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Dear Clients:

There has been much hand-wringing concerning mounting economic maladies in key economies around the world. We are understandably fixated on China but there are multiple concurrent and connected plot lines including the material weakening of the German economy, the Brexit chronicles, the price of oil and its inflationary potential, and the drastic decline in global bond yields. We have long-described the U.S. economy as the "cleanest sheet in the laundry basket" and that continues to be the case: low, stable economic growth but sporting an unimaginable *trillion* dollar deficit.

The outlook for the U.S.A. isn't what is was even at the start of the year. There are many reasons for this caution, including the threat of higher tariffs, fewer end-markets (too many trade agreements in limbo), rising wages and material costs and, maybe, the bill has simply come due after an historically long expansion. As the world's leading importer and consumer, a slower growing America tends to lead to a weaker global economy and, while the issues surrounding Brexit are self-inflicted (we will leave *that* alone), massive economies including Germany and China are heavily exposed to trade flows and are particularly vulnerable to U.S. cycles.

When the presidents of China and the U.S. first met in 2017, the Chinese leader said they had "a thousand reasons to make the China-U.S. relationship a success, and not a single reason to break it". In the clearest sign it really does take two to tango, it's just two years on and the relationship has reached its lowest point in decades and worsening by the tweet. The on-again/off-again threats to raise tariffs is a near-constant and has unleashed tit-for-tat skirmishes on trade and currency policy that risks accelerating into a larger geopolitical fight. A big part of the problem is that neither leader believes the other is serious about making a deal so that the political space for compromise is diminishing as hardliners take center stage, prompting business leaders and investors to weigh their options.

We have thus arrived at the next turning where the war over global manufacturing and technological dominance has entered a new phase -- one marked by waiting around for a change in conditions that forces one side or the other to blink. The U.S. economy is reasonably stable yet people worth paying attention to -- everyone from the Federal Reserve to many dozens of CEOs, industry trade groups -- *all* agree the economy is slowing as a direct result of the trade demons the administration has unleashed.

Needless to say, uncertainty has a chilling effect on business investment. How can a business invest -- whether in new capacity, new stores, new employees -- if its costs and supply chain reliability are hard to gauge, never mind its expected demand? It is nearly impossible without visibility on rising tariff rates (or falling, or moving sideways depending on the day!). Trade agreements take years -- even decades -- and are complex legal contracts. The language needs to be clear enough that neither side can squeeze out more concessions on the sly. This is increasingly complicated when neither trusts the other.

"Winning big time against China" has a nice ring to it but we in the data-crunching business have never been provided with a formula for what "winning" means nor evidence that we as a nation are better off today than we were three years ago. We do know however that trade protectionism is causing measurable pain to our trade partners and, absent a quick outcome the cracks are likely to widen. With this thought in mind, and Q3'19 earnings soon to commence, we launch into our observations and anecdotes obtained from this, our third quarterly trip **West of the Hudson**™ in 2019.

- The Corporate Lens

> Do you think maybe Powell is listening to what the folks at FedEx are telling him about global demand? The company "only" handles 15 million shipments *per day* and not only posted its weakest sales performance in a decade but reported that world trade volumes are contracting this year for the first time since 2009. -- David Rosenberg, *Breakfast with Dave*, 09/19/19

As always, we turn to American businesses to frame what's relevant to you and us as investors. America Inc. has enjoyed an extraordinarily good run since the nation rebounded from the 2008-09 global financial crisis. The economy has grown, inflation has been low and interest rates remain at rock-bottom. And remarkably, despite unemployment remaining below 4% wage pressures have been modest. All told, annualized corporate profits touched $2 trillion in Q2'19 -- double the level a decade ago. Add to this the 2017/18 corporate tax cut and a healthy dose of deregulation, and records amount of capital have been freed up (the fly in the ointment is of course the *usage* of that excess capital).

