June 2019 – Déjà Vu All Over Again

Another month, another trade dispute. Just last week we circulated a letter about the investment implications of rising tensions between the U.S. and China. We did not expect to be writing another letter so soon again about the fallout from more tariffs – this time on Mexican imports. On May 31st, U.S. investors woke up to the surprise announcement from President Trump that he plans to implement 5% tariffs on all Mexican imports beginning on June 10th (under the seldom-used International Emergency Economic Powers Act) if Mexico does not immediately halt the flow of illegal immigrants into the U.S. These tariffs would ramp up to 25% by October if the "national emergency" has not been resolved per the sole discretion of the Trump administration. Like him or not, give President Trump credit for one thing at least – he keeps everyone on their toes. Once again, we must consider the impacts of further trade disruption on our portfolios.

Markets are currently see-sawing between the negative impact trade wars have on confidence and earnings and the positive impact of the Federal Reserve likely lowering short-term interest rates in response to economic weakness. It is the old expression "bad news is good news." Investors are also beginning to digest the significance that Republicans and Democrats are working together to potentially lessen the influence and profitability of leading technology stocks. As Kara Swisher wrote in the New York Times, "The techlash has officially arrived."[1]

If history is a guide and investors use the Department of Justice's (DOJ) investigation into Microsoft's monopoly power in the 1990s and the company's subsequent lethargic price movement following its settlement with the government, one might question the risk / reward of owning large cap tech stocks. In contrast, "value" stocks (such as in the energy industry) are currently trading at their biggest discounts to the overall market.[2]

Unfortunately for U.S. investors, businesses and consumers, the implementation of tariffs on Mexican imports could have a devastating short-term impact – if not significant longer-term implications. While the trade dispute with China has tended to overshadow that of the disagreement between the U.S. and Mexico, we believe the latter trade war could have a greater shorter-term impact because of the types of products involved. The trade dispute between the U.S. and China mainly impacts finished goods (as supply chain integration is largely confined to the semiconductor industry); thus, any fallout is likely to be manageable as the U.S. can re-source imported Chinese goods from other trading partners or domestically. However, the dispute with Mexico could prove far more damaging as U.S.-Mexican trade is concentrated in intermediate goods – meaning that Mexico is broadly integrated into U.S. company supply chains. From automakers to energy firms to industrials, many U.S. firms have significant supply chain exposure to Mexico. Alternative suppliers don't readily exist. As we noted in our June 2018 letter, when discussing the risks of the U.S. withdrawing from the North American Free Trade Agreement (or NAFTA):

> 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..."

