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Dear Clients:

Heading into the fourth quarter of 2018, the U.S. equity market was on course for another year of above average returns only to fall prey to a confluence of self-inflicted policy events. The S&P 500 yielded the worst December return -9.0% since 1931, and the resulting -13.5% quarterly return produced just the third down quarter in *five years* and the first calendar year loss in *ten* years. As is the case when markets are in the rare free-fall, there is no shortage of finger pointing. While several fault-lines are shifting concurrently (including higher tariffs, uncertain trade policy, a slowing Chinese economy, European dis-union, a cloudier corporate outlook, and Congressional disfunction) this abrupt loss of faith was credited to the hawkish avowals of the Federal Reserve as it reaffirmed its intent to continue along the path of increased interest rates and quantitative tightening (QT).

Record corporate profitability and a generally stable corporate outlook are always good for sentiment and the market had shrugged off changes to the backdrop for some time -- including the higher cost of capital, the looming anniversary of corporate tax cuts, peak margins, and the uninterrupted length of the bull market. And yet the Fed's explicit assertiveness at this particular juncture seemed to tip investor sentiment into the doldrums. It was, perhaps, an overdue acceptance that the free money years are behind us and with it, the contours of the past decades' supra-normal growth.

Our clients and others we speak with justifiably argue that they are receiving mixed messages. The administration claims that the economy is "stronger than ever" while simultaneously protesting that the Fed is raising rates too much for the economy to handle (this when the Federal Funds rate is *not even at half* the 2007 pre-financial crisis level). We are either living in upside down times where contradictory conditions can co-exist -- strength *and* fragility -- or, more likely, one of these two convictions is false.

In the face of the market route the Fed blinked first, backtracking on its projections and announcing a cessation to further rate hikes. The robust +13.7% first quarter S&P 500 rebound is, partly, a reflection of this about-face. But so is the sentiment surrounding the other impossible-to-avoid, market impacting issue: the tariff war and the improved outlook for a possible deal with China. Optimism for a deal has improved markedly since last fall for the simple reason that the antagonists have kicked the deadline can down the road. This failure to back-up the bluster is widely presumed to mean that negations *must* be serious and *any* deal is better than no deal -- nothing like lowering the expectations bar!

However corporate sentiments are understandably slower to evolve than investors, so while the removal of higher Fed Fund rates from the field is a welcome change for businesses, the uncertainties of a trade deal with China (and Mexico and Canada and the E.U.) remains a significant overhang and likely remains *the* threat to U.S. and global growth in the quarters and, potentially, years to come.

As several recently published papers make clear, the impact of extra levies is quantifiable and the early costs these additional tariffs have had on the economy and consumers are material. These findings have been amplified by comments made in corporate outlooks. While lowering trade tensions with China would be hugely beneficial -- and a deal of some sort is highly probable and select industries *should* profit -- we do not see wide-spread sentiment improving quickly because this dispute is clearly about more than trade deficits. It is a contest of two very different national ideologies and ideologues that are not simply negotiated away. With this thought in mind, we launch into our observations and anecdotes obtained from this, our first trip **West of the Hudson**™ in 2019.

- The Evidence Grows

> Over the course of 2018, the U.S. experienced substantial increases in the prices of intermediates and final goods, dramatic changes to its supply-chain network, reductions in availability of imported varieties, and complete passthrough of the tariffs into domestic prices of imported goods. Overall, we find that the full incidence of the tariff falls on domestic consumers, with a reduction in U.S. real income of $1.4 billion per month by the end of 2018. We also see similar patterns for foreign countries who have retaliated against the U.S., which indicates that the trade war also reduced real income for other countries.
>
> -- *The Impact of the 2018 Trade War on U.S. Prices & Welfare*, NY Federal Reserve, 03/01/19

The use of tariffs is one of the most powerful tools available in a trade war. However, the evidence is mounting that this particular war was launched at the wrong time and is generating a considerable amount of economic uncertainty. The prolonged ambiguity has hampered corporate outlooks as the trade bombast has raised legitimate doubts about the future of America's economic relationships, requiring companies to increasingly lower expectations. We can't think of a time when we've seen this approach before. The dominant view has long held that doubt is bad for growth, impedes investment and unnerves financial markets. One would think that no administration should want to *purposely* inject uncertainty into the investment decisions of private businesses, and yet their stated intention has been to do exactly that: conjure uncertainty as a dis-incentive for companies to invest outside the U.S. *and* to destabilize the economies of trade partners.

