ATLANTIC
FINANCIAL GROUP

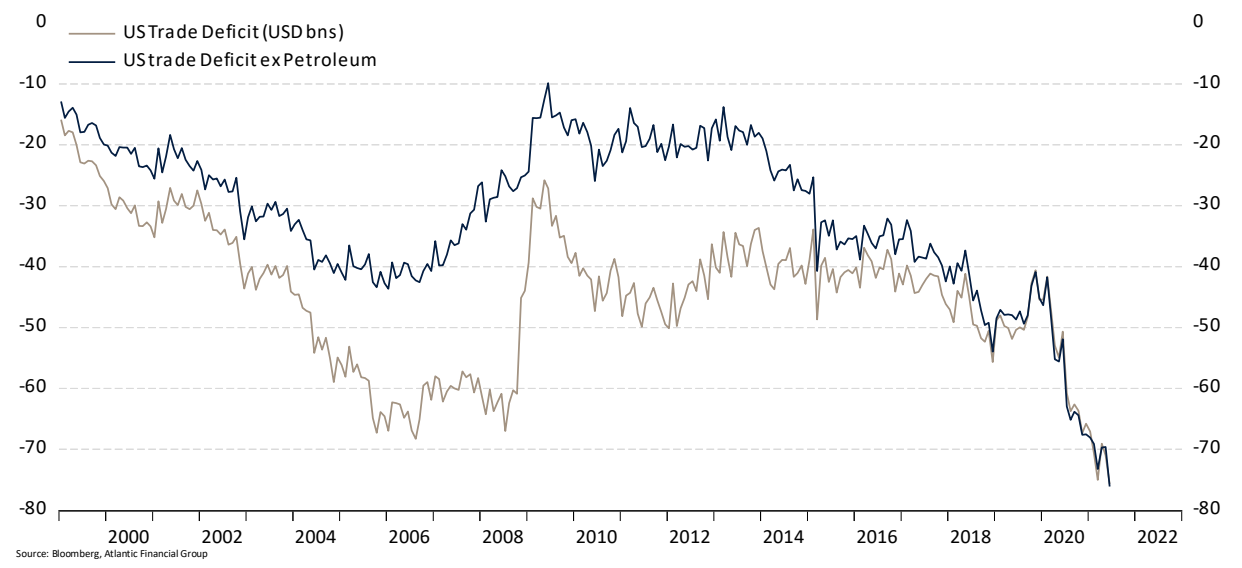
Weekly Investment Focus

16 August 2021

"THE QUEST FOR LOST COMPETITIVENESS"

- US trade deficit hits all-time high
- It is no longer because of oil imports but advanced technology products
- This external imbalance reflects the loss of US competitiveness
- As long as this situation persists, it will increase the downward pressure on the dollar

CHART OF THE WEEK: "The US trade deficit is not linked to the oil bill anymore"



ECONOMIC & FOREX MARKET ANALYSIS

The publication received little coverage but the US trade deficit widened to a record: -$429 billion since 1st January, including -$76 billion in June. It represents 6.5% of Gross Domestic Product (GDP). **Should we be concerned?** Readers who are comfortable with the concept of trade deficit or who want to get straight to the heart of the matter can go to section B. Those who want to know the impact on the exchange rate should go to section C.

A. How is a trade deficit generated? A more complex question than it seems.

The trade balance of a country refers to the difference between the value of exported and imported goods and services. If it is positive, the country has a surplus. If it is negative, it is called a trade deficit. At first glance, this is quite simple. A trade surplus suggests a country in good health, in a position of competitive dominance. On the other hand, a deficit suggests a declining economy, suffering in the international market. However, economic terms are misleading: the use of positive and negative qualifiers is correct from an accounting point of view, but it does not imply anything obvious about the health of the economy. **Economists are keen to say that, like cholesterol, there are good and bad trade deficits.**

The trade deficit is the result of a combination of many factors, **which can be divided into four main categories, two good and two bad:**

1- **Demand exceeds production capacity**
When a country grows rapidly or becomes richer, its domestic demand for certain consumer and producer goods surges, and with it, its imports. Thus, a trade balance in the red does not necessarily mean a weak economic situation. On the contrary. This phenomenon helps to explain why the United States, whose economic growth is more dynamic than that of the Eurozone in general, and of Germany in particular, suffers from a colossal trade deficit compared to these countries.

