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The first rule of studying international trade is that no single rule, statistic or equation is capable of adequately explaining either current or future trade patterns. Trade is too intricate and too variable, its shape naturally adjusting to conflict, politics, disruptive technologies, and so on. This makes reliable data difficult to collect, and the presentation of trade data, like any statistic, can be manipulated to support almost any argument. Anecdotal evidence can complete the picture, or even paint a different one, and thus is just as important as what the numbers say. -- Geopolitical Futures, 6/30/18

June 30, 2018

Dear Clients:

After decades sitting atop the global trade massif, the United States has grown accustomed to being the world's sole economic superpower. But China's swift economic ascent has increasingly tested the psychology of this hegemony and has, in turn, been weaponized into a political rallying cry meant to arouse an old-fashioned nationalist crusade. China trade rhetoric was central to the administration's manifesto since before the election so its onset was expected. What was not widely anticipated was the breadth of and fervor for the America First movement, as trade barriers were leveled against friend and foe alike. As the unfolding dispute demonstrates, no interested nation is willing to back down, amplifying economic *and* political uncertainty where none previously existed.

The revelation that the U.S. would not differentiate between long-standing allies and China was met with condemnation (Japanese Prime Minister Abe branded the tariffs as "incomprehensible and unacceptable"). Our allies have reason to be angry as the impetus for trade protections didn't result from their behavior. In contrast, China employs many millions of workers and provides cheap, state-directed financing to produce enormous quantities of steel, aluminum, solar panels and wind turbines -- much more than they can possibly consume domestically. It has been a recurring tale of excess capacity leading to a collapse in market prices and hard times for foreign competitors. Punishing our NAFTA and EU allies however provides no relief from institutionalized, subsidized Chinese overcapacity.

The U.S. has been rapidly refashioning its approach to the gamut of established international norms. We have withdrawn from long-negotiated treaties on climate and nuclear weapons and have attempted to dispossess the international community of agreed-upon participation in highly integrated, international trade agreements. This has resulted in the trashing of global trade norms meant to pool economic resources, increase prosperity and deter war by increasing linkages among nations (the very root of the EU concept).

As is evident from the initial salvos launched in this quickly escalating trade tit-for-tat, bombastic speeches to fervent disciples make for good theater but they can also open a can of unintended consequences which -- relevant to our clientele -- muddles the business outlook for domestic investment.

Grouping our allies and rivals together is of course unproductive and in no way dents Chinese resolve. So, as we launch into our observations and anecdotes from this second quarterly review **West of the Hudson™** in 2018, we share with you a composite of conversations, musings, and analysis that help to contextualize and shape the current investment environment. Depending on numerous variables, there is mounting opinion that what is unfolding today will eventually feed through to U.S. interest rates, productivity, profit margins, and corporate growth.

- The Only Certainty is Uncertainty

> In a transactional business like real estate, you probably won't deal with the same counterparty again. Burning bridges behind you can make sense if you have thousands more unburned bridges in front of you. In politics, both domestic and international, you must negotiate with the same people repeatedly on different topics. If you're unreasonable on Item A, it also affects Item B.
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> -- Patrick Watson, Mauldin Economics, 4/10/18

The administration's worldview -- and how they try to effect change to "our advantage" -- is important because, as analysts often state, "flawed methods usually produce flawed results". We would adopt this aphorism for our purposes and suggest substituting "economics" for "methods".

As is noted *every time* a businessman runs for public office, "government cannot be run like a business". Trade negotiations are a perfect example of this truism because they are time-consuming and so many parties have a stake in the outcome. Unlike a private business that represents only itself; inter-governmental deals require give and take across innumerable topics among many constituencies with varied interests. Overt threats typically slow progress if the intimidation leaves little room for counterparties to offer concessions. As China's biggest export market, the U.S. theoretically has plenty of leverage to make sweeping demands. We could have brought even greater leverage (not to mention credibility) by working jointly with China's other top end-markets that have chafed under Chinese mercantilism for years. However, that horse has left the barn. A trade war with China is a big deal; a trade war with Europe is an even bigger deal; a trade war with Canada and Mexico is a really big deal. Yet, in an act of extraordinary economic evangelism, the U.S. has chosen to attack all three at once.

