

## Investment Commentary—July 2018

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For much of this year's second quarter, fears of a trade war weighed on capital markets. Heated rhetoric over tariffs pushed stock prices down several times, with shares rebounding when the rhetoric cooled off. Thus far in the third quarter, the stock market seems to be shrugging off trade worries. Should it?

Getting tough on immigration and trade was at the heart of President Trump's 2016 campaign. His aggressive (and long held) views on trade were reflected in the appointment of two hardliners to key positions: international trade lawyer Robert Lighthizer as U.S. Trade Representative and economist Peter Navarro as Director of the White House National Trade Council. Lighthizer and Navarro's presence was initially balanced out by the free trade views of Treasury Secretary Steven Mnuchin and Director of the National Economic Council Gary Cohn. Throughout 2017 and early 2018 the moderate Goldman Sachs alums seemed to hold sway. Occasional tariff threats never got very far and negotiations over restructuring NAFTA<sup>1</sup> were reasonably amicable.

The dynamics within the administration seemed to change abruptly earlier this year as Trump announced--to almost everyone's surprise--tariffs on all aluminum and steel imports. Cohn fought hard to reverse the decision but failed, and submitted his resignation in early March. Later that month Trump zeroed in on China, unveiling tariffs on \$50 billion of Chinese goods. Beijing quickly responded with a similar declaration of tariffs on American products.

Perhaps fearful of China's potential for mucking up the planned summit with North Korean leader Kim Jong-Un, White House rhetoric cooled in the early spring. By mid-May the administration had struck a tentative deal to hold off on tariffs in exchange for Beijing's expanded purchase of U.S. agricultural and energy products. Treasury Secretary Mnuchin declared "We're putting the trade war on hold."

Crucially President Xi made no concessions with respect to "Made in China 2025," which a researcher at the mainstream Council on Foreign Relations describes as "a blueprint for Beijing's plan to transform the country into a hi-tech powerhouse that dominates advanced industries like robotics, advanced information technology, aviation, and new

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<sup>1</sup> The North American Free Trade Agreement negotiated by the Clinton administration.

energy vehicles” and “an existential threat to U.S. technological leadership.” If there is a compelling rationale for a risky confrontation over trade, “Made in China 2025” is it.

As it turned out the trade war wasn't put on hold for very long. On June 15<sup>th</sup>, shortly after returning from the summit with Kim Jong-Un in Singapore, President Trump decided to proceed with tariffs on Chinese goods. The initial wave, impacting \$34 billion of Chinese imports, went into effect July 6<sup>th</sup> as did tariffs on \$34 billion of U.S. exports to China. Another \$16 billion will go into effect at the end of this month.

China has not been the only target of Trump's ire. He lashed out at allies on the subject of trade before and after the early June G-7 meetings in Quebec. Perhaps with Germany in mind, Trump has increasingly spoken about a 20% tariff on imported cars, which could increase the price of imported autos by \$6,000 a vehicle, and spook capital markets.

It's easy to exaggerate the threat of a trade war. One sometimes reads, for example, that the Smoot-Hawley Tariff Act caused the Great Depression. In reality, the rapid buildup of debt in the late 1920s and subsequent monetary and fiscal contraction (when the opposite was warranted) played a much bigger role<sup>2</sup>. Still, there are several reasons to be concerned. The first cause for concern is the complexity of modern supply chains. Before they reach consumers, finished goods have often crossed borders multiple times as components from around the world are integrated into a final product. These supply chains include significant redundancy in order to be able to respond to changing conditions. Still, a full-blown trade war could stress supply chains dramatically, creating production delays, eating into profit margins, and forcing CEOs to proceed with caution.

