

## **The Outlook: August 3, 2018**

### ***The Trade War Nightmare . . . in daylight.***

The market always has an array of nightmares stacked up in the back of its mind, waiting for a cue to step onstage, and today is no exception. But so far this year, the market's "Nightmare!" with a capital "N" has certainly been "Trade Wars!" It's time we took a hard look at it . . . in daylight.

"Trade Wars!" is a first-class nightmare because, first and foremost, the nightmare is very hard for most people to understand—which means it's very easy for all kinds of "experts" to grab the media's megaphones and make all kinds of awful assertions and predictions about it. So the first advice Outlook gives itself, and its clients, is to remember that when a subject is hard for most of us to understand, we often eventually discover that a great many supposed "experts" also don't understand it. (Neither does the media, but that's true about many things.)

Let's tackle the subject not with a textbook discussion, but simply by listing a few deep truths about trade and trade wars.

- Global trade is a good thing for everyone for exactly the same reason that free markets are a good thing: when two people meet and exchange goods or services at a price agreeable to both, both are better off than before.
- The trouble comes when the markets aren't free; when government interferes in some way with the two people's ability to make or sell things, or with the price they'd like to agree to. And that's both the reason for international trade agreements, and the problem with them. Nations want the agreements so they can be sure their own citizens aren't handicapped when they meet in those international marketplaces; and they wonder about the agreements because (like possibly 95% of all the treaties and agreements made in history), once they're signed, the cheating begins.
- America's President believes that a good many of America's trading partners—but especially China and Europe—have been cheating more or less flagrantly for a very long time: backing their own citizens and companies with government money, or taxing America's companies and their products (with tariffs) to give their own people and companies a significant advantage when it comes to competing in those supposedly free international markets.
- Mr. Trump further believes that China and Europe know perfectly well they've been doing that, and they had assumed (until his election) that every U.S. President would continue the decades-old practice of essentially doing nothing about it.

That last point, in Outlook's opinion, matters a lot. Political leaders in China and Europe have, of course, publicly expressed their hurt feelings and even outrage that anyone could accuse their nations of such things. They will not change that tune for all the tea in China, so to speak, because the loss of face would be career-ending for any politician. But if, nevertheless, they know Mr. Trump's accusations are correct, or mainly correct; and if they come to believe Mr. Trump is not bluffing when he says, "Either change, or let's have a trade war," then they are pretty likely to look hard for some way to "make a deal" with the President they are beginning to recognize as America's "dealmaker in chief." The deals will have to be fogged with a cloud of rhetoric, to accomplish the face-saving goal; but they'll also have to mean some

degree of real change—depending, again, on the degree to which Mr. Trump means what he says, and sticks to it.

The “deal” a couple of weeks ago with Europe’s envoy to the White House, Jean-Claude Juncker, sent a clear message to all concerned: Mr. Trump will negotiate, and will compromise. Now Europe will discover, step by step, how much actual behavior change Mr. Trump will insist upon, as the agonizing details are worked out over a long time.

It's obvious that Mr. Trump sees China as a much more hostile “trading partner,” and more determined cheater, than Europe. And here is the next key bullet point:

- Most of the world shares Mr. Trump’s opinion. Fearing China’s ill will, global business leaders have kept such opinions to themselves for a long time. But here Outlook makes an assertion unsupported by anything but intuition, common sense and scattered CEO remarks over the years: “Global business leaders, and European politicians, overwhelmingly share Mr. Trump’s China opinion. It’s simply been something everyone “knows” but doesn’t talk about, for a decade or more.”

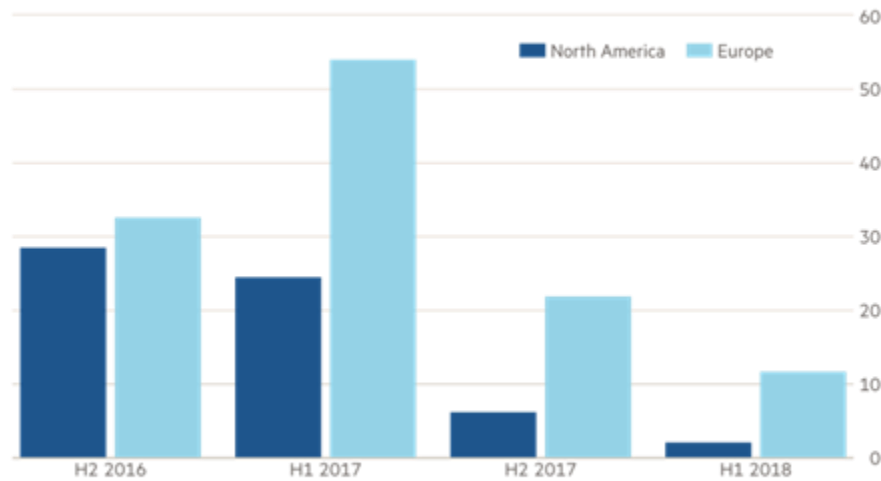
Here are just a couple of isolated recent events in Germany (which has been completely soft-spoken toward China) to support this “intuition:”

In Germany, the government last week directed KfW, a state development bank, to take a 20 per cent stake in 50Hertz, a high-voltage power network operator to pre-empt the company’s acquisition by a Chinese state investor. This week, Berlin is expected to block a Chinese takeover of Leifeld Metal Spinning, a small machine tool manufacturer that specialises in materials for the aerospace and nuclear industries. *It is unprecedented for German ministers to intervene in such a way.* (Financial Times, Aug. 1, 2018.)

And here is a picture of plummeting Chinese investment in both America and Europe:

## Chinese investment into US slumps

\$bn



Data represent the combined value of direct investment transactions by mainland Chinese companies, including greenfield projects and acquisitions that result in significant ownership control (>10% of equity). Europe includes the EU-28 and the European Free Trade Association countries: Iceland, Liechtenstein, Norway and Switzerland. North America includes the US and Canada.

Source: Rhodium Group

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As the FT article noted, this plunge in China's acquisition of western companies has been driven by a fairly abrupt change in American and European government attitudes. The U.S. has said, out loud, "China's acquisition of our technology—against the terms of membership in the World Trade Organization—is unacceptable and will stop." Europe has said nothing out loud . . . but simply acted.

It will not be easy for China's leader, Xi Jinping, to find a face-saving solution. He has been unusually strident, these past few years, about his big plans for China and aggressive attitude toward the U.S. As the Financial Times put it, he has ignored Deng Xiaoping's proverb: "Hide your strengths and bide your time." (Deng pushed China toward markets and capitalism, triggering its economic explosion.) But it's surely clear to him that Mr. Trump is not acting alone when it comes to the western world's desire to stop China's "most unfair" (the polite term) trade practices.

So there will be a behavior change of some degree from China, and there will be an easing of "Global Trade War" as the market's chief nightmare. Outlook doubts it will happen very fast; it's more likely to play out over the next 6 to 24 months. But meanwhile, this Quarterly Earnings Season, near its end, has shown us something completely striking. Company after company has reported strength and growth. It's been obvious with Outlook's core companies, as Theresa's reports have shown; but it's been just as obvious with the lion's share of other large U.S. companies. With the usual exceptions of the likes of Tesla and Netflix, most of corporate America is valued, by this market, with anxiety and doubt, regardless of the striking health of their business operations. So we hold, and we buy more.

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