THE IMPACT REPORT

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Foreign Investors Bullish on America

By W. Michael Cox and Richard Alm

We typically think of governments as spendthrifts, doling out whatever they reap in taxes and then borrowing to spend even more. That's certainly been Washington's way, with cumulative deficits topping $8 trillion over the past decade.

Several dozen governments, however, are actually saving at least some of their money. They've created sovereign wealth funds that siphon off a portion of the today's windfalls from oil production or trade surpluses and create pools of investment money that operate like national mutual funds to benefit current and future generations.

Sovereign wealth funds have spread around the world in recent years, but the idea has roots in Texas. The state created the first funds more than a century ago—the Permanent School Fund to benefit secondary education in 1854 and the Permanent University Fund to benefit the state's colleges in 1876. Both are still up and running, and nine other states have similar funds.

Nations didn't get into the act until the 1950s, when Kuwait began to sock away some of its oil revenue. A handful of nations started funds over the next few decades, but the real boom has come since 2000. Today, industry watchers track at least 80 sovereign wealth funds in 45 nations, with total assets under management of nearly $7.4 trillion in September.

The biggest sovereign wealth funds are concentrated in just a few countries. Two-thirds of all fund assets are in just four of them—China, the United Arab Emirates (UAE), Norway and Saudi Arabia (*see chart right*). The top 12 nations hold more than 93 percent of assets in sovereign wealth funds.

Secrecy cloaks the holdings of many funds, but Norway pulls back the curtain by issuing quarterly reports. Since 1990, the country has diverted some of its oil wealth to the Government Pension Fund Global, which over the years has grown into the world's largest sovereign wealth fund, with assets of almost $955 billion.

To reduce risk through diversity, a fund as big as Norway's holds thousands of investments, across a wide range of industries and countries, but half of its 10 largest assets speak with an American accent—Apple, Alphabet Inc. (Google), Microsoft, Amazon.com and Johnson & Johnson. Rounding out the fund's Top 10 are Switzerland's Nestlé, Novartis and Roche Holdings, plus Britain's Royal Dutch Shell and HSBC Holdings.

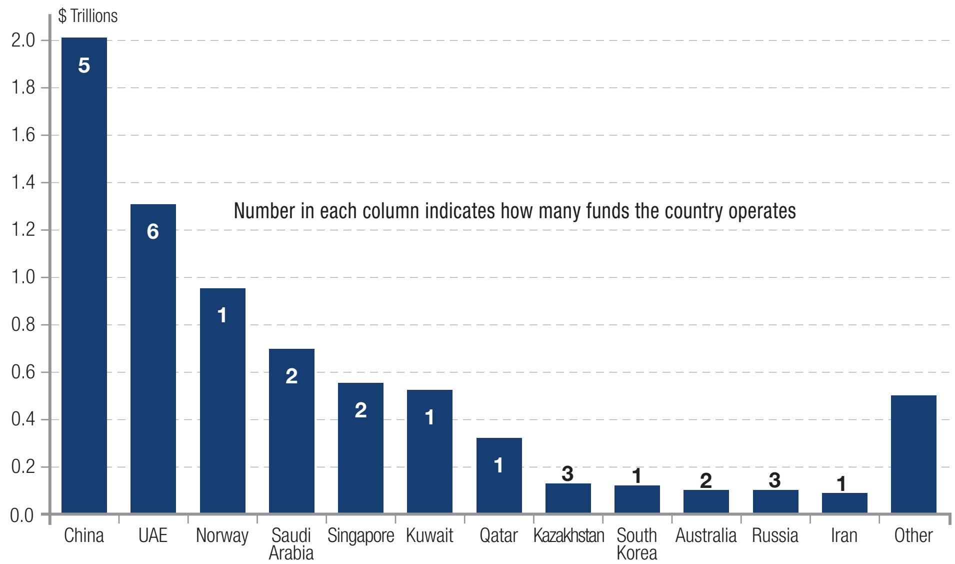
These assets combine the growth potential of U.S. technology, the security of well-established companies and the stability of the world's leading capitalist economies.* The investments suggest a conservative, long-term strategy that balances potential growth and risk—just the kind of investing we usually see from pension funds in the private sector.

So why don't these governments simply distribute all this money to their citizens, who can then spend and save as they see fit? Why not accomplish the same end by simply lowering taxes?