Companies large and small are grappling with the effects and the disruption -- including the tariffs already in place and the possibility of more -- threatens growth. The panoply of earnings-related calls makes clear that businesses are feeling the heat and, unsurprising for a globally integrated economy, the number of companies harmed by higher tariffs is exponentially larger than those that are helped by them. The only startling aspect of this is how *quickly* these costs have shown up in the results as the first round only went into effect in late September 2018. Some struggles have been well-documented -- Harley Davidson mentioned "tariffs" sixteen times on a recent call -- but it's not the only company deeply concerned about the trade war as mentions of "tariffs" and "trade war" have risen steadily since going into effect (source: FactSet, CB Insights). Until the ink is dry on a deal, attention and worry on trade tensions will continue to fester.

Tariffs have pushed up the prices of steel and aluminum and have raised costs for companies that make everything from cars and tractors to dishwashers. These companies face a choice: bear the higher costs and report weaker profits, or raise prices on their products and pass the financial burden onto their customers. Many companies are opting for the latter and, contrary to the presidents claim that the Chinese are paying for these contrived costs, several recent studies show American consumers are footing the bill.

In one recently published paper (*The Return to Protectionism*, Fajgelbaum, Goldberg, Kennedy, and Khandelwa, 03/10/19), a team of trade economists declared the president's tariffs to be "consequential" and found that the initial cost of the duties to the U.S. economy was being "borne largely by American consumers". Tariffs were almost completely passed through into U.S. domestic prices "so that the entire incidence of the tariffs fell on domestic consumers and importers with no impact so far on the prices received by foreign exporters". The authors concluded that tariffs had already reduced national income in the U.S. and that the total cost to the economy had been made larger due to price increases. By the end of 2018 -- mere months after they were launched in earnest -- the report estimated that tariffs were costing consumers and importers nearly $4.5B a month. Another study, spearheaded by the New York Fed, found that tariffs were causing the diversion of $165B a year in costs for corporate supply chain reorganization (Centre for Economic Policy Research, 03/02/19).

Despite the repeated boasts of "winning", the evidence is growing that the U.S. economy is thus far a net loser. Punishing tariffs may well yield concessions, but it has taken a heavy toll on farmers, automakers, manufacturers and nearly every other business with Chinese exposure. Reinforcing this data is a plethora of other studies, including from the U.S. Chamber of Commerce, which notes that tariffs are damaging industries that levies were intended to protect. They conclude with:

> Half of all U.S. manufacturing jobs depend on exports, and one in three acres of American farmland is planted for international sales. Recent and proposed trade actions threaten as many as 2.6 million jobs, including manufacturers, farmers, ranchers, and technology companies (01/19/19)

An analysis by the Federal Reserve Bank of Dallas revealed that *half* of the surveyed Texas manufacturers reported being negatively affected by tariffs. These results were better than a similar Ohio manufacturing survey, where *two-thirds* of manufacturers reported being negatively impacted by tariffs.

Treasury Department reports show receipts from all customs duties have risen sharply since the tariffs took effect. According to data from U.S. Customs and Border Protection, more than $13 billion in additional duties were assessed on imported goods, with $8 billion coming from duties on Chinese goods (as of December). U.S. importers of record are responsible for the duties and ultimately businesses and consumers pay for them through higher costs. China has nothing to do with it. And companies aren't equivocating about this either: Ford sees a $700 million headwind from duties this year while GM and Caterpillar said that steel and aluminum tariffs have "already cost" $1 billion. The legitimacy of this sentiment is buttressed by the sentiment of an administration cheerleader and Chamber of Commerce president Thomas Donohue: "Let me be very clear: tariffs are taxes paid by American families and American businesses, not by foreigners".

