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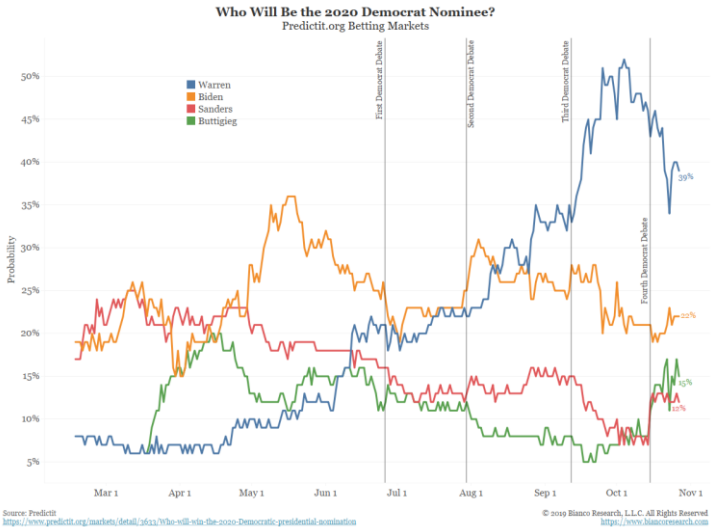
Throughout the course of human history, there have been seminal and transformative events and decisions that have, as if one flipped a switch, fundamentally changed the outlook for the global economy and the global capital markets. Examples of this phenomena are as diverse as they are rare, and include cases such as the fall of the Berlin Wall, the collapse of Lehman Brothers, and the introduction of the internet as a public utility.

We believe that the realization of a substantial and enforceable trade agreement between the U.S. and China would very likely mark a similarly seminal and transitional event. However, we will strongly emphasize the counter-factual nature of this statement, as the aftermath of a successful trade deal is probably not that far removed from the *status quo*. In other words, the most important benefit of a trade agreement is likely found not in the positive changes that it catalyzes, but in the future negative consequences that it avoids.

That is what potentially makes this a seminal event, as the great likelihood is that the failure to reach a deal would ultimately result in a world that, over the longer term, is more isolationist and less global, more protectionist and less free-market, and potentially much slower growing, with diminished innovation and constrained productivity gains.



The upcoming presidential elections further magnify the importance of a trade agreement, as failed negotiations would likely result in additional tariffs, which would greatly increase the likelihood of a 2020 recession in the U.S., which should increase rather dramatically the likelihood of, at least according to the current polls and prediction markets, an Elizabeth Warren presidency, which is expected to be openly hostile to both investors and to the capital markets themselves.

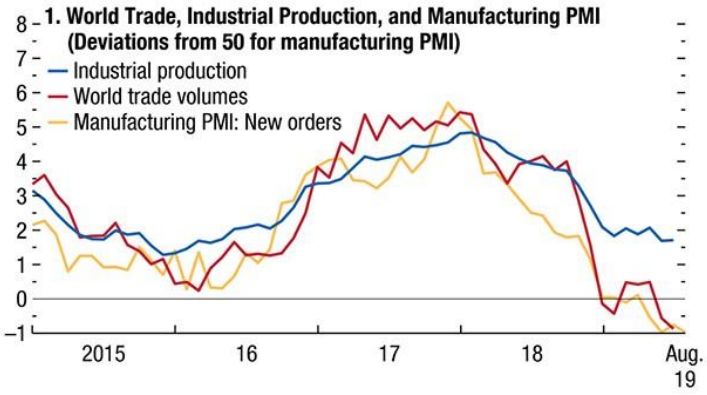
Indeed, recent polls show that 92% of polled investors view the potential presidency of any Democrat other than Joe Biden to be either "bearish" or "very bearish". In contrast, the potential of a Biden presidency was viewed as a "neutral", as his election would be viewed as a continuation of the (as strange as it sounds) relatively more centrist Obama administration.

As a backdrop, the latest Gallup poll showed that 52% of respondents not only support a Trump impeachment, but also a conviction and removal from office, and this is starting to impact the prediction markets, which currently reflect a 48% likelihood that the next president will be Republican, but only a 41% likelihood that it will be President Trump.