There is a sad irony in trying to game trade war winners and losers. For example, while lashing out at non-American automobile brands, the president complained about seeing too many German cars on Fifth Avenue and threatened heavy tariffs on imported foreign cars. However the cars he saw on New York's streets were not only manufactured in the USA, but made by the very workers who voted for him in South Carolina (BMW), Alabama (Mercedes), and Tennessee (Volkswagen).

Even more ironic is how those car companies came to put down roots in the U.S. In the 1990s, Southern states were desperate to replace manufacturing jobs lost when the textile industry decamped (to Asia!). They wooed carmakers with tax breaks, subsidized energy, and other sweeteners. Over time, these carmakers expanded their operations not only to build vehicles for American buyers, but also for export markets…in China and Europe (helping to reduce the trade deficit that so vexes the administration). Germany's Big Three carmakers all have mammoth manufacturing facilities in the Deep South. Collectively, these European brands directly employ tens of thousands of workers, and indirectly support hundreds of thousands more jobs in the communities where they are based. Even Sweden's Volvo is ramping up its first U.S.-based factory in South Carolina. Incidentally, Volvo is owned by Zhejiang Geely Holdings…a Chinese car manufacturer!

It doesn't end there and the winner/loser calculus gets fiendishly more complex. Fallout from any automobile tariffs will feed through to automobile parts manufacturers in the industry's supply chain, including the very aluminum industry that the president professes to protect. According to the Aluminum Association, 97% of American jobs in aluminum are downstream from the smelter -- particularly in businesses that shape the metal into things…like auto parts. These companies will obviously feel the tariff pinch as they pay higher input prices. But even more confounding is that the administration is at the same time seeking to repeal Obama-era fuel economy standards which have boosted demand for aluminum as stringent mileage rules helped create a market for lightweight cars that use aluminum rather than steel. That is a remarkable set of conflicting policies being slung about and this reality has not been lost on companies thinking about their capital allocation plans.

- Corporations Hate Economic Uncertainty

> The current rhetoric around trade is worrying. If strict tariff policies implemented in one country are mirrored in others, the world will become more insular, goods and services will be less affordable for consumers and that will have a negative impact on economic prosperity. -- Scott Leith, Coca-Cola

These are early days but the unpredictability of many of the president's proposals -- the lack of clarity on when or how NAFTA might be renegotiated, the rollback of automobile regulations, the ways in which other countries might retaliate -- seeds confusion across the American economy, making it tough for businesses to plan effectively for the future. As unfathomable as it is to consider, the administration's rudderless approach suggests a systematic lack of appreciation for the complexities of global commerce.

It is safe to say that the law of unintended consequences has been unleashed. With an "us-vs-them" trade threat heating up, two *iconic* American brands (Harley-Davidson and Jack Daniels) may be canaries in the coal mine. Singled out for tariffs, both companies have warned that retaliatory measures will have tangible effects on their businesses and are shifting some production offshore. As the list of goods in the crosshairs of our trading partners grows, we would be naïve if we didn't expect more companies to voice their concerns or even quantify the pain ahead when quarterly results and 2019 outlooks are announced in the coming weeks and months. As foreign end markets and globally integrated supply chains span across a range of industry sectors, it is extremely difficult to game which industries will be hit hardest, and when companies would initiate the costly and messy process of re-sourcing those supply chains, especially with multiple escalation/climb-down scenarios still possible.

The trade tension is not occurring in a vacuum and it is not just a "China thing". The motorcycle tariffs are courtesy of the EU, which has also announced levies on tobacco, fruit juice, peanut butter, apparel, and playing cards. The potential impact from these duties spans the corporate landscape, from packaged-food and soft-drink companies, to consumer-goods conglomerates. Companies must also contend with Mexican tariffs on items including pork, apples, potatoes, steel, and our beloved Tennessee whiskey. Canada is targeting steel, foods, and home appliances. India has raised levies on chickpeas, walnuts and steel. China has for now only levied duties on agricultural products and cars.

