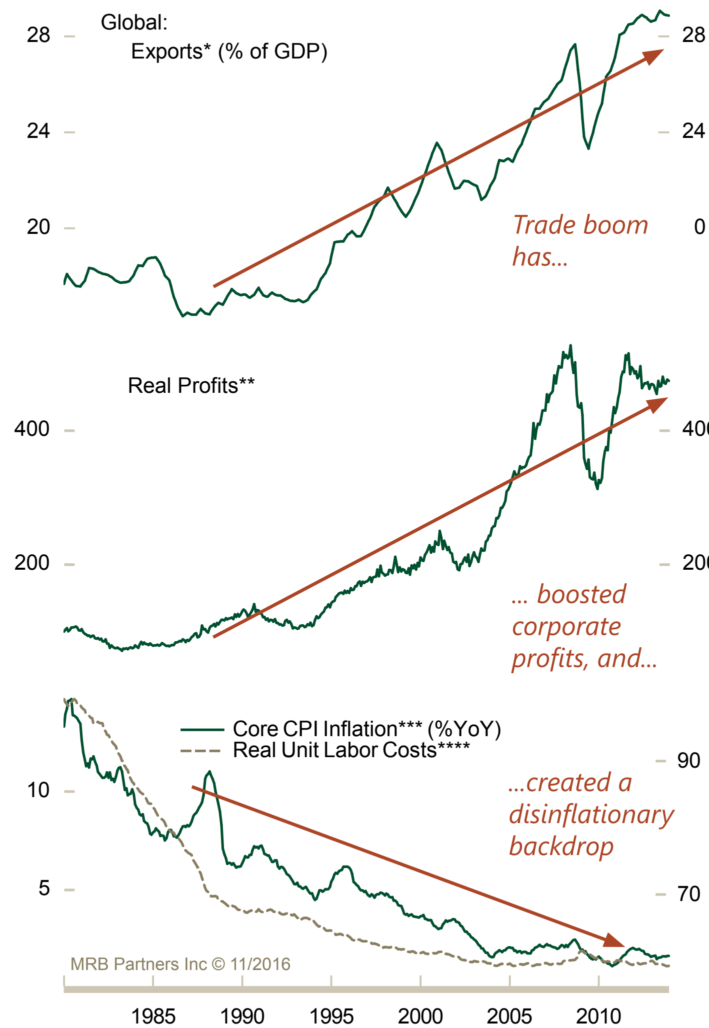
assembly and call centers for after sales service) for the goods and services they produce to obtain access to lower input costs. In these situations, they capture the consumer surplus identified in **chart 4B** on page 5. This allows them to either widen their profit margins or lower the price of the goods and services they produce. In practice, some split typically occurs depending on the pricing power they command.

Final Word: *Engaging in global trade provides an aggregate benefit to the domestic economy. In general, a freer exchange of goods and services leads to a surplus for the overall economy. This gain is usually delivered in the form of stronger corporate profits as well as lower prices on tradable goods and services, which contributes to generalized disinflation, greater discretionary incomes and lower interest rates. Indeed, this has been the case for the U.S. and nearly all other major economies over the past three decades*[4] *(**chart 6**). However, increased global trade also brings with it some adverse consequences that need to be properly managed (see below).*

Chart 6 **Increased Global Trade Has Been Beneficial**



* Source: OECD
** Deflated by core CPI; rebased; source: Datastream
*** Excluding food and energy; source: OECD
**** Deflated by core CPI; rebased; source: OECD

Adverse Consequences Of Global Trade

Engaging in global trade results in an aggregate GDP and wealth benefit, which can prove to be substantial. However, left unchecked the gains will not be equitably distributed. Also, increased specialization

[4] Inflation fighting by the Volker-led Fed and other central banks also contributed materially to the global disinflationary trend, particularly during the 1980s and early-1990s.

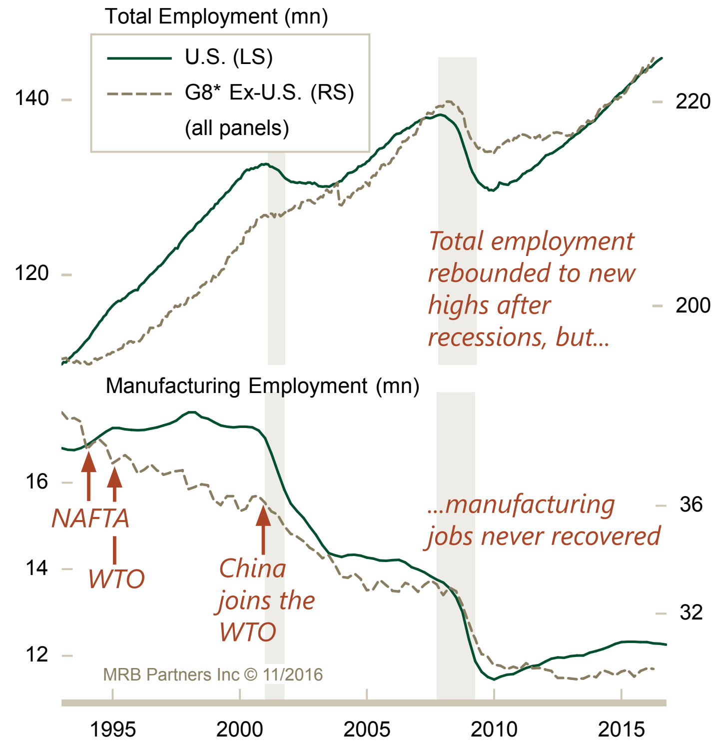
and the reduction of industries that have comparative disadvantages, can create structural unemployment for workers that are unable to transfer to other industries. This has been the case for much of the developed world, creating imbalances and stoking social unrest.

