Vol. 9, Issue 26
August 28, 2015

Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

Not long ago, my father and I were talking about McDonald's, and the reasons for that company's declining market position, or at least the perception of it. He threw out the oft-given explanations, things like changing American consumer patterns and more flexible competition, and there is a lot of truth to that. However, I said the core reason is much simpler: everyone else simply caught up.

By that I meant, McDonald's single biggest comparative advantage had/has deteriorated. This being commoditization, and the folks at the golden arches aren't alone. In fact, the commoditization of products and services has been the underlying business model for many American corporations, and it has served them well. Now, however, even commoditization has become, well, commoditized, if that makes any sense.

When I was a child, there was some real value added in the fact the menu at all McDonald's was essentially the same, as was the quality and quantity of the product. A, say, Big Mac and French fries in Seattle were almost identical to the same thing in Brunswick, Georgia, a distance of 2,946 miles. While it is still a pretty neat trick when you think about it, it was an even bigger deal back in the 1970s, let alone the 1960s and 1950s.

You knew what you were getting, and you knew about how much it was going to cost you. There were virtually no surprises, and no one else was quite as good at it as McDonald's until now. This level of commoditization and consistency is pretty industry standard across most restaurants, let alone other consumer products like sodas, beer, snack foods, etc. Heck, even professional wrestling is commoditized and sanitized beyond almost all recognition when compared to the orchestrated farces held down at the Boutwell Auditorium in Birmingham.

As an aside, those used to be fun, and I still run across some of the old 'local' talent, guys like The Great Kaiser. While I don't talk to Sam every time I see him, it is fun when I do. For those of you who remember the local cast, you might like to know Tojo Yamamoto was an excellent cook, and liked to entertain. Apparently he liked to serve up more than the chops and 'claws' he delivered in the 'squared circle.' Who knew?

Now, what made this possible was a vast domestic market flung out over the better part of a continent incorporating a mélange of different ethnicities and cultures. Instead of focusing on the niches, there was greater wealth and growth to be had appealing to the widest number of people with an inoffensive product. That might sound pretty obvious, but it really isn't. After all, folks in Chicago might think everyone eats pierogis and kielbasas with some regularity, just like Southerners have a hard time believing grits aren't universal, let alone pulled pork BBQ.

I tell you all this because while trade has always been integral to our economic well-being, believe it or not, the United States is not as trade oriented in relative terms as much of the remaining world. We have had the luxury of a wide domestic market with a preference for commoditized goods and services, and corporate America really focused on this, as opposed to the global economy as a whole.

Let me give you a surprising statistic. I had to pull the numbers twice to make sure I had them right. In 1960, the United States exported $25.94 billion worth of goods & services, and US GDP that year was $543.20 billion. As such, exports divided by GDP was equal to 4.78%. So what, right?

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Well, fast forward to today, when the average man on the street will happily tell you the US doesn't produce anything any lone. In 2014, the US exported $2,342 billion worth of goods & services. GDP was officially $17,348 billion last year, and is subject to further revision. As such, exports divided by GDP was/is equal roughly 13.5%, suggesting the US is more export and trade focused now than it has been at least since I have been alive.

I found that very surprising. However, event these numbers pale compared to those of other countries, and this is important. *As an aside, total manufactured goods exported last year were equal to 9.41% of GDP compared to 3.62% in 1960. Again, I would not have thought that.*

As you have probably read this week, folks are worried about a slowdown in China's economy. They are all the more worried because it is almost impossible to get a completely transparent look behind the curtain as to what is actually going on, at least on the books. After all, there are a lot of countries who export a lot of stuff to the Chinese, and any significant slowdown in the Middle Kingdom will have ramifications in those trading partners. Consider the table below, which I compromised with data from MIT, Bloomberg, and the World Bank. It represents China's major trading partners, who account for at least 2% of Chinese imports...and should be viewed as good faith approximations.

Country	Exports To China (Billions $)	Nominal GDP (Billions $)	Exports to China % of GDP	Total Exports % of GDP	Exports to China % of Exports
Japan	147.373	4,616.00	3.2%	16.2%	19.7%
South Korea	131.524	1,470.00	8.9%	50.6%	17.7%
United States	113.513	17,419.00	0.7%	13.5%	4.8%
Germany	83.973	3,860.00	2.2%	45.6%	4.8%
Taiwan	82.121	530.00	15.5%	59.2%	26.2%
Australia	72.484	1,444.00	5.0%	20.9%	24.0%
Saudi Arabia	48.231	752.00	6.4%	47.5%	13.5%
Brazil	41.304	2,353.00	1.8%	11.5%	15.3%
Russia	38.105	1,857.00	2.1%	28.6%	7.2%
Thailand	30.841	374.00	8.2%	75.0%	11.0%
Singapore	30.771	308.00	10.0%	187.6%	5.3%
Malaysia	29.587	327.00	9.0%	79.6%	11.4%
Angola	28.707	127.00	22.6%	58.5%	38.6%

