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Dear Clients:

As we peruse the books on the office bookshelf, it seems fairly well-established among economic historians that tariffs and trade wars are bad for economies. Protect an industry like steel from foreign competition and you raise costs for a far greater number of domestic companies that depend on steel as an input. You also invite retaliation that hurts other parts of the economy so that any short-term benefits lead to bigger long-term costs.

But what if the leader of the world's largest economy doesn't believe in the heavily analyzed historical record? As he dials up the pressure on China -- and threatens Europe, Mexico, Canada, Japan, India, and South Korea -- the President of the United States has weaponized an economic tool for political purposes and seized on the idea that his trade war is boosting U.S. growth and is, therefore, a strategic success.

This alternative theory of economics hinges on two data sets: better-than-expected Q1'19 GDP and continued sturdy employment data. In a flurry of tweets following the GDP data release, the president declared his tariffs "are responsible for our great economic results", soon followed by the Treasury Secretary's tweet, "there's no question that some of the trade policies helped in the GDP number". These statements are not factually incorrect: heavily-tariffed imports slowed in the first months of 2019 helping to boost "net exports" (exports *minus* imports) which, thanks to the way GDP is calculated, gave a lift to the growth rate.

This counteracts the effects we saw only one quarter ago (Q4'18), as the constant threat of tariff hikes caused U.S. companies to pull forward Chinese imports. This supply chain "padding" helped lead to both a buildup in inventory stockpiles and a narrowing of the trade gap but, using the same formula for GDP calculations, the growth rate slowed. So the effect of lower imports during Q1'19 was to make growth appear stronger. Meanwhile, the headline jobs number was not what it was tweeted to be either. The key manufacturing employment number added just 4,000 jobs, while the critical factory-line jobs the president has claimed to bring home (nonsupervisory production jobs) declined again. This comes amidst signs that employment gains in industries protected by tariffs are petering out. The primary metals sector especially, including steel and aluminum producers, have experienced jobs shrinkage in recent reports.

We estimate that our clients and larger readership are fairly divided in their assessment on the president's efficacy and internalize the above data accordingly (somewhere between "fake" and "frightful"). This divide wouldn't matter if the tariffs were bearing fruit in the administration's two main goals: extracting major concessions from China and bringing jobs back to the U.S. But these outcomes have not come to fruition and worse, Beijing appears to believe that it can hold the line until the U.S. reaches the conclusion that the political costs of tariffs have outpaced their usefulness.

Trade policy is an esoteric field and we keep expecting the easier road taken: to declare victory around a limited deal that removes tariffs and mutes criticism from affected industries than to defend a damaging fight that has yet to bring China to heel or restore manufacturing's lost glory. And yet here we are. With this thought in mind, and Q2'19 earnings season upon us, we launch into our observations and anecdotes obtained from this, our second quarterly trip **West of the Hudson**™ in 2019.

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## Revenue: The Foreign Slice

It is impossible to over-state the relevance of the small and medium-sized companies on U.S. domestic job creation. While there is some evidence that small business growth has stalled (ADP reports small business hiring has fallen the past two months, the first two month decline since 2008) there is no published data to corroborate the impact tariffs have had on product sourcing or margins. Probabilities nevertheless are rising that smaller companies who source discrete products from China are going to be in a tough position should tariffs remain in place or expand. But we do have current data on the very large, multinational companies (who also have a large role in domestic job creation). In the most recent report from the Shanghai-based American Chamber of Commerce (May 2019), 75% of American businesses operating in China said the increases in U.S. and Chinese tariffs "are having a negative impact on their businesses". Companies reported experiencing lower demand for products (52.1%), higher manufacturing costs (42.4%), and higher sales prices for products (32.2%).

