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Dear Clients:

It is frequently claimed that the summer months are the most leisurely on Wall Street's calendar. While we can point to a handful of notable moments in summers-past that defy this axiom, it is hard to argue with the current Teflon-like returns of the U.S. equity indices. The market's drivers are manifold but led by reasonably steady economic output -- results that firmly separate the U.S. from the global pack of developed economies in investor eyes, and confirmed through healthy corporate income statements. True, our politics are worryingly dysfunctional and our media has forsaken its role as a fourth-estate, but corporate stewards don't generally become leaders without the capabilities necessary to navigate and adapt to changing landscapes and challenging times. And yet, the equity markets' steady beat has been easy to miss through the mist of rising investor anxiety -- an unease which has grown with the market's tenacity. The apprehension is understandable as we bear witness to a global breakdown in decorum, trade, and the status quo at the same time as all-time high corporate profitability, and with the tax cuts initial impacts in the rear-view mirror. Globalization has been highly profitable for U.S. companies, so it makes sense for investors to worry that the future pattern will be less so.

Certain truths supersede others and the fact is, recoiling from globalization is a primary ambition for the administration's economic nationalists as they go all-in on coercing American businesses to re-shore operations. The obvious risks to employers and investors are scorned as 'fake' in a manner now familiar to all. These policies however defy the reality that 1) there is already a shocking skills mismatch for currently available jobs in the U.S., 2) our labor force is many years away from closing the skills gap with Asia, and 3) a high-priced U.S. labor force virtually ensures that automated processes and robotics will take a more prominent role in any domestic manufacturing renaissance.

As in any dispute, it pays to look not only at intended targets (the international community) but also the collateral damage (U.S. employers). While a trade war has only just begun to ramp, corporate earnings commentary already confirms what should be obvious to any rationale investor: the number of companies harmed by higher tariffs are exponentially larger than those that are helped by them. Already the dispute has forced some companies to fine-tune (i.e. re-state) their earnings estimates for the coming quarter and year. In nearly every case, these numbers are being impacted by the early stages of this trade war in two forms, 1) higher input-cost inflation, especially energy and raw material costs, and 2) foreign exchange volatility, driven by currency speculators who see global economies slowing as U.S. interest rates move higher (and the cost of U.S. dollar-denominated debt-servicing with it).

How do investors calculate the impact of an entirely different global hierarchy, a system where decades-old alliances appear to have fallen by the wayside and allies begin to look more like rivals? As evidenced by forward earnings estimates, this is a scenario that analysts have not fully begun to consider despite the president repeatedly casting doubt on the usefulness of alliances like NATO and NAFTA.

The market is clearly willing to assume the best for now but if the discourse continues to deteriorate further, will it impact confidence levels and business spending decisions? And if so, then what? So, with these points laid bare, this is where we launch into our observations and anecdotes obtained from this, our third quarterly trip **West of the Hudson ™** in 2018.

- Currencies to the Main Stage

> Some people say too much growth is not a good thing. Why? Because they are jealous. It is nothing else.
> -- Recep Tayyip Erdoğan, President, Republic of Turkey, August 2018

We have spent recent communiqués focused on the coming impact that tariffs are having on corporate profitability and consumer affordability, and we will return to the topic shortly. But a familiar story reared its head *again* this summer that overwhelmed the news cycle and sent volatility soaring: the strength of the U.S. dollar and its complement**,** the weakness of non-U.S. dollar currencies.

As was expected (by anyone reading this we hope), the removal of massive global monetary stimuli should have to be done in a somewhat coordinated fashion. It was much-discussed that a lack of organization could ignite a crisis at some point, somewhere.

Coordination is of course *not* what transpired and the U.S. Fed is far ahead in its reversal of monetary stimulus and balance sheet shrinkage. And, with the U.S. economy also exhibiting relative strength against all other economies, the value of the U.S. dollar has soared, placing incredible stress on the currency market -- especially those countries that hold onerous U.S. dollar-denominated debt.

When looking at a state's finances, it's easy to get bogged down in technical complexity or led astray by trivial details. But it bears repeating that foreign-denominated debt comes with challenges that domestic-denominated debt does not. When a country borrows in its local currency, it pays back the principal and interest in that currency. Whether the value rises or falls, the cost of debt servicing remains payable in a currency *the State* controls.

