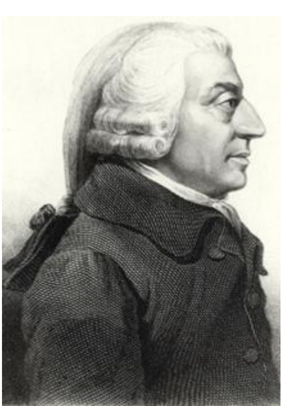
Second Quarter 2024 Letter



"It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest."

- **Adam Smith**, The Wealth of Nations

To begin this quarter's letter, we will start with a discussion of Adam Smith's foundational economic theory on trade. We will highlight how our current globalized economy has created structural trade imbalances that are having a significant impact on financial markets. It is the nature of today's global trading system and their resulting capital flows that are crucial to understanding the extreme behaviour in today's financial markets. This letter will touch on the US stock market phenomena and its relationship to the collapse in the US Net International Investment Position. Finally, we will provide an update on the Avenue equity portfolio and discuss one of our investments that was recently acquired by another company.

This letter's quote is attributed to Adam Smith who was born over 300 years ago in Scotland during a time known as the Scottish Enlightenment. His seminal work, *The Wealth of Nations*, served as a groundbreaking treatise on economic theory. One of Smith's core ideas was that trade between countries could be mutually beneficial when each country focused on producing what they do best. This concept was further advanced in the 19th century by British political economist David Ricardo with his idea of comparative advantage.

A country has a comparative advantage in an economic activity if it can produce a good or service better than another country. This advantage could come from better access to human capital, natural resources, or industrial capacity, among other things. Based on Smith's theory, countries should focus on producing goods where they have a comparative advantage, while participating in trade with countries who are better at producing other goods or services. Each country pursuing their best interest via the principle of the 'invisible hand' would lead to a material rise in prosperity and economic activity.

Smith's concept of the invisible hand exists to guide the economic behaviour of individuals. The idea is that it is the individual producer pursuing their own self-interest (their desire to earn a profit or income) that produces the goods that consumers want to buy. Smith reasoned that the most efficient use of resources within an economy happens when individuals pursue their own economic self-interest.

Fast forward to today, as the economy has become hyper-globalized over the past 30 years, we have reached a moment where our current system of global trade is causing immense distortions to the world's balance of both trade and capital flows, for reasons we will explore below. The distortions have built up especially since the economic liberalization that occurred in the 1990s with various multi-lateral trade deals like NAFTA and the creation of the World Trade Organization (WTO).

The Era of Globalization

This year is the 30th anniversary of the North American Free Trade Agreement (NAFTA) which was signed between the United States, Canada, and Mexico in 1994. The goal was to create a unified trading bloc between the three countries where trade could be conducted with no tariffs or trade barriers. This multilateral agreement was a core achievement of the liberalization of global trade that occurred during the 1990s.

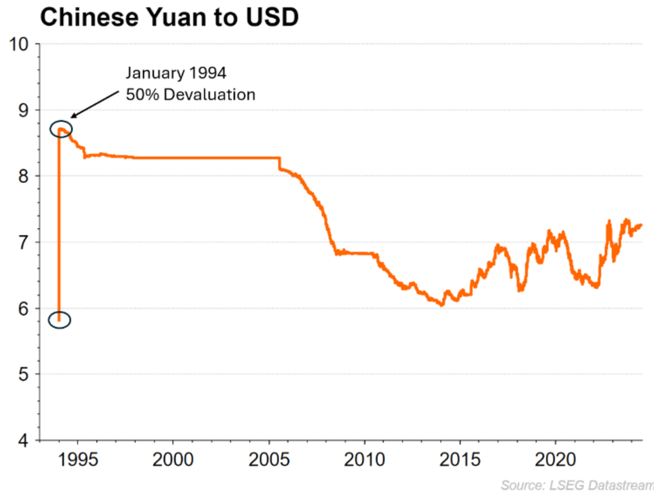
The argument in favor of NAFTA was that each country could focus on producing goods and services where they had a comparative advantage and then trade freely for other goods and services with their neighbours. One of the arguments against NAFTA was that it would lead to the loss of higher value manufacturing jobs from the United States and Canada into Mexico as companies would be incentivized to move their manufacturing production to where it was cheaper, in Mexico.

For example, Canada had 2 million manufacturing jobs in 2002 and 22 years later we now have 1.5 million manufacturing jobs[1]. Canada suffered a net loss in manufacturing employment of 500,000 over this time. But meanwhile Canada has added over 5 million net new jobs in this period in total. The composition of our labour force has changed as we moved to a more services-based economy. A trade deal like NAFTA may be good in aggregate but it creates conditions where some industries win while others lose.