For many countries, sovereign wealth funds represent a conscious policy to cope with tidal waves of money that, if allowed to flow unimpeded into the

* Nations with high scores on the Economic Freedom of the World index rely more on markets and private enterprise to drive economic activity. The latest EFW report (2017) ranks Switzerland fourth, the United Kingdom sixth and the United States 11th in economic freedom.

A Handful of Countries Dominate in Sovereign Wealth Funds



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domestic economy, would threaten to ignite inflation or strengthen currencies. Both pose serious risks to growth and stability, so nations decide it's safer to tuck the money away in sovereign wealth funds.

Land sales fueled Texas 19th Century sovereign wealth funds. In today's world, the big money flows come from two other sources—natural resources and trade. Government-controlled oil and gas riches have fueled the sovereign wealth funds in Norway, the UAE, Saudi Arabia, Kuwait, Qatar, Russia and about 40 other countries. The September data put the value of the energy-based sovereign wealth funds at $4.2 trillion, or 57 percent of the total assets under management.

Rather than let currency appreciation erode its trade edge, China kept its export machine humming by accumulating foreign assets, growing five sovereign wealth funds to a collective $2 trillion in assets. Singapore's much smaller economy created three wealth funds worth $500 billion.

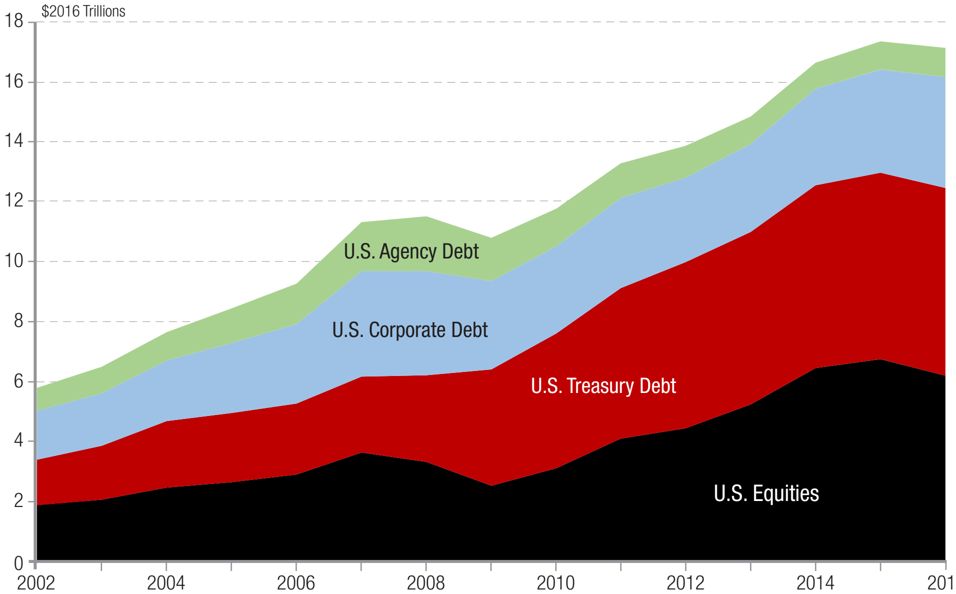
FOREIGN FLOWS RISING

Even with global assets topping $7 trillion, sovereign wealth funds represent only a small slice of the global investment pie. At the end of last year, for example, Norway's Apple holdings were bigger than any other sovereign wealth fund, but they ranked only 13th among the company's largest shareholders. Vanguard Group, the U.S.-based mutual-fund giant, held an Apple stake that was seven times larger than the Norwegian fund. For Alphabet Inc., the Vanguard stake was 20 times larger.

Treasury data provide a more complete accounting of foreign holdings of U.S. financial assets. As of the end of 2016, investors from abroad held more than $17.1 trillion in American stocks and bonds, private and public, short- and long-term. The most recent figure represents a tripling from the inflation-adjusted $5.8 trillion of 2002 (*see chart above*).

The United States isn't just getting more foreign investment. It's also getting a larger slice of the global pie. As a share of economic activity outside the United States, foreign investment in U.S. financial assets jumped from 18.4 percent in 2002 to 30.4 percent in 2016.

Money Magnet: Foreigners Invest More in U.S. Financial Assets



The financial crisis of 2008-09 roiled markets in the United States and overseas. Foreigners' holdings of U.S. equities declined sharply but then bounced back. The appetite for agency debt, a relatively small category for non-Treasury public bonds, fell during the crisis and so far hasn't recovered.