2- **An improvement in price competitiveness**
By buying basic resources or intermediate goods abroad, which are cheaper than at home, companies increase their profitability. They can thus lower costs or improve the quality of their production and, ultimately, increase their sales and margins. For example, when General Motors imports its brakes from Canada, the American car manufacturer generates a trade deficit for the United States, but this import helps to produce cheaper cars and sell more. Similarly, when Apple imports the skeleton of its computers from Asia, it gains in price competitiveness, but the design, software and marketing remain Made in the USA, developed and produced by American workers whose wages can rise thanks to the savings the company makes on Asian components. Other multinationals, particularly in technology and pharmaceutical sectors, choose to locate their headquarters in Ireland to benefit from attractive tax treatment and lower production costs. These companies also generate a trade deficit.

3- **An unfavourable competitive position in international markets**
On the other hand, in some cases, a trade deficit can be a sign of economic weakness and, in particular, of de-industrialisation. Foreign production is so cheap or of such high quality that imports supplant domestic production, thus contributing to the destruction of jobs and the increase of the country's unemployment rate.

4- Excessive price increases

Finally, the external trade imbalance may be caused by a price surge or a significant appreciation of the local currency. In both cases, domestically produced goods and services will appear relatively expensive in international comparison, dampening exports and facilitating imports. These situations are likely to be temporary as the slowdown in sales will tend to reduce inflationary pressure or lead to a depreciation of the exchange rate.

In any case, national accounting states that the trade deficit is a reflection of another imbalance, X-M=S+(T-G)-I, **between savings and investment.** If an economy has a trade deficit, it is because it invests more than it saves. It finances its excess investment by using part of foreign savings: it borrows from the rest of the world. The question that arises is: how are the capital inflows used? If they are used to finance productive investments, the deficit will be easily redeemable. On the other hand, if the country is living beyond its resources by financing unprofitable projects or companies, this imbalance must be quickly eliminated. On this point, it is interesting to note that during the 1990s, the United States attracted up to a quarter of all foreign investment. While the flows are still very significant, part of the world's savings are now also going to Europe, China or the emerging markets.

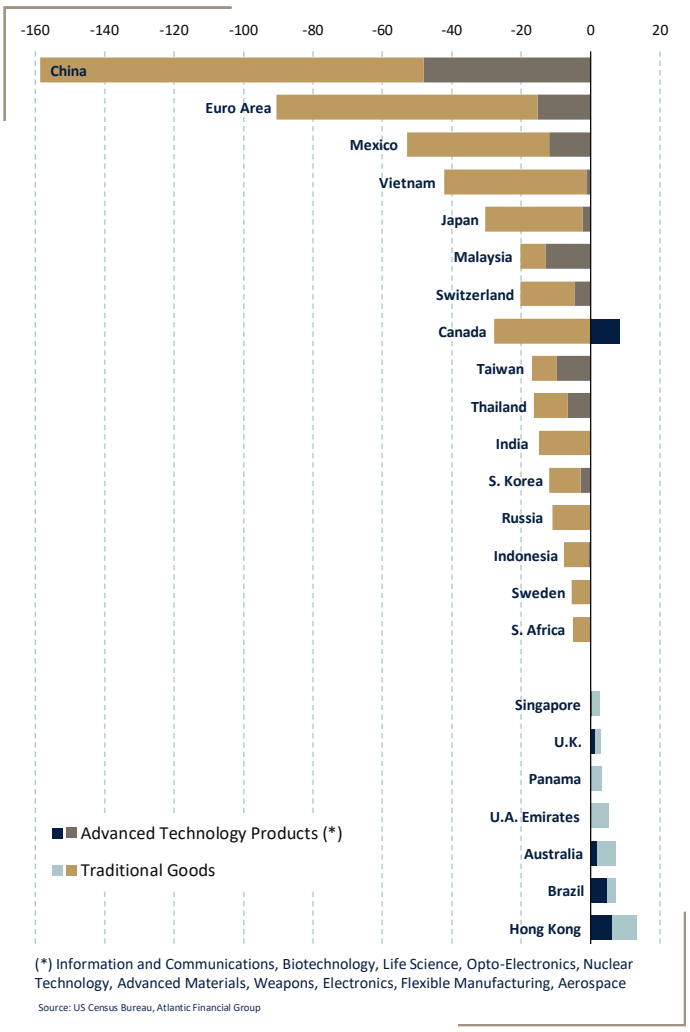
During his term in office, Donald Trump sought to reduce the US trade deficit, in particular by raising tariffs. His administration never succeeded because it was confronted with the accounting reality. Restoring the US trade balance requires increasing private savings. On the other hand, Donald Trump was taking measures to encourage companies to invest and households to spend. The Biden administration is facing the same problem. **The challenge is to rebalance US trade without increasing savings and generating an economic slowdown in the US... and, by ricochet, at the global level.**