And yet the outlook from the C-suite is less ebullient than the trailing data. Business leaders cite various reasons for the dimming forecast (the most common refrain being that trade frictions are "wreaking havoc with supply chains and costs"). This has served to dampen productivity expenditures so that, coupled with headwinds including a strong dollar and higher input costs, manufacturers are making less than they did a year ago. A widely watched index of manufacturing activity compiled by the Institute for Supply Management (ISM) has confirmed an emerging and worrisome drift: factory output has now contracted two consecutive quarters. This in and of itself is not historically noteworthy: consecutive quarterly contractions in industrial production occurred in 2016 as the collapse in oil prices sped quickly through the energy sector into oil-service-related manufacturing. But the industrial job surge out of that downturn has gone into reverse without a similar exogenous event and increasingly appears self-inflicted.

The president nonetheless lashed out at businesses that blame tariffs for their woes, calling them "badly run and weak" and threatened to force American companies to "abandon" China. That may seem absurd but what was once absurd is now par for the course as the best of American capitalism butts heads with an executive branch and its alarmingly collectivist predisposition.

This selective bias is best found in the effort to revive the steel industry. Steel prices surged after import tariffs were imposed in March 2018 and stock prices followed suit. Two years later steel prices have plunged as an opaque economic policy backdrop and poorly applied tariff regime prevail. The price decline has a lot to do with the administration's ideological need to recraft NAFTA (rebranded as USMCA but otherwise unchanged). In order to reach an agreement, among other sweeteners, the administration *removed* steel tariffs against Canada and Mexico -- two of the largest sources of low-priced steel imports. A significant, large steel manufacturer (U.S. Steel) has since announced it will idle plants and consolidate its operations -- proof that when the government picks winners and losers in an economy, it's called socialism…and tends to backfire.

A more complex and appropriate anecdote for misapplied trade policy is found in the very well-run U.S. large cap company, Cummins. The company expects to spend more than $150 million on tariffs this year -- more than ***twice*** the $70 million it expects to save as a result of a cut in the corporate tax rate. While it is working on sourcing parts from other countries to reduce this bill, the company dismisses the idea that simply pulling out of China is an option, where it makes and sells 40% of its engines. Cummins began selling engines in China in the 1980s and has spent decades building its presence and its brand. They reported $5.7 billion in China sales in 2001 which have grown to an impressive $24 billion in 2018. China is viewed as the bogeyman that stole America's factories, but the reality is that many manufacturers' fortunes remain heavily linked to China -- as an end-market or supplier -- and that profitability is far larger than understood, and effectively irreplaceable.

It is now looking increasingly likely that few large American companies will be able to sidestep the toll exacted by tit-for-tat tariffs. These costs will quickly fall to the bottom line. Many business leaders have

kept a low profile as the trade war intensified in the hope that the threats of tariffs could be negotiating tactics that would lead to some sort of détente. That outlook is dimming. While corporate earnings have held strong, a large swath of companies across sectors have warned that they are trimming profit expectations. If the stock market is efficient -- a big IF after so many years of Fed price-fixing -- it will re-price valuations accordingly. That is our universe and we will manage through it. But the larger universe that makes the world go round -- "Mom & Pop" farming and protein production -- do not enjoy the advantages of publicly traded companies and have "earned" some ink in this relatively small space.

- Farmageddon

> We have more commodities, more grain sitting on the ground now because we lost huge export markets. We've lost export markets that we've had for thirty years that we'll never get a chance to get back again. -- Patty Edelburg, National Farmers Union (represents ~200,000 U.S. farms)

If throwing the steel industry under the bus in order to close a trade deal that didn't need a do-over is deplorable, what has morphed into a war on the American farmer is appalling (but *entirely* predictable). As with factory jobs, while the number of people employed on farms has been declining for some time, agricultural is still a $1 trillion industry and has a huge impact on many hundreds of communities across the U.S.A.

