Northern Trust

WEEKLY ECONOMIC COMMENTARY

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- **Reflections From a Whirlwind Tour of Asia**
- **Roads and Ports are Pathways to U.S. Prosperity**

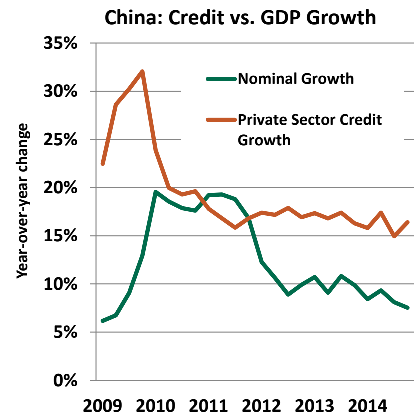
The Lazy Susan rotated slowly, bring its cargo closer. The location was Taipei, and a group of partners and clients were celebrating our association over lunch. Our hosts had included chòu dòufu (臭豆腐) on the menu, a particularly odiferous creation that was heading in my direction. Several of our number turned aside as the dish passed by, unable to cope with the aroma.

The platter stopped in front of me, and the group awaited my reaction. Instead of spinning the carousel away quickly, I dug in. The texture and taste were unlike anything on Western menus, but ultimately very interesting. After everyone else had been required to take a sample, I went back for a second helping.

Westerners who travel in Asia confront an environment that can be far from familiar. The region's sights, sounds and sensibilities are quite different from what we are used to. But if you are willing to dig in, you can enhance your understanding of the other side of the world.

I tried to approach last week's meetings in Asia in that spirit, and updated understandings did emerge. Following is a summary of insights that accrued prior to, during and since the journey.

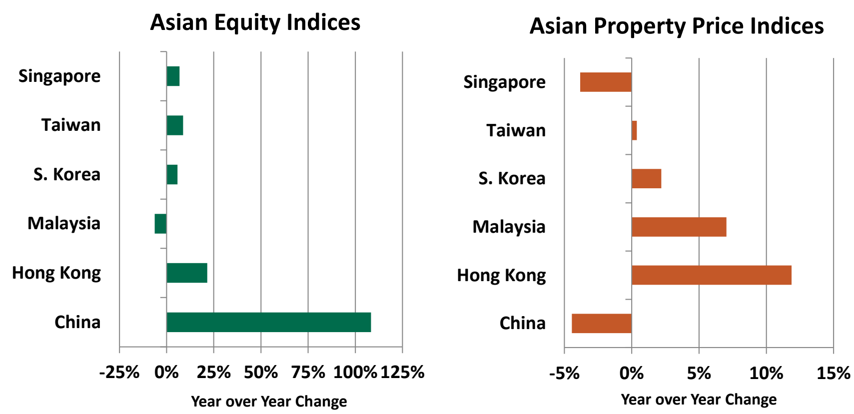
- China is working hard to balance the need for short-term economic stimulus and long-term economic restructuring. The country's economy is decelerating, and the People's Bank has responded with measures to stimulate credit. But leverage in the Chinese economy has been expanding rapidly, and will one day need to be rationalized.



Source: Haver Analytics

Many countries in the Asia-Pacific region are reliant on demand from China, so any downward shift is a source of concern. With so many sellers in the world, the question remains: who is going to be a buyer? China would certainly like to find a better balance between production and consumption. (Consumption is only about 40% of Chinese gross domestic product (GDP), as compared to almost 69% in the United States.) But economic uncertainty and retirement obligations underpin a strong culture of saving in Asia, and the region's system of consumer credit is nowhere near the scale seen in Western countries. So the transition to higher rates of spending may take time.

- The deep pools of saving in China have a profound impact on the region's asset markets. Equity and property have both been the focus of immense investor interest.



Sources: Bloomberg, Haver Analytics

Rapid rises in Chinese asset prices present systemic risks.

The equity rallies in Hong Kong and China have been attributed, in part, to new linkages constructed between stock exchanges in those centers. The correction in Chinese real estate markets has also played a role; investors no longer see the same promise in property, and have been shifting to stocks instead.

A number of people I have spoken with over the past month are uncomfortable with the doubling of Chinese equity indices amid slowing economic performance. Perhaps I am old-fashioned in thinking that asset prices should be moored to inherent value, at least over the long run. But those calling for a correction could be wrong for a very long time before being proved right.

- There was a note sitting on the desk of the hotel room in Beijing, politely informing visitors that a series of websites would be unavailable for access. Included were Google, *The New York Times*, Facebook, Bloomberg and Twitter.