B. What is special about the US trade deficit? Should investors be concerned?

During the first six months of the year, the US trade balance showed a deficit of -$429 billion. Historically, and this is once again the case this year, **this deficit is mainly due to trade in goods** (-538 billion) **while services show a very clear positive balance** (+109 billion). Unsurprisingly, China, which Donald Trump has designated as the usual suspect, accounts for a third of the imbalance (see Fig. 2). Next comes the Eurozone, led by Germany and also Ireland, France and Italy. Between the two big neighbours, Mexico and Canada, are Japan, Malaysia, Switzerland and the world's new factory: Vietnam (see Weekly Investment Focus of 5 July 2021). At the other end of the scale, and this is worth noting because it is not often mentioned, the United States exports more than it imports to Hong Kong, Brazil, Australia and the great European partner, the United Kingdom.

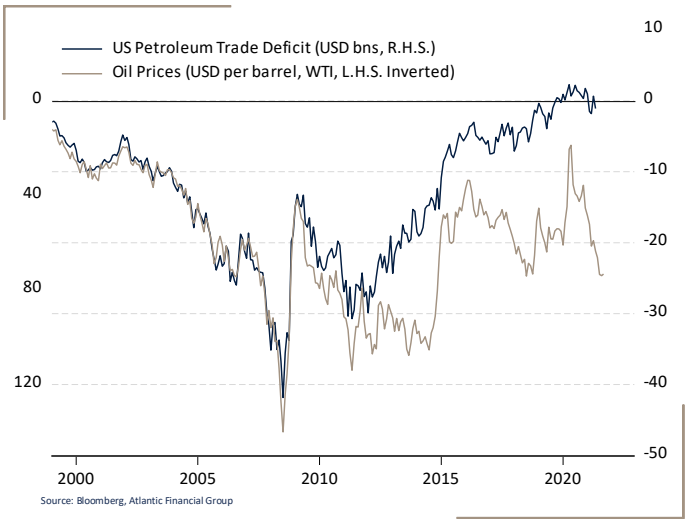
At this stage of the analysis, it is interesting to break down the deficit by category of goods. **Contrary to past experience and popular belief, if the US trade deficit is growing, it is not because the oil bill is increasing.** On the contrary, it is exclusively linked to non-energy goods (see Chart of the week). At the end of the 2000s, after the Great Financial Crisis (GFC), under the impetus of George W. Bush and then under the presidency of Barack Obama, the United States supported shale oil production. The results are convincing, since the annualised oil deficit has gone from 504 billion in 2008 to a surplus of +24 billion in 2020 (see Fig. 3). Today, except for the mismatch between oil extracted and oil consumed, the US is self-sufficient in fossil fuels. Without this increase in production capacity and at current oil prices, the US oil deficit would be around $300 billion annualised, adding to the overall bill.

Fig. 2 – Trade balance in goods by country
(in billions of dollars, from January to June 2021)



Since the US trade deficit is not in services or oil, where does it come from? Unfortunately, the United States does not only import low value-added products such as basic materials, fruit and vegetables or clothing from emerging markets. The world's leading power is short of automobiles, electrical and office machinery, telecom equipment and also pharmaceutical products (see Fig. 4). **Overall, advanced technology products account for 18% of the current trade deficit. This is a lot.** Reflecting this picture, the US is a net exporter of low value-added products such as cereals, feeding stuff for animals, and plasticsin primary forms. Fortunately, it also exports transport equipment and, as mentioned above, services.

