VIEWPOINT

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A Stephens Inc. Economic and Financial Commentary

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Another quarter of mediocre economic growth is in the books. Politicians and pundits continue the blame game for the American economy's failure to achieve its potential. Invariably a portion of the blame is focused on America's trade relationship with the rest of the world. The reasoning goes something like this: the United States has a trade deficit, and the country has lost millions of manufacturing jobs; therefore, America's economic problems must be trade related.

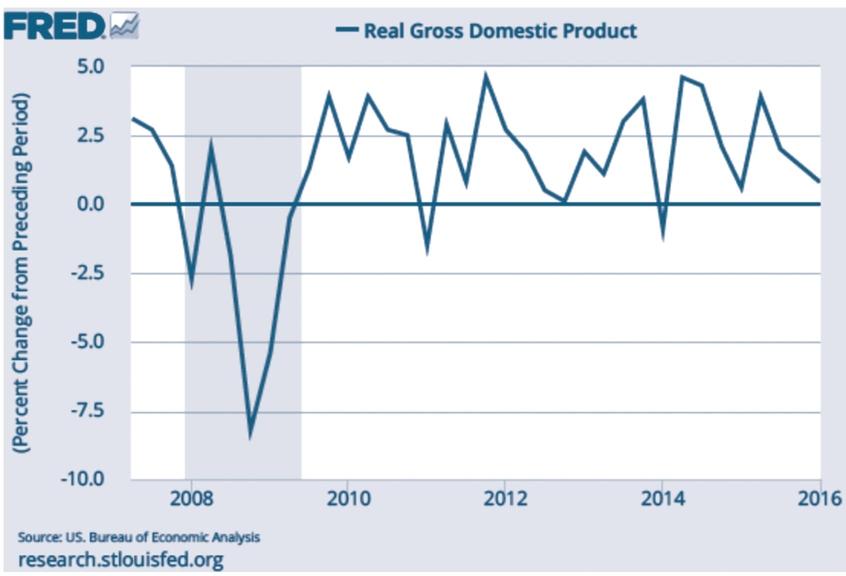
This issue of Viewpoint assesses the condition of the U.S. economy and the impact trade has on our economy.

- Will American economic growth return to its "normal" 2% rate?
- How will the recent surprise decision by the United Kingdom to exit the Europe Union impact growth and trade prospects for the world and the United States in particular?
- Is the United States competitive with its trade partners?
- How robust is our international competitiveness?

U. S. and Global Growth Prospects

In isolation, the growth of the United States economy is tepid to say the least. (*See Figure 1.*) In the most recent quarter (Q1 2016) U.S. real gross domestic product (real GDP) growth was 0.8%, worse than the fourth quarter of 2015 when the growth rate was an anemic 1.4%. In the last six months, the economy has grown only 1.2% on an annualized basis.

Figure 1:
Real Gross Domestic Product (Q1 2007 to Present), Seasonally Adjusted



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on June 2, 2016.

An examination of the components of recent real GDP report (*See Figure 2.*) reveals several important conditions:

- **Consumption** by households remained strong except in the most recent quarter.
- **Non-residential investment** (business investment) was a drag on real GDP in the first quarter of 2016. Companies were hesitant to make additional investments in their business.
- **Government** spending had a fairly neutral impact on real GDP growth.
- **Net exports** (exports minus imports) were an ongoing drain on real GDP growth.
- **Inventory** reductions rather than production were used to meet demand in the past two quarters. This inventory reduction was a subtraction from real GDP.

The negative elements together produced weak growth in the most recent two quarters. In general, American consumers continue to spend, but businesses are hesitant to invest. Consumers are choosing imported goods relative to domestic goods. U.S. businesses are meeting part of consumer demand by reducing inventories rather than through incremental production.

