Volume 89

THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

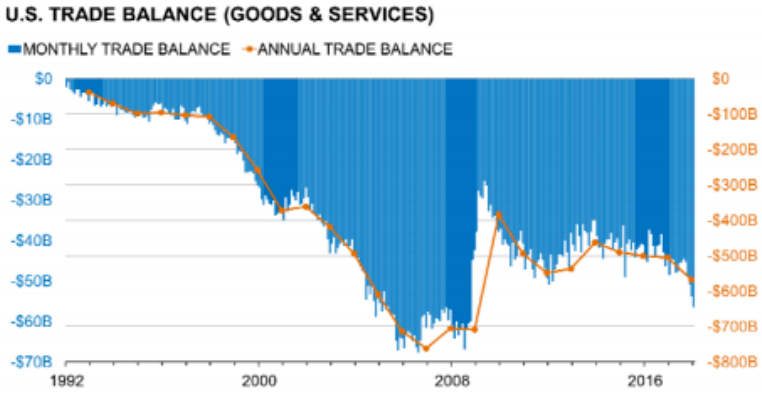
March 2018

We had noted in a January Reuters interview our belief that, "Short of something truly stupid like a trade war with China or a withdrawal from NAFTA, or something horrific like a nuclear conflict with North Korea, we don't see a scenario where investors are likely to elevate politics to the same level of importance as the global recovery and improving earnings."

Two months later, the global recovery continues to gain such impressive momentum that the European Central Bank and Bank of Japan are actively planning the reversal of their quantitative easing policies, and corporate earnings growth has been nothing short of spectacular.

Even North Korea has apparently been diminished as a near-term threat, with at least some potential now existing for a longer-term solution. Unfortunately, we remain very skeptical, as recent overtures from North Korea are very reminiscent of the strategies employed throughout the regime's history as a means of gaining political and economic concessions. The world can only hope that "The Art of the Deal" works as well with dictators as it reportedly does with capitalists.

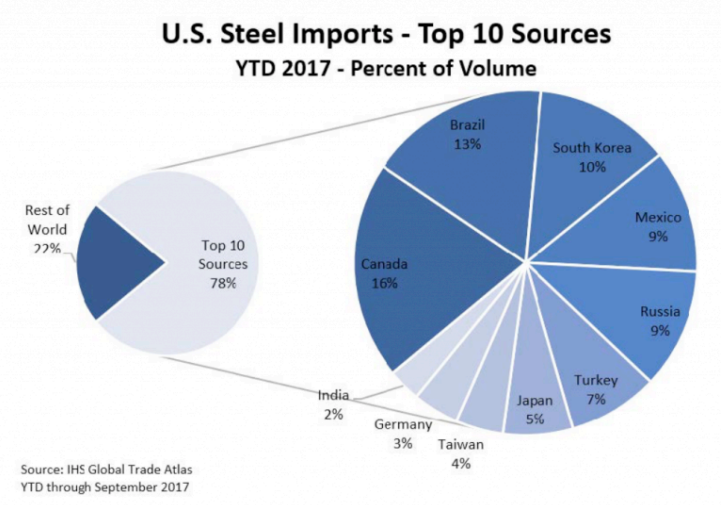
We believe that it is noteworthy that President Trump has one big incentive to lower tensions between the U.S. and North Korea, which is that it makes U.S. foreign policy in the region much less dependent on Chinese cooperation, and thus makes it much easier for President Trump to impose the $60 billion of trade tariffs against China that were announced on March 22nd, and which he described as "the first of many".



Source: U.S. Census Bureau

Ironically, a less hostile North Korea may actually prove negative for the world's stock and bond markets, as it increases the likelihood of protectionism and a trade war, which would almost certainly hurt corporate profits and increase inflation. In other words, "something truly stupid like a trade war with China or a withdrawal from NAFTA", is no longer just some distant hypothetical concern. To the great dismay of the equity markets, one and/or both outcomes increasingly seem to be the path of least resistance.