Fig. 3 - Oil prices and US oil deficit



Joe Biden's administration is fully aware of the situation. The President has just signed an executive order that sets the objective of producing 40% to 50% of electric or hybrid vehicles by 2030 in the United States. Of course, Tesla is the undisputed leader in this segment, but this decree aims to give a new impetus and

financial incentive to the three major historical producers in Detroit, the cradle of the American car industry, who have been slow to convert: General Motors, Ford but also Chrysler which is now in the fold of Stellantis. The message has been heard across the oceans, as BMW, Honda, Volkswagen and Volvo, often considered more advanced in the electric field than the big names from Detroit, have applauded the initiative (see Weekly Investment Focus of 9 August 2021). To be effective, this executive order will have to be followed by other regulations, notably on fuel consumption. According to the International Energy Agency, electric vehicles accounted for only 2% of new car sales in the United States in 2020, compared with 10% in Europe. **By producing electric cars, the Americans will kill three birds with one stone: they will green their car fleet, reduce their trade deficit and create jobs.** The city of Detroit has lost its manufacturing jobs over the decades, causing the unemployment rate to rise. The city was even declared bankrupt in 2013. The new Stellantis Mack assembly complex is the first new auto plant in Detroit in 30 years. The group has enough to employ nearly 5,000 people, including more than 2,000 new employees. **The Biden administration will then have to support its farmers, re-industrialise the country not only to be able to manufacture electrical and office machines but also to produce medicines.**

Fig. 4 - Trade balance in goods by category
(in billions of dollars, from January to June 2021)

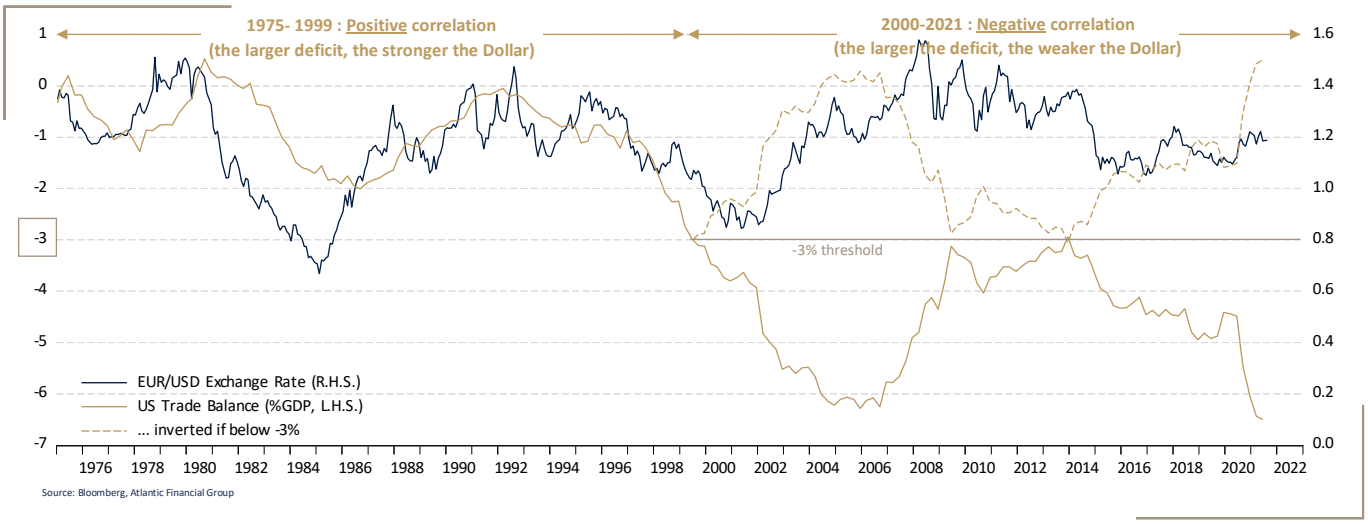
Source: US Census Bureau, Atlantic Financial Group

C. Trade deficit and exchange rate, a two-way relationship

In the financial markets, the trade deficit is important. It is, for example, a variable in our econometric models to forecast the evolution of the dollar. It is not the most influential factor, but it is significant. Usually, economists use the evolution of the exchange rate to calculate its impact on exports and imports. The more undervalued a currency is, the more the terms of trade improve and the more the trade balance increases. We use this relationship in this sense but also in the opposite manner.

