Volume 10, Issue 3

July, 2018

# Tarheel Advisors Newsletter

## All's Fair In Love and Trade War

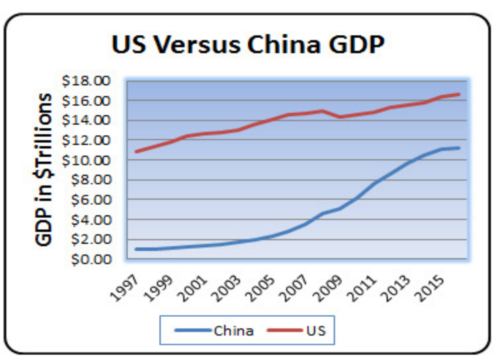
Star Wars fans endured a 16 year lull in between the end of the original trilogy and the launch of the much anticipated prequel films. What were fans rewarded with after all that time? For all their anticipation all they got in return was one of the most hated and mocked films of all time. And, at the center of the story line, Intergalactic trade.

In short, it is REALLY boring to talk about the finer details of trade. However, as you turn on the TV nowadays you'd never know this from the consistent talk of a global trade war and impending financial doom. How does an investor make heads or tails of this chatter?

First of all, take anything you hear about trade with a massive grain of salt. International trade is a centuries old system that is incredibly complex with very few people (if any) that have a significant grasp on it. Just consider the car you drive. It has around 30,000 parts, and it would be a daunting task to track down the country of origin for just a fraction of those parts. Now imagine having a firm grasp on the of the rest of the US economy's $18 trillion GDP—Good luck!

While the trade war fireworks between Donald Trump and the media are mildly entertaining to watch, the real economic story here is the meteoric rise of China from an agrarian society to an industrial power house. In just two short decades the per capita production in China increased an astonishing 1,000%, going from around $800/year to the current $8,000/year in goods and services produced per person. To put that growth into perspective, US production increased only around 75% over that same time period.

Part of the reason for China's incredible success over the past 20 years is that it was allowed to compete on the world stage essentially with training wheels on. For years China utilized a manipulated and undervalued currency and widespread industrial subsidies from the central government.




Many people, including myself, have assumed that China's success in manufacturing was based primarily on low wages. However, labor in China are far from cheap now thanks to manufacturing wages tripling in the last 10 years. So, there are clearly other factors to consider for Chinese manufacturing success.

Let's take a look at the global implications of Chinese industrial subsidies when left unabated. According to a research piece by the Alliance for American Manufacturing, it is estimated that the Chinese government gave out energy subsidies totaling about $27 billion between 2000 and 2007. About 95% of this amount was earmarked towards the coal industry (the primary ingredient of steel). U.S. consumers and the rest of the world enjoyed cheap steel and coal at the time, but there was a steep price to pay. Fast forward a decade and nearly every coal and steel producer in the U.S. filed bankruptcy between 2014-2016 due to highly depressed commodity prices.

There weren't many tears shed for the death of the coal industry in the United States. It was considered an "unclean" relic of industry on the way out the door. However, the same story played out in emerging industries like solar panels and 3D printers during the past decade. Bristling young companies with profit potential were brought to their knees repeatedly by Chinese competitors dumping product at a loss, most likely thanks to back-end government subsidies.

With China's emergence onto the global stage this century, it is time for it to start playing on a level playing field with the rest of the industrialized world. This either means a substantial reduction in industrial subsidies or enduring global tariffs enforced against most of their exports.

It is almost unanimously considered that trade wars are negative for all participants in the short-run. For investors this may cause some heart burn in the months to come. However, it is my opinion that the economic changes needed in China will end up being a positive for all parties. After all, the long term elimination of dumping policies should equate into greater profits for business, and thus greater profits for your portfolio.

**-Ryan Glover, CFP®**

### 2018 Market Update

| | |
|---|---|
| **S&P 500** | **2.65%** |
| **DOW** | **-1.12%** |
| **RUSS 2000** | **8.81%** |
| **MSCI World** | **-3.34%** |
| **BONDS** | **-1.53%** |
| **GOLD** | **-4.04%** |

### Mortgage Rates

| | |
|---|---|
| **15-Year** | **4.1%** |
| **30-Year** | **4.6%** |
| **5/1 ARM** | **4.4%** |

### Did You Know?

* China's stock market entered bear market territory at the end of June with a 20% correction since its February market highs.

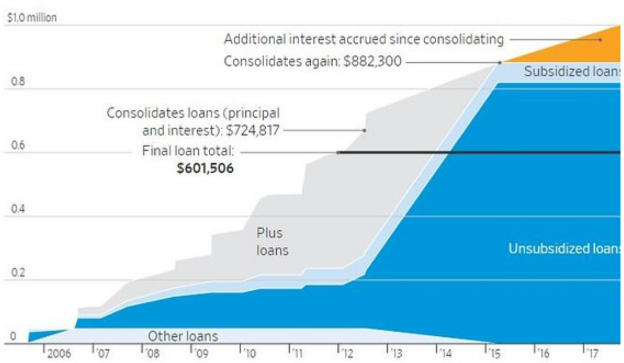
* Bitcoin finished the first half of the year down 52% at $6,387.31

* General Electric (GE) was dropped from the Dow Jones Industrial Average, ending a more than 100 year run in the 30 stock blue-chip index. It was replaced by Walgreens Boots Alliance (WAG).