It's also important to recall that China and Mexico are two of the largest export destinations for U.S. farm products. That's tough news for the farmers (who voted for the president) who rely on foreign demand to offset domestic surpluses. Meat producers describe facing "day-to-day uncertainty" amid the trade volatility. Altogether, the EU, China, Mexico, India and Canada are the destination for more than 60% of U.S. exports (U.S. Chamber of Commerce). It remains a small portion of U.S. GDP but these are early days.

It goes without saying that there are many problems with tariffs. Above all, they benefit far fewer people than they harm. Sticking with examples in aluminum, employment in the upstream segment -- production and alumina refining -- supports just 4,000 jobs. The downstream however employ's *millions* across aerospace, automotive, construction, electronics, appliances, and packaging. And of course, while the intention of tariffs is to boost employment in the industries that benefit from such protectionism, they immediately raise prices of the protected goods for *all* consumers. According to work produced by our friends at Yardeni Research, "The CPI for laundry equipment has been falling steadily since late 2012. It jumped 14% from December through May because of the tariff on washing machines and the jump in steel prices. The PPI for steel mill products in the U.S. jumped nearly 10% from February through May after the president's threat to impose steel and aluminum tariffs". (6/18/18)

Anecdotes abound. A medium-sized manufacturer of sophisticated industrial equipment (for export) was in the late stages of plans for a new domestic facility. But with the uncertainty surrounding the cost of steel and aluminum in its products, they had no idea if they would be caught in the middle of a trade war with their end markets. As they described it, the introduction of "tremendous political risk" is weighing on their decision to invest and expand. For this manufacturer at least, they are postponing their expansion plans and

adopting a wait-and-see attitude. This is just one example, but we imagine that this firm's experience is hardly unique.

- Inefficient Stability

> Deadweight loss, meaning just throwing away money by forcing people to do non-market things, is getting pretty big. It's starting to mount into the hundreds of billions of dollars. Somebody loses money when you force people to put investment, to put work, to get things more expensive than they should have to, when they have to break up supply chains, when they lose market opportunities -- all of it adds up.
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> -- Adam Posen, President, Peterson Institute for International Economics, Bloomberg TV 6/04/18

A 2016 study by neuroscientists regarding the causes of physiological stress in humans showed that uncertainty is even more stressful than knowing something bad is defiantly going to happen (Computations of Uncertainty Mediate Acute Stress Responses in Humans).

The economic fight of the new century has now begun and the unknowns, as well as the level of uncertainty and stress are mounting. The underlying competition between the world's two largest economies has been building for some time and, while the combatants may sometimes find common ground, both sides view the dispute as a fight for not just economic supremacy, but for global supremacy. It won't be a battle either side will take lightly and it won't be one without economic casualties. This conclusion is not lost on the lifeblood of our economy: businesses. However, what is often lost when trade tempers flare is the fact that companies (and people) can be quite resilient, and can often adapt quite well to changing landscapes.

As tends to happen when one flies a lot for work, you sit next to other road warriors with assorted observations honed from experience. In this case, it was a European banker-type who noted that in developed market economies, businesses can thrive *despite* bad or inefficient policies. They cited Japanese taxes on imported beef, German stores that are shuttered on Sundays, and other seemingly obtuse policies in Sweden, South Korea, and Canada that are the embodiment of rules which, theoretically, impede the market. Yet, companies have adapted and business is sound.

The conclusion was that these regional policies may be inefficient, but that *they are stable in their inefficiency*. And we can take this observation a step further: despite these arcane regulations, the business environment is stable and offers an important distinction between developed and emerging country investment climates. In less developed countries a lack of stability makes long-term investments difficult, in part, because they don't know what future tax and regulatory policies might be. Following many decades traveling, analyzing, and investing, this observation squares with our own reflections: certainty and stability constitute the proverbial secret sauce for success, even if the business environment is sub-optimal from a market efficiency point of view.

The administration got the tax overhang out of the way and the market has rewarded this fiscal giveaway, but the administration's trade policies have been inconsistent and unpredictable. Judging from the fallout, the sequence of events on steel, aluminum, autos, (and everything since) is a prime example of the finding that uncertainty is more stressful than knowing something bad is definitely going to happen.