Global Activity Indicators

(Three-month moving average; year-over-year percent change, unless noted otherwise)

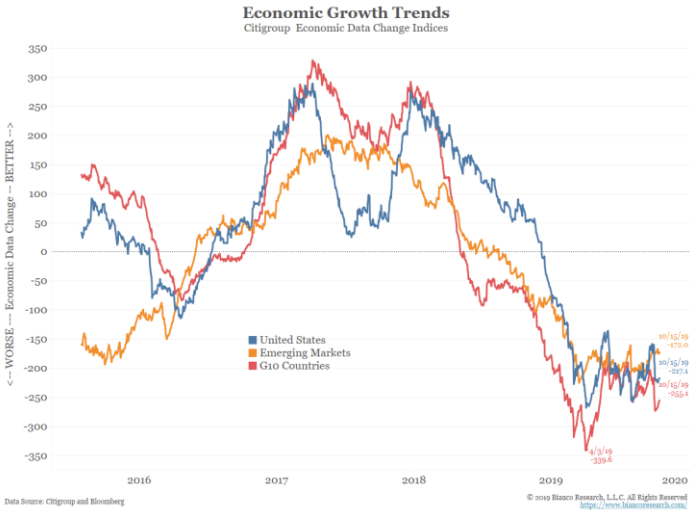
Over the past 12 months there has been a geographically broad-based, notable slowdown in industrial output.



This dynamic must heighten both President Trump's desire for a trade de-escalation and his need for a political victory.

Even without the political implications of the trade war, the working premise for investors at large is that the trade war is a significant drag on the global economy (a self-evident truth) and that any further escalation of the trade conflict will likely catalyze a global recession by sometime in 2020.

Of particular concern are the 15% tariffs on $155 billion of consumer goods that are currently scheduled to be implemented on December 15th, which have the potential to significantly crimp domestic consumer spending and, in so doing, tip the global economy into recession.

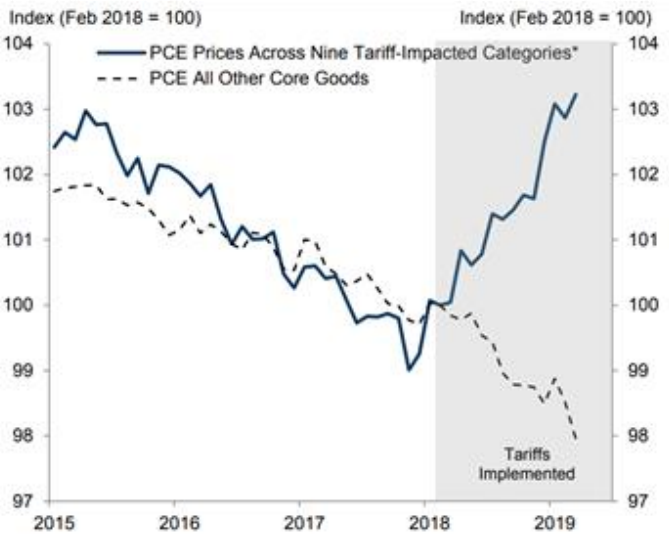


While such draconian expectations may initially seem like hyperbole, it is important to consider that domestic consumer spending represents almost 70% of the size of the U.S. economy and 30.4% of all global consumer spending.

With the lowest unemployment rate in fifty years and recent wage growth in excess of 3%, the domestic consumer is in great financial shape, and represents one of the few bright spots in a world which is growing at its slowest pace since the financial crisis, where Europe and Japan are already teetering on the verge of recession, and where China is growing at the slowest rate in thirty years.

It is against this backdrop, and the strong headwinds being created by the trade war, that a combination of domestic consumer spending and global monetary stimulus (which is running low on ammunition) has been largely responsible for propping up the global economy.

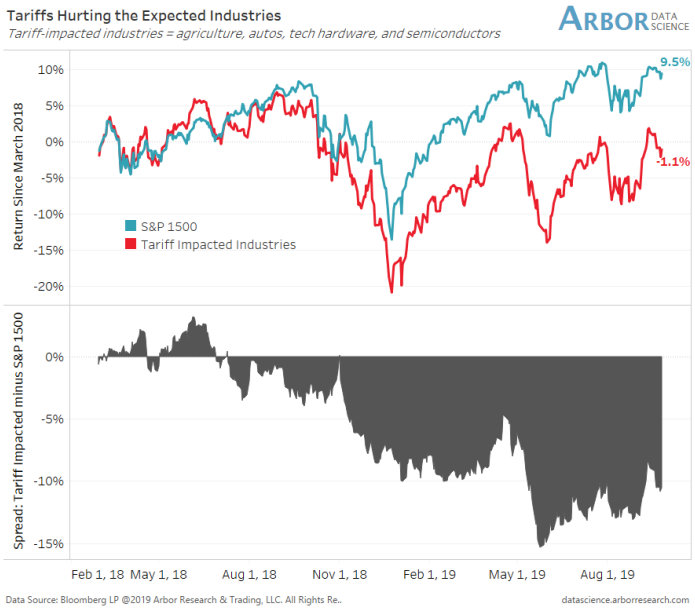
For the record, the "very substantial phase one deal" announced by President Trump on October 11th was anything but the requisite "substantial and enforceable trade agreement". However, that is not to suggest that the most recent meetings were not important, as they did demonstrate a growing willingness of both parties to at least pursue respectful negotiations, which provides a much less threatening environment for the risk markets than did the previous *modus operandi* of escalating tariffs, company blacklists, and sanctions.