As described in section A, a trade deficit can mean that domestic demand exceeds production capacity when the economy is booming. In this case, as in the period from 1975 to 1999, a trade deficit goes hand in hand with a capital inflow to the United States and, ultimately, an appreciation of the dollar (see Fig. 5). On the other hand, **if the trade deficit becomes too large,** as has been the case since 2000 when it has exceeded -3% of GDP, **investors believe that it is the consequence of a loss of international competitiveness. In this case,** capital drains away, the relationship is reversed and **the dollar falls as the deficit increases** (see Fig. 5).

Fig. 5 - US trade deficit and EUR/USD exchange rate



Conclusion:

The trade deficit is not the easiest economic variable to grasp. This imbalance is not a problem in itself, even if economists will always tend to prefer the equilibrium between deficits and surpluses. The US deficit has multiple causes, but it is not linked to services or oil. It will persist as long as Americans live beyond their resources and import advanced technology products, cars, electrical and office machines and medicines. Joe Biden seems to be fully aware of this and is trying to address it in stages, but he will be constrained, like his predecessors, by his unwillingness to increase savings in the US and slow down global economic growth. As long as this period of excessive trade deficits persists, the dollar will be under pressure. It is not the most influential variable on the exchange rate, but it plays a significant role.

RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2021 Year-to-Date (%)	2020 (%)	2019 (%)
Equities							
World (MSCI)	736.0	63.43	0.7%	1.5%	15.3%	16.9%	27.3%
USA (S&P 500)	4 468	66.27	0.8%	2.4%	20.0%	18.4%	31.5%
USA (Dow Jones)	35 515	61.84	0.9%	1.9%	17.3%	9.7%	25.3%
USA (Nasdaq)	14 823	58.36	-0.1%	1.0%	15.5%	45.1%	36.7%
Euro Area (DJ EuroStoxx)	473.9	69.75	1.3%	3.8%	21.6%	0.8%	27.3%
UK (FTSE 100)	7 219	62.77	1.7%	1.9%	14.5%	-11.4%	17.2%
Switzerland (SMI)	12 464	73.91	2.4%	3.3%	19.7%	4.3%	30.2%
Japan (Nikkei)	27 523	49.20	0.6%	-2.6%	2.8%	18.3%	20.7%
Emerging (MSCI)	1 281	39.93	-0.8%	-4.1%	0.6%	18.8%	18.8%
Brasil (IBOVESPA)	121 194	39.37	-1.3%	-5.4%	1.8%	2.9%	31.6%
Russia (MOEX)	3 873	60.07	1.8%	0.9%	22.5%	14.8%	38.4%
India (SENSEX)	55 625	76.04	2.1%	5.2%	17.0%	17.2%	15.7%
China (CSI)	4 932	45.41	0.5%	-3.5%	-3.7%	29.9%	39.2%
Communication Serv. (MSCI Worl	115.99	54.74	0.7%	-0.2%	16.1%	24.2%	25.1%
Consumer Discret. (MSCI World)	403.6	48.58	0.3%	-1.8%	7.0%	37.0%	28.2%
Consumer Staples (MSCI World)	282.1	61.21	1.6%	1.4%	7.0%	8.8%	22.4%
Energy (MSCI World)	172.9	47.58	0.4%	-2.6%	23.3%	-27.7%	13.9%
Financials (MSCI World)	150.0	68.39	1.8%	4.4%	23.5%	-3.1%	24.1%