A nation that opens to global trade provides its businesses access to a much larger consumer base (discussed above). However, it also exposes local companies to significantly more competition. Those that survive are usually made stronger, but businesses that lack a comparative advantage are typically unable to compete in a global arena and ultimately fail. In general, companies in developed economies that are reliant on low-skilled labor simply cannot compete with their emerging market counterparts.

The emerging world has an abundance of low-skilled workers, which reduces the costs of labor-intensive manufacturing and assembly processes. This comparative advantage has enabled emerging Asia and Mexico to build global manufacturing hubs to the detriment of jobs in the developed world (**chart 7**). We point out in ***Part II*** of this report that increased globalization is not the only cause of displaced labor in the developed world. Indeed, technological advancements are arguably now a larger force. Nonetheless, the number of manufacturing jobs in the U.S. and other major advanced economies has fallen sharply since the formation of NAFTA (1994) and WTO (1995), and especially since China joined the WTO (2001), although the downtrend preceded these events. Correspondingly, employment trends among under-educated and low-skilled laborers have deteriorated (**chart 8**). This is partially why academic research shows that support for trade restrictions is highest among respondents with the lowest levels of education.

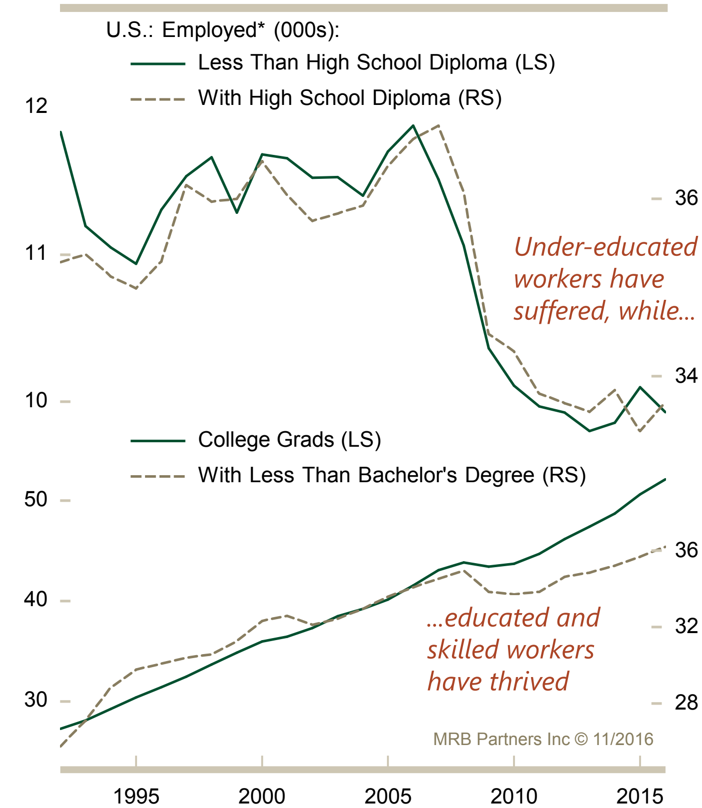
The offset has been that consumers in developed markets and businesses that outsource parts of their value chains have received lower prices due to increased

Chart 7 **Manufacturing Jobs In The Developed World Have Dissipated**



* Includes Canada, France, Germany, Italy, Japan, Spain, U.K., and U.S.; source: national sources

Chart 8 **U.S.: Education Determines Job Prospects**



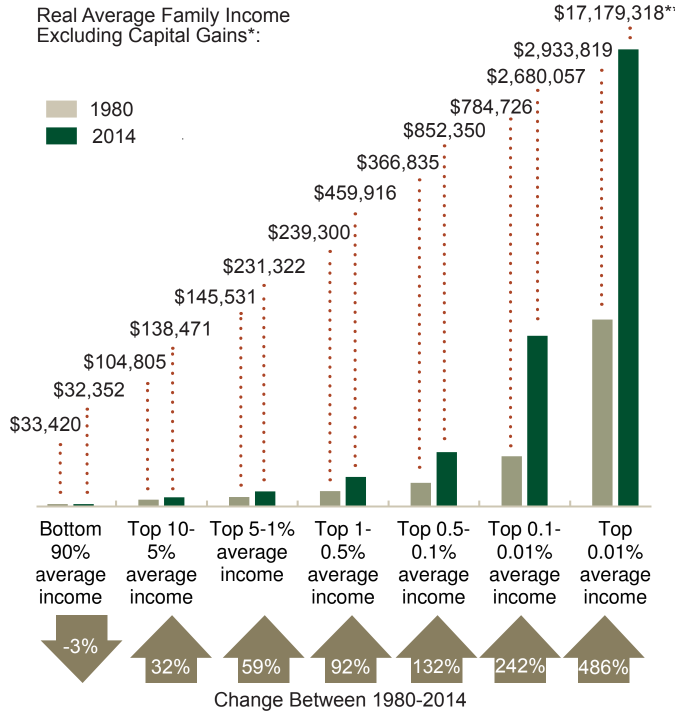
* 25 years and over; source: Bureau of Labor Statistics

trade. This has freed up discretionary incomes and bolstered corporate profit margins (**chart 6** on page 6). Also, industries in the developed world with comparative advantages (largely those that provide higher value-added goods and services) have thrived from an increased consumer base. This has created jobs for educated and skilled workers (**chart 8** on page 7).