As you can see, the United States is less directly exposed to a slowdown in China than any of the other countries listed. Frankly, it isn't even close, which suggests a lot of growth in the world over the last decade has come from other countries exporting increasingly to China. For instance, South Korean trade to China was virtually non-existent 20

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years ago, with total imports + exports being roughly $20 billion. In 2013, TOTAL trade was $274.24 billion...over 20 fold higher!!! Shoot, it doesn't even include countries like Vietnam and the Philippines where exports to China constitute 7.4% and 5.8% of GDP respectively.

These are gaudy numbers, particularly when you consider our biggest export market is Canada, at about 1.8% of GDP. Mexico comes next at 1.4%, and China rounds out the Top 3 at 0.7%. So, you can add up our three largest export markets AND still not have the impact exports to China, alone, have on South Korea, Taiwan, Australia, Saudi Arabia, Thailand, Singapore, Malaysia, Angola, Vietnam, and the Philippines. Shoot, China is at least double the importance of our three largest export markets for South Korea, Taiwan, Thailand, Singapore, Malaysia, and Angola. *Okay, I admit Angola is not a global mover and shaker, yet, but I still have to include them in the list because the numbers are what the numbers are.*

Now, you have probably heard the old expression: "when the US sneezes, the rest of the world catches a cold." While that is still largely true, with the exception of Germany, China is a larger export market for all of the countries listed in the table than the United States, although the numbers for the Saudis are roughly approximate. When you add up the GDPs for those other countries (all except Germany and US), you come up with $13.6287 trillion, which would make the combined countries the third largest trading bloc in the world behind NAFTA and the Eurozone, representing, get this, over $4.1 trillion in exports.

So, I guess you can say: "when the Chinese sneeze, the rest of the world runs out to get a flu shot." If so, I suppose the rest of the world headed out to the CVS to get theirs this week.

I have gone through all of this for a reason: the Chinese would be wise to adjust their economic model to more fully tap into a potentially enormous domestic consumer market, and this will be bad for many of its current trading partners, who export primarily capital goods and natural resources to the Middle Kingdom.

Consider this: the C+I+G =/- Net Exports for China looks like this: 38% + 46% + 14% + 3%. That is clearly mismatch which can't continue, as 46% devoted to I (investment) will lead to the building of unnecessary capacity, which is exactly what we have seen *(as an FYI, that expenditure on I is about double what the US spends in absolute nominal terms, which is it has been doing for quite literally decades).* As a result, Beijing should be trying to shift that C+I+G to closer to 50% + 34% + 14% + 3% in relatively short order, that would free up a lot of domestic capital that would go into services and greater consumer goods.

In essence, assuming a constant CNY64,079.64 trillion Chinese economy, this would mean a 32.6% increase in consumer expenditures and a 26.7% decrease in capital investment. Man, that would throw the Japanese, Koreans, Nationalist Chinese, and Australians into a snit, particularly the Koreans and Nationalist Chinese.

However, at some point, it would make sense to start tapping that vast domestic consumer market as opposed to building shopping malls, cities, and factories no one needs. The growth would be spectacular, and you would undoubtedly see an improvement in overall Chinese manufactures, as we have seen in other economies with both vibrant consumer and export sectors. In essence, the best chance for China to grow from this point, is to take the next step towards capitalism, open up its domestic markets to greater competition, and relax its capital controls. The overriding emphasis on exports, construction, and manufacturing appears to have crossed the tipping point, and is now offering up the law of diminished marginal returns. On the flipside, the Chinese economy has miles to go and umpteen opportunities remaining in the consumer goods and services sectors, in aggregate.

This will be a difficult sell to the folks in Beijing, but, man, the opportunities. Commoditization and consistency from Shanghai to Urumqi; from Beihai to Heihe and all points in between.

Sure, it might take away from some of the uniqueness of an area, but I have noticed something: for all the McDonald's and its ilk across the United States, I can still order up biscuits & gravy (I don't), grits (I do), and any number of other Southern delicacies in any number of other restaurants (it depends on what they are). I am certain the folks in Chicago can dine on central and eastern European dishes all they want. Hmm…

Char siu with scallions, slivered cucumbers, and sweet bean sauce served in bo bing should play well in both Beijing and Guangzhou. Heck, it would play well here.