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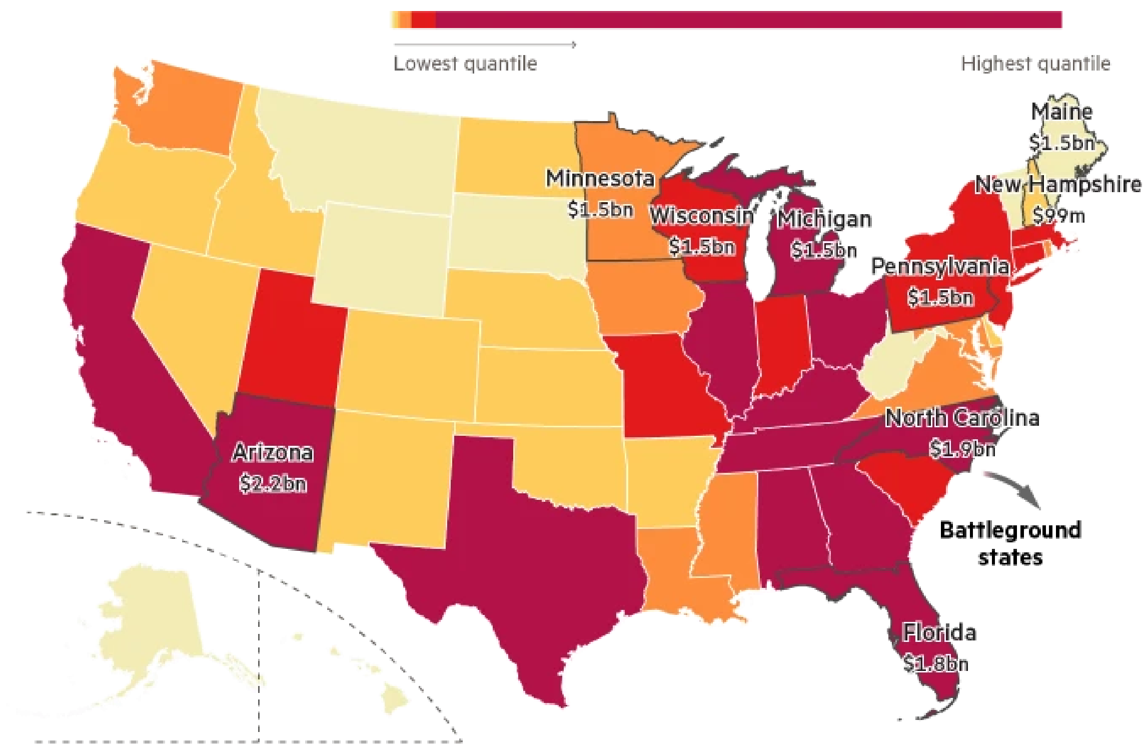
In 2018, U.S. goods and services trade with Mexico totaled an estimated $671.0 billion, $371.9 billion of which were U.S. imports of Mexican goods.[3] A 25% tariff would be the equivalent of a $92 billion tax hike. When combined with a potential 25% tariff rate on all Chinese imports (roughly $550 billion) – the Trump administration would essentially be implementing a $230 billion tax increase on American consumers (assuming that importers pass on their cost increases). This would more than offset the benefits of the tax cuts passed in late 2017. Obviously, such a scenario would not be good for the economy. Despite the Trump Administration's wishes, not all manufacturing jobs are going to migrate back to the U.S. overnight (nor will tariffs likely solve broader immigration issues). If U.S. importers are unable to shift cost increases to consumers or get their suppliers to cut input prices or subsidize the tariffs, corporate profit margins will fall. This would be detrimental to many businesses and publicly traded stocks. We're not politicians (thankfully!), but our sense is that risking a recession prior to the 2020 elections is not a winning strategy (see below chart of impacted states),[4] which is likely why this action has animated so many Republicans.



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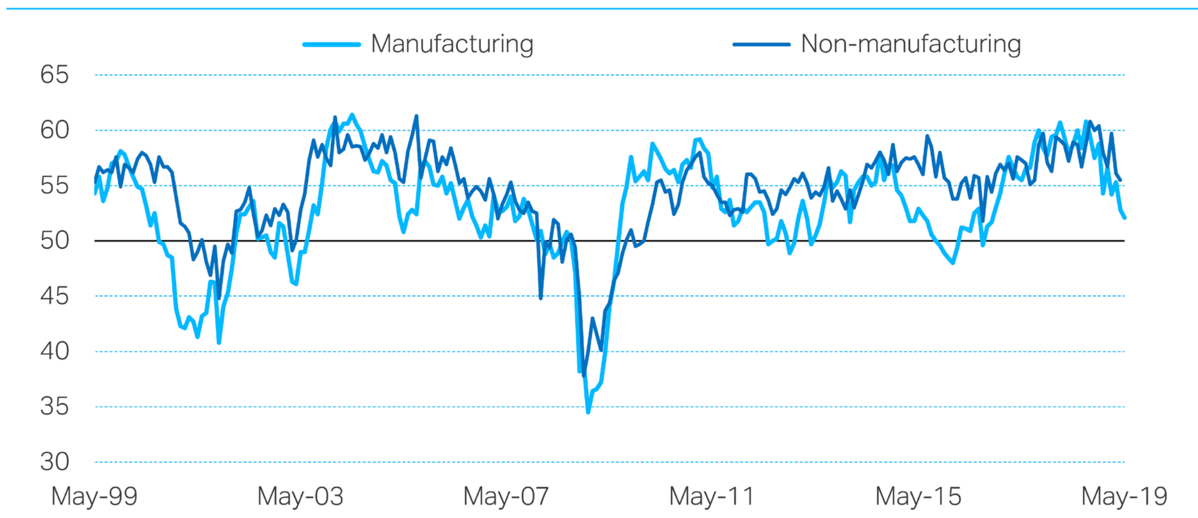
What makes the timing of this tariff announcement even more bizarre is that it came on the cusp of U.S. lawmakers reportedly being close to passing President Trump's signature trade legislation – the USMCA, which is the newly negotiated trade agreement between the U.S, Mexico and Canada. That deal now stands in serious jeopardy of collapsing. Though the S&P 500 is only down 3.5% from its May 3rd high (as of June 6),[5] tariffs and the threat of more tariffs are having a harsh impact on the real economy. Whether tariffs ultimately get implemented or not, the unpredictability of U.S. trade policy is affecting businesses. In the face of such policy uncertainty, many firms are holding off on investment, purchase and hiring decisions. This could lead to an economic slowdown and even a recession. As shown in the chart below, economic data measuring U.S. manufacturing and purchasing activity (from the Institute for Supply Management) points to a slowing economy (levels above 50 indicate economic expansion; below 50 indicates contraction).[6]



