May 2019 – Strategic Rivals

With the recent breakdown in trade talks between the U.S. and China, investors need to start preparing for the possibility that the two countries are unable to resolve their differences and will increasingly take actions intended to harm each other's strategic and economic interests. Setting aside what we think are valid U.S. economic and national security concerns, a breakdown in relations between the U.S. and China could be painful for investors. Rather than discussing the politics or strategic merits of the trade dispute with China, this letter will focus on the investment implications. While we think there are likely better ways to resolve these issues than the implementation of tariffs, as President Trump might say: "I was elected President and you were not." Better to deal with the world as is than the world as we'd like it to be.

By all accounts, the trade progress the U.S. and China had made came undone earlier this month when Chinese negotiators pulled back from commitments that the U.S. believed had already been settled – such as providing legally enforceable intellectual property protections to foreign firms operating in China. As many are aware, President Trump shortly thereafter raised the previously implemented 10% tariffs on $200 billion of Chinese imports to 25% and threatened to implement 25% tariffs on the remainder of goods the U.S. imports from China. Tensions exponentially increased two weeks ago when the U.S. Department of Commerce announced it would prohibit U.S. companies from selling equipment and licensing their technology to Huawei – China's largest and most important technology/telecommunications firm.[1] Due to Huawei's reliance on U.S. semiconductors for its networking equipment and smartphones, this action – if it sticks – is tantamount to a company death sentence. Though theoretically reversible, the Trump administration's hard line with Huawei (which has bipartisan backing due to national security concerns) is likely lead to irreversible damage in the trade talks that can only be salvaged if and when President Trump and Chinese President Xi meet in person next month at the G-20 summit in Japan.

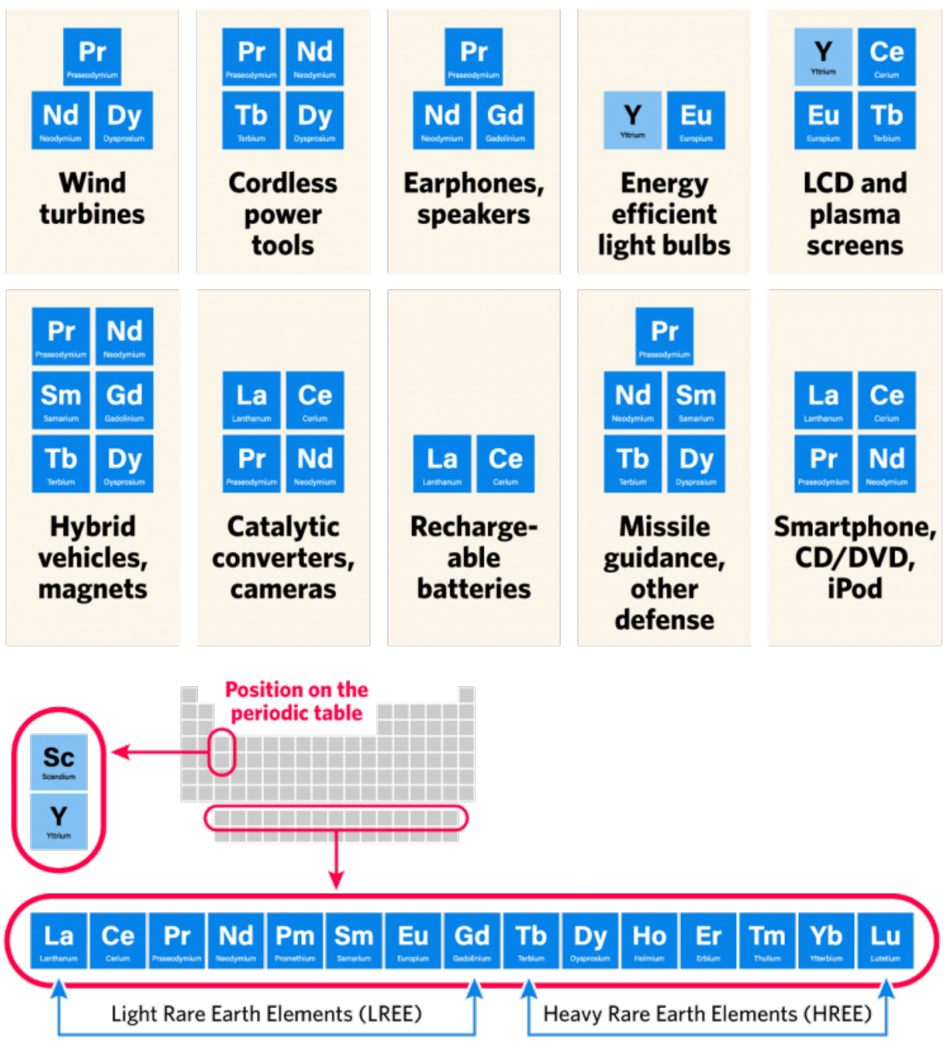
In the meantime, the immediate response from China has us concerned about the rising odds of an all-out trade war. Chinese state-controlled media seems to be preparing the country for such an outcome. For instance, instead of allowing Chinese media firms to air the final episode of Game of Thrones earlier this month, CCTV 6 – the movie channel of China's main state television broadcaster – changed its prime-time scheduling to air three anti-American movies for three consecutive nights.[2] Each movie was an old Korean War film with hostile messaging, often depicting Chinese troops either killing American soldiers or taking them prisoner. Another ominous sign: on the 21st, President Xi gave a speech in Jiangxi (where China's defeated Red Army started its Long March in 1934, enabling the forces to regroup)[3] and declared to a cheering crowd, "We are now embarking on a new Long March, and we must start all over again."[4] Though Xi did not mention the U.S. or trade directly, the message was clear. China must prepare for an economic and even technological decoupling from the U.S. That speech followed President Xi's visit to a Chinese rare-earths minerals company in the same province,[5] highlighting a source of leverage China has over an industry key to various high-technology components (see below graphic).[6] China dominates the global market in the mining and processing of these critical materials.

