Gyroscope Capital Management Group

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Quarterly Review and Commentary

In our first commentary of 2017 we discussed the potential economic and capital market impacts of President Trump's economic, social, and trade policies. Our conclusion at that time suggested that the market was focused on the beneficial components of those policies; namely, expansionary fiscal policy, sweeping regulatory reform, and aggressive tax cuts. Since then, the S&P 500 Total Return Index has generated a 28.22% (from 1-18-17 to 8-2-18) return as the benefits of these policies have helped to drive robust corporate earnings growth.

At the time we also cautioned, "…the market does not appear to have priced in the potential for devastating trade policies that Trump consistently purports to favor and his actions suggest he is laying the foundation for." Since then, the President has continued to move forward with implemented and prospective tariffs and appears to be staging ever greater battles in a developing trade war.

To be fair, American companies have legitimate grievances with some of our trading partners and China in particular. The Chinese have engaged in corporate espionage to steal trade secrets and forced U.S. tech companies to deliver patented technology in order to access Chinese markets.

Pressuring China to abandon unfair practices such as these and increase market access requires a coordinated global alliance and a tactful approach. Unfortunately, in attempting to fight a (trade) war on all fronts by battling with Mexico, Canada, the E.U., and China, among others, the U.S. has forfeited the opportunity to confront China with a unified coalition of major Western economies.

Today, investors appear to remain unconvinced that trade conflicts represent a material threat to financial markets. In our opinion there are three possible explanations:

1. **Trade wars are in fact good and easy to win.** Trump campaigned on the promise that he would renegotiate U.S. trade deals and his voters expect him to keep this promise. Thus, his actions on trade may seem the fulfillment of prior commitments.
2. **Cooler heads will ultimately prevail as all participants ultimately lose in trade conflicts.** Many observers, including ourselves and representatives of the Trump administration, have suggested that the President does not desire long-term trade barriers but is instead posturing for a favorable negotiating position.
3. **The macroeconomic impact of even a global trade war with tariffs on all U.S. imports and retaliatory responses is limited.** Imported goods and services represent less than 15% of U.S. GDP. A tariff of 10% on all imported goods and services would thus represent 1.5% and after you adjust for some substitution to domestic goods the number is likely less than 1%.

While we have a hard time accepting that trade wars are good (all wars are costly and entail casualties), we certainly acknowledge that the last two explanations are plausible. Trump may in fact be a "pragmatic negotiator" as we've previously suggested. It's also possible that trade conflicts will remain "trade skirmishes" limited in scope and scale.

Rather than critiquing the economic and rationale logic of engaging in trade disputes with allies and key trading partners, we prefer to focus on potential economic impacts and implications for financial markets.

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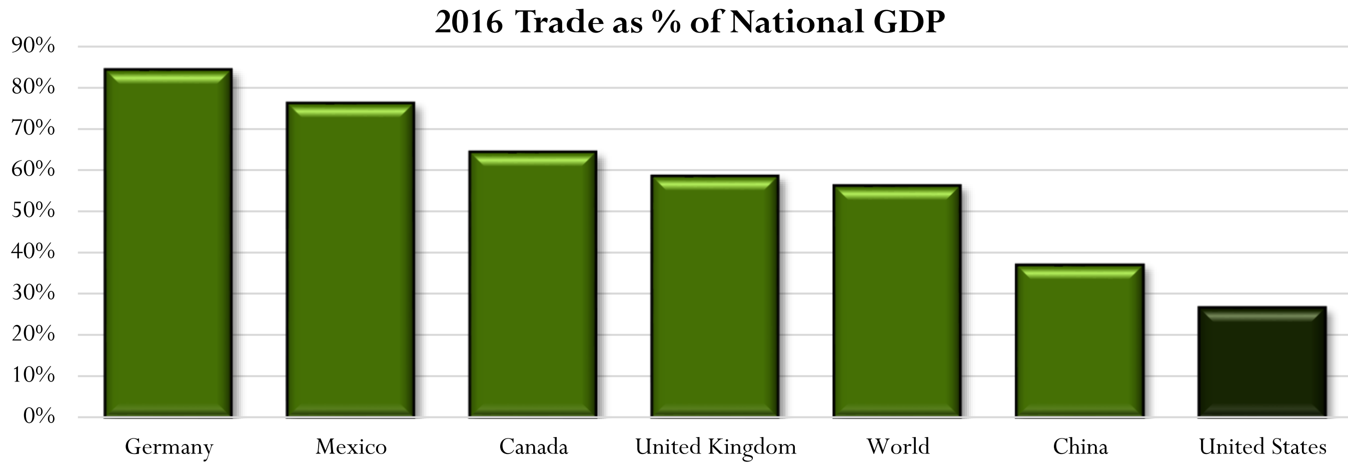
HOW VULNERABLE IS THE U.S. TO RETALIATORY MEASURES?