Most importantly, it also resulted in the White House canceling the 5% tariff increase (from 25% to 30%) on $250 billion in Chinese imports that was scheduled to go into effect on October 15th, and that reduction in tension alone was sufficient to allow the domestic equity markets to make another attempt at all-time highs.

Thus far, U.S.-imposed tariffs have concentrated on industrial machinery and heavy equipment. Even so, and despite the quite limited nature of the tariffs to-date, you can already see evidence of their impact in everything from inflation to share prices, and we believe that this is just a hint of things to come if U.S./China negotiations break down yet again, and both sides return to their previous strategy of escalation and retaliation.

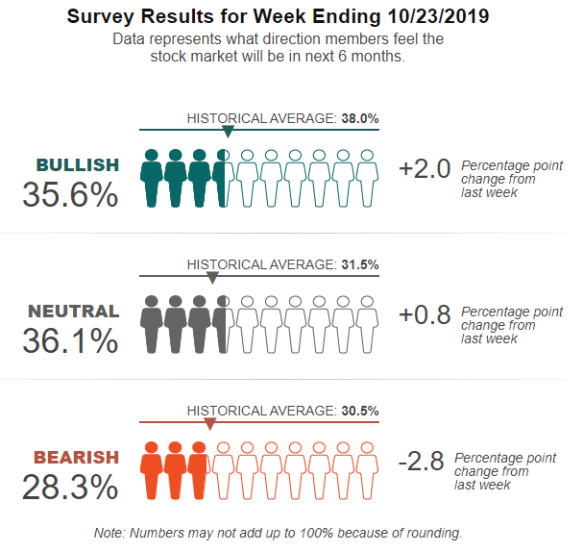
In regards to inflation, and contrary to the White House claim that it is Chinese exporters rather than American consumers that are paying the tariffs, prices of tariff-impacted products have surged over 3% since the initiation of tariffs, whereas prices in non-tariff-related categories have actually declined by over 2% (likely a result of the tariff-catalyzed slowdown). It is only reasonable to assume that any expansion in tariffs would also produce an increase in tariff-driven inflation.



You can also see the impact of tariffs on corporate profits and therefore share prices, with the equity market performance of companies in tariff-impacted industries (red line) badly lagging the equity market overall, as represented by the S&P 1500 (blue line). Similarly, it is reasonable to expect that any expansion in tariff-impacted companies will produce an expansion in tariff-depressed equity prices.

However, recent comments from National Economic Council director Larry Kudlow that the December consumer product tariffs may be cancelled upon the signing of a "phase one deal" are music to the ears of the financial markets, as such a cancellation would remove a significant economic risk.

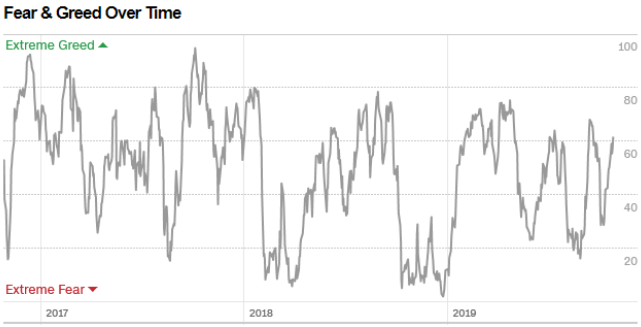
Further, reports that President Trump's hardline trade advisor, Peter Navarro, has been unsuccessfully attempting to derail the "phase one" deal because of the removal of previously-existing protections for intellectual property and information technology suggests that President Trump is increasingly willing to accept a watered-down deal in the name of political expediency.