We believe the most significant event that occurred in 1994 was not the ratification of NAFTA but was China's policy response to NAFTA. China remained a small developing economy in 1994 but had made significant progress interacting with the rest of the global economy after Deng Xiaoping's modernization efforts over the previous decade.

NAFTA was ratified and came into effect on January 1st 1994. That same month China devalued their currency by 50% from 5.8 to 8.7 Yuan to USD. Sensing a competitive threat from the new North American trading bloc, China sought to maintain their export competitiveness by devaluing their currency and thus keep their exports the cheapest in the world.

[1] Stats Canada, https://www150.statcan.gc.ca/t1/tbl1/en/tv

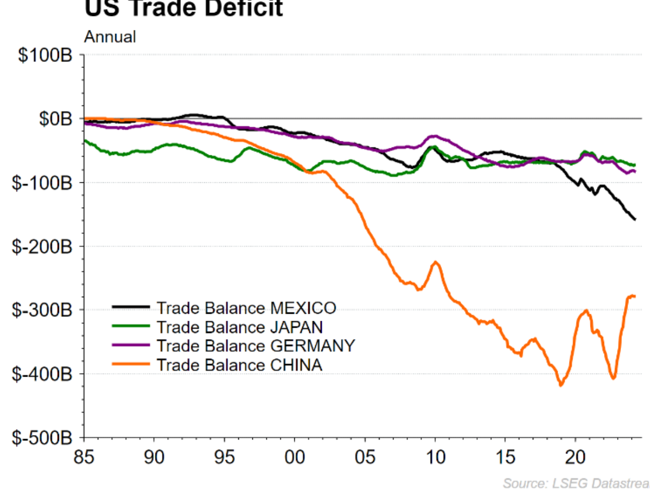


The United States allowed China to enter the World Trade Organization in 2002 at this lower devalued exchange rate. China was now able to compete with the rest of the world by selling its exports with a devalued currency.

As China became a dominant export economy, one would expect a significant increase in foreign capital flowing into the country to exploit the high return on capital opportunities that an emerging economy of China's size offered.

However, this misses a critical point, China is a state-run economy with a closed capital account. This means that there are significant restrictions and constraints on foreign capital entering China that still exist to this day. This environment created a major kink in the global economy as the Chinese economy has grown, particularly after 2008.

To maintain their export competitiveness, China has pursued mercantilist trade policies that favour a weaker currency and large export subsidies to support their export heavy economy. China has one of the weakest consumer economies in the world at only 38% of its GDP. Over the past 20 years China has managed its exchange rate to avoid the currency appreciation that would otherwise have occurred given its economic rise. The opposite side of this has meant the Chinese consumer did not benefit from an appreciating currency relative to the rest of the world.

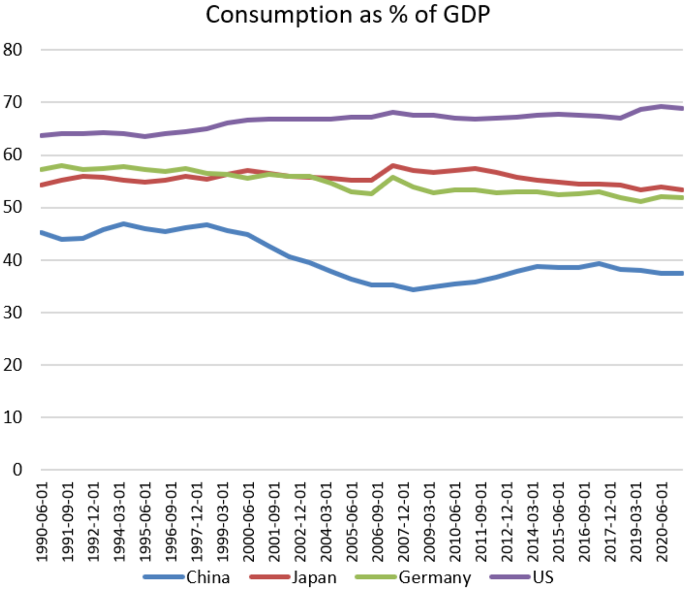


Both Japan and Germany have pursued similar, albeit less extreme, policies which put an emphasis on the export side of their economies.

As a result, China, Japan, and Germany run large persistent trade surpluses versus the United States.

The chart on the left shows the annual dollar value of trade deficit the US runs with each country.

All three countries have very weak consumer economies, which means the US consumer must make up for this weak consumption from the rest of the world to balance global trade.