Figure 2:
Contributions of Components to Real GDP (Q2 2014 to Present)

	2014			2015				2016
	2nd	3rd	4th	1st	2nd	3rd	4th	1st
Final Sales	3.46	4.34	2.13	-0.23	3.94	2.73	1.62	1.05
Consumption	2.60	2.34	2.86	1.19	2.42	2.04	1.66	1.29
Fixed Investment	0.87	1.23	0.39	0.52	0.83	0.60	0.06	-0.25
Nonresidential	0.56	1.12	0.09	0.20	0.53	0.33	-0.27	-0.81
Residential	0.31	0.11	0.31	0.32	0.30	0.27	0.33	0.56
Government	0.21	0.33	-0.26	-0.01	0.46	0.32	0.02	0.20
Federal	-0.08	0.26	-0.41	0.08	0.00	0.02	0.15	-0.11
State and Local	0.29	0.07	0.15	-0.09	0.46	0.30	-0.13	0.31
Net Exports	-0.24	0.39	-0.89	-1.92	0.18	-0.26	-0.14	-0.21
Exports	1.28	0.24	0.71	-0.81	0.64	0.09	-0.25	-0.25
Imports	-1.52	0.15	-1.60	-1.12	-0.46	-0.35	0.11	0.03
Changes in Inventory	1.12	-0.01	-0.03	0.87	0.02	-0.71	-0.22	-0.20
Residual	-0.155	0.038	-0.138	-0.017	0.012	-0.01	-0.027	-0.019
Real GDP Growth	4.57	4.28	2.07	0.64	3.92	1.98	1.39	0.84

Source: Federal Reserve Bank of St. Louis. *National Economic Trends*. June, 2016.

America's new millennial growth rate of 2% should continue in the second half of 2016 even with the turmoil surrounding the Brexit decision by the United Kingdom. We expect that the wide fluctuations in currency values, stock prices and interest rates will shortly begin to subside as market participants await a clearer understanding of the "Brexit" timetable.

How the exit will be implemented is largely unknown at this time. We expect that the exit's full implications and effects on global and American growth and trade will be discernible in 2017 and 2018 rather than the latter half of 2016.

In the meantime we expect America's modest growth to continue. Our forecast for U.S. GDP growth is consistent with the World Trade Organization's economic outlook for modest 1.5% to 2.0% GDP growth in most of the industrial countries.

The Brexit decision is relevant for financial markets but currently less significant for the real global economy. It is important to understand that the United Kingdom's GDP is only 4% of the total global output. Its exports are a mere 2.7% of total global exports.

Like the United States, the United Kingdom has a perennial trade deficit in goods and services. The U.K.'s weak export record in manufactured goods combined with large losses in manufacturing jobs probably played a contributing role in the decision to exit the European Union. That same perceived weakness in the manufacturing sector is haunting the American political landscape. Let's look at the facts about America's trade situation and implications for U.S. growth.

American Trade Relations

Many Americans and almost all presidential candidates in 2016 believe that a major culprit in U.S. lackluster growth is its "unfair" trading relations with the rest of the world. But the trade deficit is hardly a new economic reality. America has run a trade deficit with the rest of the world since the mid-1970s. (*See Figure 3.*)

The current trade deficit as a percent of GDP is the same as it was in the late 1990s when economic growth was robust. In other words, the U.S. trade deficit is unlikely to explain the current economic malaise.

Figure 3:
Net Exports of Goods and Services as a Percent of Gross Domestic Product (1975 to 2015)