In our Q1'19 communiqué we noted that ***one in three acres of American farmland is planted for international sales***. Feeding China's growing appetite has meant big business for the U.S. farm economy. China is/was the largest export destination for U.S. agricultural commodities. In 2017, Chinese buyers imported $19.5 billion in farm goods -- that dropped 55% ($9.1 billion) in 2018 and, through June 2019, agricultural imports from the U.S. are down another 20% from 2018.

More than two years into the dispute, China's retaliatory efforts against the U.S. farmer has been ruinous, affecting farmers growing soybeans in Illinois, raising cows in California, and breeding hogs in North Carolina. Lucrative contracts that farmers long relied on as a significant source of income have evaporated, with Chinese buyers looking instead to sellers in Brazil and Canada. According to the American Farm Bureau, bankruptcy filings in the year through June were up 13% from 2018 and loan delinquency rates are climbing (despite billions in government handouts intended to bridge the gap).

Efforts to cultivate China's appetite for American soybeans alone stretch back almost *four decades*. At its highpoint, purchases exceeded $21 billion per annum, but the grain ships have essentially stopped sailing. Given the scale of China's agricultural imports, it will be hard -- if not impossible -- for U.S. farmers to make up for those sales. The National Milk Producers Federation said dairy exports to China have dropped 54% this year, lamenting that "any step away from an agreement that further escalates tensions puts recovery of these sales further out of reach". The National Farmers Union didn't waste words, describing U.S. negotiations as "a strategy of constant escalation and antagonism".

Farmers in Wisconsin especially are feeling the heat as one in nine jobs are tied to agriculture (predominantly soybeans and dairy). Egg producers in Iowa, Indiana and Pennsylvania -- the largest egg-producing states -- have lost a significant source of sales and, with more than 65 billion eggs produced thus far this year, are faced with substantial over-capacity. All this has opened another door adding additional pressure on agricultural communities -- as more farmers fall behind on their loans, big banks have cut their agricultural loan portfolios making emergency capital harder to access.

These results reveal themselves through large multinationals as well. Fertilizer maker Mosaic has seen its earnings forecast plunge (-45% in 2019, -189% in 2020); logistics and agricultural behemoth Cargill reported a 67% drop in quarterly profits; equipment manufacturer Deere has cut its profit forecast twice this year; and Archer Daniels Midland, after reporting a 59% decline in quarterly earnings, noted that China is becoming more comfortable buying food elsewhere, recently approving poultry imports from

Russia and pork shipments from Argentina. Said ADM's chief executive, "people find alternatives, and eventually, they become a little bit more comfortable with those alternatives".

Ironically, the administration wants Beijing to quit subsidizing strategic industries, yet that hasn't deterred the White House from doling out billions in aid to these struggling American farmers. ***At $28 billion to date, the farm rescue is more than twice as expensive as the 2009 bailout of Detroit's Big Three automakers, which cost taxpayers $12 billion*** (but resulted in a profit for the U.S. government). Think about that! The sad irony is that agriculture is/was one of the rare U.S. industries that consistently runs a trade surplus, and not just with China. The American Farm Bureau Federation had projected that multi-national trade deal we backed out on the first day of this administration (the Trans Pacific Partnership) would have increased net farm income by an additional $4.4 billion annually – a testament to the gains that have accrued to American farmers from globalization and comprehensive trade agreements.

- Tariff Policy

> If the President's goal is to bring manufacturing back to the U.S., then doubling down on tariffs makes about as much sense as bowling cleats. At the end of the day this means smaller profits, selective price increases, and supply chains moving from China to countries such as Vietnam and Mexico. It does not mean more American manufacturing jobs.
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> -- Kip Eideberg, the Association of Equipment Manufacturers, 08/02/19

The Fed recently published a report titled, "Does Trade Policy Uncertainty Affect Global Economic Activity?" (09/04/19). Their short answer was "yes", but their discussion around its results are so typically cryptic as to add nothing serviceable to this discussion. The Atlanta Fed however stepped out with a survey of its own and provided concrete results. It found that tariffs and trade threats have negatively affected 30% of manufacturers and 28% of those in retail, wholesale, transportation, or warehousing industries. The poll also showed that in the broad business sector, 67% of companies are putting capital expenditures "under review", 22% have "postponed" them, and 9% have "dropped" (cancelled) their spending intensions outright.