Uses and Properties of Rare Earth Elements

Unique magnetic and lighting properties, among others, make rare earth elements key in the production of a range of devices. For instance, magnets made with neodymium are far lighter than other magnets, allowing for more efficient motors.

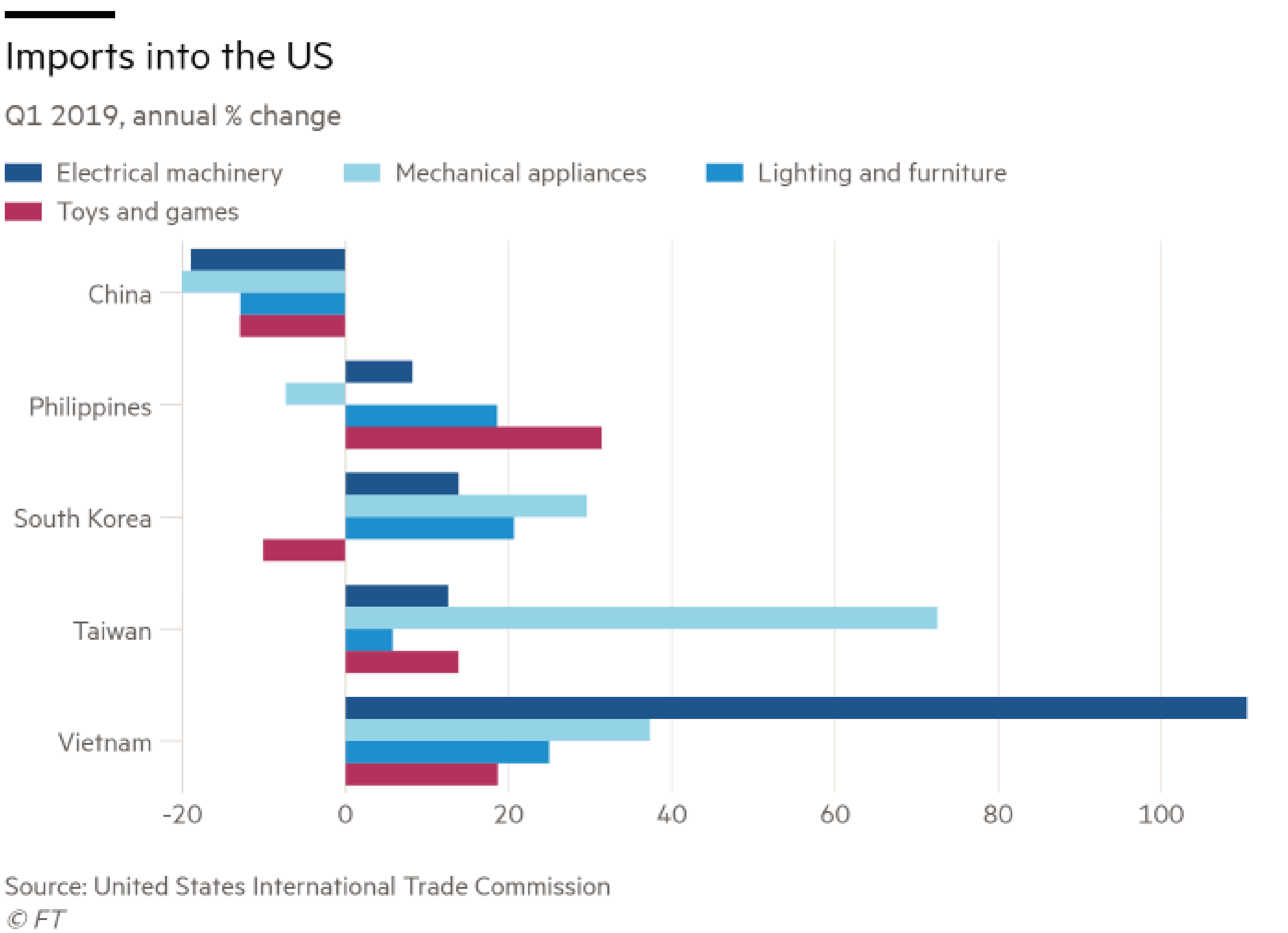
The Rare Earth Elements

Sc Scandium	**Nd** Neodymium	**Gd** Gadolinium	**Er** Erbium
Y Yttrium	**Pm** Promethium	**Tb** Terbium	**Tm** Thulium
La Lanthanum	**Sm** Samarium	**Dy** Dysprosium	**Yb** Ytterbium
Ce Cerium	**Eu** Europium	**Ho** Holmium	**Lu** Lutetium
Pr Praseodymium			



Source: China Water Risk

Clearly, tensions and rhetoric are substantially rising. The stakes for investors are high, as China over the last several decades has grown into a critical player in international supply chains (particularly for the technology industry) and also serves as a major growth market for many U.S. firms (such as Apple and Boeing). In 2018, U.S. goods and services trade with China totaled $737 billion (or roughly $2 billion per day). China serves as the U.S.'s third largest goods export market ($120 billion) and is the U.S.'s largest supplier of imported goods ($539 billion).[7] As shown in the below graphic from the Financial Times, trade between the U.S. and China sharply declined during the first quarter of 2019 due to increased tensions.[8] While other countries in Southeast Asia with spare manufacturing capacity (such as Vietnam) have benefited recently from U.S. firms shifting their supply chains, none can easily or realistically replace the vast pool of trained labor and supply chain logistics in China. Nor is it realistic to think that all manufacturing will move back to the U.S in the near-term. With the unemployment rate below 4%, the U.S. simply doesn't have the available workforce to quickly revive the manufacturing sector. A severe slowdown in trade between the U.S and China will be painful for companies, investors and consumers.