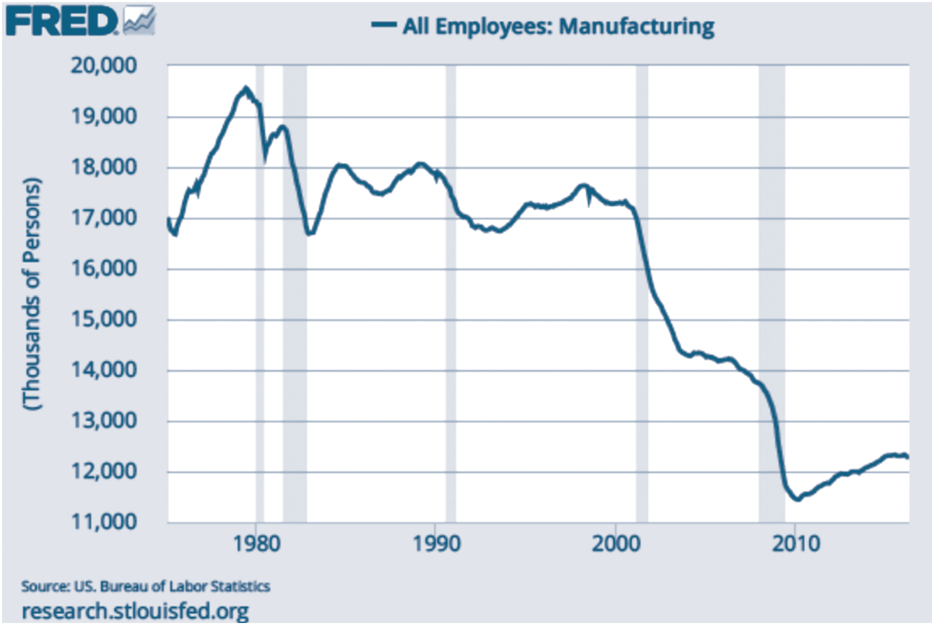
Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on April 2, 2016.

At the present time the trade deficit in goods and services is about 2.8% of America's real GDP, a little more than $500 billion per year. In 2005 the deficit was markedly higher at 5.5% of that year's real GDP.

Manufacturing and Trade

This trade deficit in goods and services (exports minus imports) leads inexorably to the conclusion that the loss in U.S. manufacturing jobs is due to a lack of trade competitiveness. (*See Figure 4.*) Since 2000 manufacturing employment has fallen from over 17.3 million jobs to about 12.5 million in 2016, a loss of almost 5 million positions.

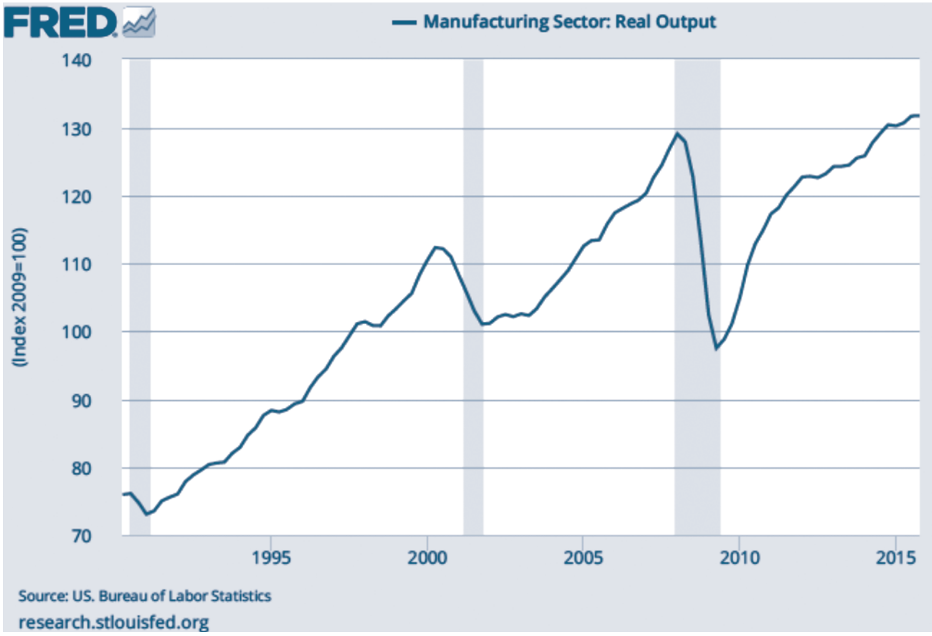
Figure 4:
Total Manufacturing Employment (1975 to Present)



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on June 2, 2016.