And while the U.S. job market remains healthy (with unemployment under 4%), sectors most impacted by rising import costs and trade uncertainty are showing signs of strain. As depicted in the below chart, job cuts in the auto, industrial and retail sectors have jumped over the last several months.[7] The disappointing May jobs number released on June 5th by ADP – that reported private payrolls increased by only 27,000, which was the lowest monthly gain since 2010[8] – hints at the economic malaise that may come if trade uncertainty remains heightened. A recent Duke University Fuqua School of Business "CFO Magazine Global Business Outlook" survey of CFOs from 469 U.S. firms reveals that 67% of them believe that the U.S. will be in recession by the third quarter of 2020 and 84% believe that a recession will have begun by 2021.[9] In the face of weakening economic data and increasing policy uncertainty, investors have bid up U.S. Treasuries (as discussed in last month's letter), which has resulted in the 10-Year U.S. Treasury (which reflects growth expectations) yielding less than the 3-Month Bill (which reflects monetary policy).[10] This "inversion" of the yield curve is signaling that monetary policy is likely too restrictive. As a result, investors anticipate that the Federal Reserve will soon have to cut interest rates to support the economy.[11]

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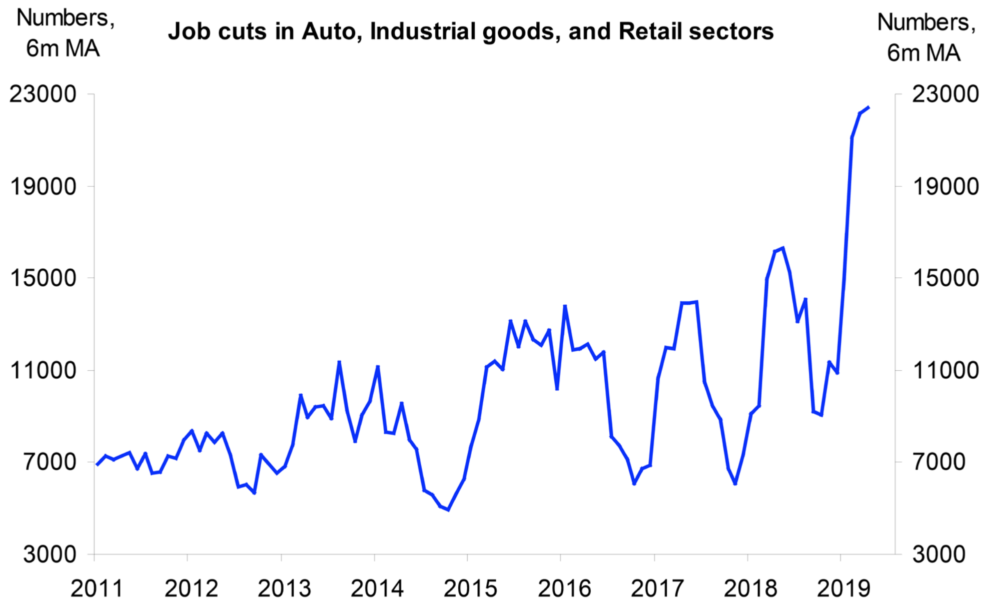

