Q4 2018 Market Insights
Tariffs, Trade Wars, and Capitulation
Ryan J. Lehman, CFA, CAIA – Director of Investments

Integrated|Capital|Management

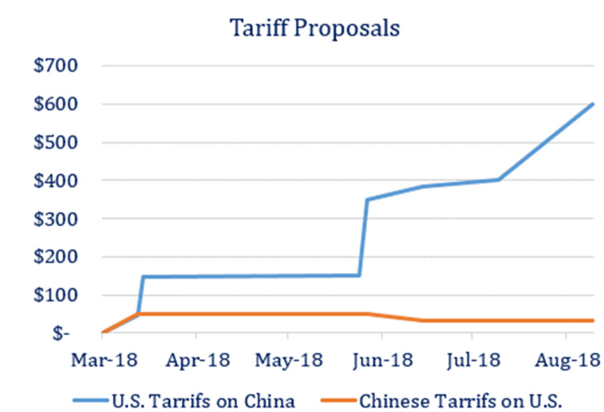
"As history has repeatedly proven, one trade tariff begets another, then another - until you've got a full-blown trade war. No one ever wins, and consumers always get screwed." - Mark McKinnon

One of the primary themes driving market performance thus far in 2018 has been investor fears over newly imposed tariffs and the potential for a global trade war. As such, before taking a deeper look at this subject, while doing my best to avoid any political discussion, I'd like to start this quarter's letter by laying out some facts about our current trade situation.

One of the key platforms of the Trump presidential campaign was a hard stance on global trade, driven by the view that the U.S. was being unfairly treated by many of its major trading partners, particularly China. Not only are Chinese companies able to produce goods at significantly lower prices than in the U.S., but they are also notorious for pilfering intellectual property from the companies that do business in their country. In an attempt to rebalance the scales, the U.S. has threatened tariffs on approximately $600 billion worth of Chinese goods (some of which have already been put into place), leading the Chinese government to promptly retaliate.

Most of these events have occurred over just the past few months, leaving a great deal of uncertainty on the table for investors. This has implications for both the U.S. economy, as well as stock markets around the world. In this quarter's Market Insights letter, we will discuss some of these potential impacts. In particular, we will take a look at the likely effect that a trade war may have on the U.S. inflation picture, and how trade fears have led to a bear market, and possibly capitulation, in emerging markets stocks.

Trade War Timeline



Source: BBC

The trade war between the U.S. and China has heated up quickly since it initially began in April of 2018. As of the end of August, the U.S. had announced plans to place new tariffs on roughly $600B worth of Chinese goods, while China has proposed new tariffs on $50B worth of U.S. imports.

The Economics of a Trade War

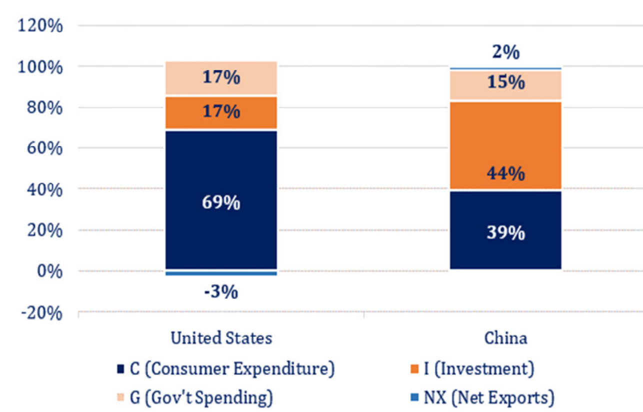
A trade war, by definition, is exactly what its name implies….a war between two (or more) nations over global trade practices, where tariffs and/or restrictions on imports and exports are the weapons of choice. In the case of our current battle, the goal of the U.S. government is to protect domestic industry and ideally create high quality manufacturing jobs at home rather than abroad. The theory behind this argument is that as tariffs increase the prices of imports, demand should increase for domestically produced goods, and therefore require additional manufacturing resources and workers. The strategy thus far, at least with China, has been to impose tariffs on billions of dollars' worth of goods entering the United States. While many hoped this would serve as a starting point for new trade negotiations, it has unfortunately led to tit-for-tat tariff policy announcements from both nations.