Displaced workers from uncompetitive businesses can be absorbed by more productive industries. However, the education and skill deficit among many of those previously employed in manufacturing has prevented this from occurring. Some have shifted to low-skilled domestic services (which have historically paid lower wages than manufacturing), but the vast number of displaced jobs has made these workers difficult to absorb elsewhere. In turn, this segment of the population has faced chronically weaker employment conditions.

Likewise, the ***income*** gains from increased globalization have been highly concentrated (albeit arguably disinflation and lower interest rates have benefited the overall population). Specifically, capital owners and those able to provide high value-added inputs have thrived, while real wages for most others have stagnated (**chart 9**). This has contributed to a structural deterioration in income equality (**chart 10**) and pressure on policymakers to restrain global trade[5]. Wealth gains in the emerging world have also been concentrated; however, real wages for the broader population have increased steadily, helping to dramatically reduce the number of households living in poverty.

Chart 9 **U.S. Income: Not Distributed Equally**



* In 2015 dollars, source: The World Wealth And Top Incomes Database,Thomas Piketty and Emmanuel Saez
** Series was curtailed by $10 million to show variance in other income segments
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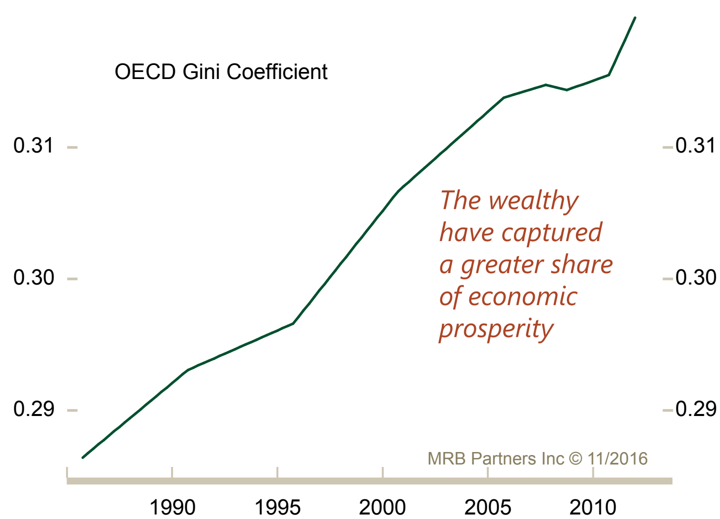
Chart 10 **Prolonged Trend Towards Greater Income Inequality**



Final Word: *There have been clear economic benefits for those nations that have opened to global trade in recent decades. However, these gains have not been equitably distributed and large segments of the labor force in the developed world (namely under-educated and low-skilled workers) have had extreme difficulty finding new employment, especially at comparable wages.*

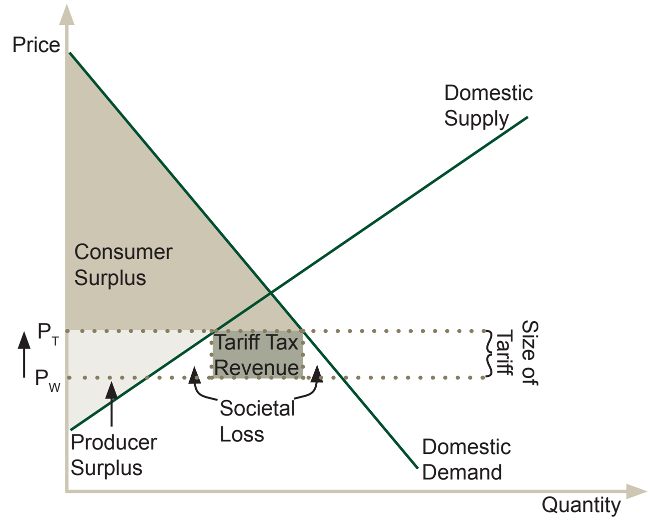
The cost is that uncompetitive businesses and workers suffer

[5] MRB *Theme Reports*, "A Perfect Storm For Political Instability (Part I)", September 27, 2016 and "A Perfect Storm For Political Instability (Part II)", September 28, 2016

Closing The Boarders: Costly And Not A Sustained Solution

It is not a viable solution for a country to close its boarders to global trade as an effort to recapture low-skilled manufacturing jobs. Yet, there is substantial pressure on politicians in the U.S. and Europe to adopt protectionist policies. However, very few jobs are likely to return, and at a hefty cost for the domestic economy (not just their global trading partners). Also, structural fragilities would increase, rather than decline, for the nation. Its economic and political standing in the world will shrink, along with the global purchasing power of its domestic assets.

Chart 11 Adding A Tariff To Protect A Domestic Industry With A Comparative Disadvantage



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To illustrate the consequences of adopting protectionist policies, it is probably most effective to revisit **chart 4B** on page 5. After all, it is the decline in the producer surplus and the associated job loss from the shrinking of uncompetitive domestic industries that those chanting anti-trade rhetoric are targeting.

Enforcing A Tariff

Chart 11 shows the economic impact of adding a tariff on imported goods and services, such as Trump's suggestion for a 35% tariff on Mexican produced automobiles and parts. The implementation of the tariff substantially increases the price the goods and services are sold for in the domestic economy, potentially by up to 35% in the example of the automotive tariff (i.e. PT > PW). The higher selling price enables the domestic industry with a comparative disadvantage to grab greater local market share, thereby increasing the producer surplus and strengthening corporate profitability or potentially encouraging more jobs (if the jobs have not been displaced by other forces such as technological advancement, as discussed in ***Part II*** of this report).