Despite this large loss of jobs, manufacturing output is higher than it was in 2000. (*See Figure 5.*) Manufacturing output has increased by 12% while the number of positions has fallen by 28%.

Figure 5:
Index of Real Manufacturing Output (1990 to 2015)

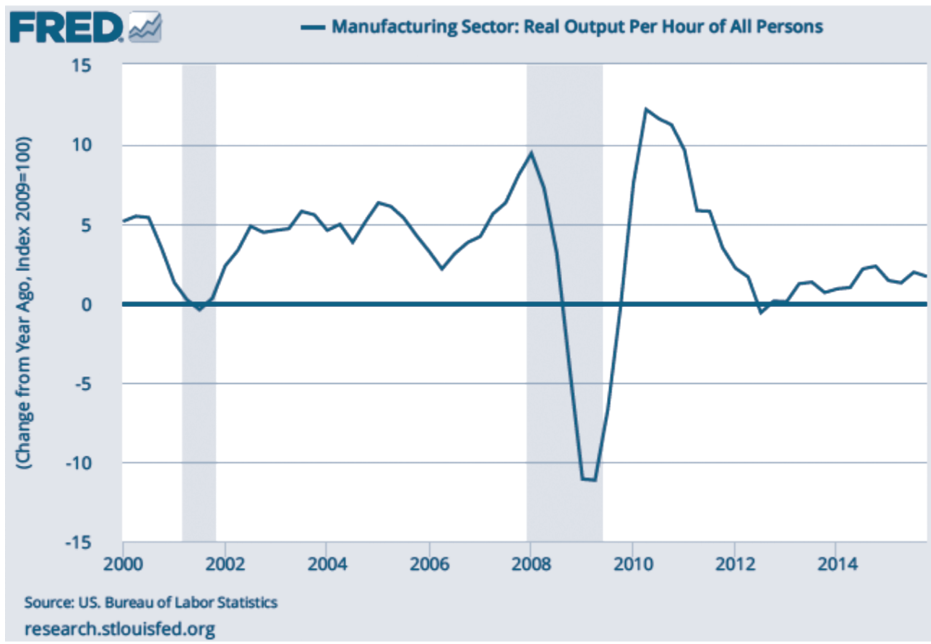


Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on June 2, 2016.

From 1990 to 2000 the trade deficit as a percentage of real GDP soared, as did manufacturing output while manufacturing employment remained virtually unchanged. Since 2000 American manufacturing output is increased significantly, and manufacturing employment has plunged while the trade deficit has improved. There is clearly a disconnection between trade deficits and manufacturing employment.

There is a fairly simple explanation for the combination of rising output and a significant drop in manufacturing employment: increases in labor productivity in the manufacturing sector. (*See Figure 6.*)

Figure 6:
Real Output Per Hour in the Manufacturing Sector (2000 to 2015)



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on June 2, 2016.

Manufacturing Productivity

Several observations are noteworthy about U.S. manufacturing productivity which is called real output per hour.

- American manufacturing productivity has grown at a healthy pace since 2000.
- Productivity plunged during the financial crisis in 2008-09. That drop is normal in a recession as firms fail to eliminate positions fast enough to match falling sales. Thus output per worker falls.
- Labor productivity has waned over the past several years caused in part by manufacturers' inability to find enough skilled workers. About 600,000 manufacturing positions in America are unfilled due to "skill shortage." Without an adequate supply of skilled workers, manufacturing productivity suffers.

The phenomenon of rising productivity and falling manufacturing employment is not unique to the United States. (*See Figure 7.*) Almost every major developed country in the world is experiencing this same issue. In the table below all the countries listed experienced reasonably strong productivity in manufacturing over the last 30 plus years, but the number of hours worked fell. The drop in the number of hours worked is a proxy for a drop in manufacturing employment.