From a short-term perspective, the economic impact of a trade war should be minimal. In fact, it may actually achieve one of its overarching goals, by causing domestic companies to reconsider plans to expand manufacturing operations overseas. Over the long-term, however, these types of policies tend to be lose-lose situations for all parties involved, as the end result is typically unwanted inflation.

To explain, let's look at this through the lens of the consumer, as well as the manufacturer. As the producer of a good, a company typically needs raw materials to manufacture a product....steel, aluminum, copper, etc. Ideally, the U.S. producer would like to source high quality materials at the best price possible, as this lowers their cost of production and increases the profit earned on each finished product. Let's look at a simplified example.

Hypothetically, let's assume ABC Bottling Co. produces beverage goods and they currently import aluminum from China. Aluminum is critical to their manufacturing process, as they sell their beverages primarily in aluminum cans. If new tariffs are suddenly implemented, ABC Bottling is forced to decide between continuing to buy Chinese aluminum, which now comes with a 25% tariff (i.e. it costs 25% more than it did previously) or purchase aluminum from a U.S. producer. For the sake of this example, we will say the cost of aluminum from the U.S. producer is 15% more expensive than what ABC Bottling currently pays. So what is ABC Bottling to do?

Components of GDP Growth



Source: CIA World Fact Book

One of the primary differences between the economies of the U.S. and China is their reliance on trade. The U.S. tends to be a net importer of goods and services (i.e. trade subtracts from GDP), while China tends to be a net exporter (i.e. trade is additive to GDP growth.)

Common sense tells us that they should change their raw material provider to the U.S. company, given that their product now comes at a discount to the imported aluminum from China. Here the new tariff was effective in shifting production from abroad to the U.S., clearly benefitting U.S. aluminum manufacturers, but what about ABC Bottling and the end consumer? Neither are better off. All we have done is increase the input costs for ABC Bottling's manufacturing process, leaving the company with several options to consider.

First, ABC Bottling can simply absorb the increase in price of aluminum, which would have an immediate negative impact on their profits. Conversely, they can pass this cost increase along to the end consumer, knowing the risk that higher prices may lead to lower sales. The last, and most likely, scenario is some form of cost sharing between ABC Bottling and their customers, where ABC accepts slightly lower profits and the consumer is left with a marginally more expensive can of soda.

To sum up, over the long-term, none of the major stakeholders in our example benefit, regardless of ABC Bottling's decision. Under option one, ABC's costs increase, causing a decline in profits and a stock price that will likely follow suit. Under option two, the consumer suffers from the negative impact of inflation, which decreases their purchasing power, while under the last scenario both parties lose, just to a lesser degree.

Who Feels the Greatest Impact? Why the Markets Might Have it Wrong...

There is little room for debate when discussing trade wars and the likely path to higher inflation, but there is a question of who feels the biggest negative impact if a trade war were to persist. In our case, is it the U.S. or China that appears to suffer most? Listen to Mr. Market and he would tell you that the U.S. is in the clear, while emerging markets are in for a tough road ahead. Just look at the performance of these two asset classes through the first three quarters of 2018. We have the S&P 500, a proxy for U.S. large cap stocks, up 10.56%, while the MSCI Emerging Markets index has now lost 7.68% YTD (a spread of 18.24%!). But does the market have this right?

For the record, it is true that emerging markets economies would be hurt by an escalated trade war. Just as a quick Economics 101 refresher, GDP = C + I + G + NX or, said differently, GDP growth is driven by the combination of consumption, investment, government spending, and net exports. Many emerging economies, are driven by the "NX" component of the equation, relying much more on net exports to propel their economic growth. Conversely, in the U.S., roughly 2/3 of our economy is driven by consumer spending or the "C" component of the equation.