As trade relations have deteriorated, foreign firms operating in China have noted increasing difficulty in running their businesses. Per a May 21st report from the Financial Times: "Roughly 47% of the members of the American Chamber of Commerce in China and a similar group based in Shanghai said that on top of recently imposed tariffs, they faced retaliation such as slower customs clearance, more inspections and delayed approvals for licenses... About a third of the 239 American companies surveyed said they were cancelling or delaying investments in China while about 40% said they were considering relocating manufacturing facilities outside of China, with south-east Asia and Mexico among the favored destinations."[9] A similar survey of European companies operating in China noted an equally challenging business environment.[10] Apart from tariffs, the U.S. may additionally increase the cost of doing business in China. The Trump administration's likely restriction on U.S. companies from supplying technology/components to Chinese firms involved in the surveillance of China's Muslim Uighur minority hints at what could come next:[11] so-called "know-your-customer regulations" for technology firms engaging in business overseas. If such regulations are implemented, compliance costs will rise and foreign sales growth may slow as a new regulatory regime comes into place. Even if trade differences are resolved, the bi-lateral business environment appears to have taken a near-mortal blow.

As the dispute between the U.S. and China has evolved from one over trade deficits to one over technological leadership (particularly in the 5G, networking and semiconductor areas), U.S. technology firms operating in China face substantial risks to both their supply chains and sales outlooks. This likely will hold true even if the trade issues are soon resolved. The semiconductor industry, in particular, faces heightened risks, as China is home to large-scale chip fabrication equipment plants (where chips designed in the U.S. are oftentimes produced) as well as the location of many large-scale technology product assembly factories (where chips are incorporated into final products for shipment overseas). Apple – an important holding in many of our portfolios – faces significant risks, as the iPhone is assembled in China's Foxconn plant and the company derives almost 20% of its sales from the Chinese market. While we think the risk of China shutting down Foxconn's local operations is low (as the firm employs an estimated 1 million Chinese workers), we expect Apple's sales in China to decline as nationalist fervor and frustration over U.S. actions against Huawei is likely to dent demand. We would not be surprised if Apple's executive management is currently considering longer-term contingency plans for shifting manufacturing out of China.

While aggregate data on company supply chains is difficult to piece together, we have included a list at the end of this letter of S&P 500 firms that derive over 10% of their sales in China.[12] Unsurprisingly, many of these firms are semiconductor companies. In addition to Apple, we would highlight Intel and Boeing as key portfolio holdings that have China sales risks. While we don't think that sales will drop to $0, there is a chance they could fall meaningfully; and if trade talks continue to deteriorate, we think investors will price this into the stocks.

Fixed-income investors are taking a different view of the trade war and its impact on the U.S. economy. As the graph below shows,[13] bond yields have retraced expectations of higher interest rates and instead now price in lower future rates. The futures markets project that short-term interest rates will drop to 1.85% by March 2021.[14] This is related to the inverted yield curve which we have written about previously. At a 2.3% yield, some investors view 3-month Treasuries as a perfectly safe investment alternative to weather out the trade storm.

The next month will be key in determining whether the trade dispute between the U.S. and China risks blowing up into a new "cold war" focused on technological, geopolitical and economic supremacy. As investors, we hope that the two countries can resolve their differences, but we are beginning to prepare for an adversarial outcome. Please let us know if you would like to discuss our thoughts as they relate to trade and how that may impact your portfolio holdings.