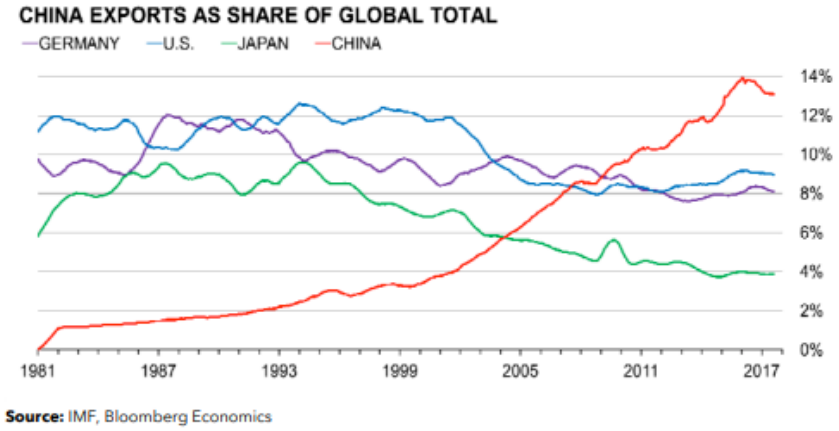
Over recent decades, the U.S. government has normally relied on "watch-maker's" tools to make slow adjustments over time to its foreign, trade and immigration policies, so as not to disrupt the world order that the U.S. was primarily responsible for putting in place.



In sharp contrast, President Trump prefers to use a sledge hammer to try to force other parties to bend to his will. It is important to note that each of these are policy areas where there are relatively few checks and balances, and where Trump has a great deal of authority to act unilaterally.

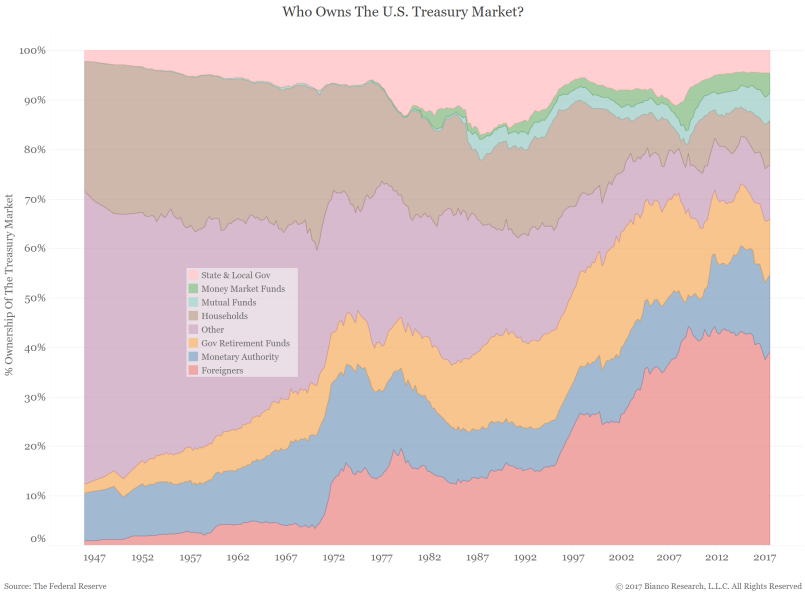
There is also a pattern emerging in regard to how President Trump operates. When he wants to force changes to long-established practices, he threatens an action that would have draconian consequences in order to force the other parties to the table, and to give himself negotiating leverage and credibility (i.e. "He might just be crazy enough to go through with it."), only to ultimately settle for targeted and/or relatively minor concessions.

The recently announced steel and aluminum tariffs are a great example of this strategy. President Trump originally threatened to apply stiff tariffs on these commodities regardless of their country of origin, but ultimately excluded Canada, Mexico, Australia, the European Union, Argentina, Brazil, and South Korea from the tariffs. These countries combine to provide almost all of America's imported steel and aluminum, thus rendering these tariffs largely ineffectual. It is noteworthy that only about 2% of the steel consumed in the American economy even comes from China.



We do want to emphasize that the Trump administration's openly protectionist attitude is not without some justification, as there are notably more trade barriers and value-added taxes faced by American exporters into foreign markets than there are faced by foreign producers exporting into U.S. markets, and it is further true that the massive purchases of treasury debt by Japan and China (in particular) keeps their currencies undervalued versus the dollar thus helping to make the prices of U.S. goods less competitive in their countries, thus further exacerbating the respective trade deficits.