As investors in large, global companies, we know all too well that what happens abroad doesn't stay abroad and the specter of geopolitics and trade on overseas economies will impact S&P 500 corporate revenue. While it is hard to determine the exact foreign sales exposure of the S&P 500 (such disclosures aren't technically required), most of the marginal global growth comes from the emerging markets with China far atop the leader board. According to the June 2019 report by Standard & Poor's Howard Silverblatt, the share of foreign revenue in the S&P500 stands at 44% -- a significant decline from a decade ago but nonetheless substantial all the same.

The largest foreign sales breakdown by *region* are Asia (8.3%), Europe (8.1%), Africa (3.9%), Canada (2.2%), and Japan (1.5%). The largest foreign sales exposures *by country* are China (4.3%), Japan (2.6%), and the UK (2.5%). As noted, many companies do not break down sales by region, categorizing them broadly as "foreign" sales, which explains the relatively low regional share reported.

Information Technology was the sector with the most foreign exposure with 57%, closely followed by Energy (54%), Materials (53%), Industrials (45%), Health Care (38%), Consumer Discretionary (34%), Consumer Staples (33%), and Financials (31%). This ranking goes a long way to explain why certain sectors sell-off more than others on days where tariff-centric headlines dominate market psychology.

As a region, emerging/developing Asia historically grows far faster than the U.S. economy and, while its growth is slowing, the data does not paint a rosy picture of forward growth rates. Some of the slowdown has been developing for years as ageing demographics and lower birth rates take hold. However, the rapid decline cited in the ACC report is very much a reflection of current tariffs and a hostile operating environment. We are seeing companies guide down earlier estimates for the year across industries, with the decline in international trade, uncertainty about new investment, and lack of policy visibility cited as the most common causes.

- The Mechanics of the Global Supply Chain

That is the raw data. But zeroing in on the root of business anxiety and diminished outlook is the assault on supply chains. This includes both the time and costs required to establish them, as well as the time and costs it will consume to build new ones.

The concept of a supply chain is simple: all products begin with a primary input like oil, zinc, or corn, that are refined and sold to another entity that will further refine them into a multitude of other products which, ultimately, take the finished form of everything from processed foods, auto parts, and smartphones.

Industrial production involves moving the primary input from its place of origin -- a mine or a farm -- to locations where it is made into a specific product and moved to another factory where it is further developed using components from other factories, then sent on further still to other factories where it is further refined, until it can finally be sent to a consumer. Thinking about the impact of Mexican tariffs for example is best explained from this supply chain perch: a single car part can cross the U.S./Mexican border as many as *eight times* during its production. The chain has multiple parts with branches and alternative movements that take a particular item to many points that produce seemingly unconnected things. It bogles the mind to think a simple, lowly, piece of cloth for example can become a shirt, or a component of an electric drill, or used to polish jewelry.

The very process of imposing a higher price at our borders on Chinese, Mexican, Canadian or European goods disrupts the supply chain on which U.S. business have become dependent. Each country's ability to tolerate the pain is dependent on whether an alternative supply chain is available or can be rapidly found. Among the many problems is that higher value products are often more complex to fabricate and can require more specialized, discrete supply chains. And the U.S. sits atop the value-added chain.

The U.S. has used supply chain disruption as a weapon in the past. Pearl Harbor was a direct result of the U.S. interrupting the flow of oil and steel to Japan; and the Reagan administration blocked wheat exports to the Soviet Union in the 1980s -- a core staple on which they were entirely reliant. But the impact to U.S. business was negligible. Today, American companies have become dependent on components from around the world and the possibility of a parts disruption by their own government was not factored in. Businesses rightly think of themselves as central to the economy. They (and we) are quickly learning that the structure of the supply chain is intrinsically political and not sacrosanct. They are as sophisticated about their supply chains as they are naive about the supply chain's geopolitical security.

This emerging naiveté may well be the lasting impact of this assault on globalization: public companies will be slow to deploy capital as they wait and see the retaliatory response as well as the results of the election in two long years from now. This will not only diminish revenue, but it is possible that innovation and productivity will suffer as well as companies are slower to invest.