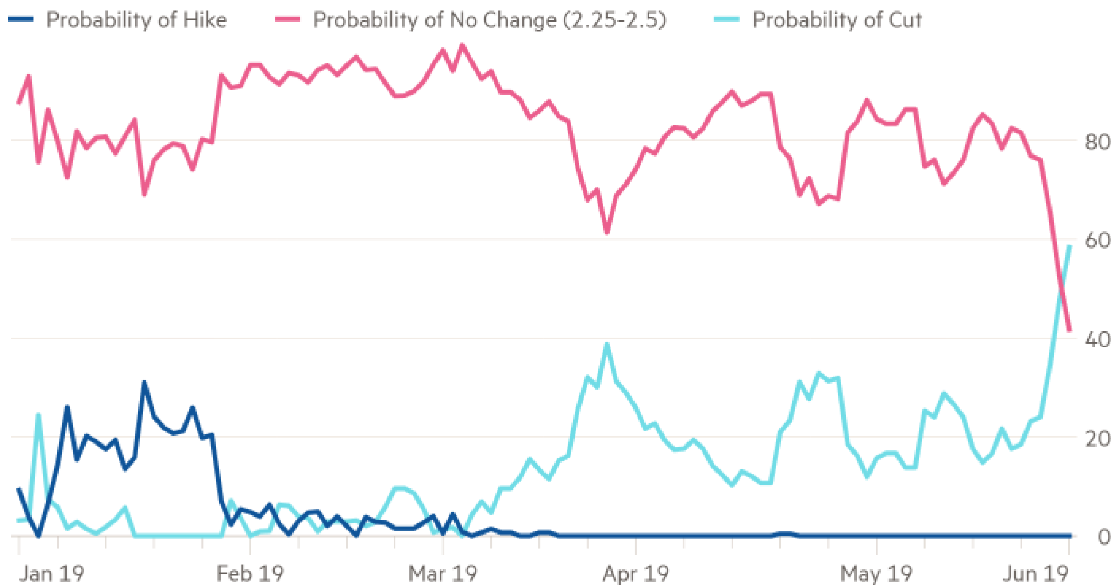

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The longer trade policy uncertainty persists, the weaker and more erratic we anticipate that economic data will come in. It will be difficult for markets to materially rally under such circumstances and easier to envision a correction. Policy uncertainty will lead to uncertainty surrounding corporate profit levels. The more uncertainty investors have around corporate profits, the lower the earnings multiple they will be willing to pay to own stocks. The current 18.5x earnings that investors are willing to pay to own the S&P 500 could easily revert to or below longer-term average of 16.5x over the last 50 years.[12] We hope that the Trump administration is able to resolve its trade disputes soon, as there are material economic and investment risks to further trade disruption. We will make sure to keep you apprised of any developments and how they impact our portfolios.

As if escalating trade disputes were not already causing enough uncertainty for businesses and investors, the U.S. Department of Justice (DOJ), Federal Trade Commission (FTC) and Congress all have opened investigations into prominent U.S. technology firms for alleged anti-competitive behavior. We wrote in detail about the potential application of U.S. antitrust policy to big tech firms in our March 2018 letter and won't rehash the legalese again, but we want to provide a few high-level thoughts.

Based on scholarship coming out of the University of Chicago in the 1970s, U.S. antitrust law over the last 40 years has focused on consumer welfare. Courts and government agencies (like the DOJ and FTC) have generally applied a de facto rule that antitrust violations are presumed not to have occurred absent evidence of company actions that result in an increase to consumer prices. Under such a framework, it is difficult to argue that tech firms have engaged in anticompetitive behavior. To the contrary, companies like Amazon and Google have likely lowered consumer prices by providing exceptional services and democratizing price discovery information. Today's large-cap tech firms have gained substantial market power not because they unfairly control supply chains (like Standard Oil at the turn of the 20th Century), but because their services and products are so popular that they win over consumers – in essence they have a monopoly on demand, which they largely gained organically (outside of Facebook's acquisition of Instagram and WhatsApp). There is nothing illegal about attaining monopoly power under the current antitrust framework – it is only illegal to abuse it.[13] The upcoming investigations are likely to consider two issues: (1) has abuse occurred and (2) should regulators and courts apply antitrust law under a different framework. As to the question of abuse, investors should not fret. As to the question of the consumer welfare framework versus some new framework for applying antitrust law such as market power generally, that is problematic.

Despite calls from several politicians like Senator and presidential candidate Elizabeth Warren, we think there is a very low chance of any company being broken up. However, we do think there is a very high chance that the outcome of the investigations and congressional reviews could include new regulations (particularly around data privacy) and a new framework for considering potential anticompetitive behavior and certainly for mergers/acquisitions. The current "techlash" is part of a broader wave of concern amongst policymakers that market power amongst the largest firms in the country has grown too strong. As can be seen in the below graphic from JP Morgan,[14] the post-Financial Crisis period has seen a trend toward industry consolidation, resulting in a select few firms holding substantial power.

