Rising Sovereign Risk…at Least for Now

Summary: The world of sovereign credits has seen risk climb higher over the past couple of weeks, and one of the economic impacts is on U.S. corporations. Not the little ones — the big U.S. corporations that get a large share of their profits from overseas. Overall about 44% of S&P 500 firms’ sales come from foreign markets. Consequently, additional risk to U.S. corporate earnings will come if the China-U.S. trade war slows China enough to produce weaker growth in the Asian economy, with a knock-on effect to other overseas markets, U.S. multinationals and other U.S. trade partners (like Europe, Japan and Brazil). It’s something to watch as the Trump Team gets pushed along with new tariffs and the pushback from China.

Adding to the sovereign risk is an upping of tensions in the Persian Gulf between Iran and the U.S. Given the Iranians have control of the largest dry dock in the region, it doesn’t make a lot of sense for them to blow up a freighter in the Straits. More likely some poor unhappy person from, say, Pakistan, plants a bomb below the deck rather than an Iranian Guard.

And, of course, we are in the run-up to the May 23rd European Union parliamentary elections. The trade issue is the most weighty as it hangs heavy over the Chinese and American economies as well as the rest of the world (which includes the EU). Although we believe that a China-U.S. trade deal will be worked out in the months ahead, ongoing friction between the two countries is likely to continue. A number of economic issues pertaining to technology and copyright laws will be difficult to bridge, while geopolitical tensions will continue over such issues as the South China Sea, Taiwan, and Beijing’s penetration of Africa and the Western Hemisphere (most recently underscored by events in Venezuela). We also note the potential for sovereign ratings pressures to re-emerge in Europe if trade protectionism rises further and growth cools in key economies, like Germany, Italy and France.
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Prior to SMITH’s Research & Gradings, Mr. Smith was the president of Global Guaranty, which he founded in 1987 to provide publishing and conference products for the emerging financial guaranty industry. In late 1989, Global Guaranty was sold to Thomson International. While at Thomson, as the head of a business unit, Mr. Smith was a member of the executive management team which oversaw Sheshunoff, Muller Data, Thomson BankWatch, American Banker Newspaper, The Bond Buyer Newspaper, and 40 newsletters. Mr. Smith was responsible for the creation and launching of the American Banker and Bond Buyer Conference Division. In 1990, Mr. Smith founded Global Guaranty’s All-American Municipal Analysts Team to provide greater recognition for the contributions of municipal analysts to the industry. Mr. Smith has worked in marketing positions at both Ambac Assurance Co. and E.F. Hutton. He has also worked as the managing editor of Investment Dealers’ Digest and as a reporter for Institutional Investor’s newsletters.

In 2015, Mr. Smith was awarded the National Federation of Municipal Analysts’ prestigious Industry Contribution Award. Mr. Smith received his B.A. in English Literature from St. Joseph’s University in Philadelphia.
Risk

China-U.S. Trade – A Few Quick Thoughts:

While we concur with the Trump administration’s being tough on China to create a more equitable agreement, we do have concerns that the ongoing turn to tariffs will function as a brake on the U.S. economy. This comes in two ways.

The first is that tariffs are a tax. Higher tariffs on Chinese goods are eventually going to be transferred from importers to consumers. While this is likely to function as a brake on the U.S. economy, the impact is not likely to be noticeable in the immediate term due to the strong growth fostered by the Trump tax cuts and deregulation. First quarter U.S. economic growth was an unexpectedly strong 3.2% and unemployment is now around 3.6%, two impressive numbers by any standard. The U.S. remains a growth engine in the global economy – at least through 2019. But as tariff costs filter into the general economy, a number of sectors will find the business environment more challenging, including retail, warehousing and transportation. Moreover, Chinese counter-tariffs and trade actions will continue to hurt the agricultural sector.

As we mentioned at the beginning of the briefing, the second economic impact on the U.S. is that U.S. corporations get a large share of their profits from overseas.

The U.S. economy has demonstrated considerable strength, making it the most powerful growth factor in the global economy. This is not to say that there are not problems – the budget deficit has widened; government debt to GDP is substantial, and both Republicans and Democrats both seem to like the idea of spending more money. That stated, the Trump tax package and deregulation have boosted economic growth, while some sectors have benefited from protectionist trade policies. The challenge ahead is to manage the trade issue with an eye to economic growth. Using tariffs against China as a weapon against that country’s unfair trade practices is one thing; continuing to wage trade wars with a widening list of countries (which would be done over autos with Europe and Japan) runs the risk of boomeranging on the U.S. economy. All of this will certainly be taken into consideration by the U.S. Federal Reserve. If the tariffs become long-term and slow growth, chances of a rate cut are likely to increase. But much will depend on how the central bank sees the economic direction and how much the consumer pulls back. We see rates staying where they are now through much of the year, but trade policy will increasingly be felt as the year enters its second half.

