



# *That '70s Show:* *Part II*

By: Thomas F. Landstreet

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**W**hat began as a simple trade war has escalated into a major shift in global strategic alliances, a development accelerated by a growing number of armed conflicts.

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Over the long term, the breakdown in trade is inflationary and will create subpar economic growth.

It might even present a challenge to the U.S. dollar's preeminence as the global reserve currency. The toxic combination of inflation and subpar economic growth, a condition called "stagflation," persisted throughout the 1970s. It was a grueling decade during which the Federal Reserve tinkered nonstop with interest rates in an effort to fight inflation.

Investors and business owners are fixated on the Federal Reserve and whether it is finished raising interest rates this cycle. The market assumes the answer is yes and that cuts are imminent. The Fed Funds Futures Market eagerly priced in seven rate cuts for 2024 until Fed talking heads recently reiterated their concern about inflation. Expectations have moderated to four to five cuts in 2024. It is impossible to forecast the Fed's policies, but it is not impossible to forecast inflation. Markets have decided that inflation will soon return to the Fed's stated 2% target. But will it?

Milton Friedman famously declared that inflation is "too much money chasing too few goods." Since the Great Financial Crisis, the economy has been flooded with money. Quantitative easing, zero interest rates, the CARES Act, stimulus checks, PPP loans, the Employee Retention Tax Credit, the bailout of Silicon Valley Bank, the Inflation Reduction Act and CHIPS Act add up to a record trillions of dollars created and injected directly into the economy.

Though I do not want to dwell on it here, to pay for all this fiscal stimulus, the U.S. government took on loads of debt. It now has amassed \$34 trillion in total debt and currently has a \$2 trillion-a-year budget deficit. Here's a not-so-fun fact: The U.S. budget deficit is currently greater by all measures than during WWII when we were fighting two wars on two continents. The monetary and fiscal stimulus is unprecedented in U.S. history, as are the federal debt and deficits.

It is rare in world history that a regime has been this profligate. Those that embark on these types of policies are infamous. Prominent examples in history include Germany's

Weimer Republic, John Law's France and Argentina under Juan Peron.

Back to Friedman's equation that inflation is "too much money chasing too few goods," it is clear from the above that we have created "too much money," but how do we get "too few goods" in a free-functioning economy? Well, that is the issue. This is no longer a free-functioning economy.

We can understand this through the lens of Arthur Laffer's "four grand kingdoms" of macroeconomics, which are monetary, fiscal, trade and regulatory policy. It is through these "kingdoms" that all government policy is exerted. Trade is the least appreciated of Laffer's kingdoms. Any impediment to the free flow of goods and services across national boundaries (free trade) impedes economic growth and increases prices. The concept of the "gains from trade" was developed by 19th-century British political economist David Ricardo in his book "The Principles of Political Economy and Taxation." In the book, he discusses the theory of comparative advantage, which simply suggests that if I produce something you need and you produce something I need, we should trade. Trade benefits both parties. Seems so simple!

Unfortunately, politicians often see trade, specifically imports, as a benefit to the trading partner and a detriment to domestic producers. This unwise prejudice leads them to resort to trade protectionism. At their worst, politicians use trade as a weapon. The term "trade war," in my view, is an oxymoron. For the first time in decades, trade has been weaponized, and the free flow of goods and services has been disrupted.

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The main victim here is the glorious free-trade relationship between the U.S. and China, which will be revered as one of history's greatest. Students for generations will study it. In this relationship, China manufactures increasingly high-quality goods cheaply, and U.S. consumers buy everything they can get their hands on, increasing their quality of life along the way. This relationship is a large part of why inflation has been subdued for decades. It has also been a big driver of global GDP growth.

The breakdown between these two parties began when Donald Trump imposed import tariffs seeking to correct imbalances in the rules governing trade. But with much less fanfare, the Biden administration has doubled the number of trade restrictions in the last three years, many of them aimed at China. The number of specific trade restrictions is too numerous to list here, but they continue to increase.