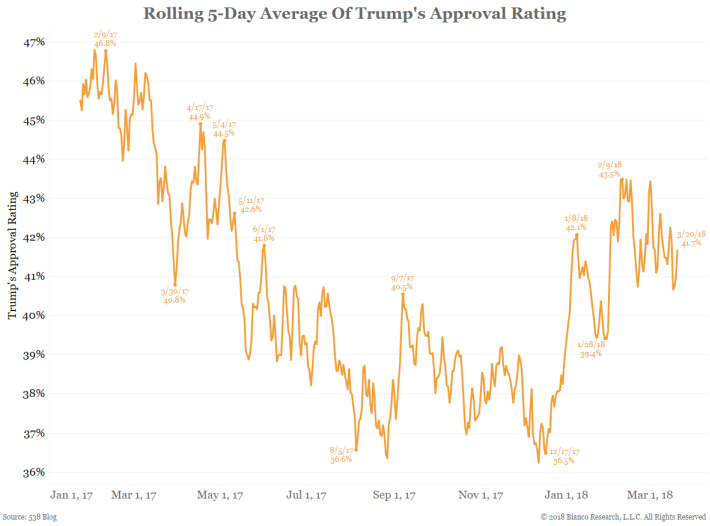
To explain, foreign exporters into the U.S. receive dollars in exchange for the goods that they sell. They have three options once they receive the dollars. They can then use those dollars to buy U.S. goods and/or real assets like real estate and companies, which is happening on a limited basis. However, these are primarily exporting-based economies with rather restrictive trade provisions (again, primarily China), so importing goods from the U.S. is the last policy that they would pursue.



They could sell dollars in the currency markets in exchange for any other currency (including their own), but that would decrease the value of the dollar, which would make foreign goods more expensive for U.S. consumers and make U.S. exports more competitive overseas, which makes this an unattractive option for exporting-based economies.

The third thing that they can do is to buy U.S. debt, which is soaring in supply by the day. This does relatively little to support the dollar on a trade-weighted basis, and thus maintains their competitive trade advantage versus the U.S. Indeed, Peter Navarro, who serves as the Director of the White House National Trade Council, just accused China of using their purchases of U.S. debt as an unfair trade tool.

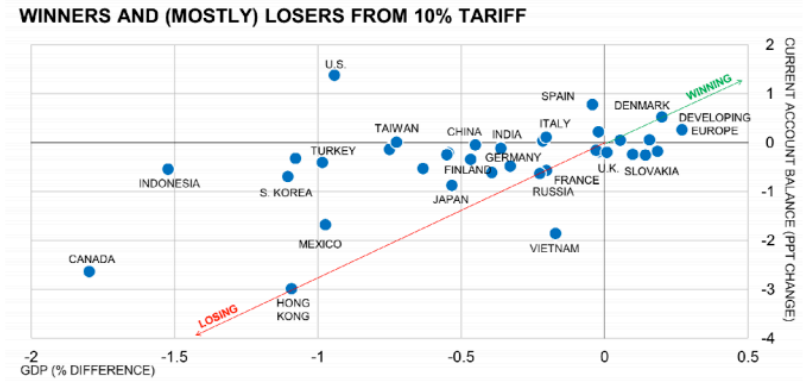
To us, that is like being mad at someone for throwing you a life preserver, as U.S. interest rates would undoubtedly be much higher (and thus the economy much slower) if not for foreign purchases of treasuries, particularly since the Federal Reserve is now actively in the process of reducing its own massive holdings of U.S. debt.



One thing that causes us some significant concern is that President Trump's approval rating seems to be directly tied to his increasingly protectionist actions and language, and this is likely to reinforce the influence of United States Secretary of Commerce Wilbur Ross, U.S. Trade Representative Robert Lighthizer, and Director of the White House National Trade Council Peter Navarro, each of whom is espousing a remarkably anti-free-trade agenda. As noted previously, President Trump has already stated that his protectionist actions to date are "the first of many."

Markets hate uncertainty even more than they hate bad news, as they know how to price in bad news, but they can't price in uncertainty (particularly open-ended uncertainty), and Trump's posture represents unfathomable uncertainty at the most macro-economic of levels.