Tariffs force domestic consumers to fund inefficient industries...

...it would also be met with retaliation and...

...end up killing more jobs than it salvages

However, implementing a tariff comes at a substantial cost. The domestic consumers end up paying a higher price for the good or service, causing a significant portion of the consumer surplus to evaporate. Some of this loss is captured in increased taxes, but part is permanently lost. In other words, for the potential to recapture some jobs, the local population needs to be willing to experience a sizable reduction in their discretionary incomes (i.e. they directly fund the inefficient industry). At the same time, other countries would retaliate with their own tariffs and trade barriers, removing much of the comparative advantage that many U.S. and European businesses hold. This would wipe out much of the producer surplus (and associated jobs) resulting from increased global trade that is illustrated in **chart 3B** on page 4.

The net result of curbing global trade and suffering the retaliation would prove stagflationary at best, and potentially deflationary for the overall domestic economy. Aggregate economic growth would erode (if not contract) and domestic inflation would rise, sapping discretionary incomes. Higher inflation would also push up borrowing rates and mortgage burdens for the domestic economy. This would cause stress among some borrowers and could trigger a recession. If so, the stagflationary backdrop would prove temporary and ultimately turn deflationary. This was the experience of the 1930s.

Providing A Subsidy

Rather than attempting to curb globalization, the other option is that governments may decide to support domestic manufacturers (or other industries with comparative disadvantages) by providing them a subsidy. This approach is not yet being openly promoted in developed economies, but has been used in the past to support the agricultural industry. A subsidy would help local businesses compete more effectively with lower cost producers abroad, and ideally it would encourage increased domestic employment in that industry. **Chart 12A** shows what happens when a subsidy is given to producers of a good or service. The supply curve shifts to the right since businesses are willing to provide a greater quantity of the product now that the government will ensure that they receive a higher price than the market is willing to pay (i.e. PS > PW).

Chart 12B highlights the impact on the domestic economy of providing a subsidy. This approach does not increase the price consumers pay, which means that there is no direct inflationary consequence and the consumer surplus is left unchanged. The producers are the ones that receive the subsidy and thus their surplus (or gain) increases.

However, as the shading in **chart 12C** illustrates, government spending increases to provide producers

Chart 12A Providing A Subsidy To Support A Domestic Industry With A Comparative Disadvantage

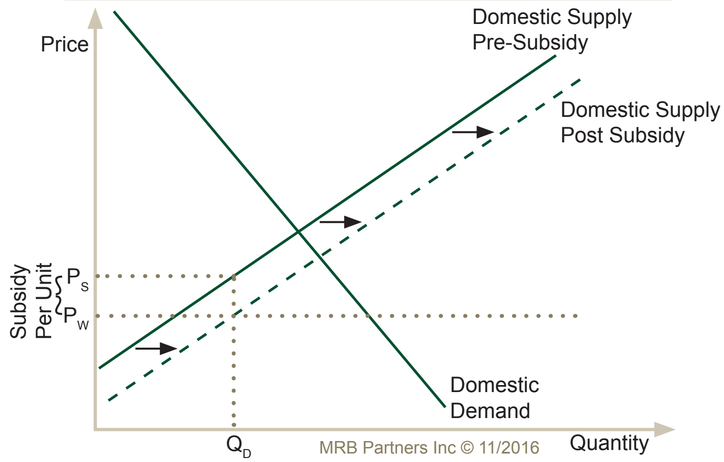


Chart 12B Increases Producer Surplus, And Consumer Surplus Is Unchanged

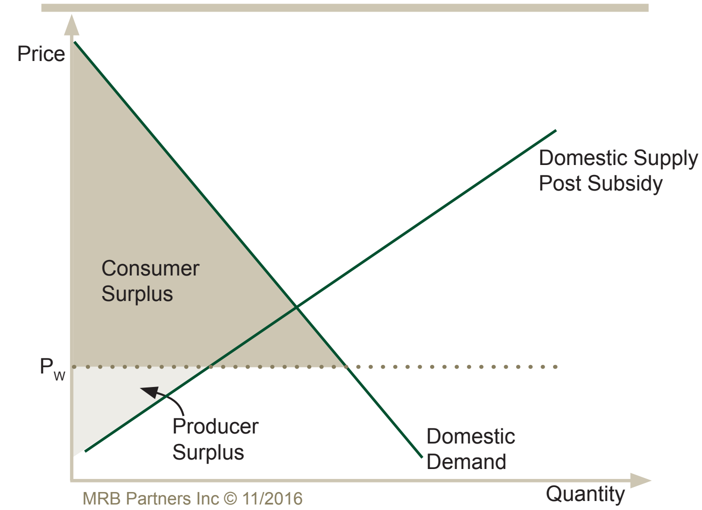
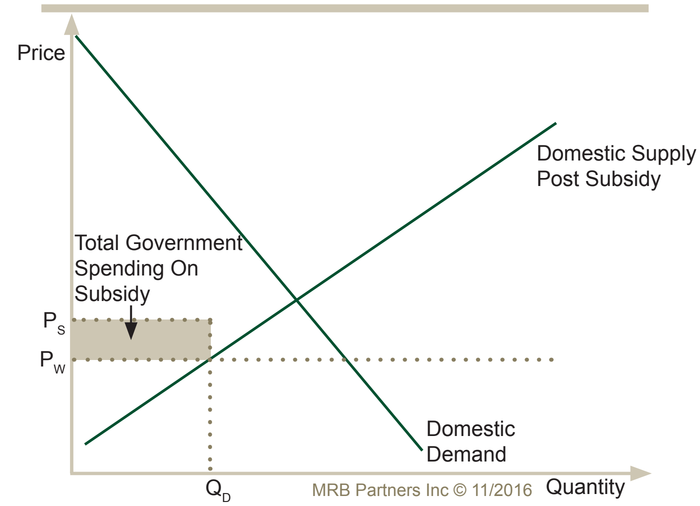