U.S. Stock prices of companies with China exposure over the past month – Stock Prices $

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<thead>
<tr>
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<th>April 16</th>
<th>May 16</th>
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<tbody>
<tr>
<td>Apple</td>
<td>201.35</td>
<td>190.92</td>
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<tr>
<td>Boeing</td>
<td>377.02</td>
<td>345.81</td>
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<tr>
<td>Caterpillar</td>
<td>140.13</td>
<td>127.34</td>
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<tr>
<td>Deere</td>
<td>163.44</td>
<td>144.85</td>
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<tr>
<td>Intel</td>
<td>57.25</td>
<td>45.61</td>
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<tr>
<td>Macy's</td>
<td>24.57</td>
<td>21.69</td>
</tr>
<tr>
<td>Nike</td>
<td>87.64</td>
<td>84.01</td>
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<tr>
<td>Tesla</td>
<td>270.09</td>
<td>231.92</td>
</tr>
<tr>
<td>WalMart</td>
<td>102.72</td>
<td>99.90</td>
</tr>
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Source: Yahoo Finance
### Major Geo-economic and Geopolitical Risks

<table>
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<th>Rank</th>
<th>Risk</th>
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| 1.   | **Trade Wars (Risk: Up)**<br>(Countries involved: China, the United States, and Europe)  
      The worst-case scenario is that U.S.-China trade relations remain in a state of elevated tariffs, with sides refusing to find a compromise. According to the IMF, an extended trade war would translate to a shedding of about 1% of the workforce in the U.S. agricultural and transportation sectors and 5% in Chinese manufacturing (excepting electronics), including furniture and jewelry. Growth in both economies would cool. The fall-out elsewhere would be profound on commodity exporters (copper prices have been down) and export-driven economies, like Germany’s and Italy’s. If the Trump administration were to add in tariffs against European auto imports, the EU would retaliate. All of this must be balanced with domestic considerations — re-election prospects for President Trump in 2020 and the risk of a major slowdown in the Chinese economy, something that President Xi and the Communist Party leadership worry about. Although we see a deal of some sort in the months ahead, the trade picture and its threat to global economic growth remain at an elevated state. |
| 2.   | **Persian Gulf Tensions (Risk: Up)**<br>(Countries involved: Iran, the U.S., Saudi Arabia, the UAE, Yemen, China and Russia)  
      Escalating U.S.-Iranian tensions, attacks on Persian Gulf shipping, and drone attacks on the Saudi East-West oil pipeline (claimed by Iranian-backed Yemeni rebels) have pushed up geopolitical risk in the Persian Gulf. The situation has not been made any better by the rumor that the Trump administration has updated plans to send more than 100,000 troops to counter Iran if necessary. This was quickly denied by the Trump administration, but U.S. economic sanctions are hurting Iran's economy. This has left Tehran in a difficult situation; the government has substantial cost outlays throughout the Middle East (through its various military alliances in Syria, Lebanon and Yemen) and its ability to provide a basic form of guns and butter (strong military and growing domestic economy) is coming under considerable stress – again. We expect this story to get worse before it gets better. |
3. North Korea  
(Risk: Up)  
(Countries involved: North Korea, U.S., China, Russia, South Korea and Japan)  
Despite earlier efforts by the Trump administration and the Moon government in South Korea to normalize the Korean Peninsula, it appears that North Korea's Kim Jong-un has little intention of surrendering his nuclear weapons. The Trump administration is keeping the door open to the Kim regime. At the same time, the U.S. has maintained economic pressure, with the most recent example of this being the seizure of the Wise Hornet, a North Korean cargo ship, now being held in American Samoa. The U.S. claims the ship is being used to export coal and heavy machinery in violation of sanctions imposed on North Korea over its nuclear arms program. North Korea protested the action. The drama over the ship came in the wake of North Korea's early May testing of ballistic missiles off its eastern coast. The sticking point for another round of negotiations between President Trump and Kim remains the North Korean demand of lifting U.N. sanctions before any further steps toward denuclearization. Kim has also sought to improve relations with two other key players in Northeast Asia, visiting both China and Russia.