# Scaling the Student Debt Mountain

Some of you may have seen the recent article in the Wall Street Journal about a dentist in Utah who has accumulated $1 million in student loan debt. Before you write this off (pun intended) as a rare, one-of-a-kind case, you should know that according to the Department of Education, 101 people currently owe that much or more in federal student loans! In fact, around 2.5 million people owe at least $100,00 in student debt.

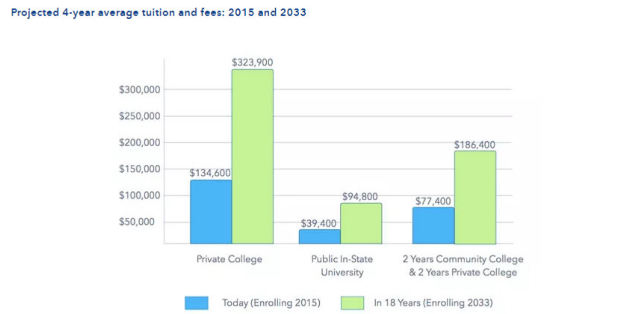
The 37 year old dentist, Mike Meru, obviously took a big gamble on his education and hoped that the investment in his future would eventually pay for itself. In this case, it may or may not. Laws concerning the payment of student loans have changed quite a bit over the years. You can no longer claim bankruptcy and get rid of them, but if you aren't able to pay them off within 25 years, the remaining balance will be forgiven (sigh..covered by us taxpayers), but taxed as ordinary income. In the case of Dr. Meru, he entered into a government sponsored payment plan based on his income level that allowed him to make monthly payments equal to 10% of his discretionary income. This comes to $1,589 a month. Without government help, the monthly payment would be $10,541. Given that Dr. Meru makes $13,333 per month after taxes, that chunk would certainly be unmanageable. He will watch his total debt climb to over $2 million by the end of the 25 year time frame. When forgiven, the debt forgiveness will net a tax bill of approximately $700,000 at his current income bracket. How will he pay for that then? I think we can all say "wow" to figures like these.




Note: As of May 6. Subsidized loans do not accrue interest until the borrower enters the payback period; unsubsidized lc accrue interest from when they are originated.
Source: Mr. Meru's student loan records

It's perhaps mind-boggling to most people how anyone could end up in that situation, but from reading the article, I can see how it developed and exploded to the level it is now. It reminds me of the story of a frog in a pot not realizing it's getting too hot until the water is boiling.

Dr. Meru never intended for the debt to get this high, but what started out as smaller loans with lower interest rates ballooned into a giant mess with the compounding of time and interest. In 2005 when Dr. Meru first started his education at USC, tuition was $56,757 and the interest rate was 2.77%. In his second year, tuition jumped 6% and the interest rate more than doubled to 6.8%. As you can probably guess, tuition at USC continued to rise and now would cost about $91,000, or approximately $137,000 when you include living expenses. Whether it be dental school or some other post-graduate degree such as an MBA, or law degree, keep this in mind as you plan for yours, your kids, or even grandkids' education funding. The cost of a college education has continued to skyrocket over the last decade and modeling at least a 5% rise in cost each year would be prudent.




*Based on average tuition and fees for 2014-2015 as reported by The College Board® and assumed to increase 5% annually. The figures above do **not** include other costs your child will incur as a college student, such as room and board, books, supplies, equipment, and transportation. These additional expenses can increase your child's cost of attending college by a substantial amount.*

Another mistake that plagued the early years of Dr. Meru's debt problem was making only the minimum payment. One could argue that it's difficult to study, get a job, start a family (in his case) and do more than that, but the debt adds up quickly. It's like the reverse of dollar-cost-averaging into your 401(k) at work. The bigger the debt in the earlier years, the faster it will compound, especially when you are only paying interest and not paying down the principle. Another major blunder happened when he graduated and used a government option known as forbearance. This allows a borrower to postpone payments, and Dr. Meru felt it a necessity in his first years out of school to support his family. Meanwhile, the interest continued to accrue and he expanded his debt monumentally through the miracle of compounding.

Make sure that you factor this in when deciding which degree and career to pursue. Dr. Meru earned $225,000 last year, which is much higher than the median income for dentist of $158,000. Clearly his education has helped him achieve an above-average job in a corporate practice, but was it worth it? He will never get out from under the mountain of debt he piled up at that rate. Again, it sounds like Dr. Meru had the best of intentions and even made a calculation before deciding on this path that turned out to be incorrect. Just because unlimited student loans are available to you and the colleges financial aid directors tell you what to expect, it doesn't mean you should jump aboard full tilt. Consider your earnings potential and whether the cost in the end justifies the investment in your education.

**-Walter Hinson CFP®**


**<u>Our Advisors</u>**

**Walter Hinson, CFP®, AIF® (919) 439-0383**

**walter_hinson@tarheeladvisors.com**

**Ryan Glover, CFP® (336) 510-7255**

**ryan_glover@tarheeladvisors.com**