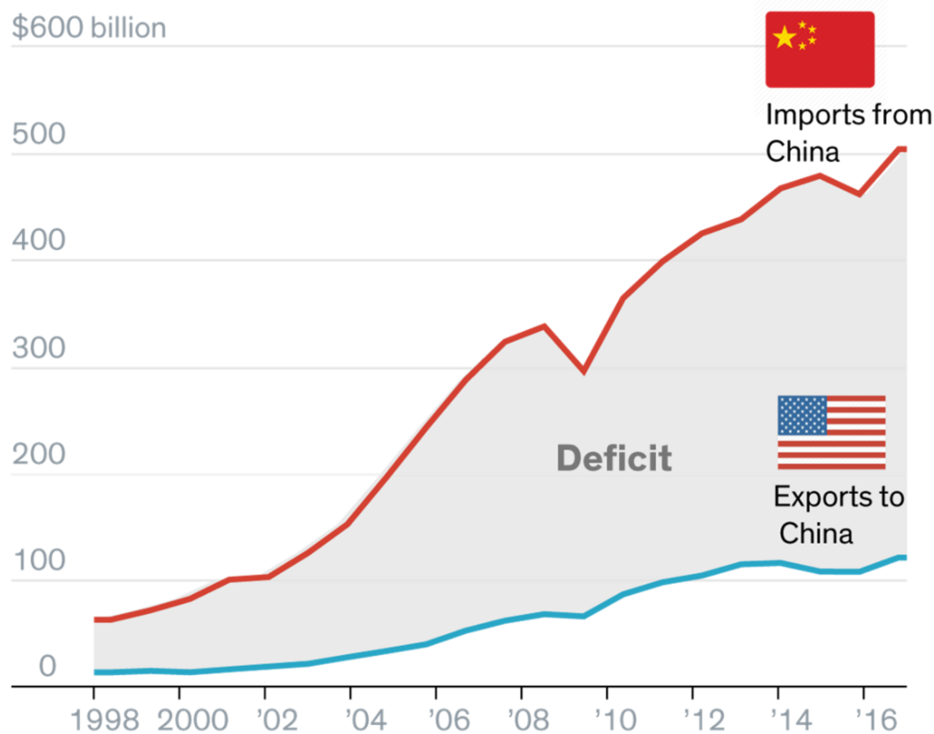
June 2018: That Great Sucking Sound

Since the Trump presidency began, threatened attempts to change the global trade order have yet to materially interfere with both the 10-year bull market in stocks and the global economic expansion. Deregulation, improving company earnings and a lower corporate tax rate have all rightly overshadowed concerns over trade, monetary tightening and the length of the current economic expansion. Recent developments, however, are putting these concerns back in the spotlight. While we are still positive on the individual companies we own, we are growing cautious on the market overall as we think that the tailwinds of the last two years may give way to stronger oncoming headwinds.

Start with trade. Whether you support the Trump administration's proposed tariffs or not, the administration's enacted tariffs (on aluminum and steel) and proposed tariffs on Chinese imports (of up to $450 billion) could have a disruptive impact on the U.S. and global economy. The Trump administration would likely point out that China has much more to lose than the U.S. if trade tensions escalate. As shown in the below chart, China exports roughly $500 billion of goods to the U.S., while the U.S. only exports about $130 billion of goods to China. And, whereas China's overall exports account for close to 20% of its GDP, U.S. exports account for only about 5% of GDP.[1] Based on the numbers, the U.S. seemingly has the upper hand in this dispute. However, that does not mean that a deterioration in trade relations between the U.S. and its trading partners would be harmless.

U.S. – China Trade Relationship[2]