If the U.S. authorities expected China to make concessions, they were wrong. Instead, China has been emboldened, enacting retaliatory policies and seeking markets and alliances elsewhere. Incidentally, if trade restrictions worked, Cuba would be a liberal democracy.

In response to U.S. tariffs, China turned its attention to belligerent Russia, the ASEAN nations and the Middle East. A mere trade war has developed into a realignment of allies and

interests among global powers. Not since the (stagflationary) 1970s has West vs. East been so divided. Making matters worse, there are at least 20 armed conflicts in the world as of January 2024. It is more difficult to settle a trade war amidst a "hot" war.

The Organization of Petroleum Exporting Countries (OPEC), which expanded in 2016 to become OPEC+ (Russia), has become antagonistic to the U.S. When the Biden administration released hundreds of millions of barrels of oil into the market from the Strategic Petroleum Reserve, oil prices crashed. Saudi Crown Prince Mohammed bin Salman vocalized his displeasure, calling it market manipulation, then cut Saudi production to retaliate. When I said that trade had been weaponized, this is what I meant.

Perhaps related to the trade war, the BRICS trade alliance – Brazil, Russia, India, China and South Africa – has expanded by adding five new countries. Over 20 countries applied for membership. There is nothing wrong with trade alliances, but the new BRICS agenda appears to be to wean the group of its dependence on the U.S. dollar. I mentioned the significance of the U.S. dollar's role in global trade. That role might be diminishing as more trade among these economies is conducted without the dollar. Helping to drive this effort are Saudi Arabia, China and Russia. Russia chairs the BRICS alliance and will host the 2024 meeting on its turf. The alliance is surely drifting away from the West.

In response to Russia's invasion of Ukraine, the U.S. imposed trade restrictions, froze Russian assets and blocked them from the global SWIFT system, which facilitates trade among nations. Russia's wealth and influence has only grown. Russia supplanted Saudi Arabia as China's top oil supplier despite Western efforts to thwart their oil and gas exports. India, formerly a reliable U.S. ally, is now flaunting U.S. trade restrictions to buy as much cheap Russian oil as they can. Russia is a top three producer of major commodities: oil, natural gas, uranium, tin, wheat and more. Trade between Russia and China has soared to a record \$277 billion annually.

Until recently, the Saudis were the only major U.S. ally in the Middle East. In exchange for their allegiance and to ensure the free flow of oil, we supplied them with military technology. Now, Saudi Arabia is not only buying Chinese military equipment but is also paying for it in renminbi, the Chinese currency. The Saudis recently resumed diplomatic relations with their former mortal enemy, Iran. When the U.S. recently sought support from its allies to punish the Houthis for attacking cargo ships traveling through the Red Sea, the Saudis refused even though they have been fighting the Houthis for many years on Yemeni soil. Global alliances have been set adrift.

There is a historical precedent. In the early 1970s, the Yom Kippur War between Israel and Arab nations Egypt and Syria not only affected global trade, but it also created a divide that took years to mend. Along with Nixon's price controls, the trade war fueled the inflation of that period. Mideast oil producers coalesced in opposition to Israel and its backer, the U.S. OPEC quickly evolved from a loose selling group to a price-fixing cartel, and the major governments of the region kicked American oil companies out and nationalized their resources. Oil prices skyrocketed, exacerbating the inflation of

the time. The Russia/Ukraine war, the Israel/Hamas war and the balkanization of East and West are functional equivalents to the Yom Kippur War and its aftermath. Today's fracturing is much bigger.

Following the Bretton Woods Agreement post WWII, most global trade has been conducted in U.S. dollars. French Prime Minister Charles de Gaulle's minister of finance is credited with referring to the dollar's "exorbitant privilege" as the global reserve currency. This reserve currency status allowed the U.S. to amass high levels of debt and to print more dollars without the repercussions that other countries would have suffered.