We believe that investors appreciate the fact that the U.S. and American companies will experience some incremental benefits, if the U.S. can negotiate some improved trade terms. Further, it would be significant if the U.S. could lessen the theft and forced transfer of American intellectual property, where China's policies are particularly egregious. Depending on the source, the global theft of intellectual property costs the U.S. between $225 billion and $600 billion per year.

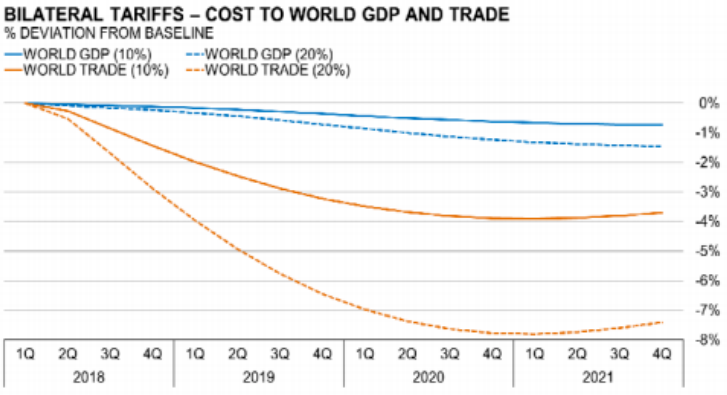


Source: Bloomberg Economics

However, to apply a Wall Street term to the administration's current trade policy, we are concerned that they are "picking up quarters in front of a steamroller". In other words, we acknowledge that the current hard line stance that the Trump administration is taking on trade may produce some economic benefits. However, we also believe that they are taking on fairly extraordinary risks in pursuit of potentially only modest gains.

Indeed, if President Trump truly believes his March 2nd statement that, 'Trade wars are good, and easy to win", then he clearly has no working knowledge of history and no grasp of economic theory. It seems that brinksmanship is the only strategy in President Trump's repertoire, and many of the President's statements and threats may thus just be posturing to improve his negotiating leverage. It is a very dangerous approach under any circumstances, and particularly so if President Trump actually believes his own statements and tweets on trade.

For the record, trade wars are neither good nor easy to win. Indeed, it is said that a trade war is the only kind of war that nobody has ever won.

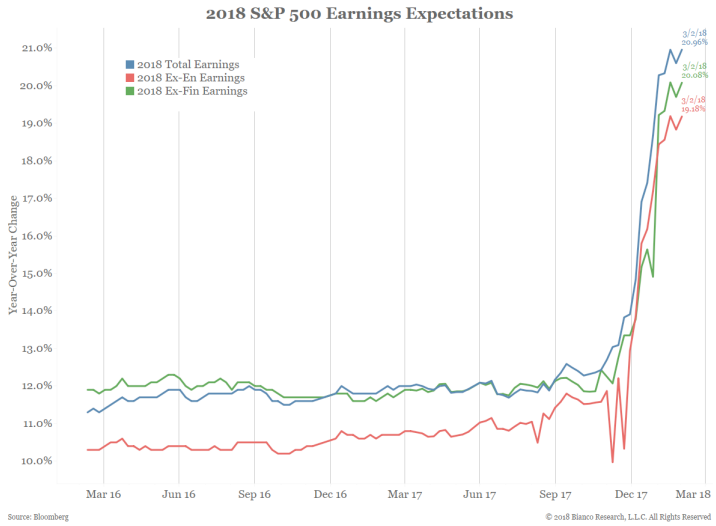


Source: Bloomberg Economics

According to Bloomberg Economics, Denmark and emerging Europe are the only two areas of the world that would not experience economic shrinkage in the event of a 10% global tariff. In addition, their research shows that the world economy would shrink by just over one-half percent in the event of a global 10% tariff and by approximately 1.5% in the event of a 20% global tariff. Their estimates show that, in the event of a 10% global tariff, the size of the U.S. economy would be 0.9% smaller in 2020 than it would be otherwise. While 0.9% is a small percentage, it is being applied against a $19.4 trillion economy.