As a result, any meaningful decrease in trade with the U.S. would surely produce economic headwinds for emerging markets economies going forward. The U.S., being less dependent on global trade, would see less of a direct negative impact on future GDP growth, but may be at risk of something far more concerning… inflation. In fact, an unexpected uptick in inflation, could just be the event that finally puts the brakes on the longest bull market in U.S. history.

But why is the risk of higher inflation so concerning? Let's think back to our 2Q 2018 Market Insights letter – *The Elephant in the Room*. In this letter, iCM's CIO, Michael Paciotti, examined the relationship between equity market valuations and a number of different variables. More specifically, his research concluded that inflation and movements in interest rates have a meaningful impact on equity market valuations. To quote his research directly: "*As a single variable, inflation has a greater influence on the market valuation level than any single interest rate variable. The 2-year treasury yield is close, probably because the 2-year treasury is more of an inflation proxy than the 10-year bond. When inflation and the 2-year bond rise, equity valuations tend to fall. Generally, we don't see valuations above 20x earnings, or more, beyond 4% inflation. That's particularly relevant today, since the PE multiple is well above 20. Both the inflation and 2-year treasury relationships are strong for single variables, accounting for about 60% of the movement in the valuation multiple. Interestingly, what matters more is not the movement of any single interest rate or maturity, it's an upward movement of rates across the balance of the yield curve. Movements in rates across the yield curve in total explains approximately 78% of the market PE multiple".* Let's apply these findings to our current situation….

Earlier we discussed a simplified example describing the impact that a trade war could have on our hypothetical company, ABC Bottling, and saw the potential effect that tariffs could have on consumer prices. Now let's assume that higher prices affect not only soda cans, but a much larger set of consumer goods. This is an assumption that's not unreasonable, given that many companies within the U.S. utilize foreign imports at some point in their supply chain. But, what impact might this have on the market?

We all know that higher prices result in inflation and we also know that one of the Federal Reserve's key mandates is to keep inflation at a reasonable level, as to prevent the U.S. economy from overheating. Their primary tool in combatting inflation is the Federal Funds rate. Today, the Federal Funds rate sits in a target range of 2.00% to 2.25%. Looking ahead, members of the FOMC (Federal Open Markets Committee) expect rates to be just 3.4% by the end of 2020, while inflation expectations sit at just 2.1% over the same period.

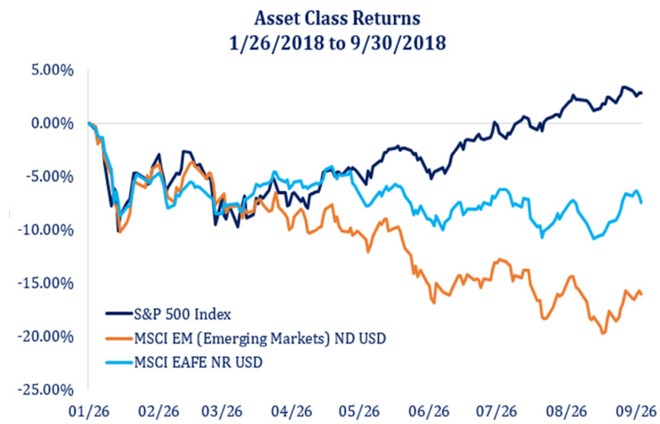
This is where our concerns start to come into play. Regardless of any potential trade war, we are already seeing signs of higher inflation on the horizon, with labor markets at historically tight levels, crude oil prices up nearly 50% over the past 12 months, and the ISM Price index near its highest level since 2011. If our current trade war does continue to progress and adds to the current inflation picture, the Fed will likely have no choice but to increase rates above current expected levels. This action would inevitably lead to higher interest rates, as the Fed Funds rate tends to be the baseline from which all market interest rates are determined. Not only does this negatively impact bond investors (bond prices decline as rates increase and vice versa), but as we discussed in Q2's Market Insights letter, equity investors are also negatively impacted, as the path of interest rates explains nearly 80% of the change in U.S. equity valuations. This is where it becomes scary for investors and where the potential path to a U.S. equity bear market inescapably lies. But what about emerging markets?

