STEPPING STONES MANAGEMENT, LLC

Second Quarter 2018 Commentary

July 23, 2018

They say a picture is worth a thousand words and many multiples of that have been written about an iconic moment caught when the Group of Seven major advanced nations met last month. President Trump's threatened tariffs had roiled relations with most of his colleagues who came to Canada that weekend. Leaders representing almost half of the world economy were prepared to rebut the president's assertion that "trade wars are good, and easy to win." However, Trump came with a fresh solution to his trade war, completely free trade among the seven countries, zero tariffs.

As nice as a world without tariffs sounds, it's not remotely realistic to think the intricate trading regime constructed since the end of World War II can be replaced at the whim of a single leader. The picture makes clear the President did not come to the summit to get along like all his predecessors had. German Chancellor Angela Merkel is seen leaning over an obstinate Donald Trump as if pleading with him to be reasonable. French President Emanuel Macron looks on with a furrowed brow standing in front of British Prime Minister Teresa May whose face is obscured by Trump's advisors. Japanese Prime Minister Shinzo Abe emotes a hopeless expression.

The picture went viral after Angela Merkel posted it to her Instagram account in a challenge to the US president's social media prowess. Commentators have disparate views of what they think happened in that scene but we all know the summit ended with the United States refusing to endorse the joint statement calling for a reduction of "tariff barriers, non-tariff barriers and subsidies" among all the usual bromides about a fair and sustainable world economy. Not only did Trump withdraw from the statement, he also called out Canadian Prime Minister Justin Trudeau as "dishonest & weak" in an epic Twitter war between the North American allies. We are seeing what it is like to have a disrupter as President of the United States. The stock market shrugged off the hysterics, perhaps expecting the tariffs would eventually be abandoned, with the S&P 500 rising by 2.93% in the second quarter recovering almost all of the first quarter's decline. The president's face told the story as most of the tariffs went into effect on July 6.

Playing Chicken

President Trump isn’t just disrupting his predecessor’s policies or modern treaties like the North American Free Trade Agreement (NAFTA) that he’s criticized since it was implemented in 1994. He is disrupting a meticulously constructed international tariff infrastructure that began to take shape after World War II but harkens back to policies enacted in the 1920s as the Industrial Revolution brought a surplus of products to the world economy. Tariffs were embraced by Europeans as well as the US where average tariffs rose in the decade from an historical low of around 20% to almost 60% of the value of imported products. The 1920s roared along anyway as domestic production boomed but the Smoot Hawley Tariff Act of 1929 proved to be a disaster that was widely, if incorrectly, blamed for causing the Great Depression.

Then as now, protecting domestic producers was justified on national security grounds. Countries wanted to ensure they could always produce enough food and armaments so certain industries were protected with government subsidies and limits on imports. Europeans struggling to rebuild after two world wars didn’t appreciate all the innovative American products that were lowering prices for their citizens to enjoy but their producers to match. Tariffs are always about helping the politically connected at the expense of the rest.

In 1947 a consensus emerged among nations to form the General Agreement on Tariffs and Trade (GATT) whose stated purpose was the "substantial reduction of tariffs and other trade barriers and the elimination of preferences, on a reciprocal and mutually advantageous basis." 23 nations signed the original agreement and more signed on in each of seven subsequent rounds over coming decades finally culminating in today’s World Trade Organization governing international trade among 164 signatories.

Various rounds of GATT addressed more than tariffs. Preferences and subsidies for domestic producers have been some of the most contentious topics. When US farmers developed ways to mass produce chickens, supply exploded and prices crashed. By the 1960s the former delicacy became a staple. When US chicken exports hit Europe, they began to drive out domestic producers leading France and Germany to institute chicken taxes and price controls. The US reciprocated and the Chicken War lasted from 1961-1964 and included such casualties as the VW Microbus, hit with a 25% tariff that still exists today. The German Chancellor said that about half of his considerable correspondence with President Kennedy concerned various foreign hotspots and about half concerned chickens. The 25% tariff is the reason there are so few foreign pickup trucks on US streets.

Despite vestiges of old wars persisting today, average tariffs in the US and EU have steadily declined to about 1.6% of the imported value of goods into each market in 2016 according to the World Bank. Japan is lower at 1.35% and Canada at 0.85% but China and Mexico are higher at 3.54% and 4.56% respectively, although the Mexican rate does not apply to most US products under NAFTA. With imports representing about 16% of the US economy, raising tariffs from such a low level shouldn't have a great overall impact. Except for those targeted by European and Chinese retaliation.