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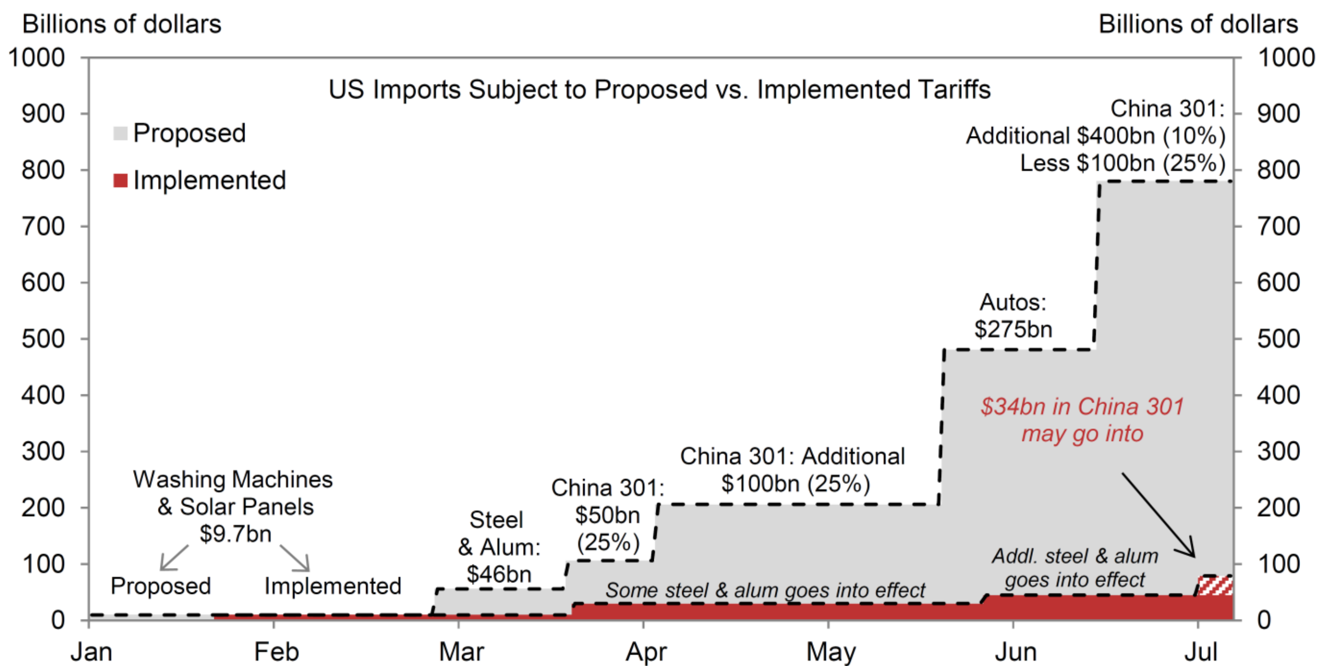
Supply chains today are global, as are the markets for the goods and services sold by U.S. companies. For instance, 40% of U.S. imports from Mexico and 75% of U.S. exports to Mexico are in intermediate inputs – meaning component parts used to produce final goods. Any disruption to a major trade arrangement, such as NAFTA, could have a serious impact on large segments of the U.S. economy and ultimately raise end prices for consumers. As noted in a recent Peterson Institute study on trade and NAFTA, "Firms such as General Motors and Ford send auto parts back and forth across the border as cars are produced, using a regional supply chain, which makes production more efficient, lowers the cost of cars to the consumer, and makes firms more globally competitive. If it becomes costlier to access intermediate inputs, this can cascade down many stages of the production chain..."[3]

China, with whom the U.S. is engaged in its most sizeable trade dispute – stemming from concerns over the size of the trade deficit, market access and intellectual property protection – is not only an important intermediate market for supply chains, but also has been a large growth market for leading U.S. companies. As an example of the importance of China to global supply chains, 32% of global semiconductor revenues come from China (per a recent analysis from SIA and Deutsche Bank).[4] This overstates Chinese end-market consumption but reflects the fact that a significant portion of technology hardware manufacturing (such as Apple's Foxconn plant) is located in China. While the Chinese may be unable to match U.S. tariffs on exports dollar for dollar, they could make it harder for companies like Apple, Yum Brands, Starbucks and Nike to operate locally. All of these firms, along with many other U.S. companies, have benefitted from sizable growth over the last decade in China. Any escalation of trade tensions could shut off this important growth engine. The one solace in the Trump administration's trade actions to date has been that tariff announcements have barely translated into tariff actions (see below chart). However, we remain concerned that the recent trade rhetoric and tariff threats are more serious than just a negotiating ploy.

Far Fewer Tariffs Implemented than Proposed (so far)[5]



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If the U.S. and China engage in an all-out trade war, in which round after round of tit-for-tat tariffs are implemented, it would likely affect a number of our investments, as well as the overall stock market. Any company reliant on a Chinese supply chain or that has sales exposure in China would likely see its stock price decline on escalating trade tensions. The two holdings that most readily stand out, and that we have received the most questions about, are Boeing and Apple. In Boeing's case, the impact of China trade tensions is overstated. While the company delivered 23% of its planes last year to Chinese purchasers, its future sales backlog has far less China exposure. As of the first quarter this year, Boeing only had 301 orders in its backlog for Chinese customers, which amounts to just 5% of its total backlog.[6] Additionally, planes are not easily fungible goods. While the Chinese media has noted that its country's airlines could easily replace Boeing purchases with planes from Airbus, it is not so simple. As of May 2018, Airbus has a backlog of 7,153 aircraft – representing nine years of sales.[7] Chinese purchasers can't just cancel their Boeing orders and jump to the front of Airbus's line. Boeing is likely to suffer more from higher materials costs stemming from the aluminum and steel tariffs than it is from a breakdown of trade with China.