Figure 7:
Manufacturing Productivity (output per hour) and Manufacturing Hours Worked in Select Countries (1979 to 2012)

Country	Avg. Annual Growth in Output per Hour	Avg. Annual Change in Hours Worked
United States	+4.0%	-1.5%
Canada	+2.1	-0.6
France	+3.1	2.1
Germany	+2.8	-1.4
Japan	+3.3	-1.0
United Kingdom	+3.1	-2.7

Source: The Conference Board. "International Comparisons of Manufacturing Productivity and Unit Labor Costs Trends." (Table 1: Productivity, output and hours worked.) 2014.

Rising U.S. manufacturing productivity was documented by Deloitte. That organization found that of the 25 largest global manufacturing exporters, America is the second most competitive country after China and significantly ahead of Germany, Japan, Canada and Mexico, among many others.

In a world of rising manufacturing output coupled with strong labor productivity, the net result is falling manufacturing employment—not just in the United States but also in other major industrialized countries. Manufacturing employment losses are also common in developing and emerging countries like Brazil and South Korea. From the American viewpoint, productivity gains explain more than half of the employment drop according to some economists.

Trading Partners

The remaining drop in American manufacturing employment is possibly traceable to trade imbalances. (*See Figure 8.*) Several points are relevant.

- Two of our three largest trading partners (Canada and Mexico) are members of the North American Free Trade Association (NAFTA).
- Total trade with those two countries is almost $1.2 trillion, which is 30% of total American trade.
- Out of the $1.2 trillion in trade, the U.S. negative trade balance is $88 billion—hardly a staggering amount for the $18 trillion American economy.

When politicians and others lash out at NAFTA, they may not realize that in the broadest terms those trade relationships are a major part of the North American economy, and the United States is integrated into that regional economy. Economists in general would say that the U.S. trade imbalances with NAFTA countries are relatively minor.

Figure 8:
2014 Total Trade With America's Major Trading Partners (in billions of U.S. dollars)

Rank	Country	Exports	Imports	Total Trade	Percent of Total Trade
—	Total, All Countries	$1,623.3	$2,345.8	$3,969.1	100.0%
—	Total, Top 15 Countries	1,127.4	1,781.6	2,909.1	73.3%
1	Canada	312.0	346.1	658.1	16.6%
2	China	124.0	466.7	590.7	14.9%
3	Mexico	240.3	294.2	534.5	13.5%
4	Japan	67.0	133.9	200.9	5.1%
5	Germany	49.4	123.2	172.6	4.3%
6	Korea, South	44.5	69.6	114.1	2.9%
7	United Kingdom	53.9	54.0	107.9	2.7%
8	France	31.2	47.0	78.2	2.0%
9	Brazil	42.4	30.3	72.8	1.8%
10	Taiwan	26.8	40.6	67.4	1.7%
11	India	21.6	45.2	66.9	1.7%
12	Saudi Arabia	18.7	47.0	65.7	1.7%
13	Netherlands	43.7	20.8	64.5	1.6%
14	Italy	17.0	42.1	59.1	1.5%
15	Belgium	34.8	20.9	55.7	1.4%

Source: U.S. Bureau of Census. "Foreign Trade: Top Trading Partners: December 2014." 2015.

If one is seeking a culprit for declining American manufacturing China fits the bill. America's trade imbalance with China is $342.6 billion—almost 4 times our trade imbalance with Canada and Mexico combined. (*See Figure 9.*) Seekers of "trade villainy" in America's trade picture need to throw in Germany and Japan. The United States has large trade imbalances with those two countries.

Figure 9:
2014 Total Trade Deficits With America's 15 Largest Trading Partners (in billions of U.S. dollars)

Rank	Country	Deficit
1	China	-$342.6
2	Germany	-73.7
3	Japan	-67.0
4	Mexico	-53.8
5	Canada	-34.0
6	Saudi Arabia	-28.4
7	Ireland	-26.2
8	Italy	-25.1
9	Korea, South	-25.1
10	Vietnam	-24.9
11	India	-23.6
12	Venezuela	-18.9
13	Malaysia	-17.3
14	France	-15.8
15	Thailand	-15.3

Source: U.S. Bureau of Census. "Foreign Trade: Top Trading Partners: December 2014." 2015.