The impact of the tariffs, and who bears their brunt, will have big implications for the economy. The tariffs are raising expenses at a time when companies are paying more for material and labor. As we have noted in prior quarterly communiqués, large companies generally have enough redundancy, scale and operational levers to adjust to the playing field, including alternative sources of supplies. As higher prices tend to eat into spending, the question we pondered a few quarters ago -- can companies pass on these costs to their end consumers -- has been answered.

Tariff's affect businesses differently but size matters. They are effectively non-market-based costs and, while they aren't invisible to larger players, they aren't usually existential either. Yet the U.S. economy is so much more than large multinational companies and is in fact mostly composed of small businesses. So while tariffs on Chinese (and other) imported goods have yet to fully translate into large price increases across our very large economy, the Labor Department's monthly inflation statistics for things like "clocks, lamps and decorator items" tells a very different story: these companies tend not to have alternative sources and don't have the ability to pass on costs in these hyper-competitive and price-sensitive consumer goods. As one respondent noted, "tariffs on Chinese imports are becoming a material percentage of our material costs". The question which remains to be answered is whether the benefits of any pending "huge" deal outweigh the costs.

- The Long Game

The U.S. accounts for nearly 25% of global GDP. It is the largest importer of goods and services in the world, consuming about 14% of total global exports. It's also the largest export destination for China, India and Germany, and the second-largest for Japan. These four major economies are heavily dependent on exports -- nearly 50% of Germany's GDP comes from exports -- so a global decline in demand has the potential to affect their financial systems, employment rates and socio-political dynamics.

The upshot, if there is one, is that the U.S. is fairly insulated from the global economy as only about 13% of GDP comes from exports (nearly *half* of which go to Canada and Mexico). So, while the relatively low dependency on exports limits U.S. exposure to foreign business cycles, other large countries that remain heavily dependent on exports are vulnerable to fluctuations in demand which, if meaningfully weakened, will feed back onto our shores in short order. This makes the continued threat of automotive tariffs especially worrying. As we noted in a prior letter, in a White House brimming with bad economic ideas, this would be the worst one yet. The Commerce Department recently completed a confidential report on the national-security implications of automobile imports. If the probe uncovered a threat of some kind --

real or imagined -- the president has wide latitude under the law to erect steep barriers for U.S. entry (as we have seen with steel and aluminum). Not content to wage just one concocted war, he has repeatedly mused about imposing duties of 25% to induce the European Union to make trade concessions. Europe must "play ball, or we're going to tariff the hell out of you".

Obviously a tariff of that size would act like a huge tax increase on the U.S. economy as it would increase prices, reduce growth, impede investment, and cost American jobs. Not to mention it would infuriate allies, invite painful retaliation and undermine the system of global trade for which the U.S. economy has long-been the uncontested "winner". A recent history of similarly bad ideas offers examples. As we highlighted at the time, former presidents Bush (steel) and Obama (tires) levied targeted tariffs but they helped the intended beneficiaries only modestly, while temporarily damaging the broader economy.

This return to protectionism is unprecedented in the post-war era due to the sizes of the countries involved, the magnitudes of the tariffs, and the breadth of impact across sectors. The U.S. is by far the larger economy and wields considerable power, but China has been responsible for roughly one-third of global growth since 2008 and, as Chinese growth goes so goes global growth. E.U. retaliation seems all but certain, and would similarly come at the expense of American farmers, manufacturers, and consumers. In the words of one European Commission member, "we can also do stupid".

- Political Realities

> There is, however, one big procedural problem that could get in the road. And that's how the principals of the two countries actually go about doing negotiations. [The president], as we have seen throughout his business career and most recently in Hanoi, wants to do a large part of it himself in a final round of brinksmanship with his opposite number. Unfortunately, the Chinese just don't do it that way with their leaders. They will not risk a possible loss of face for their leader by having him attend a high-profile summit with the U.S. president without everything beforehand being signed, sealed and delivered. -- Kevin Rudd, former Australian PM, 03/18/19

As trade talks bump along there is optimism that a deal can be reached. With the Chinese economy slowing and the administration in need of some good political news, both sides face pressure to compromise. The problem is, a truly comprehensive trade pact will be difficult to reach because many of the problems the administration wants resolved in China require more than a few regulatory tweaks. Making legitimate changes to the harassment, IP theft, State financial support, and overt local favoritism that embodies doing business in China means changing China's basic economic system. Beijing's leaders cannot possibly achieve such an overhaul in the short term -- assuming they even want to.