Apple, on the other hand, has more at risk from deteriorating trade relations with China. For one, Apple's most important manufacturer, Foxconn, assembles iPhones in Zhengzhou, China. Secondly, Apple has approached $50 billion in sales in China annually over the last three fiscal years.[8] This represents over 20% of total company revenue. Unlike planes, phones, tablets and computers are easily fungible goods. Chinese consumers, out of a sense of nationalistic fervor in response to U.S. tariffs, could easily switch to buying phones from Samsung, or local companies like Huawei and Xiaomi. Additionally, Chinese authorities could make Apple's local operations more difficult. Apple has over 40 stores located in China.[9] If trade tensions continue, Apple is unlikely to grow its China presence to 50 locations anytime soon. Even in the worst-case trade scenario, we doubt that Foxconn would shut down (as it employs hundreds of thousands of local workers) or that Apple's China sales would plummet to $0. However, it is conceivable for China sales to fall by 50%, which would slash total revenues between $20-25 billion (or roughly 10%). If Apple's sales fall, the stock will perform poorly. We don't think Apple will ultimately have a long-term setback in China or that sales will drastically fall, but it is a hypothetical worth highlighting. In short, a serious trade dispute with China would be a net negative for many U.S. stocks and most likely the broader economy. Equally, if not more, important are the deteriorating relationships between the U.S. and Canada and Mexico. The ramifications from a change to NAFTA could be even greater than those from the dispute with China. To quote Stuart, "If NAFTA blows up, nothing is going to escape." Or to steal from Peter's former boss, that "great sucking sound" may be the world's financial markets.

As we have written in prior correspondence, our other concerns stem from the gradual transition away from global fiscal and monetary policies that have been accommodative to markets to those that are more hawkish.

1. In the U.S., the Federal Reserve under Chairman Powell has shown few signs of backing off its intention to raise interest rates. We doubt that Mr. Powell will be as market sensitive as his predecessors when it comes to sticking to the Fed's stated policy objectives.

2. In Europe, the European Central Bank (or ECB) is unlikely to intervene to assist Italy's deteriorating economy, as it did in 2012 during the Greek banking and economic crisis. Under Italy's new populist government, painful but necessary economic reforms – such as the extension of the retirement age – are likely to be reversed and

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further pressure the country's finances. As BCA Research notes, "It was one thing for [ECB president] Mario Draghi to promise to do "whatever it takes" to protect Italy when the country was the victim of contagion from the Greek crisis. But now that Italy is the source of the disease, the rationale for intervention has weakened."[10]

3. In China, the government is unlikely to maintain its recent role as the global stimulus provider of last resort (as occurred during the 2008 Financial Crisis and during the last economic scare in emerging markets during 2015). When emerging markets succumbed to pressure in 2015, China intervened with massive stimulus, with fiscal spending and credit growth growing 15% year-over-year.[11] The bar to stimulus is higher today than in the recent past, as Chinese growth is now slowing, President Xi is intent on seeing through structural economic reforms and local concerns are rising over high debt levels, manufacturing overcapacity and pollution.

4. In Mexico, Andres Manuel Lopez Obrador is expected to win the July 1st election and become the next president. AMLO – as he is called – is a left-wing candidate who has made promises to cancel NAFTA. Unlike Trump, AMLO thinks the agreement has hurt Mexico.

Unfortunately, concerns over trade, coupled with these broader macroeconomic policy shifts, are surfacing during what may be the later stage of the U.S. economic expansion. While tax cuts and deregulation have stimulated U.S. growth, the goldilocks environment for U.S. stocks is unlikely to remain "just right" for much longer. Buoyed by tax reform, profit margins are at record highs of 11%. However, a tighter labor market (unemployment is at 3.9%),[12] should result in accelerating wage inflation, which will pressure margins. Tariffs, if implemented, may add upward pressure on already increasing input costs. Again, the net result is that profit margins are at risk. This does not mean that companies can't continue growing if they execute well. Rather, in such a market/economic backdrop, valuation multiples are unlikely to increase. That means that any stock market appreciation going forward will need to be organic (meaning earnings grow) as opposed to benefitting from the rising tide of investors willing to pay higher multiples for the same level of earnings.

The above analysis does not mean we are bearish and expect a significant correction. However, we are increasingly cautious and believe that the tailwinds which have propelled markets over the last two years may be shifting. Accordingly, we are marking adjustments to portfolios such as investing in Treasury bills and trimming positions where valuations have become extended. This is particularly relevant for non-taxable accounts. As always, please let us know if you would like to discuss any of the ideas in this letter or your overall portfolio. Many thanks.

Sincerely,

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Citations and Disclosures

[1] BCA Research (April 4, 2018).
[2] Barron's, *The Brewing U.S.-China Trade War, Explained in Charts* (April 9, 2018).
[3] Peterson Institute for International Economics, *Why Renegotiating NAFTA Could Disrupt Supply Chains* (April 18, 2017).
[4] Deutsche Bank, *How do China trade issues impact the Semiconductor industry?* (June 20, 2018).
[5] Goldman Sachs Economic Resarch (June 20, 2018).
[6] Wolfe Research (April 4, 2018).
[7] Airbus Investor Relations (May 2018)
[8] Bloomberg.
[9] www.apple.com/retail/storelist
[10] BCA Research, *Three Policy Puts Go Kaput* (June 19, 2018)
[11] BCA Research, *Three Policy Puts Go Kaput* (June 19, 2018)
[12] U.S. Bureau of Labor Statistics (as of June 2018).

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