The relative magnitude of America's imbalance with its major trading partners is seen in the ratio of its imports to its exports to these countries. (*See Figure 10.*) For every dollar the U.S. exports to China it imports $3.76 of goods and services. Other significant imbalances are with Germany and Japan, as noted above. On the other hand when the U.S. exports one dollar of goods to Brazil, it imports only 72 cents of goods. Among America's largest trading partners the only "balanced" trade relationship is with the United Kingdom.

Figure 10:
Relative Trade Balance of America's Major Trading Partners as Measured by the Ratio of Imports to Exports in 2014

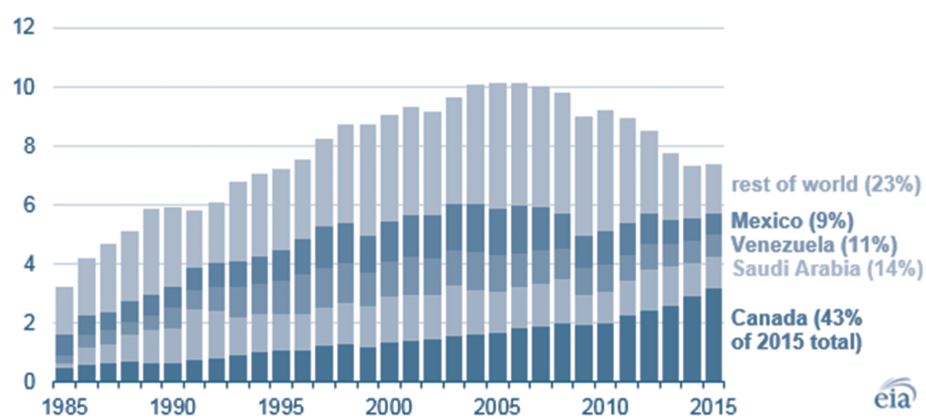
Country	Ratio of Total Imports to Total Exports
China	3.76
Germany	2.49
Japan	2.00
Korea, South	1.56
Taiwan	1.51
France	1.51
Mexico	1.22
Canada	1.11
United Kingdom	1.00
Brazil	.72

Source: Author's calculations from *Figure 8* above.

In brief, America's most imbalanced trading relationships are with China, Germany and Japan. In absolute terms (the size of the negative trade balance) and relative trade balance (the ratio of imports to exports) these three countries top the list. The U.S. has no free-trade agreements with these three countries. By comparison, America's NAFTA partners, Canada and Mexico, are models of almost balanced trade.

What is truly startling about America's trade imbalances with Canada and Mexico is that crude oil constitutes a significant part of its imports from those two countries. Together, our two NAFTA partners provided 52% of America's crude oil imports in 2015. It is not the least bit surprising that the United States runs trade deficit with Canada and Mexico when it imports so much oil from these two countries. Excluding crude oil imports, America would have a more balanced trade situation with NAFTA.

Figure 11:
Gross Imports of Crude Oil to the United States by country, (1985 to 2015)
Million Barrels Per Day



Source: U.S. Energy Information Administration. "Canada provides record-high share and amount of crude oil imports in 2015." (by Tom Doggett.) April 12, 2016.

In this current presidential cycle, politicians of both parties have devoted much negative rhetoric about free-trade agreements, especially NAFTA. The United States has free-trade agreements with 20 countries, including Canada, Mexico, Israel, Australia and 16 countries in Latin America and Asia.

The National Association of Manufacturers (NAM) pointed out that in 2014 the United States had **a positive trade balance with its free-trade agreement partners of $55 billion in manufactured goods**. In the same year where no free-trade agreement existed with trading partners, the U.S. had a negative trade balance of $579 billion in manufactured goods. Forty-eight percent of American manufactured exports are destined for its free-trade partners, with Canada and Mexico accounting for 35% of America's total manufactured exports in 2014.