In terms of exposure to direct economic impact, the U.S. is less vulnerable to the effects of taxes, tariffs, and quotas resulting from trade disputes. The U.S. retains claim to the world's largest economy and this economy is very well diversified. Further, trade does not constitute a relatively significant proportion of our economy relative to those of other large developed nations or even the world in aggregate. The following chart depicts World Bank data for national trade as a percentage of GDP for 2016 (the latest period for which common data is available):



Reductions in global economic activity growth resulting from a prolonged trade war will likely have a greater impact on countries who are more reliant on international trade. Our main trading partners' economies are both smaller and more reliant on trade than the U.S. economy, which makes them more exposed to the effects of trade barriers.

However, in the event of a prolonged trade war the U.S. would experience economic "pain" which does not necessarily appear in GDP estimates. There are costs associated with protectionism which are not always apparent and can take time to materialize. The most prominent of these are:

- **Costlier Financing** – Uncertainty, dollar strength, and inflation raise the cost of capital. Trade wars increase these three factors. Debtors command higher risk premiums and investors apply higher discount rates.

- **Higher Inflation** – Domestic capacity constraints have already pushed prices higher. Tariffs not only further raise the prices of foreign goods but also domestic substitutes. Increased and unanticipated inflation detracts from economic growth and lowers consumers' living standards.

- **Supply Chain Disruption** – Establishing relationships and operations with foreign suppliers can take years. The uncertainty associated with a trade war makes identifying new suppliers and predicting the impact of retaliatory responses very difficult. Unfortunately, foreign firms will be very slow to re-establish relationships with U.S. firms if they switch suppliers.

- **Reduced Business Investment** – The managers of numerous U.S. firms have already noted that they are putting off capital spending. According to the minutes of the Fed's June 12-13th policy meeting, "Contacts in some districts indicated that plans for capital spending had been scaled back or postponed as a result of uncertainty over trade policy."

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- **Economic Inefficiencies** – Trade barriers restrict the efficient allocation of physical, human, and financial capital. U.S. firms import goods or services from other countries that have a comparative advantage and are thus able to carry out a given economic activity more efficiently given relative opportunity costs. The introduction of tariffs causes costs and prices to rise and real output to fall.

- **Damaging Effects of Uncertainty** – In the near term, uncertainty will remain the most damaging aspect of current trade disputes. Unlike the effects of inflation, interest rates, money supply, etc., economic models are notoriously incapable of accurately incorporating the effects of uncertainty. When businesses are uncertain, they are less likely to expand their workforces, invest in physical assets, undertake new risky projects, or expand their businesses /product lines.

Of course, Trump may yet compel our trading partners to concede favorable trading terms for the U.S. We must acknowledge that the President has suggested to European leaders the U.S. and E.U. scrap trade barriers entirely. Perhaps history will reveal Trump as more of a free-trade advocate than he is given credit for.

As we look forward to the second half of 2018, we expect U.S. economic activity to remain robust, inflation to increase or accelerate, interest rates to rise twice, and market volatility to increase. Trade conflicts are unlikely to be resolved before the start of 2019, since neither Beijing nor Washington has demonstrated an intention of retreating from a trade war. In U.S. equity markets we anticipate continued elevated dispersion across both individual names and sectors as investors respond to trade developments. Clearly, if Trump delivers on his $500 billion trade threat, capital markets would not respond favorably. That being said, we do not see any looming economic shocks that could derail strong corporate earnings growth or U.S. economic activity.

For information regarding Gyroscope Capital and our actively-managed investment strategies please visit our website.