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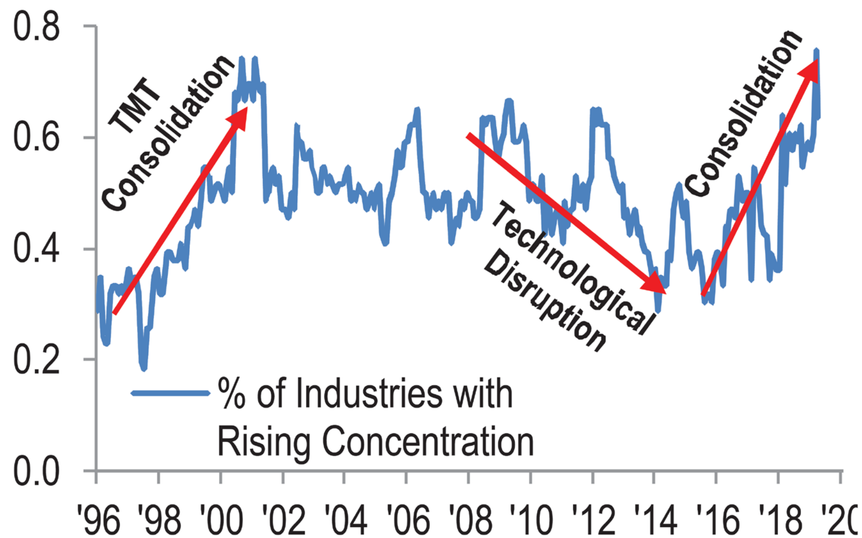

We tasked our associate, Alissa Hirsh, with summarizing the likely focus areas for the upcoming technology company investigations and have included her thoughts below. Even if the investigations and congressional review amounts to nothing, we think it will be difficult for the large-cap tech stocks facing scrutiny (Amazon, Alphabet, Facebook and Apple) to continue their 10-year record of outperformance. We are not suggesting it is prudent to sell these stocks if in your portfolio, we just want to note that the intensifying regulatory and political headwinds could weigh on share price performance. From Alissa's review:

"Ever since the DOJ's antitrust case against Microsoft nearly 20 years ago, regulators in the US have taken a hands-off approach to the growing dominance of tech firms, especially compared to regulatory bodies in the European Union (EU). Google has not faced investigation from the FTC since the 2011 probe into whether the company ranked the search results of competing shopping, travel and reviews sites unfairly low—which led to only minor voluntary commitments from Google and no monetary penalties.

However, public perception and posturing towards technology giants has sharpened over the past year. Lawmakers have grown increasingly frustrated about foreign election interference involving Facebook, the failure of technology firms to protect data privacy, alleged suppression of conservative views on social media platforms, and the alleged detrimental impact of large-cap technology firms' market power on smaller firms' ability to compete. In March, the FTC set up a task force to examine anti-competitive practices of technology firms.

Since then, lawmakers have stepped up pressure on regulators to scrutinize whether technology firms are abusing their market dominance. The DOJ's new investigation into Google may center around whether Google unfairly favors its own services over those of rivals and whether it's advertising and search businesses should be run independently. The investigation into Apple will likely focus on whether the company abuses its App Store monopoly on the iOS platform by charging 30% commissions for third-party app sales (a similar case is being tried

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in federal courts). The FTC will likely review Facebook's acquisitions of Instagram and WhatsApp and its control over user data, while the trade commission's examination of Amazon may focus on whether the company uses third-party merchant sales data on its e-commerce platform to create unfair advantages for its own private-label brands.

Analysts have contended these technology firms are unlikely to be broken up under the antitrust framework – which measures anti-competitive behavior by its impact on prices for consumers – because they offer free services or services which have generally driven prices down. However, some have called for antitrust law to be expanded to include factors such as control of user data and ability to discriminate against rivals, in addition to prices. A re-imagining of the anti-trust framework would increase the likelihood of penalties being levied on the firms in question.