Chart 12C Government Spending Rises To Pay For Subsidy



with the increased surplus. Thus, taxpayers will ultimately be left to fund the bill to support the uncompetitive industry. This has been the experience in many countries related to their agricultural subsidies: pay hefty burdens to chronically support an inefficient industry. Also, providing local subsidies could breach global trade agreements and/or cause other countries to act similarly for other industries. If everyone does so, government debt could rise across the globe and taxpayers will be forced to shoulder the burden to offset comparative disadvantages in their local economies. They will effectively end up paying to unwind the benefits of global trade, with no offsetting gains (i.e. higher government debt and/or taxes for similar economic activity).

Providing a subsidy forces taxpayers to fund uncompetitive industries...

...if other countries follow, taxpayers effectively pay to unwind the benefits of global trade

There are cases where countries may decide for national interests to protect an inefficient or uncompetitive industry. This is often for defense purposes or ensuring the country has a reasonably self-sufficient supply of food. It may be decided that these industries are worth perpetually using taxpayer dollars to keep alive. A nation may also decide to support a budding industry for a few years to allow it to develop into something that is internationally competitive and can stand on its own, rather than being crushed out in its infancy by stronger global rivals. The goal in the latter situation is that national support is not permanent, but rather the industry eventually becomes a productive force in the national business sector, contributing to profits, employment and investment. That said, manufacturing in developed economies is not a budding industry with attractive prospects and is unlikely to have other strategic importance for the nation. Yet, protecting it comes at a sizeable cost.

Final Word: *Increased global trade has created tremendous benefits for all countries, even though the gains have not been equitably distributed. Policymakers that fixate on the negatives and believe the answer is in adopting protectionist policies are naïve. Efforts to curb global trade give up the net benefits associated with it. Protecting uncompetitive domestic industries comes at a hefty cost to either the taxpayer or consumers (via higher prices and less discretionary incomes). There is also potential for higher inflation and borrowing rates. At the same time, retaliation across the globe will crush corporate profits in those domestic industries that are globally competitive, and will almost certainly cost more wealth and job losses than those salvaged by anti-trade policies.*

Policymakers that believe the answer is protectionism are naïve

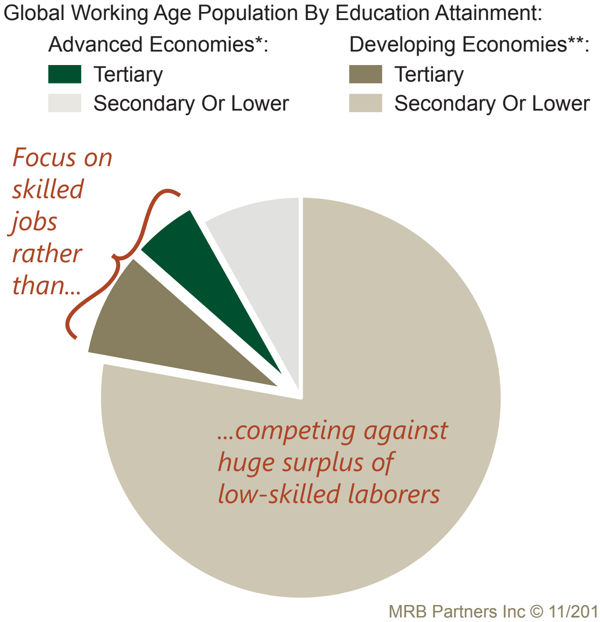
Moreover, protecting an industry that has a comparative disadvantage typically does not encourage efficiencies to develop and for the industry to become globally competitive over time. In turn, consumers or taxpayers are forced to permanently shoulder the burden. Ultimately, voters in the U.S. and Europe may patriotically support their manufacturing sectors, but they should understand that doing so will leave them with perpetually less discretionary income, greater mortgage burdens, and reduced global wealth (due to lower asset prices and/or currency, see below).

Focus On Sustainable Competitiveness And Labor Market Flexibility

Politicians across the globe fixated on the aggregate benefits of global trade when forging ahead with trade agreements. Perhaps it was expected that job displacement in certain industries would be absorbed elsewhere, redirecting resources to areas with national comparative advantages. However, the magnitude of the job displacement among low-skilled workers and their inability to transfer into other industries should have been acknowledged many years ago and managed effectively.

Global trade agreements should still have been formed given the net benefits, but there needed to be some focus on how to more equitably and ***sustainably*** redistributing these gains. MRB's view is that a substantial fiscal initiative was warranted (and still needs to occur) to retool and better educate the workforce that has been displaced, as well as equip the next generation with adequate skills. This fiscal initiative should be on the scale of the reconstruction efforts after a major war.

