# Bauerle's Bank Notes

## China Syndrome

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Global financial markets last week flashed sharply different signals to open the New Year. Despite a good U.S. jobs report, the Financial Times summed the week saying, "China's slowing economy and currency deprecations spooked investors around the world leading to the worst start to a year for markets in at least two decades." The newspaper continued, "Some fund managers argue that the developing world could be in the final stage of a three-part rolling global crisis that began in the U.S. in 2007 and moved to the eurozone in 2010."

In our view, the relevant time horizon is three decades, the root issue is dislocation attending globalization, and the shift underway could (finally) favor U.S. middle market businesses and the banks and other financial services providers that finance them.

Developing nations, especially China, have attracted foreign investment using currency manipulation, poverty-level wages and indifference to social goods like clean air and water. America's largest companies and largest banks have been complicit in the scheme. Pharmaceutical industry production workers in India earn less than 10% of their American counterparts' income. Meanwhile, by acquiring Ireland-based Allergan for $160 billion, Pfizer will cut its U.S. tax bill and continue to dodge taxes on billions of dollars held in offshore accounts.

National Geographic, hardly a political organ, this month offers a one page profile of China's cement and concrete production as a proxy for the nation's economic surge. "The foundation of China's 21st Century growth is concrete. Literally. The country's cement production has spiked 3,000 percent since 1980. Since 2012, China has made more cement than the U.S. has since 1900." The quote is not a typo. The last three years of Chinese production equals the last century's worth in the U.S. "But there's a downside," NatGeo adds. "Cement production, especially in antiquated plants, emits large amounts of $CO_2$, about 5 percent of all anthropogenic emissions, reports a U.S. study. China's cement contributes as much toward that tally as all other countries combined" (emphasis mine).

If the economic slowdown in China and other developing nations is bad for the S&P 500, can it be good for the rest of us? Yes. Small and middle market businesses

benefit the U.S. economy in several ways. That is where the job creation is. That is where innovation takes place. And those are companies and people who are most deeply rooted in their local and regional communities. Pfizer and companies like it are necessary but not sufficient. And, in this business cycle so far, globalization has greatly benefitted S&P 500 companies, while small and middle market businesses have not participated in the rally. So that is where the cyclical upside remains.

How can bankers and business owners capitalize on that opportunity, especially as the Fed retreats from its unprecedented nine year zero interest rate policy?

1. Find Gold Amid the Sand and Gravel. Resetting the economic table in developing nations will affect some industries and businesses more than others. For example, China's reduced industrial production will eliminate imports of Appalachian Basin coal, likely the last nail in that industry's coffin. On the other hand, Congress in December cleared the path for export of Appalachian Basin natural gas to international markets. Higher European prices for natural gas will help enable a rebound from today's prices, which are depressed due to transportation bottlenecks, warm winter weather in major U.S. gas consuming markets, and loss-making production by companies that will be consolidated through bankruptcy cases this year.

As a second example, we know a middle-market European company that serves the U.S. primary metals industry from Pittsburgh. All but one of its business acquisitions during the last decade were in China or South America. Whether that will change because of the slowdown in those markets is unknown presently. But emerging fault lines in those economies are likely to make the U.S. more attractive as a less volatile destination for capital investment by the Belgian executives who call the shots.

Bankers and others can profit from these changes. They must pick and choose opportunities carefully. But pick they should, because the companies that survive the current downdraft stand to do well when their markets turn higher.

2. Bet the Jockey. Many companies Pfizer's size run on autopilot. The CEO of RJR Nabisco once quipped, "The guy who invented the Oreo cookie was a genius; the rest of us are living on the inheritance." That's not true in the middle market. Those companies and their employees, from the loading dock to the C-Suite, create success or failure every day. When you find people who are talented, competitive and committed to those they serve, bet the house on them. As the cool-down of China and other developing economies unfolds, bankers should redouble their effort to find promising companies to finance close to home.

3. Financial Regulation Must Respect and Protect the Middle Market. Their tail feathers badly burned by the 2008 financial crisis, financial regulators have redoubled their efforts to reduce systemic risk, writing millions of words of new regulations in furtherance of the Dodd Frank Act. Meanwhile, industry consolidation has led JP

Morgan, Citibank, Bank of America and Wells Fargo to control two-thirds of the nation's bank deposits. Small banks' difficulty coping with the complexity of new regulations and the largest banks' oligopoly position have led some regulators to suggest consolidating thousands of banks into a handful of non-bulge-bracket-sized institutions. PNC and US Bancorp, based in Minneapolis, are offered as prototypes. Having the market consist of the big four (JPM, C, BAC and WFC) plus six to twelve second tier institutions would make the neighborhood safer and operate more smoothly says this argument.

But as the Wall Street Journal reported last month, small and middle-market businesses have found it difficult to obtain bank loans in the current economic cycle. Rigid credit standards are one reason; the weak economy since 2007 is at least equally responsible. Eliminating regional and community banks would exacerbate the situation. Needed instead is recognition that diversity in sizes and types of financial institutions mirrors our economic diversity. Ag banks predominate in Kansas and should continue to do so. Real estate-centric lenders populate Florida and should. Commercial and industrial banking is strongest in the Great Lakes states and should be. Regulatory behaviors need to respect and protect those regional differences as well as the need for smaller as well as larger operations according to local economies' characteristics.

Developing world economic issues likely will cast a shadow over financial markets this year and beyond. None of that, however, should diminish our commitment to reinvesting in our own economy, and one another, here in the U.S.

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