Some analysts point the late 1990s antitrust investigation into Microsoft as a roadmap for how the investigations of today's technology giants may evolve. In 1998, the DOJ sued Microsoft for illegally protecting its operating system monopoly and using to it establish a monopoly of its new browser, Internet Explorer. In 2000, a district court ordered Microsoft to be broken into two companies, though the ruling was ultimately overturned on appeal. Nonetheless, the investigation caused a shift in management's focus which arguably allowed competitors such as Google and Apple to beat Microsoft to the race in the internet search and mobile phone markets. **Excluding dividends, Microsoft's stock returned 0% from January 2000 through November 2016**. **Prior to that – from 1986 through 1999 – Microsoft had an annualized return of 59% and a total return of 60,000%.**"[15]

The result of these investigations might also prove to be beneficial to value stocks, which have suffered since 2008 as investors have flocked toward growth companies whose businesses in many cases have disrupted legacy industries. JP Morgan in a recent research piece entitled the "Value Conundrum" notes the drag on value's performance from the rise of new tech firms:[16]

> "Disruptive technologies are a drag on Value. The convergence of tech, media and communications began more than 25 years ago. That trend has accelerated in the last 10-15 years through disruptive integration of the internet, automation, social media and artificial intelligence in consumer and business applications. As a result, many of the legacy market leaders that did not innovate or adapt new technologies effectively have seen their equity multiples stagnate. These have become persistent members of the Value portfolio. On the flip side, many of the high growth companies are initially sustained by private equity and venture capital. They are able to attract investor interest even though the valuation of these private companies is much higher than the newly IPO-ed peers that are further along the life-cycle. It's not that Value has poor fundamentals, but its market share is being eaten away by the disruptive Growth companies (i.e. Amazon vs brick-and-mortar retailers, Netflix vs legacy cable providers, Uber, etc) or by consolidation where technology requires scalability (e.g. bulge bracket financials). We have seen a wide swing in market concentration in this cycle, initially a decline and then a sharp upswing signaling consolidation [see above chart on page 6]. Among the industries where sales concentration has risen the most are large financials, internet retail, diversified telecoms, computers & peripherals, and internet software & services. It's become a "Winner Take All" cycle."

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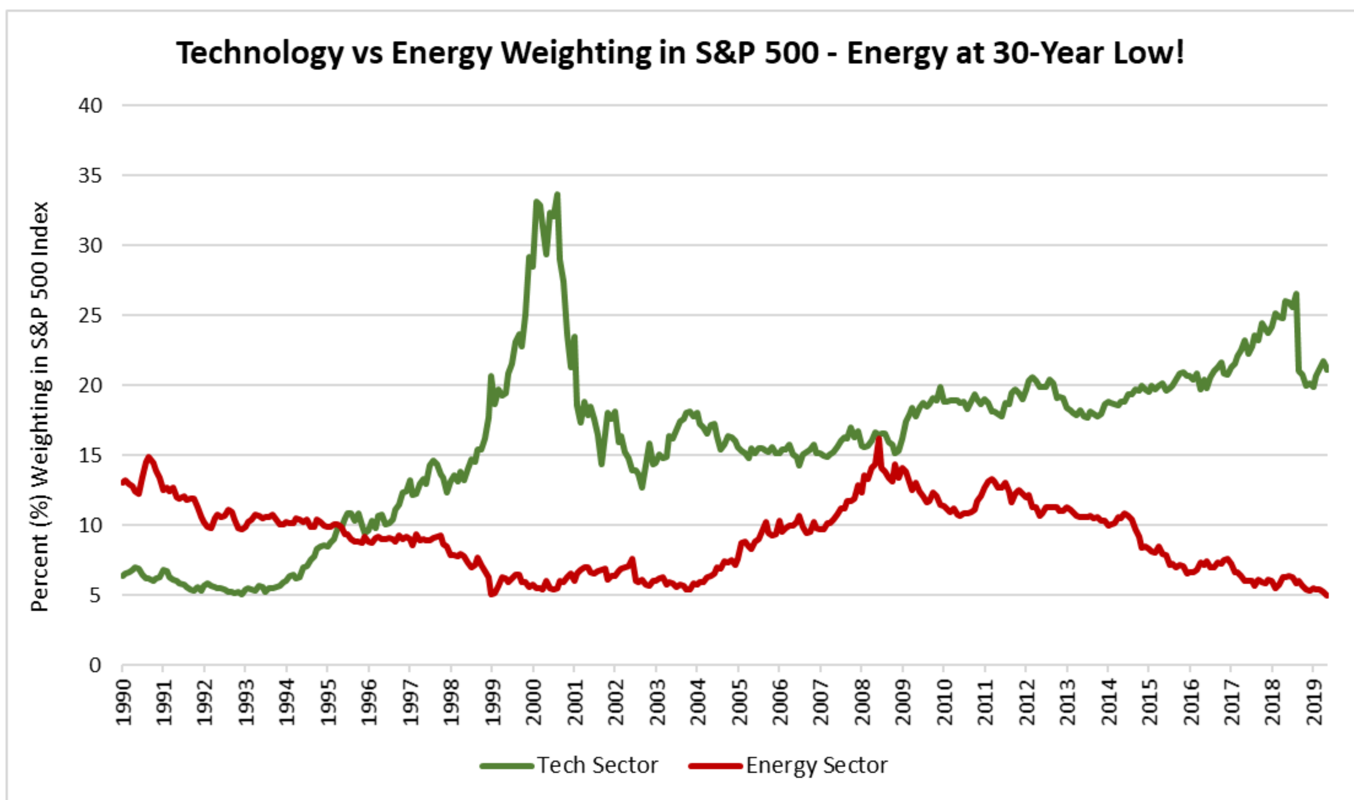
The current investigations into large cap technology firms and political concerns over market power might be the catalyst for value firms to regain their footing, as policymakers and regulators seek to halt the rise in industry concentration in order to engender more competition and dynamism in the economy. Accordingly, and given technology stock's outperformance over the last 10 years, we think more compelling opportunities exist in less favored sectors. While policy uncertainty could impact sectors such as energy, materials, industrials and health care, the valuations for many of these stocks already reflect substantial headwinds; whereas as technology firms still are trading at premium valuations. In addition to below market valuations, many stocks in these unloved sectors have attractive dividend yields (higher than 3%) that they pay out of internally generated cash flows, solid balance sheets and produce high and stable free cash flows (which is cash generated by business operations less capital investments in the business). One chart we think is particularly interesting is the comparison of the weighting of energy firms vs technology firms in the S&P 500 Index.[17] Despite the rise in oil prices since 2016 and improved cost structures and profitability, energy companies' weighting in the S&P 500 is at a 30-year low; whereas tech firms are close to their post-1999 bubble high (despite increasing regulatory headwinds). If interested, we would be happy to talk to you about potential opportunities in value stocks that already have priced in significant business and policy risks.