Chart 13 **Developed Nations Need To Educate Their Workforce To Compete**



* Source: United Nations Population Division and McKinsey Global Institute
** Includes 25 countries; sources: United Nations Population Division and OECD

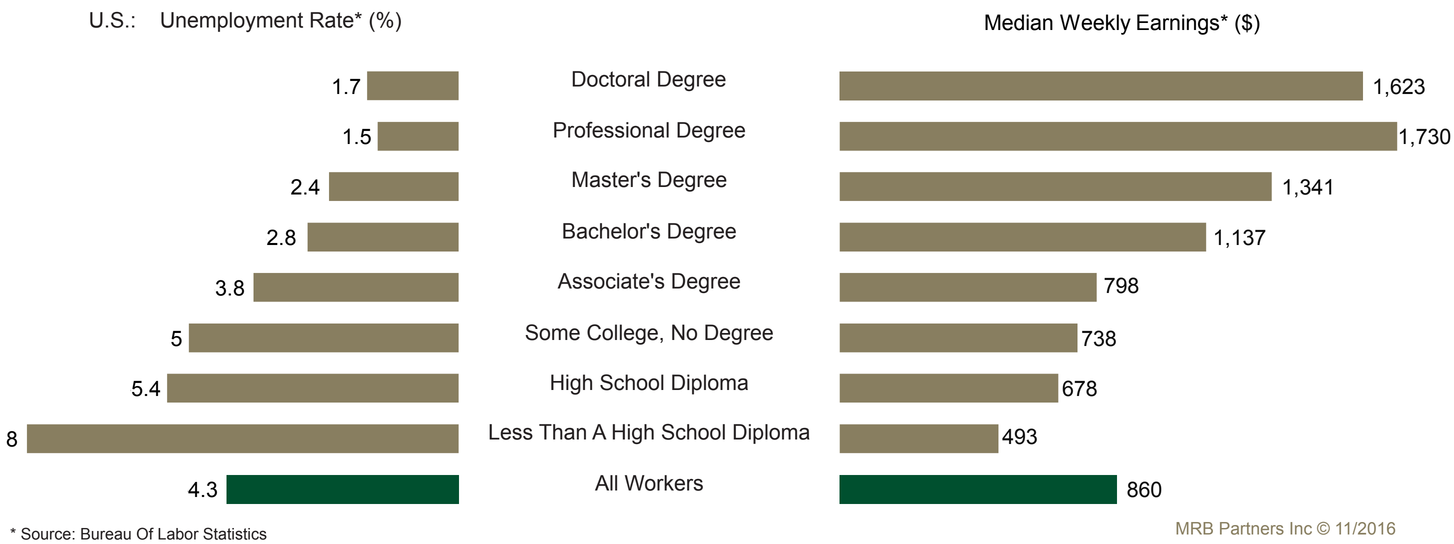
Developed economies are always going to be undercut by their emerging market counterparts in the price of under-educated and low-skilled labor, given their abundant supply of these workers (**chart 13**). Offsetting this disadvantage by using more capital and technology to improve productivity among low-skilled workers is only a temporary fix. These still result in a displacement of labor and emerging markets are also adopting similar processes. Thus, the U.S. and Western Europe should not attempt to compete in this area. Instead, they should focus on developing sustainable competitive advantages in the production of higher value-added goods and services, and lead innovation in select industries. A more educated and flexible workforce will also reduce the potential for chronic labor market displacement originating from technological innovation (discussed in ***Part II*** of this report).

Countries need to educate and retain workers to sustainably redistribute gains...

...they also need to focus on fostering durable competitive advantages

In addition, developed countries should focus on making their domestic business environments attractive for global companies, including investing in infrastructure, legally enforceable property rights and developed financial systems, while preventing punitive tax rates or rigid labor markets. Perhaps most important, efficiencies, productivity, innovation that creates new industries and sources of employment, and durable competitive advantages are often fostered by encouraging industry clusters to

Chart 14 **U.S.: Higher Demand For Educated Workers**



form within nations. Silicon Valley is a clear example, where the gains/advantages more than offset the higher direct cost of operating in the region. Governments should be proactive at fostering these industry clusters.

A flexible workforce is needed to reduce the odds of chronic labor market displacement

We acknowledge that it is expensive to retrain and educate a major portion of the workforce in attempt to lift an entire country up the global value chain. This is especially true in places like the U.S., where there is a large segment of the population that is under-educated. However, not doing so also proves costly. There is a strong correlation between education level and employment and/or wage prospects (**chart 14**). The nation may find itself persistently supporting an unproductive and unemployment (and potentially homeless) part of the workforce through its social system.

Leaving this part of the population to struggle (i.e. failing to redistribute gains) is not sustainable over the long haul, as social unrest will build and policymakers will be pushed into radical change. The latter could disrupt wealth and activity in the aggregate economy. Indeed, the lack of affordable education dramatically curtails social and economic mobility in a world now characterized by an ample surplus of low-skilled laborers. Education has become the vehicle that is creating a new class system. Inaccessibility leads to a sense of desperation, which fuels the political instability we are currently experiencing in many countries across the globe[5].

Ignoring the struggles of under-educated and lower-skilled workers fuels political instability

Developing a flexible workforce that can adapt and not easily be structurally displaced by foreign competition or new technologies will prove economically rewarding over the long haul. However, the training and education costs will need to be paid upfront via higher taxation or increased government debt (i.e. taxation on future generations). In this regard, most developed economies squandered a great opportunity. Specifically, increased global trade provided a windfall gain for a segment of the population in developed economies, namely capital owners and skilled workers. Higher taxation of this windfall gain was appropriate. Capital owners and skilled workers would still generate outsized returns from globalization and benefit more than others, but some of the wealth could have been taxed for retraining purposes. Likewise, increased global trade provided disinflationary tailwinds. Higher taxes on consumption could have been used to capture a portion of the benefits. Disinflation would have still occurred, but at a slower pace. There is a similar case for taxing the gains of the technology revolution (discussed in ***Part II*** of this report).