Health Care (MSCI World)	362.1	64.89	0.8%	3.0%	15.1%	15.4%	23.3%
Industrials (MSCI World)	331.8	62.15	1.3%	1.6%	15.8%	11.8%	27.2%
Info. Tech. (MSCI World)	527.6	58.99	-0.6%	1.4%	16.8%	46.2%	47.5%
Materials (MSCI World)	378.9	61.02	1.9%	3.0%	17.8%	21.6%	20.8%
Real Estate (MSCI World)	227.1	55.12	0.4%	0.4%	18.1%	-5.7%	24.0%
Utilities (MSCI World)	158.0	67.93	1.7%	4.2%	6.7%	4.8%	22.3%
Bonds (FTSE)							
USA (7-10 Yr)	1.26%	53.92	0.1%	1.2%	-1.7%	9.3%	7.4%
Euro Area (7-10 Yr)	-0.16%	66.32	0.1%	1.2%	-0.2%	4.5%	6.7%
Germany (7-10 Yr)	-0.48%	65.93	0.1%	1.4%	-0.8%	3.0%	3.0%
UK (7-10 Yr)	0.57%	53.45	0.3%	0.3%	-2.7%	5.4%	4.8%
Switzerland (7-10 Yr)	-0.40%	64.21	0.1%	0.9%	0.0%	0.4%	2.0%
Japan (5-10 Yr)	0.01%	49.20	-0.1%	0.0%	0.3%	-0.1%	0.0%
Emerging (5-10 Yr)	4.37%	55.13	0.1%	0.0%	-0.9%	5.2%	13.3%
USA (IG Corp.)	2.00%	52.54	0.4%	0.1%	-0.4%	9.9%	14.5%
Euro Area (IG Corp.)	0.18%	65.74	0.0%	0.5%	0.7%	2.8%	6.2%
Emerging (IG Corp.)	4.17%	52.82	0.4%	-0.5%	0.5%	8.1%	13.1%
USA (HY Corp.)	4.11%	46.66	-0.1%	-0.2%	3.6%	7.1%	14.3%
Euro Area (HY Corp.)	2.92%	82.89	0.0%	0.5%	3.8%	2.3%	11.3%
Emerging (HY Corp.)	6.46%	51.65	0.3%	-0.5%	0.5%	4.3%	11.5%
World (Convertibles)	448.2	50.51	-0.2%	0.0%	4.7%	38.8%	17.3%
USA (Convertibles)	605.4	50.10	-0.4%	0.2%	5.2%	54.5%	22.8%
Euro Area (Convertibles)	4 196	53.23	-0.2%	0.0%	2.0%	6.1%	7.6%
Switzerland (Convertibles)	187.8	69.94	0.1%	0.3%	0.5%	0.5%	2.4%
Japan (Convertibles)	197.9	48.08	-0.2%	-0.8%	1.8%	2.8%	2.6%
Hedge Funds (Crédit Suisse)							
Hedge Funds Indus.	713.5	75.61	n.a.	0.3%	6.3%	2.5%	9.3%
Distressed	940.9	72.83	n.a.	-0.9%	9.5%	1.5%	1.4%
Event Driven	788.2	77.19	n.a.	-0.5%	9.6%	3.1%	8.2%
Fixed Income	390.5	74.28	n.a.	0.6%	4.4%	2.2%	6.1%
Global Macro	1 168.6	70.95	n.a.	0.1%	6.3%	2.0%	10.4%
Long/Short	914.4	65.74	n.a.	1.4%	6.8%	3.6%	12.2%
CTA's	338.4	65.69	n.a.	0.9%	7.2%	-3.2%	9.0%
Market Neutral	285.8	61.73	n.a.	1.5%	4.6%	-0.1%	1.6%
Multi-Strategy	687.6	74.58	n.a.	1.1%	5.5%	1.4%	7.3%
Volatility							
VIX	15.45	41.92	-4.3%	-9.8%	-32.1%	65.1%	-45.8%
VSTOXX	15.80	39.80	-11.7%	-12.2%	-32.4%	67.5%	-41.5%
Commodities							
Commodities (CRB)	564.4	n.a.	0.7%	0.9%	27.2%	10.5%	-1.9%
Gold (Troy Ounce)	1 773	44.95	2.5%	-2.1%	-6.6%	24.9%	18.3%
Oil (WTI, Barrel)	68.44	43.84	3.0%	-9.1%	41.1%	-20.5%	34.5%
Oil (Brent, Barrel)	69.40	40.26	-0.2%	-9.1%	37.1%	-23.0%	24.9%
Currencies (vs USD)							
USD (Dollar Index)	92.534	51.35	-0.4%	-0.2%	2.9%	-6.7%	0.2%
EUR	1.1785	45.18	0.4%	-0.2%	-3.5%	9.7%	-2.2%
JPY	109.42	57.10	0.8%	0.6%	-5.6%	5.3%	0.9%
GBP	1.3849	48.95	0.0%	0.6%	1.3%	2.8%	3.9%
AUD	0.7339	42.23	0.1%	-0.8%	-4.6%	9.5%	-0.4%
CAD	1.2541	46.48	0.3%	0.6%	1.5%	1.8%	5.0%
CHF	0.9163	48.44	0.4%	0.3%	-3.4%	9.8%	1.4%
CNY	6.4774	48.00	0.1%	0.0%	0.8%	6.7%	-1.2%
MXN	19.914	53.29	0.8%	-0.1%	0.0%	-4.9%	3.8%
EM (Emerging Index)	1 723.6	41.88	-0.4%	-0.2%	0.2%	3.3%	3.1%