Setting the crisis aside, the 15-year trends show that foreigners bought into the booming U.S. stock market. Equities went from 32 percent to 36 percent of foreign-owned assets. At the same time, with the Federal Reserve keeping U.S. interest rates low, corporate bonds lost favor, falling from 28 percent to 22 percent.

Turning to the public sector, foreigners are putting more of their money into Treasury bonds, bills and notes, which rose from 26 percent to 37 percent of their assets. The reliability and stability of the U.S. economy no doubt offset the Fed-driven low interest rates.

Where does this money come from? With more than $6.8 trillion at the end of 2016, Europe supplied the biggest chunk of foreign investment, slightly ahead of the nearly $5.5 trillion arriving from Asia (*see table below*). Latin America invested almost $2.7 trillion, with smaller amounts from Canada, the Middle East and other parts of the world.

The patterns of U.S. investment differ by region of the world. Europeans and Canadians favor the higher returns of the private sector; they put their money in equities and corporate debt. Investors from Asia and the Middle East seem more cautious, tilting toward Treasury debt and accepting relatively low returns on one of

Preferences Vary Among Foreign Investors in U.S. Assets

Millions of U.S. Dollars					
Countries and regions	**Equity**	**Treasury debt**	**Corporate debt**	**Agency debt**	**Total securities**
Foreign Total	6,815,574	6,267,509	3,700,184	985,967	17,139,236
Europe	2,835,915	1,603,939	2,276,169	148,681	6,864,719
Asia	1,087,203	3,218,898	452,303	694,764	5,453,173
Latin America	1,122,703	781,195	635,181	107,154	2,646,232
Canada	695,440	85,323	163,173	6,740	950,676
Other	268,796	285,665	148,874	16,270	719,588
Middle East	175,517	292,489	24,484	12,358	504,848

Continued on page 3

the world's safest assets.

To diversify, global investors scatter their money all over the world. Collectively, however, they've chosen to allocate larger portions of their portfolios to the United States, a country with a large, dynamic and stable economy that hasn't been saving enough to meet its needs for domestic investment and government borrowing.

Overseas money flowing directly into private-sector stocks and bonds helps support companies' capital and R&D projects, which promises to boost output, reduce costs and increase competitiveness. Foreign investment going to the public sector helps finance the country's budget deficits. Without it, the Treasury would have to rely on domestic savings, mostly likely pushing U.S. interest rates and taxes higher.

The incoming investment has been a godsend in recent years. It has allowed the country to sustain economic growth, with high levels of consumption and job creation, while financing huge federal deficits, maintaining low interest rates and contemplating large income-tax cuts.

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HANGING IN THE BALANCE

Americans invest their money abroad, of course. They're motivated by the same goals as foreigners who invest in America—greater diversity, higher returns, strategic niches.

When it comes to investment flows into and out of the economy, we get more than we give. Each year, the assets that foreigners buy in the United States exceed Americans' investment in foreign holdings—that is, the country runs large and persistent surpluses in our investment dealings with the rest of the world.

And it adds up over time. Since 2003, the net U.S. position in long-term securities—foreign holdings minus U.S. holdings—more than tripled from $2.3 trillion to $7.4 trillion (*black line, chart below*). The foreign investment surplus represents a sizeable contribution to U.S. prosperity that arrives from the rest of the world. Without it, we'd likely face higher taxes and interest rates with slower growth and lower living standards.

America's large and persistent investment surpluses rarely make the headlines, even though the government regularly collects and releases data on them. They're summarized in the exhibits on Page 2. What the public hears quite a lot about, however, are the country's large and persistent trade deficits, which measured by the current account topped $450 billion in 2016.

While wholly accurate, the widely reported current account doesn't give a full accounting of America's international transactions. It ignores the net investment flows we've been discussing in this issue of *The MPACT Report*.