The distrust is so extreme that meetings were held in Beijing recently to ensure there were no discrepancies in the English and Chinese-language versions of the text. The focus on the joint wording has become a key issue after U.S. officials complained that Chinese versions of the text had walked back or omitted commitments made by negotiators. That the two sides have very different understandings of certain words is extraordinary and personifies the difficulties faced in brokering anything other than a face-saving, band-aide compromise.

Beyond the nomenclature, what seems to be a significant over-hang at this writing is the same which holds up ratification of the rewritten NAFTA (now USMCA) guidelines: the president's insistence that he will not lift levies on imports even post-deal as they remain his sole source of leverage. So it remains unclear whether the final deal will achieve the kind of change that would make the fight worth the cost.
That is prompting concern that the administration will ultimately accept a weak deal that includes high-profile purchases of American products that benefit his "political base" but only vague and ultimately unenforceable commitments in the critically important areas. To appease the administrations' *singular* and -- as we detailed in the last letter -- *misplaced* focus on the trade deficit, Beijing has already pledged to purchase hundreds of billions of dollars-worth of liquefied natural gas, coal, chemicals, corn, soybeans, sorghum, semiconductors and airplanes -- goods they need anyway and bought in vast quantities before retaliatory tariffs were imposed. The problem with this arrangement is that only the Chinese state has the

purchasing capacity to import the amounts under discussion, meaning they will be carried out by state-controlled Chinese businesses (SOE's). This would create *another* contradictory co-existing condition: accepting the Chinese state's role in the economy at the same time that, on the short-list of U.S. demands, the Chinese government must cease and desist its role in managing its economy.

- Conclusion

> Xi has clearly nailed his colors to the mast of a much more state-directed economy. I'm pretty skeptical that there will be significant movement by China on these large-scale structural issues the U.S. is talking about.
> -- Arthur Kroeber, GaveKal, 01/28/19

The president's "mission accomplished" moment is in claiming his tariffs are reviving the steel and aluminum industries, stating that American steel mills are "roaring back to life". Yet, economists point out that any gains will have come at a high price: the Peterson Institute for International Economics show that while tariffs should create ~8,700 jobs in the steel industry, steel users will pay an extra $650,000 for *each* job created. We have published many quarterly letters where we have examined the immense cost of State subsidies to acquire corporate facilities (FedEx/Tennessee, Boeing/South Carolina, Caterpillar/Illinois), and this is *by far* the largest per-worker subsidy of all.

We have no idea what a final deal will look like, but it will of course lead the directionality of economies and capital markets. However, we do want to note that, while these times force us to focus on the consequences of a full-blown trade war, there are a number of fomenting problems weighing on the economies of China, Europe, Japan and the United States that that have been percolating for some time. We have been contemplating how to adjust to these trends and plan to discuss them once we have more clarity on trade and can move on. It is safe to say that the forces of de-globalization necessitate additional work on addressing the big question -- what's next -- as we reflect on the portfolio characteristics that will best navigate the coming years.

This brings us full-circle to what supposedly triggered last year's sell-off -- interest rate sensitivity. Active managers have lagged their respective benchmarks for years as easy money policies drove all assets higher irrespective of the quality of their business, balance sheets, or cash flows. A key ingredient in this prolonged 'risk-on' environment was the absence of volatility, which for active stock pickers is a crucial market factor. The dramatic return of this important variable -- reflecting the uncertainty surrounding the tariffs, trade, slowing economies, E.U., Brexit, the corporate outlook, and the political disfunction -- has stimulated actively-managed fund returns. As we never tire of pointing out, passive investors own the good with the bad, but who wants to own the bad when the backdrop changes?

From our families to yours, we wish you all a peaceful and prosperous spring.

Yours truly,

Hirschel B. Abelson
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