While this step back from the brink is being celebrated by equity investors, such a milquetoast result will just end up deferring the issues of forced-technology transfers, theft of intellectual property and Chinese state-supported industries into the future, when they are ultimately going to need to be addressed.

In the meantime, one might reasonably assume that a trade agreement would be a very bullish catalyst for equity prices. However, while that is certainly a possibility, as markets have a tendency to overshoot in both directions, we suspect that much of the trade-related bullish news has already been reflected in equity prices. Remember that a successful deal is likely to basically just maintain the *status quo* from an economic perspective, rather than to introduce new stimulus.

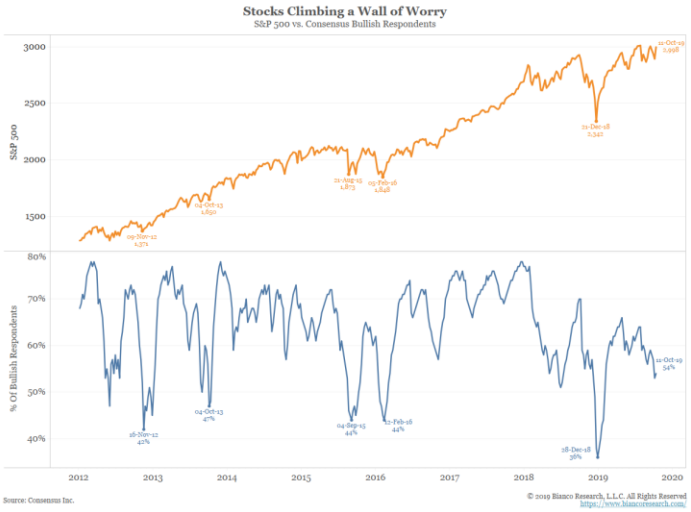
There is little doubt that the trade conflict has been a significant weight on investor sentiment, and that the recent change from brinksmanship to cordial negotiations occurred at a time when investors were very bearish. As such, the news reversed a deeply oversold condition.



Indeed, individual investor sentiment, as measured by the American Association of Individual Investors, had reached extreme readings as of the October 10th survey, with only 20.3% bulls and a massive 44.0% bears, which compares with historical averages of 38.0% and 30.5% respectively. Such extreme readings of bearishness suggested that most investors had already sold as much as they were likely to sell. However, with current readings of 35.6% bulls and only 28.3% bears, sentiment is now back into normal ranges, which suggests that much of the improving trade outlook is already largely reflected in prices.

The CNN Fear/Greed Index, which uses market-based measures to gauge investor sentiment, further confirms that investor sentiment has gone from fearful to greedy, which echoes the view that much of the perceived bullish trade news is already priced in.

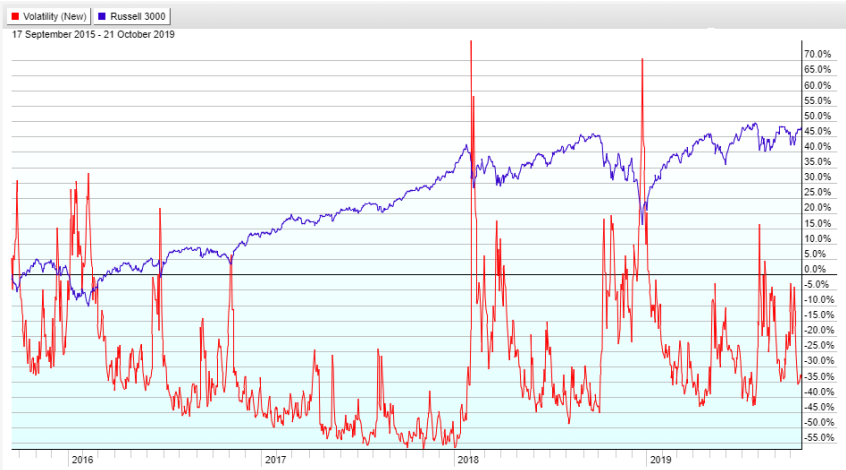
This rationale may seem counterintuitive at first glance as we, as human beings, draw comfort from being of the consensus opinion. After all, on the surface, it makes a great deal of sense that whatever the majority believes to be true is most likely true. However, in the capital markets, the exact opposite is much more likely to be profitable. This is best explained through the use of an analogy.



Imagine a giant room that contains every investor in the world. For the purposes of this analogy, assume that each investor has the same amount of money to invest and that all bulls will be fully invested in equities and all bears are 100% in cash.