- Chumming the Waters

The complexities are ultimately in the details, and the details in this case are measured in dollars and cents. It is here that the battle of tariffs, margins, and price hikes comes into view. Unlike the first round of tariffs that targeted industrial and commercial products, the next round is aimed squarely at consumer goods like footwear, toys, apparel, and cellphones. Retailers -- already tormented by vacant storefronts and deserted malls -- warn the impact will be disastrous. Even for healthy chains like Walmart and Costco, the new duties threaten the business formula that helped speed their rapid rise over the last few decades (import cheap products from Asia and sell them at rock-bottom prices).

The National Retail Federation estimates that China supplies 42% of all apparel, 73% of household appliances, and 88% of toys sold in the U.S. China also produces 82% of mobile phone imports, 94% of laptop computers, 85% of tricycles, 98% of video-game consoles, and 70% of shoes (source: Wall Street Journal, 06/17/19). China also produces 100% of holiday lights (now *that's* a war on Christmas!). Wal-Mart's CEO didn't mince words on its earnings call when he said, "increased tariffs will lead to increased prices for our customers". There is overwhelming evidence to support this claim and, while we will not review it here, we draw your attention to our last quarterly letter, March 2019 for further discussion. Any company that can raise prices to off-set increased import costs on tariffs will do so, while those that cannot will be less profitable or adjust accordingly. As GaveKal U.S. analyst Will Denyer succinctly observed, "In its totality, the additional risk in the global trading system points to lower growth and a tougher profits outlook" (06/04/19). If you need a score card of who is who, just watch their stock prices in the coming quarters.

The profit-impact will be greater on traditional U.S. retailers because they can't adjust prices as quickly as online retailers and will potentially cause more stores to close and more people to lose their jobs. So far in 2019, American retailers have announced plans to shut more than 7,000 stores, after announcing nearly 6,000 closings last year. Those numbers are largely due to the inclusion of liquidations of large chains like Payless Shoes and Gymboree, as well as mass store shrinkage at Gap. By year end, announced closings are estimated to climb in excess of 12,000 stores, whether due to tariffs, execution missteps, or changing tastes (source: Coresight Research).

But the above includes larger domestic issues which go beyond a trade war. What of American businesses operating in China? The Chinese don't buy enough stuff from the U.S. to match tariffs blow for blow, so they have turned to other forms of retaliation -- economic nationalism -- a tactic which we ruminated on for two years. This takes shape by stoking sentiment among Chinese consumers that implicitly encourages a boycott of U.S. products. Initially after the trade war started, Beijing refrained from this sort of behavior, but now it has thrown caution to the wind and the early data suggests it is having its intended effect. According to a new survey of Chinese consumers, more than half reported that they've begun avoiding U.S. products (source: Japan Times, 06/26/19). The problem for the U.S. businesses is that consumer boycotts tend to last a lot longer than tariffs which, of course, China can lift overnight. But the government does not control Chinese consumers as tightly as it controls trade policy, and the more consumers believe China is being bullied by the U.S., the more U.S. firms will struggle to recover market share if and when the trade war ends. As we have said, just watch the stock prices of global consumer name brands in the coming quarters.

- Weapons of Economic Destruction

During the quarter, the president ratcheted up his trade threats against the European Union, this time on the grounds that they're attempting to trade with Iran (as they are entitled to do under international law). This was soon followed by his warning to Mexico that he would impose tariffs on all its exports to the U.S. and steadily ratchet them up until Mexico shuts down the northward flow of migrants. As the calendar rolled into June, he also removed India from a list of developing countries that receive special trade privileges because it hasn't done enough to open its markets to U.S. companies. Then the rumor that the president had considered tariffs on Australian aluminum (nothing has come of that…yet).

