WE ARE AT WAR

The late Chuck Knox, the first coach to get the Seattle Seahawks into the NFL playoffs, had a saying: “You have to play the hand you are dealt”. In football, that is to say, you have a limited number of players, some of which might be injured, the weather may be working against you, the rival team may be more skilled, but regardless you must do your best with your team.

This eletter is neither political commentary nor meant to be political in any way, but as investors, we must address the trade war between America and China. Understand too this is not an easy exercise or simple analysis; I have heard what various financial media are predicting about the trade war, and I disagree. The agenda for CNBC and the other financial media companies is to build viewership to increase revenues through advertising. There’s not a deep analysis, and it is often a simplistic approach. My goal is to practically and realistically assess the trade war and analyze how investments may be affected.

Why does our President - and a number of Wall Street talking-heads - believe we can win a trade war? In 2018, we imported $539 billion of Chinese products and exported $120 billion. The United States can put tariffs on more Chinese goods than the Chinese can place on US goods, and if that were the whole picture, the United States would indeed win. But that is only part of the situation. President Trump announced tariffs on an additional $300 billion of Chinese goods, and the response from China was very probably the inciting moment for this trade war. “China’s position is very clear that if U.S. wishes to talk, then we will talk,” said Zhang Jun, China’s ambassador to the UN, said Friday, August 2, 2019. “If they want to fight, then we will fight.”[1]

Most manufacturers now have a global supply chain. For example, when Boeing begins production on a 737 aircraft, they begin with one very small part: the metal tab for the lavatory that says “vacant” or “occupied”. That tab is in English for American planes, in Hindu for Indian companies, etc. That is where production begins. Once that part is made, it is shipped to the latch company, which may well be in a different country. The assembled latch is then shipped to the lavatory door company, which may be in a third country. The lavatory door is then shipped to a lavatory assembly company in yet another country. Finally, the lavatory is shipped to Renton, WA for installation in the 737 jet. That is the supply chain. It is global. When Boeing is selling airplanes to foreign companies, they will often have to buy some parts in that country to offset some of the purchase price of the new airplanes. This is actually called “offset work”. It is common for large manufacturing companies to grant offset work for their supply chains.

China has the ability to disrupt the global supply chain for many US companies. Any parts manufactured in China, or components that require rare earth raw materials, are exposed to Chinese action that could disrupt and even close off the supply chain. China supplies 90% of the rare earth minerals which are used in computer memories, DVDs, rechargeable batteries, cell phones, catalytic converts, magnets, fluorescent lighting and so much more. China could selectively shut-off some US companies' access to those important supplies.

Another valuable insight on China's trade war tactics comes from the case of the Terminal High Altitude Defense System (THAAD). THAAD is an anti-ballistic missile system designed to intercept missiles fired from North Korea, but China believed it could be used against them as well. Upset with South Korea for allowing THAAD to be installed, China took action. There is a South Korean department store called Lotte that had invested $9.6 billion to expand into China. The Chinese government first declared a boycott of all the Lotte stores, then they sent in fire inspectors to close the stores for fire code violations. Then came the quality control inspectors. Eventually, Lotte decided to simply close all the stores, write off the $9.6 billion, and withdraw from China.[2]

China has ways of fighting back that, I believe, the president and the talking heads aren't taking into account. China has already begun boycotting all farm products from the United States. For example, Washington state produced 2.5 million tons of apples in 2017, and of that, 1.33 million tons, about half of the entire production, were exported to China. With China's boycott in place, that number will be zero. The Chinese are targeting those areas that voted for Trump. They will boycott hogs from North Carolina and milk from California. The Wall Street Journal quoted Georgian farmer Zippy Duvall saying, "It is a Body Blow to US Farmers."[3]

In addition, China has devalued their currency. This means that Chinese exports will be less expensive and will undercut competing products from the US. Although the United States declared China a "currency manipulator", this is a largely symbolic gesture and goes through the International Monetary Fund. China's purpose in currency devaluation, to hurt US manufacturing, is still achieved.[4]

"The Chinese have sent a strong signal that they are ready to rumble," said Paul Blustein, a senior fellow at the Centre for International Governance Innovation and the author of *Schism*, a book due out next month about the fraying relationship between the United States and China. "To depreciate the currency at such a fraught time sends a signal that they are prepared to endure a heck of a lot of pain, and it doesn't surprise me that markets would finally come around and say, 'This could be really bad.'"[4]