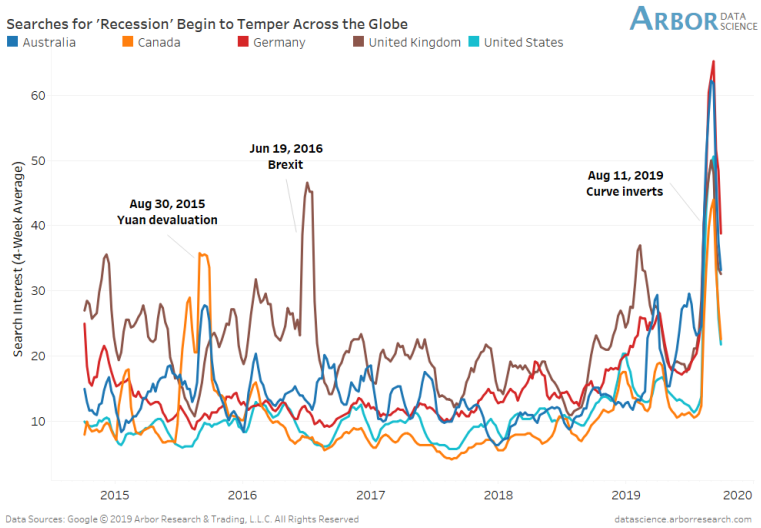
If all bullish investors were asked to raise their hands, and 90% of the room did so, it would be very natural for all of the bulls to be reassured by the fact that the collective wisdom of all investors in the world concurred with their opinion. The opposite would also theoretically hold true. However, in practice, investing with the consensus is usually a great way to turn a large fortune into a small one.

Indeed, in the counterintuitive world of investing, if 90% of the room raised their hands, it means that 90% of potential buyers have already bought and that only 10% of potential sellers have already sold, which indicates that there is very little sideline cash remaining to drive prices higher, but much equity to be sold if conditions deteriorate or opinions change. This is why rallies start at the point of maximum pessimism, and why Sir John Templeton noted that "Bull markets begin in despair, grow on pessimism, mature on optimism and die in euphoria".



You can literally see this relationship between sentiment and the risk-adjusted return potential of the market in an overlay of the VIX "fear index" [a measure of investor fear based on the prices of defensive options (red line)] and the broad domestic stock market, as measured by the Russell 3000 Index (blue line). You can see that the most profitable investing opportunities (and the best risk-adjusted return potential) takes place at the point of greatest fear (i.e. when investors are willing to pay very high prices for portfolio protection via options). Currently, low levels of fear suggest that the improving trade news has effectively already drawn much of the available sideline cash into the markets.

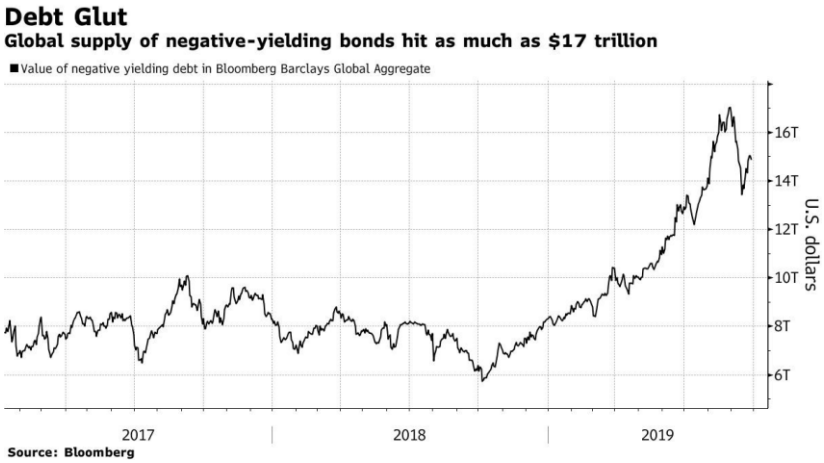
Of note, should a substantive U.S./China trade deal ultimately be successfully implemented, there is likely to be another characteristic that differentiates it from other similar seminal events. Indeed, unlike most of its predecessors, where the macroeconomic outcome and capital markets impact were very much in doubt, the prolonged nature of the current trade war, and the fact that it has largely been negotiated both in public and through the media, has provided a window into what the future might look like under different outcomes.



