August 6, 2018

Dear Client:

The dominant storyline of the past quarter was the growing specter of a bruising trade war with China. We have touched on this prospect in our last several letters but our analysis here will aim to go deeper. Specifically, we will address the question of why the U.S. stock market has continued to more or less ignore the increasingly alarming headlines. Our view on this question will do much to shape our investment posture over the near-to-intermediate term.

We can think of three plausible reasons why the market has not, to this point, really gotten spooked, and we'll comment on each one in turn.

The market suspects – correctly – that all of the foregoing threats and posturing on both sides amount to nothing more than an elaborate negotiation, and that both sides will inevitably step back from the brink (or swerve, if that's your preferred metaphor). While we'd grant that this remains the most probable scenario, if forced to choose, we've found the prevailing conversation on the chances of a full-blown trade war to be a bit simplistic and overly sanguine. That both Trump and the Chinese would prefer to avoid a mutually deleterious trade war may be beside the point, since each may want even less to create the appearance of backing down and losing face. Readers familiar with game theory and the concept of Nash equilibrium will recognize that it is exactly this sort of *internal dynamic* of a public confrontation, rather than the wishes or intentions of the parties to it, that brings on a collision in which both sides come out worse but still can't find a way to disengage. Add in the usual potential in international relations for misperception and miscalculation between actors with incomplete information and imperfect communication, and some form of tit-for-tat escalatory spiral becomes a genuine concern. That brings us to our next possibility.

We are, in fact, currently witnessing the precursor to a punishing trade conflict, and the market is simply in denial. Clearly, this is the most alarming scenario, and unfortunately it cannot be dismissed out of hand. Human beings have a funny way of pronouncing a thing impossible simply by virtue of its being unpleasant, and indeed cases abound in market history in which investors could clearly see the sky darkening for months or even years and yet the market held together until the very moment the storm broke. The Financial Crisis is only the latest example: By the late summer of 2007 it was clear to anyone who cared to look that the U.S. housing and mortgage markets, which form part of the foundation of the American economy, were crumbling, yet it was more than a year before equity prices truly collapsed. Because the stock market is demonstrably capable of hiding its head in the sand in the face of impending disaster, and because of the internal dynamics of conflict that we explained in the preceding paragraph, we cannot completely discount the possibility that the market is simply wrong and that we are on the brink of a bona fide trade war. That said, at the risk of falling victim to exactly the fallacy we made note of near the beginning of this paragraph, we suspect that all concerned – including President Trump himself – understand how damaging a legitimate trade war would be and will in fact steer clear prior to a true collision.

The U.S. has the upper hand and both Trump and the Chinese know it, and the latter will shortly give in to Trump's principal demands. This is a possibility that we have lately begun to take more seriously. While American supply chains are vulnerable to disruption, and while the Chinese government can enforce discipline among their own population and push on political pressure points among ours in ways the U.S. cannot do in return, Chinese exports to the U.S. are many times greater than vice versa, giving the U.S. much more ammunition with which to inflict damage on the Chinese economy through tariffs. And although we have some concern about China's retaliating in ways that don't show up in the numbers – for instance, by throwing sand in the gears of U.S. companies who do business in China through increased regulation and enforcement (imagine, say, how miserable the Chinese government could make life for Apple were it to enforce every regulation on the books that could conceivably apply to the firm's manufacturing operations with Foxconn) – doing so would create serious blowback for the Chinese. Companies like Apple employ many millions of Chinese workers, and any move by the regime to harm American businesses making products in China could put their employment

– and by extension the stability of China's economy, society, and political system – in jeopardy. And, knowing how China would have treated firms with operations there currently, what multinational would invest in China in the future? It appears increasingly conceivable to us that China simply may not have the capacity to hang with the U.S. in a prolonged trade conflict.

Recent developments have reinforced this last possibility. While Trump's early threats engendered prompt and proportional Chinese counter threats, the former's latest proposed tariffs have met with silence – perhaps because China can't come close to matching them. In addition, whereas people across the political spectrum earlier criticized Trump (with good reason, in our view) for fighting a multi-front war by antagonizing our European and North American allies – who don't like China's manifestly unfair trading practices any more than Trump does – rather than enlisting them in a common effort against forced technology transfers and other Chinese shenanigans, lately we seem to be moving toward settling our differences with our allies in preparation for joining forces against China. We have been skeptical of Trump's methods and policies on a range of fronts, and all of this could change tomorrow or next week, but we have to acknowledge the possibility that the Chinese have in fact been playing a weak hand strongly for a long time on trade and that Trump's hardball approach might just be bearing fruit where previous presidents' more conciliatory strategies have failed.

With respect to the consequences of each of the foregoing possibilities for the stock market, the first scenario would likely be slightly bullish, as it would lift whatever pressure the market is currently feeling from all of the trade bluster; the third might actually be a significant positive. The second scenario, on the other hand, would likely entail a major global recession and accompanying bear market. Since it is the only possible outcome that would require us to fundamentally reposition our portfolios, it is also the one that bears the most attention. While, as we stated, we still believe the first scenario to be the most probable at this stage, we cannot dismiss the possibility of a legitimate trade war and therefore must be prepared to scale back our exposure to the market to whatever degree we deem such an eventuality to have become more likely.

The prevailing economic fundamentals have changed so little in the past several months that they merit only a word in closing. There has been some angst about the yield curve, which continues to flatten and threatens to invert if the Fed tightens much further from here, but we suspect the shape of the curve has more to do with stronger short-term growth and interest rates than long-term pessimism. Moreover, we are not completely convinced that the Fed will continue to raise short-term rates to the extent of causing inversion. That said, the yield curve's impressive track record as a recession predictor warrants our attention and respect, and an inverted yield curve would certainly have to be taken as a bearish datum. Overall, however, the underlying pattern of inflation and interest rates that, while somewhat higher than a year ago, remain favorable by historical standards – and whose higher level is now being compensated for by the first bout of truly robust economic growth in a dozen years – continues to be a bullish one.

If there have been any changes in your investment objectives or in your personal or financial circumstances, or if you have any questions or comments, please give us a call.

Sincerely,

Michael G. Hofkin

Benjamin J. Hofkin

(A copy of our disclosure brochure is available upon request.)