The globalized trade policies of the past 30 years reached their crescendo in the post-2008/2009 economic cycle. The negative effects of a deindustrializing United States became clear to see for the average American. Blue collar wages in real terms have not risen in several decades.

We first saw trade tariffs against China discussed politically during the 2016 US election. Although Donald Trump's style of negotiation with China was often characterized as being unpopular in the press, his attack on Chinese trade policies was very politically popular and was key to his success in winning Michigan, Wisconsin, and Pennsylvania - three states hit hard by deindustrialization over the past few decades. Lost in the shuffle since 2020 is that current President Joe Biden's tariffs on China are even more severe than the tariffs implemented by Donald Trump in 2016.

In May 2024, Joe Biden and his administration announced more tariffs on China. Semiconductor tariffs are moving to 50% in 2025, electric vehicle tariffs are going to 100% this year, and steel tariffs are moving to 25% this year.

Below is the press release from the White House:

MAY 14, 2024

FACT SHEET: President Biden Takes Action to Protect American Workers and Businesses from China's Unfair Trade Practices

BRIEFING ROOM ▸ STATEMENTS AND RELEASES

> President Biden's economic plan is supporting investments and creating good jobs in key sectors that are vital for America's economic future and national security. China's unfair trade practices concerning technology transfer, intellectual property, and innovation are threatening American businesses and workers. China is also flooding global markets with artificially low-priced exports. In response to China's unfair trade practices and to counteract the resulting harms, today, President Biden is directing his Trade Representative to increase tariffs under Section 301 of the Trade Act of 1974 on $18 billion of imports from China to protect American workers and businesses.

This year we have also seen rising trade tensions between Europe and China, specifically around auto manufacturing. Europe has recently implemented tariffs against electric vehicles from China in another round of trade escalation. The Canadian government, always seeming a few steps behind, will also likely be adding tariffs on Chinese auto exports in the coming months.

The Chinese Communist Party provides substantial incentives for automotive investment within China, leading to significant overcapacity in the industry. China's auto production capacity for conventional vehicles is now twice its domestic demand, creating excess capacity equal to the entire European Union market and all U.S. production combined.[2]

The best analysis on global trade comes from Professor Michael Pettis who is an American professor of finance at Peking University in Beijing. In a recent article he is quoted as saying:

"*One of the concerns in American policy circles in recent years has been the long-term impact of foreign trade and industrial policies on the health and strength of American manufacturing. The Trump and Biden administrations tried to address this weakness when the former, in 2018 and 2019, put into place tariffs on hundreds of billions of dollars of Chinese imports, and the latter announced in May of this year that it was raising tariffs on other goods. It is clear that whoever wins the election in November, this attention to trade among US policymakers will only continue, and indeed is spreading throughout the world*."[3]

Western countries of the world are already in a trade war with China and they are becoming increasingly united on these issues. It is reasonable to expect the trade dispute with China to become even bigger over the coming years.

<u>Global Trade Impact on Financial Markets</u>

It is important to understand how global trade creates capital flows that have a significant impact on global financial markets.

---

[2] Oren Cass, *The Electric Slide*, The American Compass

[3] https://www.phenomenalworld.org/analysis/trade-and-the-manufacturing-share/

When a country runs a trade surplus it accrues a profit in its trade account that then needs to be used to purchase a financial asset, whether stocks, bonds, or real estate. There is only one country in the world that has large enough financial markets to absorb all this excess global savings: the United States.

The best way to graphically show this phenomenon is by examining the US Net International Investment Position (NIIP). This data point is derived from a simple formula:

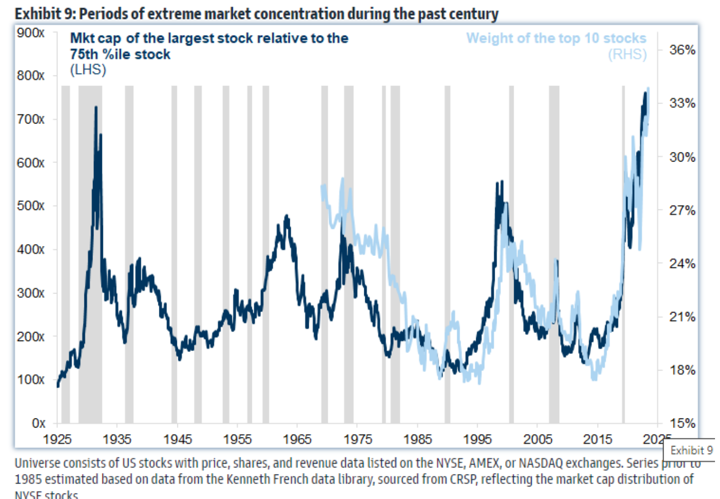
NIIP = (International Assets owned by US Citizens) - (US Assets Owned by Foreigners)

The US NIIP stands near -$25 trillion, meaning that foreigners net own $25 trillion of US assets. Another way to view the relationship the US has with its trading partners is that the United States buys goods from the rest of the world, and to pay for it they export financial assets.

