

## Is China About to Play its Rare Trump Card?

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### Key takeaways

- » *The U.S. may soon be cut-off from Chinese rare earth metals.*
- » *Americans, whether they know it or not, use Chinese rare earth metals every day.*

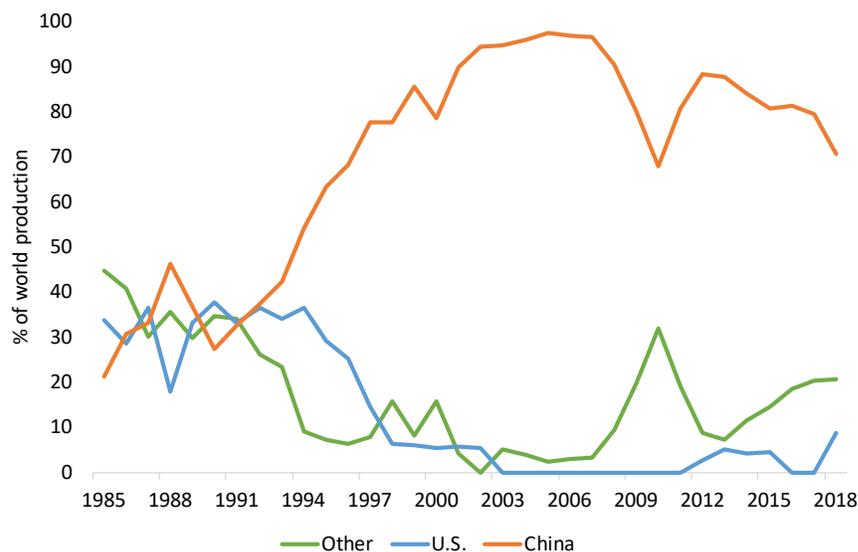
### What it may mean for investors

- » *Americans, and select American manufacturers, could soon face higher consumer product costs.*

Many believe that the U.S. holds most of the economic cards in its trade war with China. This may be the case overall, but China believes it can still hurt the U.S. In fact, China believes that it is holding a rare economic trump card that, if played, will impact every American. In recent days, China has hinted at using it.

China's economic trump card is not made of words or paper tariffs, but metal—rare earth metals to be exact. Today, China controls 70% of the world's rare earth metal production (see orange line in chart)—a conquest that began nearly 30 years ago when the Chinese government declared rare earth metals to be a protected and strategic mineral.

### Rare earth minerals and metals production



Sources: United States Geological Survey (USGS), Wells Fargo Investment Institute. Yearly data: 1985-2018.

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Why should you care? Because Americans use rare earth metals every day. Without rare earth metals, Americans would lose much of their daily technology, creature comforts, and even some national defense capabilities. Rare earths are used in the production of air conditioning and generators (home comfort), fiber optics (WiFi), silicon wafers and chips (phones, LCD TVs, computers), electric power steering (cars and trucks), hybrid and rechargeable batteries (electric vehicles), oil fluid cracking (gasoline), guided missiles (national defense), and the list goes on. Access to rare earth metals is critical to many of these technology-hungry industries, which is precisely why China believes it has leverage here.

Rare earth metals are essential for many of the products listed (and others). From that angle, China believes it has leverage. Should China decide to play this economic card, its likely first move would be to restrict exports to the U.S. As essential as rare earth metals can be to select product manufacturing, and with limited non-China sourcing available, there is little doubt that select U.S. manufacturers would be in a bind. We'd eventually expect to see higher production costs and even some product delays. The average American would likely feel a part of this pain. Products should still be available, whether produced in the U.S. or China, but likely at higher costs.

What makes this economic card so unique, and potentially impactful, is that having money doesn't solve the problem. President Trump could easily help these companies by footing China's rare export bill to the U.S., which was less than \$200 million in 2018. But the U.S. manufacturers would still need to find the rare earth metals.

We doubt that China's rare earth metals card is a trump card, though. China will have a hard time going beyond limiting direct exports to U.S. manufacturers. The reason is that China is the world's largest exporter of consumer goods—the same consumer goods listed above that rely on rare earth materials. We have a hard time seeing how China could slap rare earth restrictions on consumer goods—goods that are produced inside China and are increasingly consumed globally—and not shoot itself in the economic foot in the process.

The U.S. started seeing this as a potential problem a few years back and took action. In 2017, an executive order was signed to break the U.S.'s dependence on rare earths from China. More recently, a bill has gained momentum in the U.S. Senate with the aim of re-establishing more secure domestic supplies. Should China cut-off rare earth supplies to the U.S., this domestic solution may have potential. The U.S. does have the mineral deposits. Prior to the 1980s, the U.S. was the world's largest rare earth mineral producer. However, keep two things in mind: 1) it takes time to ramp-up these old deposits. In other words, the U.S. does not have a great short-term solution to China cutting-off supplies of rare earths; and 2) re-entering the rare earth business comes with costs—costs that most Americans will not support. It's labor intensive, toxic, and environmentally unfriendly—precisely the reasons why China now dominates the business.

The bottom line is that recent rumblings from China suggest that the country may soon restrict rare earth metal exports to the U.S. This matters to Americans, whether they know it or not, because they use rare earth metals every day. Rare earths are essential in building many of today's creature comforts—from air conditioners, to smartphones, to power steering. Should China play this card, select U.S. manufacturers will likely face higher costs, and possibly some product delays. While the average American may feel some of this cost/delay pain, we do expect consumer goods to still be available. China, as the world's largest exporter of consumer goods, has too much to lose should it take the rare earth restriction scare too far, in our view. China's threat to cut-off the U.S. from rare earth metals is real—but it isn't likely the economic trump card that many fear.

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