Equally disturbing is the Bloomberg estimate that world trade would drop by 3.5% with a 10% tariff and by over 7% in the event of a 20% tariff. A reduction in trade combined with the implementation of tariffs is an inflationary mix that is likely to make the Federal Reserve even more aggressive in tightening monetary policy, which would hurt the prices of both stocks and bonds, particularly at a time when signs of wage and capacity-driven inflation are already emerging.

It is no wonder that, in a just-completed CNBC survey of economists, fund managers and market strategists, respondents said that a trade war is now far outpacing all other factors as Wall Street's greatest concern. Indeed, almost two-thirds of respondents said that Trump's trade policies are a negative for economic growth and 48% (a plurality) said that the steel and aluminum tariffs would cost American jobs (as had been the case when George W. Bush applied similar tariffs in 2002). The Trade Partnership (a trade research and consulting firm) has just modeled this scenario and determined that the steel tariffs will create an estimated 26,346 jobs in the steel and aluminum sectors but cost 495,136 jobs elsewhere in the domestic economy.



Of note, more than 80% of respondents to the CNBC poll said that it would be an economic negative for the U.S. to withdraw from NAFTA, which Trump is threatening to do, and 48% classified such an outcome as "very negative".

Barclays has also just completed a financial modeling of the impact of a 10% tariff on all U.S. imports, and it shows that it would cost S&P 500 companies around 11% on an earnings-per-share basis, which would likely be sufficient to wipe out all of the dramatic earnings benefits produced by tax reform.

Further, the Penn Wharton Budget Model, a research center and think tank, predicts that a "full-blown" trade war would cause the U.S. to lose 5.3% of its total economic output by 2040 (a cost of $1.4 trillion), and U.S. wages to decline by 1.1% over the next decade.

Yes, Trump's approach is not necessarily unwarranted, and it may produce some benefits. However, it is also alienating most of America's traditional friends and allies, as opposed to uniting with them to force China to be a responsible and law-abiding member of the global economy. Indeed, if things don't go according to plan, and Trump's policies ultimately produce more retaliation than negotiation, those policies will be placing the global economy within reach of the aforementioned bulldozer.

Macroeconomic factors like trade policy and monetary policy will almost certainly determine the course of the capital markets over the medium and longer term. However, in the short term, markets can be driven more by emotions like fear and greed and, while the fundamental factors that create those emotions change over time, the way that investors react to those emotions tends to remain remarkably consistent, which is what forms the basis for both behavioral economics and technical analysis.

This concept was perhaps best encapsulated by Mark Twain, who noted that "History does not repeat itself, but it oftentimes rhymes". Well, from a technical perspective, history suggests (at the great risk of hyperbole) that the next week or so may be the most important period of the year for the investments markets.

To explain, the news of the current trade tensions is well known to everyone, and they have taken quite a toll on equity prices, which means that much of the risk is, at least potentially, already reflected in the market. Obviously, if an investor sells after bad news is fully reflected in share prices, they end up selling at the lows. This means that, in the immediate term, the most important question for equity investors is, "how much of this trade-related risk is already priced into stock prices?", which is a question that we hope to help answer through technical analysis (the intersection of math and markets).

History teaches us a number of things about markets. As you can see from the oscillator at the top of the chart, markets rarely trade at fair value, but instead swing between overbought (70 and above) and oversold (30 and below), where it is now.

Second, when you see major market selloffs like we saw in February, markets almost always have a retest of their prior reaction lows (just below current levels), before a rebound higher is sustainable.

Third, in what may be a case of sympathetic magic as much as anything else, downward corrections in the midst of ongoing bull markets normally stop at the 200-day moving average (red line), which is why sustained breaches below that level are often considered evidence that the primary trend has changed.

We suspect that the equity markets will attempt to make a stand around current levels, but that they <u>may</u> ultimately need to spend one or two scary days below the February lows before generating sufficient investor capitulation to power a sustainable rally. Such a sustained rally from around the February lows would likely be deemed by investors as a confirmation that the primary uptrend is still in place, and could prove to be a very opportunistic buying opportunity.

However, we would view a sustained breach below the February lows as an indication that a more significant and sustained decline may be underway, in which case it would make sense to at least lower your portfolio's overall risk profile until such time when trade and monetary policies present less significant headwinds. In the meantime, we are content to take our clues from the markets themselves, as we approach what we consider to be a potentially very important inflection point for stocks.