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INSIGHT

Cause vs. Consequence: The Unforced Errors Have Already Been Made

CRAIG BLUM, CFA | 8 FEBRUARY 2019

Among our favorite Yogi Berra quips is one tied directly to the investment game: *"It's difficult to make predictions, especially about the future."* This is particularly true when trying to process the U.S.-China trade conflict and its potential shock to confidence, global financial conditions and capital planning. We lay out some fact patterns below that give us pause as we think about trade protectionism and new risks it brings to equity markets. We also comment on investors' near obsession with an imminent Fed "mistake" in the wake of a clear peak in U.S. and global PMIs.

We would never pretend to be experts on China. We are, however, skilled at evaluating fundamental developments and understanding possible connections to economic health. Recently, corporate bellwethers Apple, Samsung, Jaguar Land Rover and others have delivered new warnings about softening demand in China that is presumably the result of trade tensions. We worry, however, that these air pockets are only exposing a deeper malaise in the region that predates these announcements. The troubling vibrations began with the country's main equity benchmarks performing worst of any large region during 2018 and falling about 25% in value. At first, this appeared less impactful to outsiders given the government's strict capital controls and lack of integration with global markets. But weakness now seems to have spread from capital markets into China's real economy, prompting global investors to begin connecting some dots. Auto sales in the country (the largest automobile market in the world) fell last year for the first time since 1991. The region's real estate market is wobbling and manufacturing output began to contract in December. Global executives also sound increasingly concerned over the complicated linkage between the trade impasse, supply chain disruption and possible blowback into weakening Chinese demand trends. Most recently, Caterpillar and NVIDIA named China as a key source of end market weakness. This all matters because approximately 40% of S&P 500 margin expansion over the past 20 years was a direct offspring of globalization (i.e. lower effective tax rates, labor arbitrage, etc.) Our point: the temptation is to simply blame the trade war for any stall in activity, but we have turned more cautious by troubling signs of a deeper and more entangled weakness in China made worse by the mistrust of regional statistics and the lack of confidence around any quick solutions.

The old (and tired) playbook of government stimulus deserves mention. Here, we note that the last 10 years of effort to rebalance the Chinese economy has left it seemingly addicted to ever higher levels of debt and construction spending.

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The Institute of International Finance estimates that China's total debt exceeded 300 percent of GDP by the end of 2018. (Much of the borrowing poured into a prolific construction boom: between 2012 and 2016, China produced nearly three times the volume of cement as the U.S. did during the entire 20th century.) The country's banking sector is now grappling with an onslaught of non-performing loans just as economic growth slows to levels not seen since 1990. It is true that more stimulus was announced recently, this time in the form of tax cuts and a drop in required bank reserves. It remains unclear, however, whether this age-old playbook of state-backed credit growth and infrastructure spending will be enough to goose up another business cycle. We emphasize again that these policy outcomes are difficult to forecast and generally "un-modellable," but we will continue to monitor events in China and carefully consider implications for global growth.

Turning to the U.S., we find another obsession with central bank stimulus, this time with an intense debate over "neutral" and acute sensitivities around any Fed move that might tip over the business cycle. We differ from the prevailing view insofar as our analysis of any current fragility actually begins with the easy-money phase that preceded it. And we conclude (again) that the most damaging errors have already been made and our struggles are now with consequences vs. causes. Unpacking that a bit, consider that tightening interbank funding markets by raising the Fed Funds rate in an effort to cool off activity is a *consequence*. The *cause* (mistake) was holding short rates near zero for 87 months (September 2008 through December 2015) and inflating asset markets well beyond levels needed to contain the 2008 crisis. Struggling with an economy built (and now likely dependent) on cheap credit is a *consequence*. The *cause* (mistake) was channeling huge volumes of borrowing to companies and governments with 3-month LIBOR near 30 basis points for six years. Trillion-dollar deficits and a U.S. government fiscally vulnerable to higher bond yields is a *consequence*. The *cause* (mistake) was making credit growth, currency debasement and a higher cost-of-living all stated objectives of the central bank. So, while we acknowledge the possibility that the Fed could tighten beyond neutral, invert the curve and trigger the next recession, it is the long list of prior mistakes that actually better describes the set up.

All of this only sharpens our conviction that episodes of volatility and disordered trading will probably reoccur throughout 2019. The threat of increased tariffs has almost surely pulled forward some demand into the current period at the expense of the future. Effects of the U.S. government shutdown are poorly understood and data delays will only add to short term confusion. Too much caution, however, carries other risks because upside surprises in the economy can quickly leave lower-beta managers behind. Federal spending increases that were authorized in 2018 will actually take place and conceivably lift demand during 2019 and beyond. Longer-tailed effects of U.S. tax cuts will likely continue pulling down hurdle rates by increasing net returns on U.S. projects. This then attracts even more foreign capital into the country and acts as a force multiplier on an already easy-money economy. Another dovish pivot by the Fed can quickly flip consensus thinking and cause forward earnings estimates to re-accelerate. Such is the siloed understanding and disordered system within which we operate, where obvious problems of the current period only matter until a central bank's policy response suddenly matters more.

In the end, these big tail events are interesting to contemplate but difficult to time. We therefore believe a deliberate strategy of process execution will be critical as the next chapter unfolds. We encourage investors to seek quality businesses that enjoy clear business model advantages and dominant market positioning. Risks and obstacles abound, but transformational companies can often exploit confusing periods on a fundamental basis and are quite capable of superior performance even in the midst of turbulence.

Finally, we close by highlighting a key advantage to long-term growth exposure that is often underappreciated in the modern era: its potential to neutralize many of the inflationary consequences that might result from the "mistakes" discussed above (and mentioned in several prior commentaries). Perhaps quality growth investing rises again to protect against yet another Yogi Berra warning: "A nickel ain't worth a dime anymore." ■

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