Emerging Markets Reaching Capitulation?

As we mentioned previously, emerging markets investors have clearly felt the brunt of any global trade war concerns. This refers to not only their equity and fixed income markets, but their currency markets as well. In fact, we have now reached a point that is eerily reminiscent of past periods of capitulation, with emerging markets stocks officially touching bear market territory in mid-September, off more than 20% from their 2018 highs.

Before diving any deeper, it's worth defining the word "capitulation". Capitulation is actually derived from a military term, which refers to surrender. When applying this term to the financial markets, capitulation describes the point where investors have reached utter despair and see no other option than to sell their assets indiscriminately. Signs of capitulation typically include; steep losses over a short period of time, exaggerated levels of selling and volume, as well as increased volatility. On a positive note, however, capitulation events are also accompanied by a market trough and ensuing rebound, making them some of the most rewarding times for contrarian investors.

Emerging Markets Sell-Off



Source: S&P, MSCI

Since the market top in late January, emerging markets stock returns have decoupled from both U.S. and non-U.S. developed equity markets. As of quarter-end, the MSCI EM index had declined by more than 16%, briefly entering bear market territory in mid-September. Conversely, the S&P 500 is roughly 3% above its earlier highs, while the MSCI EAFE index is off by 7.5%.

We can look to the commodities markets for a recent example of a capitulation event, focusing our attention on WTI Crude Oil. Over a period of just 8 months, WTI Crude prices cratered in value from over $60/barrel in June of 2015 to a low of $26/barrel in February of the following year, equating to a loss of nearly 60% in just eight months. This coincided with a period of extreme volatility, where options markets indicated an implied volatility of roughly 65% near the market bottom, which would statistically suggest an 8% chance of crude oil prices falling to zero (something we all know is impossible). Additionally, ETF investors expressed their negative view on the commodity through short sales of one of the industry's leading oil ETFs, USO (United States Oil ETF), which saw short interest peak at more than 40% of shares outstanding during the summer of 2015. Following the traditional path of a capitulated asset class, crude prices rebounded dramatically following their February 2016 lows, gaining 180% as of our most recent quarter end.

What, if any of these trends, can we identify in emerging markets stocks today?

1. **Rapid Pace of Decline & Volatility**

   The first trait of capitulation that is relatively easy to spot in emerging markets equities has been their rapid pace of decline. From its intra-year high in late January, the MSCI Emerging Markets index has declined by just shy of 20% (using closing price data on 9/11/2018). Additionally, over this period of just

158 days, 30 days (~20%) resulted in losses of greater than -1% for investors. Both events are clearly out of the norm.

2. Investor Sentiment

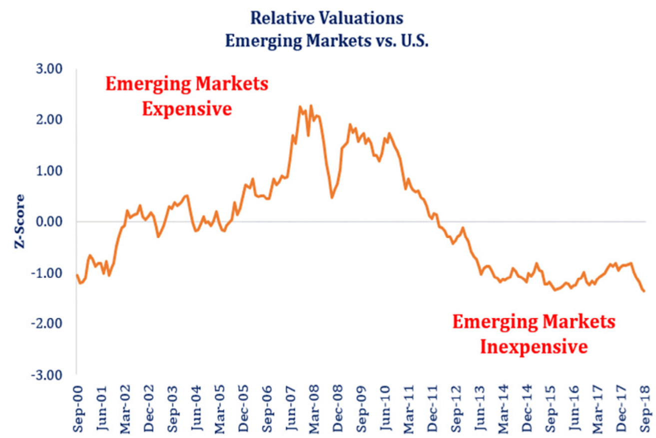
Speaking to investor pessimism in this asset class, we need to look no further than ETF flow data and short interest (i.e. the number of shares of an ETF sold short or bet against). From just the end of January 2018, EEM (iShares MSCI Emerging Markets ETF) has experienced cumulative net outflows of more than $8 billion, with the bulk of these outflows coming in May and June. As a percentage of the ETF's assets, this equates to a decrease of roughly 20% in total fund AUM over a period of just 7 months.