Source: Bloomberg, Atlantic Financial Group

Total Return by asset class (Negative \ Positive Performance)

DISCLAIMER

This document is issued by Atlantic Financial Group (hereinafter “Atlantic”). It is not intended for distribution, publication, or use in any jurisdiction where such distribution, publication, or use would be unlawful, nor is it aimed at any person or entity to whom it would be unlawful to address such a document.

This document is provided for information purposes only. It does not constitute an offer or a recommendation to subscribe to, purchase, sell or hold any security or financial instrument. It contains the opinions of Atlantic, as at the date of issue. These opinions and the information herein contained do not take into account an individual’s specific circumstances, objectives, or needs. No representation is made that any investment or strategy is suitable or appropriate to individual circumstances or that any investment or strategy constitutes a personal recommendation to any investor. Each investor must make his/her own independent decisions regarding any securities or financial instruments mentioned herein. Tax treatment depends on the individual circumstances of each client and may be subject to change in the future. Atlantic does not provide tax advice. Therefore, you must verify the above and all other information provided in the document or otherwise review it with your external tax advisors.

Investment are subject to a variety of risks. Before entering into any transaction, an investor should consult his/her investment advisor and, where necessary, obtain independent professional advice in respect of risks, as well as any legal, regulatory, credit, tax, and accounting consequences. The information and analysis contained herein are based on sources considered to be reliable. However, Atlantic does not guarantee the timeliness, accuracy, or completeness of the information contained in this document, nor does it accept any liability for any loss or damage resulting from its use. All information and opinions as well as the prices, market valuations and calculations indicated herein may change without notice. Past performance is no guarantee of current or future returns, and the investor may receive back less than he invested. The investments mentioned in this document may carry risks that are difficult to quantify and integrate into an investment assessment. In general, products such as equities, bonds, securities lending, forex, or money market instruments bear risks, which are higher in the case of derivative, structured, and private equity products; these are aimed solely at investors who are able to understand their nature and characteristics and to and bear their associated risks. On request, Atlantic will be pleased to provide investors with more detailed information concerning risks associated with given instruments.

The value of any investment in a currency other than the base currency of a portfolio is subject to the foreign exchange rates. These rates may fluctuate and adversely affect the value of the investment when it is realized and converted back into the investor’s base currency. The liquidity of an investment is subject to supply and demand. Some products may not have a well-established secondary market or in extreme market conditions may be difficult to value, resulting in price volatility and making it difficult to obtain a price to dispose of the asset. If opinions from financial analysts are contained herein, such analysts attest that all of the opinions expressed accurately reflect their personal views about any given instruments. In order to ensure their independence, financial analysts are expressly prohibited from owning any securities that belong to the research universe they cover. Atlantic may hold positions in securities as referred to in this document for and on behalf of its clients and/or such securities may be included in the portfolios of investment funds as managed by Atlantic.