Capital flows into the US have been the largest contributor to the meteoric rise of the US stock market since 2009. It is rarely discussed how much the structure of global trade and the resulting capital flows impact financial markets. But we believe they are crucial to understanding the dominance of the US stock market over the past 15 years.

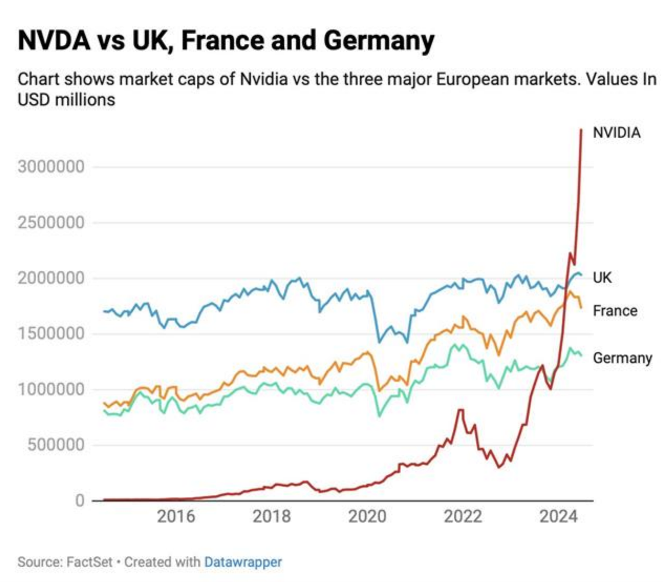
The US financial system is the only market large enough to absorb all the excess savings of the world. The size of the capital flows into the US have pushed market valuations to an extreme, where the total market capitalization of the US market is now above $50 trillion or 200% of GDP.

Recent mega trends like passive investing and the technology superstar companies in the US have further reinforced the fact that for global investors and capital flows there is no game in town other than US equities.



The trends we are discussing have all reflexively pushed the US market to a concentration level only seen during the summer of 1929.

As we highlighted in last quarter's letter, the high level of fiscal spending in the US since 2020 has helped create record profits which has further reinforced the attractiveness of US stocks to foreign investors, especially with what is going on economically elsewhere in the world.



No individual stock better represents the demand for US assets as Nvidia, which temporarily became the largest stock in the world in June 2024.

All financial bubbles need some initial fundamental truth to create the conditions for investors to become euphoric.

The trend in Artificial Intelligence and semiconductor manufacturers is just the most recent manifestation of this.

At a moment of extremes - what should investors do?

Our view is that we are at a moment where particular trends have been pushed to their extreme both economically and in financial markets. Significant uncertainty lies ahead. As the stock market begins to exhibit extreme behavior, we are increasingly cautious about the environment.

The Avenue equity portfolio has had a strong first half of the year and we continue to like the businesses we own. Our investments have had very little turnover since the beginning of the year, and we expect this to continue to be the case.

One of the particularly strong areas of performance has been in our investments that are benefiting from the large fiscal spending in the US, specifically as it relates to the construction of data centres and

the greening of the electric grid. A beneficiary of this investment was our holding Encore Wire (NYSE: WIRE).

Encore Wire is a Texas-based manufacturer of copper wiring used in commercial, industrial and residential construction.

We purchased Encore in early 2023 and we expected this to be a long-term holding in our equity portfolio. The business had all the characteristics we look for: good return on capital, strong potential for reinvestment in the business, and management who had a successful track record of allocating the capital of the business. On top of that, the valuation of the business was around 6x earnings when we purchased it.

In April of this year, an Italian based company called Prysmian offered to buy Encore for $290 per share. Upon our review of the offer, we were disappointed with the purchase price of $290 because we believe it significantly undervalued the long-term potential value of Encore's business.

We petitioned the company and its Board of Directors to reconsider the undervalued price but to no avail. The deal closed in June 2024 and clients received the $290 per share for Encore in each equity portfolio. We have included the letter we sent to Encore management as an appendix to this letter.

We hope you have an enjoyable summer.

Bryden Teich
April 2024