  Locals find this less troubling than others might. When it comes to the internet, they seemed more excited about online markets like taobao, which are transforming the retail sector in Asia. The small shops that make so many old cities charming are at considerable risk in the years ahead.

- Many countries around the world have sovereign wealth funds, which are professionally managed and have produced strong results. But a scandal unfolding in Malaysia illustrates a darker side to government-directed capital pools. Funds from a Malaysian sovereign wealth fund are apparently not well accounted for, and a *bon vivant* with ties to the prime minister is at the center of the controversy.

Countries that are transparent and appropriate funds properly are more attractive to businesses and investors. Governments that do not operate with rectitude are vulnerable to popular revolt. The recent lessons of Brazil and Nigeria are two unfortunate cases in point.

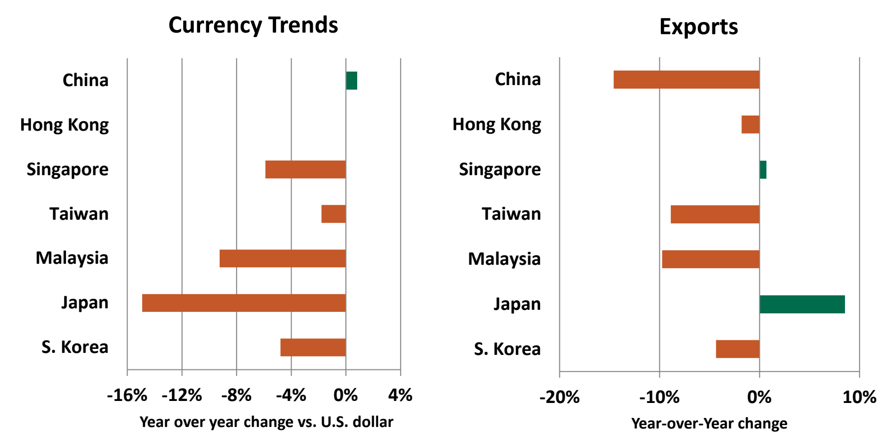
I had a long conversation with one of my partners in Singapore about Lee Kwan Yew, who is considered the father of the Republic of Singapore. Lee, who passed away earlier this year, is revered in his home country as a visionary who designed an economic and social system that enabled Singapore to become a regional power over the past 50 years.

It will be challenging to implement the Singapore model on a large scale.

Other countries in the region have endeavored to adopt parts of the Singapore model as they plot their paths to prosperity. But among the more difficult elements to import is the honesty with which Lee went about his business. He paid government officials well, so they would not be as susceptible to outside influence. And he enforced ethics rules aggressively.

Chinese President Xi Jinping has established an anticorruption campaign as a key element of his platform. But this will be challenging: as a country's riches expand, so does temptation.

- Central banks in several Asian nations have been pursuing policies aimed at weakening their currencies to enhance their trade positions. Most, however, have seen their exports continue to shrink over the past year.



Source: Haver Analytics

The problem is that when many players are following the same strategy, it is very difficult for anyone to win. The two participants who have chosen not to compete have different motivations. Hong Kong has kept its dollar pegged to the U.S. dollar since 1972, in an effort to give the local currency added strength. Hong Kong's trading relationships do not seem to have been diminished by this association.

China's currency strategy has been focused much more on the long-term. The International Monetary Fund (IMF) recently declared the renminbi (RMB) fairly valued, undercutting American claims that China is manipulating its currency. The IMF has also indicated that the RMB is on track for addition to the basket of currencies afforded Special Drawing Rights, which would be significant recognition of the currency's standing.

The RMB is gaining ground as a global currency, but still has a long way to go.

Over time, China is hoping that the RMB will gain respect as one of the world's leading reserve currencies. China still has much to do before it reaches this aim: the RMB still does not float freely on world markets, capital cannot move fluidly into and out of China, and the pool of assets denominated in RMB is shallow.

But to preserve the important progress already made, the People's Bank may be reluctant to pursue a weaker RMB as part of its stimulus program. The prospective short-term gains would be tenuous, while the long-term reputational costs could be substantial.

- The busy schedule of this year's trip (five cities in five days) limited my culinary explorations. But highlights included the pepper crab in Singapore, sticky rice dim sum in Hong Kong, and the amazing duck at the Horizon restaurant in Beijing. Many thanks to my partners who arranged such wonderful meals and provided such fine company.

But of all the impressions I returned with, none were as profound as the chòu dòufu. Like Asia itself, it takes some getting used to. But once acclimated, you have a taste for more.