If the United States does impose the tariffs on additional Chinese imports in September, it will have a negative impact on the economy. As Randall Forsyth notes in his article for *Barron's,* "Moreover, the dollar amount extracted by the tariffs will exceed the incremental benefits in 2019 from the tax reductions enacted last year, notes the keen-eyed Washington strategy team at Strategas Research Partners, led by Daniel Clifton. The additional $30 billion from the proposed 10% tariff on $300 billion of Chinese imports, due to take effect next month, would bring the total take from the duties to $138 billion this year—more than the $122 billion of additional benefits from the tax cuts."[5]

Worse, in all likelihood the United States is going into this war without allies. The Trans-Pacific Partnership Agreement was signed by twelve countries: Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, Vietnam, and the United States, and represented 40% of all world trade. The TPP would have removed tariffs from thousands of products, had Intellectual Property requirements, and other conditions that were meant to change China's approach if China were ever to be allowed to join. The administration withdrew in 2017, leaving the other eleven countries to sign their own deal, and deal directly with China.

Most of the European countries have the same issues with China that the United States has. Rather than bringing them into the war on our side, the Trump administration slapped tariffs on them as well.[6] And finally, last week the administration cut off all foreign aid.[7]

What this means is that we are at war without any allies.

Back to Chuck Knox: "We have to play the hand we are dealt". As an Eagle Scout, I learned to "BE PREPARED". It can be positive. I have been preparing my client accounts since November 2016 for this possibility.

Withdrawing into cash, I believe, is unlikely to work. If this secular bull market ends in high inflation similar to the 1961-1982 period, cash will lose 70% of its purchasing power. To put that into perspective, the Great Recession of 2007-9 saw stocks drop just 37%. I give it an 85% chance that we will see high inflation (you can read my previous article on how the secular bull market will end on my blog).

Investing in index funds that reflect the market is unlikely to work as S&P 500 companies get 40% of their revenues from international sales. If there is a trade war, it will hit many of those companies, and some are already reporting damaged earnings from Chinese tariffs. Think of the companies that do a significant part of their manufacturing in China such as Apple, General Motors, Ford, Hewlett Packard, and companies that source a significant quantity of their products from China, like Wal-Mart.

We know that asset allocation during a crisis does not work; in the Great Recession, everything went down regardless.

The solution, in my opinion, is a "bottoms up" approach to stock picking. Picking those stocks which will suffer the least - and may even benefit from a trade war. But to get there and select those stocks, again in my opinion, means to truly understand the complicated situation and evaluating company-by-company the strengths and weaknesses in the trade war.

I spoke on China's long-term goals at the Las Vegas and Seattle Money Shows. I have written about it in previous letters. I have been studying and meditating on a potential trade war for almost three years. It is not the simple situation as explained on CNBC. It is complicated.

The best thing we can do is prepare. We can see the hand we have been dealt, and we can be prepared. It is possible that while many investors may lose money, it may be possible to make money. NO guarantee, of course, but playing the hand we have been dealt to the best of our ability probably gives us an upper hand.

Footnotes:

1. Swanson, Ana. “Spiraling Trade Tensions Threaten Economy as Trump Pressures China.” *NY Times.* https://www.nytimes.com/2019/08/02/business/economy/china-us-trade-threats.html (August 2, 2019).
2. “South Korea’s Lotte seeks to exit China after investing $9.6 billion, as Thaad fallout ensues.” *The Straits Times*. https://www.straitstimes.com/asia/east-asia/south-koreas-lotte-seeks-to-exit-china-after-investing-96-billion (March 13, 2019).
3. Bunge, Jacob. “China Deals ‘Body Blow’ to Struggling U.S. Farm Belt.” *Wall Street Journal.* https://www.wsj.com/articles/china-deals-body-blow-to-struggling-u-s-farm-belt-11565093998 (August 6, 2019).
4. Mauldin, William, Nick Timiraos, and Paul Kiernan. “U.S. Designates China as Currency Manipulator.”, *Wall Street Journal.* https://www.wsj.com/articles/chinas-currency-weakening-escalates-trade-war-11565027431 (August 5, 2019).
5. Forsyth, Randall. “New Tariff Threat Bites Investors.” *Barron’s*. https://www.barrons.com/articles/new-tariff-threat-bites-investors-51564794880 (August 2, 2019).
6. Friedman, Thomas L. “How Trump and Xi Can Make America and China Poor Again.” *New York Times.* https://www.nytimes.com/2019/08/06/opinion/trump-china-trade.html (August 6, 2019).
7. Wong, Edward. “U.S. Orders Freeze of Foreign Aid, Bypassing Congress.” *New York Times.* https://www.nytimes.com/2019/08/07/us/politics/foreign-aid-freeze-congress.html (Aug 7, 2019).