If you read the transcripts of the Fed's post meeting press conference, they came right out and said, "our business contacts around the country have been telling us that uncertainty about trade policy has discouraged them from investing in their business". So the Fed isn't looking at backward looking data. They are listening to the business community.

We layered a heavy dose of trade data costs on you last quarter so we will move on. But it bears repeating that one-half of all U.S. manufacturing jobs depend on exports and, as noted, one in three acres of farmland is planted for international sale. So too U.S. oil: exports to China peeked at 1 million barrels/month in 2018 but have crashed to just 220K/month in April 2019. The many billions being spent by oil service companies to meet China's coming needs (estimated to reach 40% of total global consumption), is at risk. So too U.S. natural gas production where 33 LNG cargo ships were sent to China in 2018 but only 3 have been sent thus far in 2019. In all, recent and proposed trade actions threaten as many as 2.6 million jobs, including manufacturers, farmers, and ranchers. 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.

As we digest all this trade and tariff information, we keep coming back to the same question: "where do we go from here"? Timing is everything and it takes time for a trade deal to propagate positively through the economy, meaning six to twelve months (which is the tail-end of the election cycle). With a theoretical deadline for a deal looming, the narrative floated to us is that the president wants to complete a small deal now and punt on the stickier points until a later date. That sounds reasonable on the surface, but we would counter that a potential starter deal needs to be narrow in scope because the administration wants to avoid the need for congressional approval. While American trade law allows small concessions

to be made without approval, it is at odds with the rules of the WTO's Most Favored Nation (MFN), which says deals must include "substantially all the trade" -- broadly interpreted to mean 90% of existing trade between the countries. The limited U.S.-Japan deal just announced for example falls well short of this definition and is in danger of WTO refusal. The U.S., apparently, intends to circumvent the MFN obligation by making the dubious argument that the deal is just the first phase in what will eventually be a comprehensive free trade agreement. We shall see.

- Rest of World

> Uncertainty is a form of poison for the global economy. Without knowing what lies ahead, firms delay making potentially profitable investments and hiring new workers. -- Economist, 09/10/19

The Organization for Economic Cooperation and Development (OECD) have warned that trade frictions risk kick-starting a "vicious cycle of lower trade, investment and higher uncertainty." The organization cut almost all economic forecasts it made just four months ago, as the "global outlook has become increasingly fragile and uncertain, and escalating trade policy tensions are taking an increasing toll on confidence and investment". It sees world growth at a mere 2.9% this year.

Here too we see evidence that America remains the "cleanest sheet in the laundry basket". Germany may be the muddiest. The OECD numbers are particularly acute in the world's fourth largest economy where German manufacturing results are being described as "awful". Like Cummins and a handful of other U.S. industrials, German producers were early movers into China as its economy opened in the 1980s, investing heavily in everything from chemicals to luxury cars to industrial equipment to fill the country's factories. German exports to China rocketed from less than $10 billion in 2000 to over $100 billion in 2018. Nowhere is the reliance on trade heavier -- German exports account for nearly 50% of its GDP -- a staggering amount which makes it vulnerable to even minor belt-tightening in other large countries.

Compounding this reliance on a large and struggling Chinese end-market is that the U.S. is actually Germany's largest export market, and the U.S. is threatening a crippling tariff regime of the German auto industry. If enacted it will ripple through Germany's considerable European supply chain. As is happening throughout the broader global supply network, if the German economy contracts, the rest of Europe will suffer. A worsening storyline however is just beginning to foment and leads to our last observation.