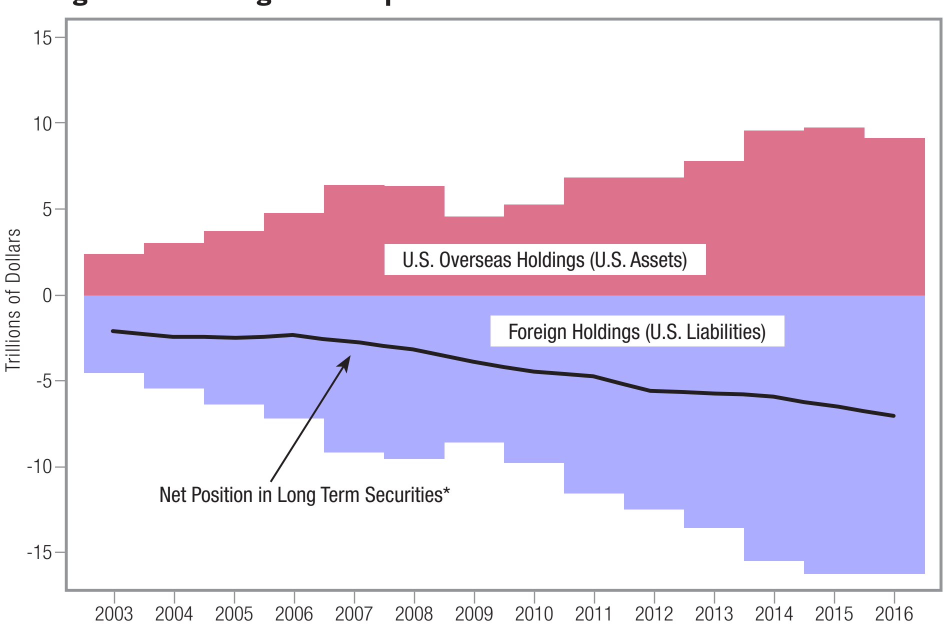
The current account measures imports and exports of goods and services, plus net income earned during the year on overseas assets. The capital account captures annual investment into and out of the United States. In 2016, the country's capital account showed a surplus of $461 billion, fully offsetting the current account deficit.

This isn't happenstance. For all nations, the balance of payments always balances—it must, as an accounting proposition of debits and credits. Imbalances with individual nations are common and of little consequence, but when all trade and investment flows are included every country fully pays for what it gets from the rest of the world. Those with current account surpluses send capital abroad; those with current account deficits, receive inflows of foreign capital.

An understanding of the balance of payments becomes increasingly important in light of the current political climate, with its re-emergence of economic nationalism. The narrative casts the world's richest and most powerful economy as hapless patsy for the rest of the world.

Those who espouse this view usually point to the U.S. current account deficits

Foreigners Run Regular Surpluses in U.S. Investment Flows



* Net position is defined as U.S. holdings of foreign securities minus foreign holdings of U.S. securities.

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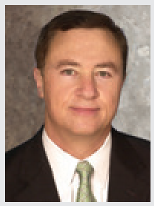
without ever acknowledging the capital account surpluses. Making the trade deficit a bogeyman inevitably leads to calls for higher tariffs and other trade barriers to block imports, with the purported goal of saving American jobs.

If successful, economic nationalists would put us on a dangerous course. All evidence from history and economic research tells us that trade contributes to prosperity and protectionism leads to ruin. If you doubt it, take another look at how the Smoot-Hawley tariff of 1929, combined with retaliation from other nations, helped topple the U.S. economy into the decade-long misery of the Great Depression.

America's string of investment surpluses goes a long way toward dispelling the economic nationalists' canard that other countries are taking advantage of the United States. If we buy more goods and services from foreigners than we sell to them, then we get more investment from abroad than we send there. It's no longer reasonable to say other countries are being unfair and trade protection will help put our unemployed to work.

Just as important, money talks, and it often speaks loudly. The investment flows data, with its steady increases in recent years, tell us how the rest of the world regards the U.S. economy. Foreigners may grouse about our politics and policies, they may criticize our brand of capitalism, but what they do with their money tells us loudly that they're bullish on America.



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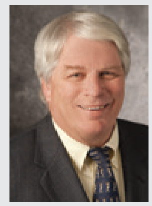

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CHARTING THE ECONOMY

Who Pays? U.S. Income-Tax Shares by Income Quintile and Top 1%

Congress is considering major changes in America's income-tax laws. It's a good time to take a look at who's been paying these taxes over the past three decades.

According to data released by the Treasury, the top 20 percent of taxpayers saw their share increase from 65 percent in 1980 to 88 percent in 2013. At the leading edge of this group, the Top 1 percent went from 18.4 percent to 38.3 percent.

All other quintiles saw their shares of income tax revenue shrink. The second fifth, for example, fell from 20.3 percent in 1980 to 13.3 percent in 2013.

The 40 percent of taxpayers with the lowest incomes paid 4.2 percent of income taxes in 1980; since then, their shares have turned negative (-5.2 percent). They're getting money from the tax system through various credits and other benefits.