Market Commentary: The Long-Term Costs of Tariffs

August 2019

Fountainhead headquarters is moving into a brand new office as of Q3 2019. As with any new office, certain essentials, such as desks and chairs, are necessary. The bill for our furniture included a "tariff" which added 2% to the cost. We are a microcosm of the economy which folds outward along the following logic:

- Our purchase becomes more complicated (resulting in lower output / efficiency) as we search for alternative product. The equation now changes:
    - Do we buy one less chair to defray costs and make one of our associates stand?
    - Do we alternatively review locally produced furniture that may now be available at a lower relative premium (currently, 2% for us)?
    - Either way, our purchase slows down and becomes more complicated, resulting in a ripple through the economy
- Vendors scramble to find new sources of product, analyzing the math involved in consumer purchases
- Manufacturers review where to source raw and finished product
- The math involved in deciding cap ex initiatives becomes degrees harder
    - If you were about to build out a presence in China do you do so now? Where is it safe to make a 10 year investment currently - how may the math and considerations change?

Trade wars, we believe, will be affecting us for some time as longer term capital expenditures take time to turn on and off. We are already seeing some of the effect in global softness outside the US as well as in US based multi-national earnings.

Blunting (short-term) the negative affects of trade wars and global softness ex-US is monetary easing by the major central banks inclusive of the Fed. The European Central Bank (ECB) indicated a deposit rate cut in September and potentially restarting a bond purchase program. The Fed cut rates by a quarter point on the last day of the month and are set to complete their quantitative tightening at the end of this quarter (the program where they were not repurchasing maturing bonds - effectively selling).

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As some may have noticed, the market themes have remained relatively constant over the last year. The main themes are as follows:

- Trade wars: BAD
- Lower rates: GOOD
  - Note, Powell has had immense pressure placed on his group to supply lower rates which have, in turn, allowed the ability to be more aggressive in our trade rhetoric leading to global softness due to uncertainty and finally, a need to lower rates. Anyone notice the circular motion here?
- Earnings: Moderately positive
  - Earnings came in as expected. With low initial guidance, companies generally beat and provided cautious but in-line forward guidance. Multi-nationals did worse as a whole given global softness and a strong dollar.
- Let's introduce two complicating factors:

(1) The election cycle is way too long! In a politically exhausting, divided country we have about 9 - 12 months of Democratic Primaries prior to an additional 6 to 9 months to election day. We are officially in an election cycle. Historically, economy trumps all. So while China trade has played well politically for the administration, if more US citizens receive a line item titled "Tariff" on a bill or if our own economy starts softening, then citizen approval for a trade war with China, which is already slipping, will fall off a cliff. China understands this and will take tremendous advantage: Is China simply looking to wait this out?[1] The administration is indeed in a tough spot here. While we were always skeptical of a deal getting done for a variety of reasons, it may be in the administration's interest to actually get a deal done.

(2) Does anyone remember that a mere two weeks ago Iran seized a BRITISH oil tanker in the strait of Hormuz? America's response has been to let the UK know that it's their responsibility. Since then, the Royal Navy has sent two warships to the gulf to protect BRITISH ships[2]. The US has had a deal with the world going back to WWII that we would police the waterways. This administration is now pulling back from that deal. Following is a

[1] There was an article the other day (forget which publication) that Iran was essentially duplicating Russia's effort to affect our national elections through fake accounts on Twitter, Facebook and the like. Russia seems to be Republican. Iran is favorable to Democrats. Can't wait to see whom China decides to back. Depending on their view, we may see some more action being taken to actually allow Americans to decide whom we elect.

[2] https://www.politico.eu/article/us-secretary-of-state-mike-pompeo-uk-must-look-after-its-own-ships-iran/ additionally, for an interesting book that discusses this theme in fascinating detail check out the "Accidental Superpower" by Peter Zeihan

graphic illustrating where Apple sources its supplies. If we decide to add tariffs AND make it more expensive for global shipping - or potentially impossible for certain countries - how expensive does your iphone become?

Countries that Apples sources parts from for its iPhone[3]

In summary, we are at a sensitive point in the cycle. Powell defined his cut last Wednesday as a “mid-cycle” cut but his timing may easily be off (depending on how he defines mid-cycle). It seems straight forward that central banks will aggressively attempt to ease out of any softness in markets - and US markets have been humming along on many metrics, but we still have a relatively expensive market with an overhang that we see sticking around for a bit due to trade wars and general global policies. We have recently lowered our high-yield exposure by 25% in our more growth-oriented models. We continue to look for ways to perhaps be more conservative in our exposures while still aligning with the traditional definition of the exposures.

[3] https://www.technologyreview.com/s/601491/the-all-american-iphone/

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