Time to Focus on the United States' Infrastructure

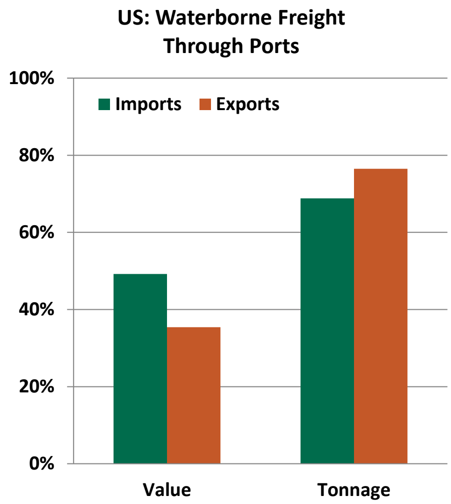
Historically, an extensive transportation system has been the bedrock of America's economic development. While many of the country's roads, bridges, water systems and electric grids were state-of-the-art when they were put in place more than 50 years ago, these systems are stretched or worn out now. Infrastructure has not been a national policy priority for a few decades; the cost to America will be immense if needs in this area remain unaddressed.

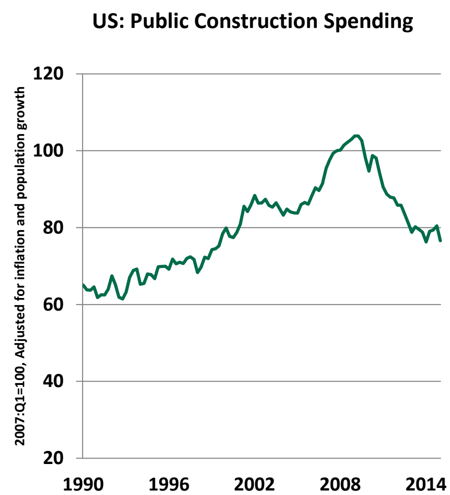
Signs of poor infrastructure are obvious across the nation. Poorly maintained and congested roads, structurally weak bridges, poor passenger rail service, and outdated airports and seaports are a few examples. Deterioration of the nation's infrastructure imposes costs in a variety of different ways.

Poor surface transportation results in higher vehicle operating expenses, time delays, and safety and environmental costs. Firms have to divert funds to overcome these setbacks instead of investing in innovation. Households are also affected by higher transportation costs that could be avoided if better infrastructure was in place.

Unfortunate incidents have brought infrastructure challenges to the forefront. The surge in domestic oil production in recent years has left producers looking for new ways to transport oil to refineries. In the absence of adequate pipelines, rail became the solution. Recent accidents in Alabama and West Virginia highlighted infrastructure's shortcomings in terms of a lack of pipelines and a safe mode of oil shipments.

A large percentage of the nation's exports and imports are delivered through seaports. Suitable infrastructure for freight transportation by water is another area where the United States has fallen behind. Although the West Coast port strike was resolved earlier this year, the quality and age of equipment at these ports remains area of concern. A ranking of world ports for productivity indicates that the only U.S. port in the top 20 is the Long Beach port (ranked 20th).





Sources: ASCE, Haver Analytics

The message is that poor infrastructure prevents optimal usage of the nation's resources. Research has shown that infrastructure is critical for productivity enhancement, job creation and economic growth. However, actual data show that infrastructure spending is weak. The Congressional Budget Office estimates that state, local and federal investment in transportation and water infrastructure has declined to 2.4% of GDP in 2014 from 3.0% in the early 1960s. Public sector construction outlays, after adjusting for inflation and population, have dropped each year since 2009.

A coherent long-term infrastructure plan for the 21st century is missing.

On one critical front, the U.S. Highway Trust Fund will expire as of May 31 if Congress fails to reauthorize it. The federal gas tax (18.4%), the main source of revenue, has not changed since 1993 and Congress is reluctant to raise it as many states have increased gas taxes to fund their own transportation requirements. Stopgap funding for infrastructure has prevailed for the last two decades, and it is a poor way to manage long-term projects.

The extent of infrastructure negligence is evident in the D+ infrastructure grade the American Society of Civil Engineers awarded the United States in 2013. Also, the United States stands in the middle among its peers in a measure of infrastructure quality. The implication is that we face a pressing need to maintain, expand and modernize the nation's infrastructure.

Failure to act translates into additional weakening of infrastructure, which will be a drag on economic growth. We suggest that Congress take a long and deep look at the facts and pass a long-term highway transportation bill without further delays. Overall, there should be a national policy to nourish rather than starve the nation's infrastructure.