Economic War: Trade wars, currency wars and intellectual property wars.

When the pie shrinks, people are less likely to share. It was clear back in early 2011 that with successive rounds or quantitative easing and debt monetization rotating through the world’s central banks, that eventually a trade war would develop. With the consumer demoralized, businesses cautious and governments broke, exports would be the last desperate hope for many countries seeking to grow their way out of voluntary and involuntary austerity. And so country after country, both net creditor and net debtor began to print money in an effort to either monetize a debt pile grown too big or to improve their terms of trade or both. Equal success in the former and equal failure in the latter has brought the phoney war to the surface. Japan’s once and new prime minister was firs to break the deadlock, sending the JPY into a downward spiral that today worries her trading partners but which tomorrow may worry the Japanese themselves as unforeseen consequences and diminishing returns to policy set in.

The phoney currency war has seen the build up of war chests in the form of bloated monetary bases and banking system balance sheets this far finely balanced country against country. What happens when someone blinks? FX risk is no longer captured in option implied volatilities;’those measures are for normal and free markets. The risk of sudden and sharp, discontinuous moves in FX rates is heightened. This poses economic, political and hyperinflation risk.

While QE is by itself inflationary, it isn’t directly hyper inflationary, nor are the sources and ultimate manifestations of inflation or hyperinflation immediately clear. In a globalized world with open capital accounts, QE in weaker developed countries creates inflation in economically more robust emerging markets. Hyperinflation, however, is always a consequence of a crisis of confidence. Continuous FX markets are unlikely to cause hyperinflation. A discontinuity in FX markets could be a sufficient trigger for such a crisis of confidence.

In a trade war, the terms of trade are but one front. The cheapness of one’s goods and services are but one dimension. The other one is the quality and desirability of one’s goods and services. The ability to provide such desirable goods and service depends on the ability to innovate. Innovation and intellectual property will be the next front. Here, countries like the US, Japan and Europe have the advantage. China has seen some of the fastest growth rates in international patents sought, yet it’s share of the global total is only 9%. The US has seen growth slow over the crisis years is seeing a rebound and still accounts for over 26% of the total. Japan is second with a share of 21% and rapid growth. While Chinese companies are among the most prolific, their ability to commercialize their inventions has been less effective. Similarly, while Japan is number 2 by number and growth of number of patents filed, their ability to commercialize their intellectual property has been less impressive. What makes the US stand out is its ability not only to invent but to market and build a brand. Apple Inc was outside the top 50 companies ranked by number of patents filed yet their innovations are front and centre in consumer electronics.

As emerging market manufacturing costs and transport costs rise, developed world companies are repatriating manufacturing. This has been especially so for US companies. This theme favors the owners and generators of intellectual property over their erstwhile outsourced producers, the so-called OEM manufacturers.

Brands are another important element in trade wars. They serve as a signal of quality and desirability. Brands are valuable and take time and investment to establish. The value of brands can be seen in the premium pricing that their goods command and in the efforts to emulate or counterfeit their products. Whereas counterfeiting can often hurt sales, the power of some brands is sufficient that counterfeiting has low substitution effects. In other words the buyer of the counterfeit good could not afford the original article and would purchase the original when they can afford it. The counterfeit is therefore not a substitute for the original.

Western countries' companies are overwhelmingly the owners of intellectual property and brands which places them well in the current brewing trade wars. While consensus economic forecasts are favorable for emerging markets like China, Asia, Latin America and the frontier markets, the nature of the growth and the trade expressions for capturing this growth through investing are not obvious or simple. China's growth expectations are based on the growing importance of consumption and the middle class. This creates a value chain that includes both domestic as well as international companies. The relative distribution of commercial benefit, of revenues and margins will vary along this chain. A simplistic macroeconomic trade expression may miss the point. A careful analysis of who is buying what, where lies the bargaining power and thus margins, and tracking of cash flows from the ultimate buyer to the ultimate manufacturer and their suppliers and counterparties is necessary to identify who within this chain or web of supply, manufacturing and distribution profits most, and should be invested in.