The well-known reflection that "there are decades where nothing happens and there are weeks where decades happen" applies to the accumulated grievances that are bubbling to the surface and suddenly all around us. The WTO has just concluded a *fourteen-year* trade dispute between the U.S. and the E.U. over illegal subsidies to airplane makers Boeing and Airbus. The WTO has ruled that the U.S. can retaliate against Europe's support of Airbus, allowing the U.S. to apply tariffs to $8 billion worth of European goods. According to reports, ***the U.S. plans to maximize the pain by applying a "carousel" approach, rotating the list of products it targets with tariffs to increase uncertainty and affect as many industries as possible***. Yet America threatens this tactic fully aware that there is a mirror case yet to be settled: the WTO will likely permit the E.U. to impose tariffs on U.S. goods over state aid for Boeing (that total figure is not expected until next year). Unsurprisingly, the E.U. isn't waiting to respond and is reportedly looking to justify off-setting tariffs on U.S. imports. And dangling above this spat hangs the administration's threat of the aforementioned tariffs on European cars/parts. That decision is due shortly. But here too the E.U. says it has already prepared a retaliatory list of U.S. goods worth a similar and off-setting amount.

- Conclusion

> There is no end in sight to the US-China trade war. It will not end because it is much more than a trade war; it is a political, economic, and low-level military war. The better question right now is not when it will end, it's how is it going to spread. -- Dan Harris, China Law Blog, 09/03/19

The U.S. economy recovered from the Great Recession much better than most other economies around the world. The American banking system is well capitalized; credit markets are vital; private equity is booming; and corporate profit margins remain near record highs.

But we are now at a crook in the road and from our conversations comes the thought that the main objectives of the trade war are at odds with one another, making it impossible for either side to construct a deal that reflects "winning". We do not really know what the Chinese have offered but it's clearly not enough. What we do know is that the president's methods and often conflicting demands have put the Chinese in a position where they cannot concede further. Let us recall that this conflict has its roots in U.S. demands for China to become a more free-market economy. Fair enough. But the president's additional obsession that China buy an unrealistic amount of goods from the U.S. in order to reduce the trade deficit is a clearly a problem and actually *distorts* the dispute by explicitly forcing China to buy goods from one place rather than another. So what began as a bid for free-market capitalism has morphed into just another strain of populist nationalism. As was pointed out to us, "these ideals do not play well together".

Indeed the administration's original objective of forcing the Chinese market to be more hospitable to American companies is fully at odds with its core nationalist objective forcing companies to move to the U.S. On this contradiction, an economist with the Peterson Institute noted that "there seems to be a fundamental inconsistency between achieving that outcome and the administration's other economic nationalist priorities, which focuses on bringing manufacturing production back to the U.S., even if that comes at the expense of everything else, including American farmers".

All this serves to illustrate a critical point: The U.S. is running out of ways to pressure Beijing into major trade concessions, and the tools it has left in its arsenal all have major costs attached. Tariffs are approaching the point of diminishing returns, trade negotiations are uninspired, U.S. consumers and corporations have eaten much of the costs, and China appears stronger and more resilient than the U.S. expected. Beijing can't stomach most of the major structural concessions the U.S. is demanding and believes it can hold steady and wait to see if the political and economic risks of sustaining the trade war in an election year may force the U.S. to back down.

A Bloomberg comment summed this up best when it concluded, "the brinkmanship on trade with China has left consumers, businesses and financial markets on edge. Not knowing whether the next presidential tweet will ease or exacerbate tensions makes for an environment of extreme uncertainty, pushing businesses to turn cautious on investment and hiring, and households to swing from spending to saving".

We remain hopeful that we are able to get closer to the action and (safely) conduct our annual visit to the Mainland and Hong Kong in the coming Q4. We will as always dutifully report back. From our families to yours, we wish you all a peaceful and prosperous fall.

Yours truly,

Hirschel B. Abelson
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