Sincerely,

Peter Karmin
Managing Member

Stuart Loren
Director

S&P 500 Companies with China Sales Exposure Over 10%

Ticker	Name	Industry	China Sales Exposure	Market Cap ($, Millions)
QCOM	QUALCOMM Inc	Semiconductors	66.64%	$ 79,470.24
QRVO	Qorvo Inc	Semiconductors	59.73%	7,235.95
MU	Micron Technology Inc	Semiconductors	57.11%	36,454.27
AVGO	Broadcom Inc	Semiconductors	49.43%	100,734.80
TXN	Texas Instruments Inc	Semiconductors	44.35%	96,832.26
IPGP	IPG Photonics Corp	Semiconductors	43.09%	6,890.10
AMD	Advanced Micro Devices Inc	Semiconductors	38.86%	31,398.87
MXIM	Maxim Integrated Products Inc	Semiconductors	35.70%	14,166.10
AOS	AO Smith Corp	Miscellaneous Manufactur	33.60%	7,197.81
APH	Amphenol Corp	Electronics	31.63%	26,512.49
AMAT	Applied Materials Inc	Semiconductors	29.64%	36,517.45
XLNX	Xilinx Inc	Semiconductors	27.81%	25,823.66
INTC	Intel Corp	Semiconductors	26.57%	195,062.89
SWKS	Skyworks Solutions Inc	Semiconductors	25.41%	11,744.89
GLW	Corning Inc	Telecommunications	24.06%	23,260.12
NVDA	NVIDIA Corp	Semiconductors	23.91%	87,287.97
WDC	Western Digital Corp	Computers	21.28%	11,596.85
A	Agilent Technologies Inc	Electronics	20.66%	21,264.36
PKI	PerkinElmer Inc	Electronics	20.15%	9,392.58
TEL	TE Connectivity Ltd	Electronics	19.58%	29,068.18
AAPL	Apple Inc	Computers	19.56%	820,049.60
WAT	Waters Corp	Electronics	19.54%	14,222.97
ADI	Analog Devices Inc	Semiconductors	19.51%	35,907.51
KEYS	Keysight Technologies Inc	Electronics	18.31%	13,747.62
MTD	Mettler-Toledo International Inc	Electronics	17.25%	17,859.11
BWA	BorgWarner Inc	Auto Parts&Equipment	17.11%	7,552.79
LRCX	Lam Research Corp	Semiconductors	16.11%	26,824.85
KLAC	KLA-Tencor Corp	Semiconductors	15.93%	16,604.87
TPR	Tapestry Inc	Apparel	15.08%	8,530.00
CE	Celanese Corp	Chemicals	14.95%	12,614.40
BA	Boeing Co/The	Aerospace/Defense	13.61%	199,666.28
DHR	Danaher Corp	Healthcare-Products	11.85%	93,164.45
LEG	Leggett & Platt Inc	Home Furnishings	11.59%	4,809.68
TMO	Thermo Fisher Scientific Inc	Healthcare-Products	10.28%	106,546.98
CMI	Cummins Inc	Machinery-Diversified	10.00%	24,994.02

Citations and Disclosures

[1] U.S. Department of Commerce, *Department of Commerce Announces the Addition of Huawei Technologies Co. Ltd. to the Entity List* (May 15, 2019).
[2] Bill Bishop, *Sinocism* (May 20, 2019).
[3] See Wikipedia article on the Long March, https://en.wikipedia.org/wiki/Long_March (accessed May 22, 2019).

[4] South China Morning Post, *Xi Jinping calls for 'new Long March' in dramatic sign that China is preparing for protracted trade war* (May 21, 2019).
[5] The Wall Street Journal, *Xi Jinping Flexes China's Trade Muscle with Visit to Rare-Earths Hub* (May 21, 2019).
[6] Stratfor, *Will Rare Earths be the Next Front in the U.S.-China Tech War?* (May 20, 019).
[7] Office of the United States Trade Representative, https://ustr.gov/countries-regions/china-mongolia-taiwan/peoples-republic-china (accessed on May 22, 2019).
[8] Financial Times*, Shifting trade and supply chains challenge emerging economies* (May 21, 2019).
[9] Financial Times, *US companies face retaliation in China as trade war deepens* (May 21, 2019).
[10] Financial Times, *US companies face retaliation in China as trade war deepens* (May 21, 2019).
[11] Bloomberg, *Daily Economics Note* (May 22, 2019).
[12] Bloomberg (May 28, 2019).
[13] Financial Times, *Yield on 10-Year Treasury retreats to lowest level since 2017* (May 28, 2019).
[14] Bloomberg and Eurodollar rate curve (as of May 28, 2019).