In terms of short interest, we see a similar story. To begin the year, approximately 8% of EEM's shares were sold short. This sat just below the fund's post-recession average of roughly 10%. Fast forward to July and we find 17.50% short interest in EEM, which, from a statistical standpoint equates to a more than 1.5 standard deviation event.

3. Sharp Decline in Valuations – Stocks & F/X

Lastly, from a fundamental standpoint, valuations for emerging markets equities and currencies have cratered in 2018, relative to both their own histories and versus U.S. assets. Beginning with emerging markets stocks, on a simple TTM P/E basis, investors saw valuations decline by 17% from their 2018 peaks, ending the quarter at just 13.3x. This corresponds to the lowest absolute level of valuations that we've seen for the asset class in over 2 years, sitting more than 10% below its long-term average of 15x. Additionally, compared to U.S. stocks, this puts emerging markets at a relative discount of more than 40%, trading at its cheapest relative valuation level in more than 15 years.

Emerging Markets Valuations



Source: MSCI, iCM Capital Markets Research

Emerging markets equity valuations have sunk to historic lows following their 2018 selloff. As of quarter-end, EM equities traded at a 44% discount to U.S. equities, their cheapest levels in roughly 20 years. From a statistical standpoint, this equates to a 1.4 standard deviation event.

We find similar results when looking at emerging markets from a currency perspective (i.e. the basket of EM currencies versus the USD). From their 2018 highs at the end of January, the EM basket of currencies has given back 8% versus the U.S. dollar, suffering from many of the same global trade fears that hit emerging equity markets. This has caused valuations to gap out by nearly 1 standard deviation, over a very short period. This has put EM currencies at their statistically cheapest levels since mid-2016 and not far off prior post-crash lows in 2002 and 2009.

Conclusion

Given the laundry list of tell-tale signs of capitulation that we just walked through for emerging markets stocks, the question becomes whether or not this asset class has reached a bottom? We can surely say that the evidence is there, but, as many investors have found throughout history, it's nearly impossible to accurately call a market bottom. However, there are a number of things that we can say with confidence, which we've addressed throughout this quarter's Market Insights letter.

First, a global trade war has no winners. Protectionist trade policies may benefit domestic industries in the short-term, particularly the manufacturing sector, but the long-term impact will inevitably be higher inflation. This presents a clear headwind for U.S. equity returns, as the Shiller CAPE ratio currently sits at 33x. As our research has shown, markets have struggled to hold onto a CAPE ratio above 20x during periods of increasing inflation, implying that the likely future direction of valuations is downward. Second, while the U.S. may be less impacted by global trade fears than its emerging counterparts, we are by no means out of the woods, despite what markets are currently telling investors. Rather, a global trade war presents U.S. investors with the all too real risk of higher inflation, potentially higher than expected interest rates, and as a result, lower equity market valuations in the future. Lastly, while a trade war would clearly present future headwinds for emerging markets investors, the market appears to be pricing in a worst-case scenario for these assets. This has inevitably led to a bear market decline in emerging markets stocks, characterized by a rapid decline in prices and valuations, as well as clear signs of severe investor pessimism. Just what implications then, does all of this have for investors?

Being disciplined contrarians, we would advise investors to continue to focus on the long-term and ignore any short-term noise created by global trade fears. If anything, the recent decline in emerging markets stocks has created an entry point for investors into an already attractive asset class. Not only do emerging markets stocks (as well as bonds and their currencies) trade at below average valuations compared to a historically expensive U.S. equity market, but they also stand poised to benefit from any potential trade war resolution, as their prices currently represent worst-case scenario assumptions. As a result, emerging markets equities and local currency debt remain two of the highest conviction positions across all of our investment portfolios. We continue to thank you for your trust and confidence.

Integrated | Capital | Management

410 Spruce Street, 4th Floor, Scranton, PA 18503
Phone: (570) 344-0100, Email: info@icm-invest.com
www.icm-invest.com