Stock markets around the world are taking the threat more seriously. The international positions in the Stepping Stones fully invested Equity ETF strategy were the weakest led by the China fund returning an unlucky -7.77% in the second quarter. The Europe fund did better losing -2.59% and the currency hedged Japan fund declined by -1.68%. The semiconductor industry is joined at the hip with China and that fund also declined by -1%. It could be their defensive nature or lower long terms rates that accounted for a 3.7% quarterly gain in the Utilities fund but the defensive consumer staples fund lagged with a 0.81% gain. Technology and cyclical stocks are overweighed in the Valueline Timeliness fund so it's quarterly decline of -1.38% could be a harbinger of economic weakness to come. The strengthening US dollar caused the reverse effect on gold prices but the gold miners fund managed a gain of 1.5%. Dollar strength did not restrain oil prices as threatened sanctions against Iran and smaller than expected OPEC cuts led to new recent highs for oil benchmarks. Our over weighted energy stance is finally beginning to pay off as our two sector positons gained about 25% each. All combined the portfolio gained 0.92% on a price basis in the second quarter compared to the S&P 500 which gained 2.93% and the MSCI All World Index which declined by -0.81%.

Liquidity Deficit

The reason why the US runs a trade deficit is because our consumers and businesses want to buy products from around the world. The fact that we buy more than we produce sends our dollars overseas where they don't buy much except Treasury bonds. Having foreigners fund our fiscal deficit is one advantage of a trade deficit. President Trump sees it differently equating the trade deficit with the rust belt. It got him elected so nobody should be surprised as he disrupts the biggest problem he sees.

Maybe more foreign producers will set up shop in the US as Harley Davidson is doing overseas. Historians will judge the long-term impact but we can already see some immediate effects. Since the beginning of the second quarter, the US dollar has strengthened against our trading partners. This offsets the tariffs by making imports cheaper. Some of this is because the Fed is causing a global shortage of dollars as it shrinks its balance sheet. In the case of China, they peg their currency exchange rate which has declined against the US dollar by 6% since the G7 summit (the Bank of China says the value is driven by supply and demand). That more than offsets the higher tariffs while creating another obstacle for US producers competing in international markets. Setting the currency value is a weapon Donald Trump does not possess, making a trade war with China less easy to win.

A stronger dollar will lighten the load faced by US consumers but the higher prices intended by tariffs will bolster the Fed's policies of higher rates and quantitative tightening where they decreased the money supply by $30 billion monthly in the second quarter. The shrinking pool of Treasury bonds has begun to affect the emerging markets which usually drop before developed markets. US Treasury bonds collateralize riskier investments so when the collateral gets called in so do those positions. Fed Chairman Powell has highlighted the strong US economy as justifying tighter monetary policy and reiterated the Fed's stated plans. That reduction is scheduled to reach $40 billion monthly this quarter rising to $50 billion next quarter. Those numbers dwarf any tariffs affecting the US economy.

Notwithstanding a difficult environment in the emerging markets, our economy has withstood the tighter monetary policy thus far. Second quarter earnings surprises have been generally positive as have economic statistics. However, in addition to the emerging market weakness, another warning sign is the flattening yield curve where long term rates are declining as short term rates rise with Fed policy. This is the typical pattern that develops when Fed policy is restrictive and usually ends in a market correction. Therefore, we are not letting the strong numbers dissuade us from our cautious stance.

The Fed chairman who created all that money was Ben Bernanke whose academic career focused on how the Smoot Hawley tariffs did not cause the Great Depression, the Fed did. His monetary expansions were designed to avoid another one after 2008. He never articulated how the unwinding would progress but we are slowly finding out. So far it has gone smoothly but it has only just begun. The US collects less than $40 billion in total tariff revenue each year, the Fed is pulling that out of the economy every month. Trade wars are not good and not easy to win unless raising taxes on your citizens is winning. War is sometimes necessary though and China's trade deficit is not as pernicious as their other offensive behavior like forced technology transfers and corporate espionage. Disparate market access is more important than tariff rates. Monetary tightening cycles are also not good and are usually not commensurate with higher stock prices. Donald Trump got it right by disrupting our regulatory and tax structures so two out of three aint bad. Whether or not he wins his trade war, we see it as a shiny object distracting from the real story of tighter money.

Please feel free to call with any of your financial concerns. Until then and as always, thank you for your trust and thank you for your business.

Yours truly,

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