Foreign-denominated debt doesn't abide this rule and must be repaid in a currency controlled by other actors. Crises are ignited then when debt repayment becomes strained. Over-extended economies can become destabilized if 1) there a significant spike in the USD exchange rate, 2) a protracted interest rate spike, or 3) a slowdown in GDP growth. Turkey, for example, is facing *all three* of these pressures and, at quarter's end, it requires 21% more liras to service each U.S. dollar of debt than at the start of 2018.

If external debt is so risky, then why do countries take on so much of it? In general terms, the answer sits at the intersection of politics and economics. In virtually every example *ever* -- be they autocrats or elected officials -- stimulus boosts economic growth, keeps the public happy, and the leadership in place. The use of external rather than internal debt is a key differentiator however, as a lack of domestic savings drives sovereign borrowers off-shore.

Turkey has assumed the unenviable role as the latest crack in the emerging market dyke and delivers us the latest debacle. For years Turkey stimulated its economy through easy credit and budget deficits. Following the Chinese playbook, they piled on debt to fund government-sponsored projects that created jobs and the facade of economic stoutness. But Turkey isn't China and that's where the comparison ends.

While it must be noted that Turkey only represents ~1% of global GDP and is therefore not a 'systemically vital' nation, Turkey is nonetheless a paragon for many of the problems that exist in so many emerging markets today: intractable debt levels with an overreliance on dollar-based loans. And, while Turkey's lira is in focus here, the Iranian rial, Russian ruble, Indian rupee, Argentine peso, and South African rand have all declined steadily for similar reasons: they all share this common challenge of unsteady economic output while sitting on a ticking time bomb of U.S. dollar-denominated debt.

In its latest quarterly report, the Bank of International Settlements (BIS) found that global U.S. denominated debt to non-bank borrowers reached the highest recorded total ($11.5 trillion) in the five plus decades the bank has tracked the data. This is a sizable sum and, regardless of how countries try to navigate the costs, the fact is that the U.S. is proceeding along a path of increased interest rates, which will continue to apply pressure on governments and their currencies. It is held that Turkey was 'uniquely susceptible' to their current position and is not symptomatic of a wider crisis, but that is a dubious argument. Authoritarian capitalism is hardly unique after all. The fact is, U.S. rates are moving higher and so too the cost of debt-servicing. The lira and other currencies will continue to exhibit highly volatile fluctuations raising the specter of contagion. This possibility is surely not lost on corporate treasury offices as they prepare their 2019 budgets.

- Corporate Sentiment

How could a flailing foreign exchange market in Turkey impact U.S. businesses? On its own, it shouldn't. But if enough foreign currencies are in decline or exhibiting above average volatility, forward earnings estimates and outlooks become increasingly hard to pin down. And as corporate executives are keenly aware, when translating earnings from weak foreign currencies into U.S. dollars at reporting time, traders are known to deliver a harsh verdict for FX-linked earnings surprises. With Q3 earnings on tap, the continued strength in the U.S. dollar is something to watch. Following Q2 earnings calls, currency swings were the most frequently cited headwind -- ahead of rising raw material costs, oil prices, and tariffs (source: FactSet).

Companies are no different from you and me -- no one likes uncertainty. But the backdrop is changing and adaptation is suddenly on tap. During the last two decades, the world economy seemed to be on an irreversible course of deepening integration. Trade expanded nearly eightfold and doubled as a share of global GDP (source: McKinsey). For some, including the asset-light, 'new-economy' technology sector, the backdrop will not subdue their disposition to invest at a very high rate. For others, especially the asset-heavy, capital-intensive, 'old-economy' industrials, there is a high degree of operational uncertainty that redirects their focus to husband resources.