As was illustrated previously, a failed agreement, and a likely expansion of tariffs and other retaliatory strategies would almost certainly exacerbate all of the current tariff-related ills, including increased inflation, slowing global growth and depressed risk asset prices.

By the same token, we believe that the recent improvement in trade-related sentiment has provided some similarly useful insight into how the world might be different in the event of a successful and substantial trade agreement. Indeed, while we suspect that much of the improved outlook is already reflected in domestic equity prices, we believe that a substantial agreement would still have a tangible impact on the prospects for global economic growth.

You can see it already reflected in both circumstantial evidence, such as the large drop in the number of global internet searches related to the risk of recession, and very tangible evidence, such as the unwinding of many of the anomalies that have persisted as a result of tariff-driven recession fears.



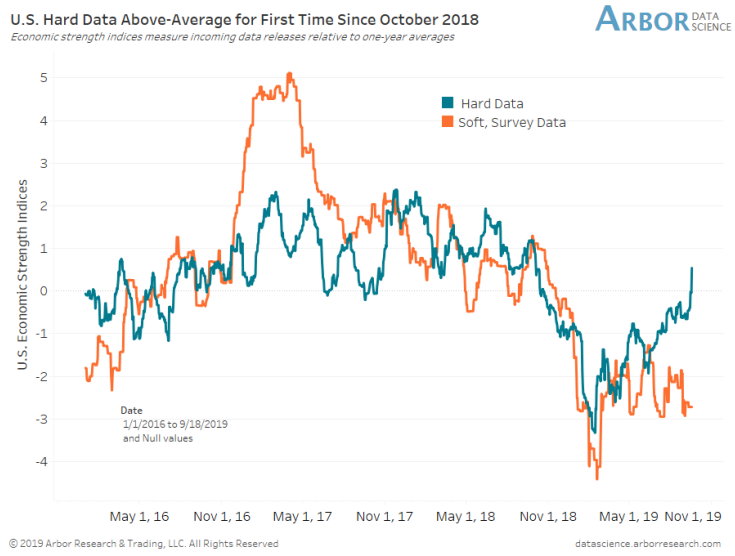
These anomalies, which started reversing and/or normalizing concurrent with the initial signs of a potential U.S./China rapprochement on or around August 27th, include the predominance of negative interest rates (where $1.5 trillion of previously negative-yielding bonds now have positive yields), the previously inverted yield curve (where shorter-term rates are now lower than longer-term rates across the domestic yield curve), and the long-term outperformance of growth stocks over value stocks, which is now showing signs of reversing.

In light of the global economic damage already done by the trade war, it would no doubt be disappointing for the White House to settle for a trade deal that is much less substantial than promised, particularly now that it looks increasingly likely that the two sides will be content to essentially just "kick the can down the road".

It is also very important not to become complacent as investors, and to recognized that there is virtually nothing in the "phase one deal" that was not already agreed to months ago, and that the only substantial change has been one of attitude and approach. All of the truly contentious and hard-to-solve issues are apparently just being postponed to a later date.

That said, even a tenuous "trade truce" is going to look pretty good to a market that was priced for a continuing escalation of tariffs and a likely 2020 recession, which explains this month's run to new highs in the equity markets (the first for the S&P 500 since late July).

Over the course of the past month, trade has gone from being a significant negative, to a strong positive to, in our opinion, a likely neutral influence for equity prices, while remaining as a substantial positive for most of the global economy, albeit less so the domestic economy, where trade issues have thus far depressed soft (survey) data much more than they have hard economic data which, as noted, we attribute to the very limited scope of the tariffs to date.



In closing, investors crave certainty and abhor uncertainty. The trade war has been the single largest source of uncertainty faced by the markets, so any introduction of clarity is likely to be celebrated by investors. At the same time, it is likely that a successful trade agreement (or even a trade truce) will decrease the Fed's willingness to cut interest rates in the future, which weakens an important support for the equity markets.

It is also important to keep in mind that risks are arguably higher now than they were a month ago, when the trade outlook was much direr and investors were pricing in a very bearish scenario.

With a trade war de-escalation now the presumed outcome, markets are much more susceptible to disappointment than was the case even as recently as a month ago. The improvement in the tone of negotiations has certainly elevated equity prices, while the resulting improvement in sentiment has simultaneously elevated the market's susceptibility to disappointment.

In the meantime, we can all take some comfort from the decreasing likelihood of the very negative economic scenario that only recently appeared to be a foregone conclusion.