Exporting economies accumulate dollars and buy Treasury bonds, which serve as dollar equivalents. Meanwhile, the U.S. Treasury is issuing trillions of dollars in Treasury bonds and notes to finance record deficits. The flood of Treasuries into the market threatens to overwhelm demand and could pressure the value of these holdings. China, Russia and Saudi Arabia have dramatically reduced their holdings of Treasuries, and foreign buyers have stepped away.

Meanwhile, these same central banks have become voracious buyers of gold, perhaps to facilitate trade outside the dollar. The Saudis reportedly traded oil with a Chinese company in exchange for a nuclear power reactor to be built near Ryad. It was recently rumored that Russia is buying Iranian drones using gold bullion as payment. Vladimir Putin bragged in his recent interview with Tucker Carlson about the declining use of the dollar in global trade.

This might not be the end of the dollar's reign, but it is quite a change. With so many major importing and exporting countries colluding to exit the dollar system, the dollar's role in global trade will diminish. With demand for the dollar falling, so might its value, and with so many dollars floating around the global economy (see money printing above), there could be protracted pressure on its value.

The breakdown in trade has profound economic ramifications, offering both opportunities and hazards. India, Malaysia, Taiwan, Indonesia, South Korea and Vietnam benefit from the U.S. trade war with China as U.S. companies seek other sources of production (friendshoring). Economic growth among these countries is accelerating, as is their industrial development. India's 7% economic growth rate is the fastest in the world, and U.S. investors are piling in as they abandon China. China's stock market has collapsed while India's hits all-time highs daily. India's Prime Minister Narendra Modi is going for it, investing heavily in infrastructure from modern airports to roads and rail. India is where China was 30 years ago.

Closer to home, "friendshoring" beneficiary Mexico supplanted China recently as the largest exporter of goods to the U.S. Mexico's stock market also trades at all-time highs. Foreign direct investment into Mexico is booming.

In response to these shifts, China's industrial policy has evolved from primarily making goods for the U.S. market to making goods for Asia's rapidly growing economies. This requires the production of higher-value goods. The country's exports of automobiles, industrial equipment like rail cars, power systems and heavy equipment such as earth-moving vehicles have

soared. The country recently surpassed Japan as the world's largest automobile exporter. Chinese automakers are producing high-quality, low-priced electric vehicles and flooding the European market, where consumers, armed with EV subsidies, appear willing to buy. Of course, the U.S. government imposed an import moratorium against Chinese automobiles, so we will not see them here.

Back home, U.S. companies are receiving free money from massive industrial spending programs, including the Inflation Reduction Act (a name steeped in irony) and the CHIPS Act, which subsidizes U.S. production at the expense of – you guessed it – China. Beneficiaries include the largest design and construction firms. Direct subsidies go to Intel and Taiwan Semiconductor to build giant new semiconductor manufacturing facilities. Solar equipment manufacturers receive subsidies, as do consumers of their products. The Inflation Reduction Act unfortunately contains some foolish expenditures, like on "green hydrogen," an impossible concept. On the other side of the equation, programs like these, where governments allocate winners and losers, are generally inflationary, and because they are fueled by unprecedented deficit spending, create another set of problems.

This protectionist impulse – powered by fiscal stimulus – will certainly boost GDP as government spending is a large component of that imperfect statistic. But reshoring, though stimulative in the near term, will lead to higher prices in the end. It is simply more expensive to manufacture in the U.S. than in China, especially with all the efficient infrastructure that has been created there by U.S. companies. Plus, U.S. environmental regulations, minimum wage laws, unionization, scarcity of skilled and willing labor, and high tax rates all add to costs. The consequences of the trade war are much greater than merely reshoring. A great balkanization of East and West has ensued.

For some reason, amidst all the talk of inflation and interest rates, this story is not getting much attention, with the existing world order changing by the day. Supply chains will permanently reorganize to the benefit of any Asian country besides China. Mexican and domestic producers have a historic opportunity. This shift will cause prices of goods to increase, and there is nothing the Federal Reserve can do about it. No amount of interest rate increases will staunch the inflation stemming from a breakdown in free trade.

## About the Author

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