Retraining a workforce takes years…

…in the interim a sizeable infrastructure spending program is needed to create jobs for low-skilled laborers

Most of the windfall gains from increased global trade have now been realized, reducing the ability of a more benign taxation. And upfront retraining generally did not occur. Technological gains persist which still provides an opportunity. Regardless, some combination of taxing higher-income earners and increasing government debt to fund affordable education is appropriate as developed economies need to proactively upgrade their workforce. After all, the emerging world is also moving up the value chain beyond merely low-skilled manufacturing and assembly and technology continues to advance. Comparative advantages are not a static concept: they can change over time. The longer developed nations neglect building a flexible workforce, the more expensive and challenging it will prove.

That said, it takes considerable time to rebalance equality through education, something the populace in many economies is unlikely to be patient enough to accept. Thus, in the interim a substantial infrastructure spending program may be needed to support economic growth and create jobs for low-skilled laborers. Better job and wage prospects would help temper social unrest until benefits from longer-term structural rebalancing start to be realized.

It costs to temper social unrest, but…

…anti-trade policies can destroy an economy

Final Word: *The transition to increased global trade was managed poorly, contributing to a large structural displacement of labor and growing inequality. A gradual redistribution of new wealth creation away from higher income earners and towards the lower and middle class via affordable quality education is needed in many developed economies. More widespread advanced education would help make the labor force more flexible and gradually lift a greater portion of society up the global value chain.*

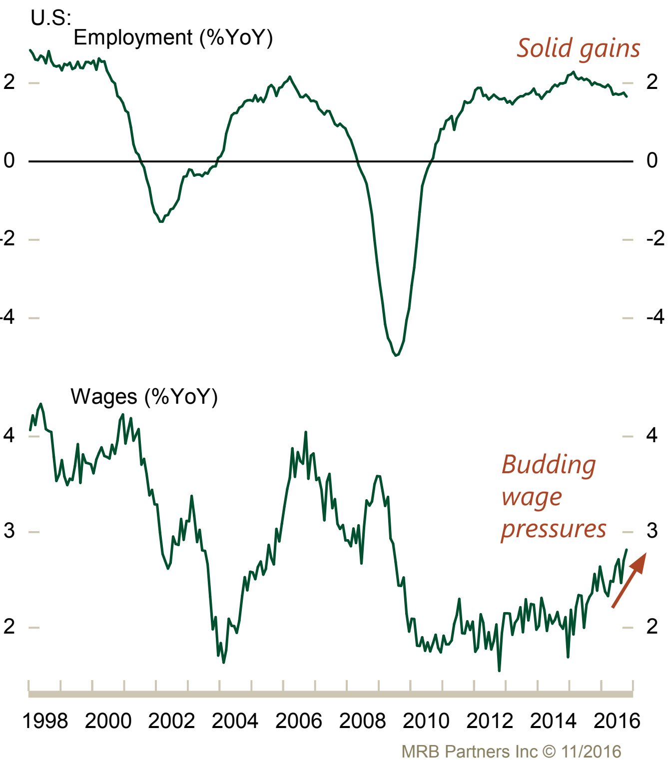
The focus for developed nations needs to be on producing higher-skilled goods and services as well as leading innovation in various industries. This would reduce the odds of chronic under-employment caused by low-cost emerging market labor and new technological advancements. It would also help build sustainable competitiveness in the overall economy, at which point globalization is not something to fear but rather embrace. Failure of policymakers to pro-actively work on developing a flexible labor force and sustainable advantages will leave a large portion of the labor force under-employed and disgruntled.

This supports social unrest and pressure for disruptive policies that will ultimately hurt the entire nation.

Investment Strategy

The U.S. (and Europe to a lesser extent) have been steadily adding net new jobs, and wage are edging up (**chart 15**). Also, the U.S. is likely to embark on an infrastructure spending program, which will create opportunities for under-educated and lower-skilled laborers. Together this should help slowly temper social unrest and ease pressures for protectionist policies, at least somewhat.

Chart 15 U.S. Employment Engine: Remains Resilient



Nonetheless, any nation attempting to actively pull back from global trade will weaken its economy, structurally eroding the value of its domestic assets and currency, while triggering global backlash. Although the objective would be to protect low-skilled jobs, few would be salvaged and it would effectively use taxpayer dollars and/or sap consumer discretionary incomes to subsidize and protect inefficiencies (see above). The drags on economic and earnings growth as well as erosion of competitiveness would put downward pressure on domestic risk assets (i.e. equities and housing) and the currency. Yields of high-quality government bonds should move lower over time to reflect the reduction in economic growth prospects, although flight by foreign investors and a temporary whiff of stagflation could prevent an immediate adjustment. This also means there would be a limited relief valve for domestic risk assets.

Structurally underweight/ short risk assets of any country adopting protectionist policies

The U.K. is a good example of what lies ahead for countries attempting to exit trade agreements (**chart 16**). The pound has already felt the backlash, sharply reducing purchasing power of domestic assets. Although equities and housing in local currency terms have managed to hold up, they have been hit in U.S. dollar or euro terms and will be smashed once Article 50 is invoked and trade terms deteriorate. Indeed, a painful deflationary adjustment is likely in store for U.K. assets, particularly the housing market if the government attempts a hard Brexit[6].