Commercial Services Trade

Lost in the political rhetoric is a discussion of trade in commercial services. The United States is the 800 pound gorilla in services trading, including such services as insurance, investment banking, accounting, legal, transportation, marketing and advertising. America had a trade surplus of $232 billion in 2014 while most developed countries run trade deficits in commercial services. (*See Figure 12.*)

Figure 12:
The World's Leading Traders in Commercial Services in 2014 (in billions of dollars)

Country	Exports	Imports	Trade Balance
United States	$686	$454	+$232
United Kingdom	329	382	- 53
Germany	267	327	- 60
France	263	244	+ 19
China	272	382	- 110
Japan	158	190	- 42

Source: Australian Trade Commission. "The world's leading trading nations." April 22, 2015.

America (like most developed countries) is a service-oriented economy. This country is very competitive in the export of commercial services, which is the heart of the United States economy.

Headlines are made when a major company announces that it is moving manufacturing operations from the United States to Mexico, relocating or losing hundreds of American jobs. Yet the job gains and benefits to our economy from international trade in commercial services such as investment banking and insurance seldom garner headlines.

Most industrialized countries have service-oriented economies with services accounting for between 70% and 80% of GDP. But compared to other economies, the United States could be viewed as the Stephen Curry or LeBron James of tradeable services.

Best Guesses for the U.S. Economy

Even with its trade deficit, the United States has a growing economy with the following conditions likely to prevail between now and the end of the year:

- **Economic growth:** About 2%.
- **Inflation as measured by the PCE Price Index:** About 1.75%.
- **Unemployment rate:** Near full employment of 5%.
- **Net new jobs created on a monthly basis:** 100,000 to 150,000.
- **Wage growth:** About 3% (1% after inflation).
- **Trade deficit:** About 2.7% of real GDP or about $500 billion.
- **Probability of a recession in the next 12 months:** About 20%.

Brexit may have long-term implications for these metrics, but we expect that such an exit is unlikely to roil the U.S. economy in the next 6 months the way Brexit has recently unhinged the financial markets.

Final Thoughts

Warren Buffett wrote in his latest annual letter to shareholders, **"For 240 years, it's been a terrible mistake to bet against America, and now is no time to start. America's golden goose of commerce and innovation will continue to lay more and larger eggs."** The "golden goose" of commerce and innovation is built on a foundation of international trade and competition in tradeable goods and services. America is a competitive country across a broad range of goods and services.

In a globalized world with significant competition, America has qualities that are the envy of almost all of our industrialized trading partners, and that includes Germany, France, Japan, Italy, United Kingdom, Canada and a host of other developed countries. The United States excels in a number of ways compared to most developed countries:

- higher economic growth
- higher manufacturing productivity and competitiveness
- higher per capita income
- lower unemployment rate

If a trade surplus was necessary for economic robustness, Germany and Japan would be paragons of economic success. They are not. They have minimal growth and stagnant employment conditions.

Now is not the time for Democratic and Republican politicians to "take their ball and go home," turning their backs on a manageable trade situation. Does the U.S. need to have intense conversations with trade representatives of China, Japan and Germany? Absolutely. Are our free trade agreement partners like Canada and Mexico the source of a major trade problem for the United States? No.

Thomas Goho, Ph.D. is Chief Economic Consultant for Stephens Inc. He also serves as the Co-Director of Stephens University at Wake Forest University. Tom enjoys a successful career in both education and business. He served as a professor of finance, Wayne Calloway School of Business and Accountancy, Wake Forest University for 30 years. Before retiring in 2007, Tom was the first to hold the Thomas S. Goho Chair of Finance. Tom also served on the Board of Directors of the Wells Fargo Family of Mutual Funds for 20 years, and also was on the Board of Directors of Lifepath Funds of Barclay's Bank. A former Certified Financial Planner, Tom earned his BS and MBA from Pennsylvania State University and his Ph.D. from the University of North Carolina-Chapel Hill.

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