4. Brexit  
(Risk: Modestly up)  
Political uncertainty has grown in the UK, with Brexit being the core cause. Although the May government was able to get the EU to extend the deadline for an exit to October 31, 2019 (allowing for a deal to be finally clinched by all parties, in particular, the UK parliament), the UK's political system seems to stumble from one crisis to another. The next round of upheaval is likely to come from the May 23rd EU parliamentary elections. The ruling Conservative Party clings to office by keeping Prime Minister Theresa May in office, despite her major losses in votes on a Brexit deal. If she resigns, the Conservatives will be thrown into a leadership fight and might be forced to hold a general elections, which they are not likely to fare well. At the same time, the upcoming EU elections show that the Brexit Party, led by Nigel Farage and favoring a no deal outcome with the EU, is surging in the polls, his fledgling party at 34% of potential voter support, ahead of the combined Conservative and Labour polling. Based on opinion polls, the Conservatives could finish the EU parliamentary elections in fourth place, behind Brexit and Labour as well as the Liberal Democrats. Adding to the uncertainty, the Prime Minister had indicated that she will introduce a new Brexit bill to parliament in early June. The stage is set for the next parliamentary elections to see the two transitional parties, the Conservatives and Labour, lose ground to the Brexit Party and the Liberal Democrats.

5. Italy  
(Risk: Modestly up)  
(Countries involved: Italy)  
Italy's EU parliamentary elections could be used to reconfigure the Italian political scene. The Five Star Movement-League government has defied expectations in that a left-far right government has lived as long as it has. Indeed, it survived most of 2018 and into 2019. However, the May elections may give the League, under Matteo Salvini, a chance to finish in a stronger position than the last vote. If so, Salvini may take the League out of the coalition government under Prime Minister Giuseppe Conte and form a new government with the rightist Forza Italia and the former fascist party, Brothers of Italy. Much will depend on the strength of the League's showing in May, but Conte will have a tough time holding Italy's increasingly fractious government together. Moreover, the Italian economy remains weak (though it did grow in Q1 2019 pulling the country out of a recession), in bad need of structural reforms, and is likely to see a testing of EU budget limits (as it is possible that the Italian government's deficit to GDP ratio could be in excess of 3.0% for the year). Look for more drama from Italy in the months ahead. We believe that Italy's sovereign ratings continue to be under pressure and the risk of downgrades by the major rating agencies cannot be ruled out, especially if the budget situation deteriorates further and the export sector is hurt by further declines in global trade on which Italy is dependent for growth.
6. EU Parliamentary Elections  
(Risk: Modestly up)  
(All EU members)  
The May 23rd elections are important in that they have become a battle between the traditional pro-EU parties of the center-left, center and center-right versus the nationalist-populist parties, which are also considered Eurosceptic. Although a major victory by the Eurosceptic parties is not likely, a major tilt to the nationalist right would likely have ramifications within the 28-country member bloc.

7. Venezuela  
(Risk: Modestly up)  
(Counties involved: Venezuela, U.S., China, Russia, the Caribbean and Latin America)  
Venezuela remains in a state of political polarization and economic collapse. The failed attempt by the pro-democratic forces of the National Assembly’s President Juan Guaidó to oust President Nicolás Maduro has further broken down law and order in the country. Pressure from the outside remains acute for Maduro to step down. Although he maintained the support of his Cuban security advisers and Russia and China, there is talk about finding an exit for the dictator. Greater pressure has been brought on Cuba, both through a tightening of U.S. economic measures (helped push the Caribbean country into food rationing) and approaches by European and Latin American countries to use Cuba’s “good offices” to facilitate a change of government in Caracas. What next? We suspect that Maduro’s external supporters have concerns that they are betting on the wrong horse in Venezuela and a negotiated change of government would be better than waiting for a full-blown civil war. That said, this drama still has time to play out, leaving Venezuela as a major flashpoint in an emerging New Cold War between the U.S. on one side and China and Russia on the other.

8. Federal Reserve Fumble  
(Risk: The same)  
(Countries involved: U.S.)  
The Federal Reserve is caught between the wishes of the Trump White House for lower interest rates to fuel faster economic expansion and a tradition of caution in terms of inflation. As an institution, the U.S. central bank is very deliberative and data driven, which means that its actions are less guided by the economic hopes of the presidency or Congress, but by a small group of men and women who seek to get policy just right – neither economic growth too fast or too slow. The Fed has also made mistakes in the past and a fair share of U.S. recessions in the 20th century relate back to its missteps. However, the Fed remains a well-respected institution, especially as it is meant to be apolitical. The risks for the Fed have multiplied during the Trump years: the President wishes to bend it to his will, much like his counterparts in Turkey and Russia have done (not a good policy option considering the Fed’s importance in backing up the confidence and value of the U.S. dollar), while the central bank’s policy options for the next slowdown have not recovered from the 2008 financial crisis.
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