- Conclusion

> The times are gone that a producer was only headquartered in one country with production in that country and exporting from that country to the rest of the world.
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> -- Erik Jonnaert, Secretary General, European Automobile Manufacturers

As investors, it is important to recognize that the duration of this developing trade conflict should be measured in quarters and potentially years, not weeks or months**.** While two large U.S. corporations have

already stepped out with the pain they foresee, most large multinational corporations -- especially the ones who manufacture abroad for regional consumption -- will not fully be able to quantify the impact to their global supply chains for some time. Benign, negotiated outcomes may still be the endgame, but an extended cycle of escalation will play out in economic data and corporate financial statements.

Sadly, what is lost in this deluge of headlines, posturing, tweets and other pronouncements is that while the U.S. tries to derail China's dominance, we have no blueprint to buttress America's dominance in industries that will power economic and job growth in the future -- what the president proclaims to be the "crown jewels of American technology and intellectual property". But the Chinese do have such a blueprint -- it's called "Made in China 2025" and it's comprehensive, long-term, and formidable. As we have noted repeatedly, rather than dictate investments in new industry innovation, the administration's efforts to date have focused on propping up legacy industries including coal mining and steel production, which have shed hundreds of thousands of jobs in recent decades and which few expect to generate significant job growth in the years to come.

We recognize these legacy industries figure prominently among the president's "support base" and is the root from which all other trade actions stem. But our competitors that so enrage this base actively support companies that can demonstrate a winning strategy. In China *especially* the government forces its subsidized, protected emerging companies to compete in the global marketplace, shutting down those that are unable to perform and pouring resources into those that succeed. That path is so depressingly different from our route of assaulting emerging and next-generation industries while bailing out failing ones and calling it progress. For instance, the president has ordered his energy secretary to "prepare immediate steps" to stop the closing of unprofitable coal and nuclear power plants, including demanding that grid operators buy electricity from struggling coal and nuclear plants. This will have a material impact on the investment dollars in green and alternative energies, effectively ceding the playing field to other nations.

It is a well-worn maxim that uncertainty is bad for financial markets but doubting readers may nonetheless point to the relatively buoyant stock market and economy to suggest that these trade concerns don't matter. The aggregate value of goods on which tariffs have been announced to date is tiny relative to GDP and quantitatively matter much less than tax cuts (Bloomberg predicts a current total tariff impact on GDP of just 0.1%). China can punch back, but not with the same force as they depend on exports to the U.S. far more than the U.S. depends on Chinese imports, and thus China is more at risk. This may be so in the near term, but is short-sighted and misses a more material truth for investors: uncertainty has been reintroduced after nearly a decade of deep-seated complacency. Earnings always matter and tax cuts are welcome relief to an aged bull market. But the simultaneous introduction of a global war on trade and the reintroduction of volatility is a meaningful change to the narrative that should not be dismissed.

It is worth keeping some perspective on the direct, immediate damage from the tariffs and likely retaliation from our trading partners. Prices for inputs like steel move around all the time, and businesses are generally pretty good at adapting. But there's a longer-term danger that's a lot bigger than an import tax, and that's an erratic, improvised, us-against-the-world trade policy anathema to businesses that must make long-term decisions about how to deploy capital.

These are admittedly very early days and even as specific companies gear up for potential pain, the U.S. as a whole isn't going to sweat the tariffs. Iconic brands they may be, but Harley and Jack are of inconsequential size to total U.S. exports and don't move the economic needle. We frame it as a trade war when really it is a GDP rounding error. A widespread war on autos would be a game changer but that is for another day. Capitalism hates economic uncertainty and anxiety over trade could start to create a negative sentiment feedback loop that starts to widely impact companies' behavior. Hard-to-define downsides and second-order effects from further escalation only heighten uncertainty.

In the meantime, we at Stralem will continue to do what has long served us well: investing in quality companies with straightforward business models, strong balance sheets, and high levels of cash flow that enable them to weather a crisis and take market share while weaker competitors falter. We will always gravitate towards companies with earnings growth but, despite the remarkable run of upside returns these many Fed-fueled (and global trade fueled) years, we believe that a growth strategy that includes a preservation of capital component is the prudent way to remain invested in increasingly uncertain times. Because, as if you need reminding, up-market participation is always welcome and expected, but preserving capital in down markets is the key to generating superior compounded returns over time.

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

Yours truly,

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