Another worry is that Europe, China and Japan have all seen economic activity soften a bit over the last six months. At the end of 2017 the global economy was firing on all cylinders but that's not the case right now with growth in most regions outside of the U.S. moderating. And it's well to remember that the U.S. economic expansion, at nine years old, is the second longest since World War II. Thanks largely to tax cuts and increased federal spending, the U.S. economy is quite strong. But that impact will begin to wane over the next six to twelve months. In the meantime, the dampening effect of Federal Reserve rate hikes will gradually mount. As strong as the economy looks right now it could be significantly more fragile in 2019 especially in the second half. Even without trade worries, the probability of a recession beginning in the next twenty-four months has been ticking up. A trade war could raise the odds significantly higher.

Some perspective is in order at this point. The tariffs that took effect at the end of last week apply to around \$70 billion worth of goods. This represents less than one percent of global trade. The direct impact will be modest, if not imperceptible. But if the tit-for-tat escalation continues,

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<sup>2</sup> The causes of the Great Depression are a subject of controversy among economic historians, so take this as a majority but not necessarily consensus view.

companies will increasingly have to contemplate the possibility of worse to come. Capital budgets and production plans would naturally become more cautious and economic activity would decelerate. The impact would be greater outside of the U.S.; as compared to countries like Germany and China, exports represent a considerably smaller percentage of our GDP. President Trump might think this gives him the upper hand, but at least in China's case that's probably a mistake. While China has a greater percentage of its GDP tied up in exports, President Xi is by all accounts bound and determined to protect "Made in China 2025," and he has a deep set of tools to utilize against American firms, ranging from bureaucratic obstruction to cajoling Chinese consumers to buy local<sup>3</sup>. Around the time President Trump announced the steel and aluminum tariffs, Xi engineered the removal of any term limits on the Chinese presidency. With the option of retaining power for another decade or more, Xi is free to take the long view<sup>4</sup>.

Assuming that this initial tariff skirmish is not terribly consequential, how much in the way of additional tariffs would constitute a serious threat to the economy? It's hard to know, but President Trump took a step in that direction in the last few days by announcing tariffs on an additional \$200 billion in Chinese goods. The tariffs are scheduled to go into effect on August 30<sup>th</sup>. It's entirely possible that the two sides will go back to the negotiating table. If they do, perhaps this time a deal will stick. But if not, the possibility of a full-blown trade war will loom larger.

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While we keep one eye on escalating tariffs, we'll be keeping another eye on corporate profits. The first quarter numbers were nothing short of stupendous, and the second quarter is shaping up to be nearly as good. For now, corporate tax cuts, a strong U.S. economy and a still pretty solid global economy are continuing to drive earnings significantly higher. That won't last forever though, especially with interest rates rising and wage inflation beginning to eat into (albeit very modestly for now) margins.

CEOs and CFOs will be conducting conference calls over the next several weeks to discuss second quarter earnings. It will be very interesting to hear what they say about the outlook for the remainder of the year and beyond. If the nine-year old bull market is going to get to the very advanced age of ten, 2019 corporate earnings will have to show continued growth. By this time next year, however, several headwinds may have emerged: The economic boost from lower taxes

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<sup>3</sup> One intriguing point of leverage is China's virtual monopoly in the supply of rare earth metals required for all sorts of personal electronics, including cell phones. While the underlying metals are found everywhere, China has nearly unique expertise in their extraction and production.

<sup>4</sup> When Nixon went to China in 1972 premier Zhou Enlai was asked what he thought of the French Revolution. His response: "it is too early to say." Zhou's answer has been used countless times to illustrate the long-term thinking of leaders steeped in the four-thousand-year history of Chinese civilization. As it turns out Zhou misunderstood, thinking the question related to events in 1968. That small detail tarnishes the story, but the lesson about the prodigious patience of Chinese leaders may still apply, especially as compared to their U.S. counterparts.

and increased federal spending will have begun to wear off. Trade skirmishes and interest rate increases may be eroding business and consumer confidence. And, wage inflation could be chipping away at margins. If some or all of these factors cause earnings to flatten or perhaps even decline next year, the bull market could be in jeopardy.

*July 13, 2018  
Boston, MA*