What's remarkable about the impact of policy headlines on sentiment -- even if it is mostly just angry tweets -- is the speed with which corporate sentiment can change. While currency swings were the topic of quarterly reports, in longer-term surveys, it is tariffs. In McKinsey's June 2018 global economic snapshot, executives expressed more caution about the state of the global economy than in earlier surveys. In the December survey, 15% of respondents said over-all economic conditions were "worse" than the prior survey. By the June survey, that "worse" figure had grown to 35%. Trade-policy was the most commonly cited risk. That assessment has declined further in the 3Q snapshot (September) as expectations for trade activity decrease, trade-related risks prevail, and for the first time this year, fewer than half of respondents expect the rate of economic growth to increase over the next six months.

If a global slowdown does materialize faster than expected, it will exacerbate the currency crisis which will cause a further deterioration in overall global corporate outlooks for growth, investment, and profitability. We are not there yet but are having the conversation.

- Tariffs Bite

> They've thrown so many unknowns into it that it's challenging to make any long-term strategic decisions. It's impossible for a company like ours to just change manufacturing locations, we have too much invested.
> -- Ralph Bradley, CEO, Jammy Inc., 09/05/18

It is perhaps low-hanging fruit to highlight the laments of a manufacturer of automobile lighting, accessories and precision metal components -- the broader auto parts industry is the tip of the spear in the president's war on trade. But these sentiments are not contained to this subsector. This small manufacturer is one of *thousands* of U.S. businesses that embraced globalization, forging a joint venture with a Chinese factory that makes the injection-molded plastic needed to produce its products.

The smaller the enterprise, *of course*, the more difficult the challenge. Companies like Jammy lack the economies of scale or the deep pockets to roll with the punches. But that is not to suggest that mega-sized companies aren't feeling the effects as well. The mighty Ford Motor Company is a ready example.

> The metals tariffs took about $1 billion in profit from us -- and the irony is we source most of that in the U.S. today anyways. If it goes on longer, there will be more damage. -- Jim Hackett, CEO, Ford, 09/26/18

Unsurprisingly, America's corporate bosses -- recently voiced collectively by the U.S. Chamber of Commerce -- disagree with the president's boast that a trade war is "easy to win." Even at a small boutique like Stralem, we deliberate over the pain China inflicted on South Korean-owned businesses last year during a relatively small dispute. It's not a huge leap to imagine a Chinese state-nudged boycott against General Motors, Starbucks, Nike, or Disney.

This is because, while China vows to retaliate, the total value of U.S. exports to China is far smaller and will therefore require more than tit-for-tat tariffs to punch back. So, if China were to employ a similar strategy to the one used against its neighbor -- shuttering stores and factories owned by South Korean companies and stoking boycotts against its autos -- U.S. brands could pay dearly. China is, after all, an essential supplier *and* corporate America's biggest growth market.

Here are a few examples. Nike's China revenue grew 21% in the last twelve months and represents 14% of its total sales. In contrast, North America revenue declined ~2%. China is also the major supplier to Nike, producing ~20% of all its goods. At Starbucks China, same-store sales grew 7% versus just 2.5% in North America during the same period. While America is a mature market, Starbucks is on-plan to add 600 stores a year in China to reach 6,000 by 2022. For General Motors China, Cadillac sales grew a whopping 39.7% in the last year. In contrast, U.S. Cadillac sales grew 8.1%. If China can successfully arrest some of this growth, the impact on growth for many large cap U.S. companies will not be insignificant.

It's far worse for the mighty American industrial companies. We have seen first-hand that the broader sector's profitability is at risk from commodity prices, labor costs, tariffs, and now currencies. Investors will soon learn which companies can successfully adapt in a cost-push inflationary environment that has resulted from supply chain disruptions. CEOs are counting on a combination of cost cuts and the ability to pass through price increases to offset rising costs or, in

their parlance, “to push price in the marketplace”. We haven’t even discussed the lurking Chinese substitution threat (which we will cover next quarter once we have visited the region).

As many of you know, we have a strong preference for the larger, global companies. This is due in part to supply chain elasticity and a business model that sources and produces in the region where they sell. This approach helps significantly mitigate the risk associated with tariffs by limiting cross-border movement of raw materials and products. But one must wonder, in the infamous words of Chuck Prince, “has the music stopped”?