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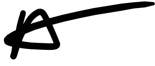
Please let us know if you would like to discuss any of the ideas reviewed in this letter and how they may impact your portfolio. The trade situation and technology backlash are fluid and we plan to remain proactive in updating you on how shifts in U.S. trade and regulatory policy could impact the market and your investments. Thank you for your continued support.

Sincerely,



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Citations and Disclosures

[1] The New York Times, *The People Screaming for Blood Have No Idea How Tech Actually Works* (June 4, 2019).
[2] JP Morgan Research, *The Value Conundrum* (June 6, 2019).
[3] Office of the United States Trade Representative, https://ustr.gov/countries-regions/americas/mexico (accessed June 4, 2019).
[4] Financial Times, *Where Trump's Mexican tariffs will hit hardest* (June 4, 2019).
[5] Bloomberg (as of June 6, 2019).
[6] TS Lombard, *Trade War Raises Recession Risk* (June 3, 2019).
[7] Deutsche Bank Research (June 2019).
[8] Bloomberg, *U.S. Companies Add Fewest Jobs Since 2010, ADP Data Shows* (June 5, 2019).
[9] https://www.cfosurvey.org/wp-content/uploads/2019/04/Q1-2019-US-KeyNumbers-1.pdf (accessed June 6, 2019).
[10] Bloomberg (as of June 6, 2019).
[11] Financial Times, *Rate cut may be 'warranted soon', says US Fed's Bullard* (June 3, 2019).
[12] Bloomberg (as of June 6, 2019).
[13] As stated in the FTC's guide to antitrust: "If a company gains a monopoly because it offers consumers a better product at a better price, that's not against the law. But if it creates or maintains a monopoly by unreasonably excluding other companies, or by impairing other companies' ability to compete against them, that conduct raises antitrust concerns." U.S. Federal Trade Commission, *Guide to Antitrust Laws, Competition Counts* (May 2015).
[14] JP Morgan Research, *The Value Conundrum* (June 6, 2019).
[15] Bloomberg (June 6, 2019).
[16] JP Morgan Research, *The Value Conundrum* (June 6, 2019).
[17] Bloomberg (as of June 4, 2019).

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