U.S. equities would be hit hard if anti-trade policies are adopted. The dollar could benefit initially, albeit largely for deflationary reasons. Protectionism in the U.S. would likely lead to sharp deterioration in the outlook for export-oriented economies, causing their currencies to depreciate. The initial support for the U.S. dollar could persist on a one-year

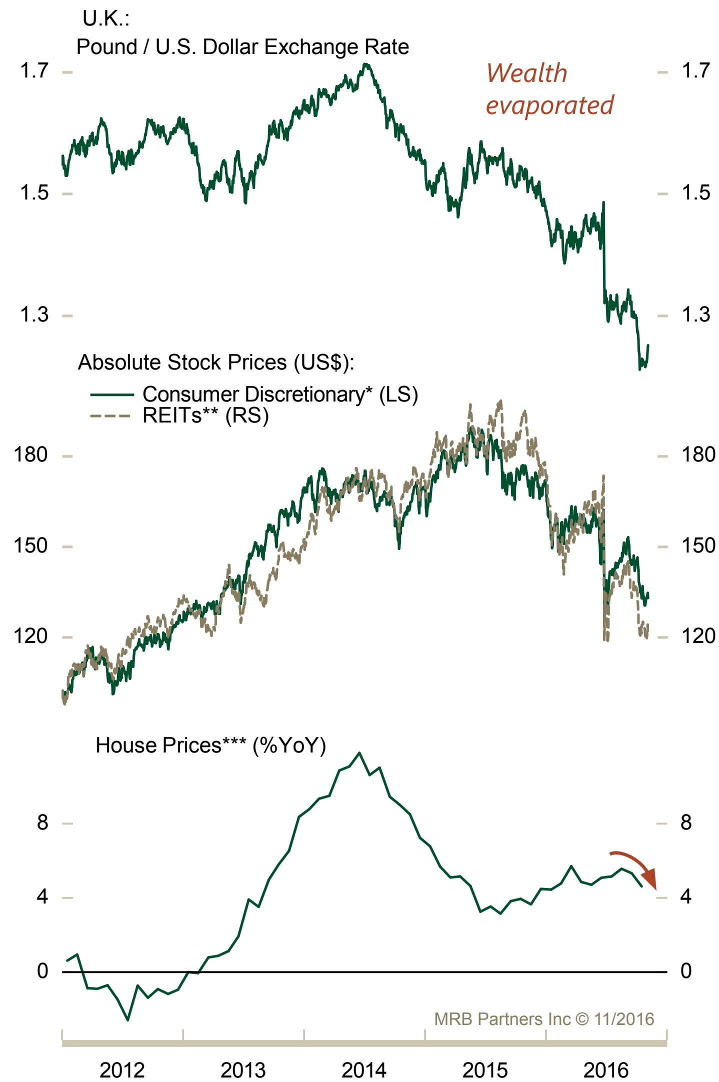
[6] **MRB *U.K. Report***, "***Betting On U.K. Fallout: An Update***", August 24, 2016 and **MRB Equities *Research Highlight***, "***Implications Of A "Hard" Brexit On U.K. Equities***", October 13, 2016

horizon if there is fiscal spending to offset the domestic damage caused by reduced trade.

However, U.S.-led anti-immigration and anti-trade policies are bearish for the dollar over the long haul. Indeed, in this backdrop we would expect the world to accelerate its evolution away from using the U.S. dollar as the world reserve currency and towards a basket of the majors (including China) as part of a new monetary regime. While most economies would weaken from a reduction in globe trade, the U.S. dollar may lose its reserve currency status, especially if it leads the charge and pushes its government debt limits in attempt to offset the growth drags from protectionist policies.

Final Word: *We will look to underweight and/or short risk assets of any country implementing anti-trade policies. If most countries retaliate and a forced reduction in aggregate global trade were to occur, we would be bearish on global equities and look for safe havens.*

Chart 16 **U.K. Highlights The Consequences Of Exiting Global Trade Agreements**



* Rebased; source: MSCI
** Rebased; source: Datastream
*** Source: Nationwide Building Society

The Past As Potential Prologue

Proponents of protectionism point to job losses in manufacturing and the de-industrialization of many regions in the developed world. But memories are short. Many economies in the post-war period experimented with protectionism, infant-industry subsidies, import substitution strategies and other tools designed to assist domestic producers/manufacturing. Australia and New Zealand were sclerotic basket-cases in the 1970s and 1980s, before embarking on liberalization and trade-opening that has since spurred rapid economic progress. Argentina is a classic example of the repeatedly unsuccessful Latin American strategy of protecting domestic industry, at an enormous cost in low productivity, rampant inefficiencies and a general lack of domestic competitiveness.

Final Word: *We have been down this path and it fails. Yes, we need to change, but we need to change in a thoughtful, rational manner, not knee-jerk, overly simplified reactions.*

Phillip Colmar

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For more information, please contact:
Client Relations
clientrelations@mrbpartners.com

London
Token House
12 Tokenhouse Yard
London, EC2R 7AS
United Kingdom
Tel+44 (0) 20 7073 2792

Montreal
2001, boul. Robert-Bourassa
Suite 810
Montreal, Quebec
Canada H3A 2A6
Tel+1 514 558 1515

New York
122 East 42nd Street
Suite 2310,
New York, NY 10168
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