- The Golden Goose: Autos

This is an addendum to a story we highlighted in the June quarter: the BMW Spartanburg plant. Since then, further facts have accrued that add compelling texture to the backstory and we wanted to close the loop on the narrative. The South Carolina facility is BMW’s largest -- one of every ten people in Spartanburg (population 37,876) earns a living making vehicles or parts. Its presence has helped draw more than *two hundred* companies to establish facilities nearby. Unknown to all, the German company -- *not* American icons Ford or GM -- is the largest exporter of cars made in the U.S.

It bears repeating that automobiles don’t come together in one plant with one work force but a result of *hundreds* of companies working in a supply chain that can snake through small towns everywhere. A significant chunk of the thousands of parts in a BMW X3 for example aren’t imported for assembly but manufactured by small and midsize companies in the U.S.A.

Nonetheless, the administration has forced the hand of U.S.-based companies large and small. Harley-Davidson received a lot of negative attention, but they are hardly alone. BMW has received scant attention but stated that auto tariffs “would have an impact on jobs in the United States”. Then, just a few months later, the company announced they would “cut investment and production in Spartanburg if selling its American-made sport-utility vehicles abroad became too expensive”. Today, mere months after that warning was issued, BMW has ceased exporting its X3 brand from Spartanburg to China and is moving production of the SUVs to plants in China and South Africa.

- The Golden Goose: Agriculture

> We are borrowing money from China to pay our farmers to not sell their crops to China.
> -- U.S. Senator Brian Schatz, 09/26/18

We have rightly focused on that which informs our investment posture but there is a human cost at the end of all of this. And as evidenced from the above, this self-inflicted harm to our free-market economy is patently absurd. In interview after interview, farmers have delivered essentially the same response to the president’s pledge of financial assistance: “we don’t want handouts, but we can’t eat patriotism”.

Our main agricultural commodities are soybeans and pork (followed by corn, fruits, and vegetables for those keeping score). All commodity prices are essentially linked so that, if soybean prices fall, so do corn and wheat…and soybeans have already suffered a 20% collapse. Putting aside the industry’s faux ‘small government’ defiance, the fact is that the U.S. farmers are *regular* recipients of government aid (including an estimated $9.2 billion YTD). Agriculture is the third-largest U.S. export and American farmers ship ~35% of their output abroad, generating an estimated $21 billion trade surplus in the last twelve months. Given both its size and the industry’s vocal support for the president, it is unsurprising that it was the first industry China struck back at.

- Conclusion

As the U.S. Chamber of Commerce said in a recent letter to administration officials, "tariffs won't effectively address concerns about China's trade behavior, but the number of objections to the duties speaks volumes about the damage that additional tariffs will do" (08/20/18). The main risk looming for the U.S. economy is protectionism. The ongoing battle over tariffs has already seized up some global supply chains and triggered the start of a slowdown in the global growth momentum. Tariffs are affecting businesses big and small and not just in the automotive supply chain. An abbreviated list of companies who have cited tariffs impact on estimates includes some of the largest employers in America: Walmart, Newell Brands, Bunge, Cummins, Tyson Foods, Caterpillar, Eastman Chemical, General Motors, Coca-Cola, Ford, Harley-Davidson, Whirlpool, Illinois Tool Works, Stanley Black & Decker, General Electric, PPG Industries, Alcoa, Procter & Gamble, and Brown-Forman (source: Bloomberg Tracker, 09/25/18).

We began by citing investor anxiety and yet that is not a sentiment we share. Our strategy -- our mantra -- has long been 'participation with protection' and, given the market's current level and the heightened state of uncertainty on the political, geopolitical, and policy fronts, our approach to portfolio construction continues to be more relevant than ever. We are constantly striving to address 'what's next' and, were some dislocation to occur as the markets shift back to fundamentals and/or investor funds start to flow out of passive strategies, we like our positioning. We don't make predictions, but we do prepare for various scenarios including the challenges highlighted in this communiqué. This is a gradual process, but with the tug-of-war playing out between bulls and bears, it is more critical than ever to seek a solution that allows for participation in the continued upside momentum in the market, but in a way that will protect on the downside if the conventional wisdom at play were to not be confirmed by the markets.

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

Yours truly,

Hirschel B. Abelson
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