Tariffs and sanctions aren't the same thing, of course. Tariffs are a trade instrument intended to protect the interests of producers and imposed by most countries on friend and foe alike. Sanctions is an openly punitive tool intended to bend a country to your will and often include demands that encroach on national sovereignty. Such is the case with U.S. demands on China. Sanctions and tariffs work in similar ways for the administration because they both leverage the global desire to do business in the U.S.

The U.S. application to deploy both tariffs and sanctions even when the president's goals aren't economic. They're becoming the essential tools of "America First," and have become an indistinguishable mash-up of politics, diplomacy, trade, and finance.

- Conclusion

> America controls or hosts over 50% of the world's cross-border bandwidth, venture capital, phone-operating systems, top universities and fund-management assets. Some 88% of currency trades use greenbacks. Across the planet it is normal to use a Visa card, invoice exports in dollars, sleep beside a device with a Qualcomm chip, watch Netflix and work for a firm that BlackRock invests in. Despite this, the president and his advisers are convinced that the world order is rigged against America and rather than mimic the relatively restrained tactics of the last trade conflict, with Japan in the 1980s, they have redefined how economic nationalism works.
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> -- The Economist, 06/08/19

The consequences of a protracted trade war are many, with potential impacts including a drag on economic growth, import price inflation, higher prices, and the knock-on effects to other trading partners as they shuffle to find new sources and markets for different products. Trade barriers between the world's economic superpowers will continue to slow global growth and put political pressure on all affected governments, stoking increasing nationalism and protectionism overseas while increasing inflation and reducing living standards at home.

As Guggenheim's Scott Minerd recently noted, "The conclusions are obvious. The cost to the United States will be high; the cost to the Chinese will be higher. The only question is who will endure and be the most innovative in this battle of wills" (05/23/19).

As we go to press with this communiqué, the U.S. and China will restart tariff negotiations. As The Atlantic observed:

> If anything comes to pass that resembles détente and past behavior is any guide, the president will call [any deal] the greatest deal ever, and global markets will breathe a sigh of relief. But the deal will likely constitute only a modest pause. That's partly because [for the president] no agreement is truly final. He has repeatedly agreed to new trade terms with foreign partners, then talked about undoing those deals to achieve additional goals. He has already begun to renege on commitments made as part of the United States-Mexico-Canada Agreement, which he hailed as 'incredible' in October. (04/21/19)

GaveKal analyst Udith Sikand concisely observes that "no country is immune from capricious U.S. foreign policy".

Wrapping this up, we share our quarterly findings first and foremost with our clients and are cognizant that this research paints a rather drab investment backdrop -- especially for new capital. We are also mindful that the first question raised is, "how do we at Stralem approach these many known-unknowns" this toxic atmosphere has produced. To start, we are not speculators and have *nothing* to gain by taking a bullish position that effectively ignores the mounting challenges laid out by the companies in which we allocate capital. We do not profess to have a crystal ball and don't time the markets.

We are however in the business of designing a portfolio that somewhat immunizes our clients from volatility, especially the ebb and flow of "natural" volatility most investors recall from the decades prior to the financial crisis, but also the infrequent but severe variety we have experienced ever since. While we don't know "what's next", the investment environment has changed, and we believe that the next five years won't be like the last five years. The time and severity in between bouts of volatility have increased and we believe reflect this outcome. This uptick in volatility rightly has investors worried.

We know that markets tend to revert to the mean over time and this market has been exceptional for its length, total return, and sustained lack of volatility. Those metrics are beginning to reverse. In this environment, having a long-term perspective, a disciplined process and remaining focused on fundamentals and valuation is a real recipe for success -- and we have the track record to prove that. From an economic standpoint, while global growth remains positive the macroeconomic and geopolitical risks have deteriorated. While changing fundamentals do not always impact stock performance immediately, they tend to reveal themselves over time, and we are seeing this emerge today.

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

Yours truly,

Hirschel B. Abelson

Chairman

Adam S. Abelson Chief Investment Officer

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