GOLUB GROUP
BUILDING SUSTAINABLE WEALTH
Quarterly Commentary

Q2 2018 Quarterly Commentary – July 1, 2018 Tariff Concerns: More Heat Than Light

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The old Wall Street adage, "The market climbs a wall of worry" seems apropos today, as it so often does. In the second quarter of 2018, the market did indeed climb in the face of economic and policy news that was often confusing and at times concerning. The S&P 500 rose by 3.4%, including dividends, the Dow Jones Industrial Average increased by 1.3%, and the technology-heavy NASDAQ Comp Index rose by 6.6%. Long-term interest rates rose only slightly during the quarter, with the 10-year Treasury note yielding 2.85% at June 30th, versus 2.74% at March 31st. In the face of the slight rate increase, the Barclay's Aggregate Bond Index declined by -0.16%.

There is certainly as much to worry about today as ever, but to succeed as investors we have to remind ourselves to watch the fundamentals and to try to filter out the noise. The noise is, of course, the daily economic, financial and political "news" which, while seemingly important, matters little to an investor's ability to climb the wall of worry and compound wealth. Compounding wealth is a long-run effort that is disrupted frequently, unpredictably and temporarily in the short run. While there is a tremendous temptation to react to—or try to anticipate—short-term market-moving news, every person at this firm and every reader of this commentary has been around long enough to recognize the low probability of a desirable outcome from this kind of behavior.

The principal market-moving, discomfort-inducing, factor in recent months is the threat of a trade war. Classic economic theory asserts that free trade between two nations is beneficial to both parties—a fair argument, but one that is too simplistic to describe our relationship with any two trading partners. The Administration takes the position that the current trade relationship between the U.S. and China is anything but free, and that the only way to even the playing field is to use the considerable leverage the U.S. possesses to pry open an economy that restricts U.S. exports and investment. To the observer, this move to liberalize trade by employing the tools of a protectionist is very confusing. Subtle and diplomatic it is not, and time will tell if the ploy works or backfires. The U.S. markets have not yet decided their verdict, but China markets have concluded that companies on that side of the Pacific are in deep trouble.

The question for the fundamental investor is whether this news is noise, or if it has real, significant economic implications that will impair the intrinsic value of the companies that make up the market. Some perspective is in order. Exports to and imports from China totaled $129 billion and $506 billion, respectively, in 2017, resulting in a trade deficit of $376 billion. The magnitude of this trade deficit is less than 2% of the U.S.'s Gross Domestic Product. The "remedy," in the form of the various tariffs proposed (including those not yet enacted), total $41 billion, plus a like amount threatened by China in retaliation. The $82 billion of proposed tariffs, therefore, amount to roughly 0.4% of U.S. GDP. Next to these tariffs, consider that the scope of fiscal stimulus enacted within the past 6 months, including tax reform and the increase in direct government stimulus spending approved in the current budget, totals roughly $800 billion, some 4% of GDP. The trade imbroglio with China (or Canada, Mexico and the E.U. for that matter) has not fully played out, so it is too early to call it noise, but it certainly does not seem at present to be something that will derail our economy. At the company level, there is no doubt that some firms will be affected more than others. Our job is to look at the exposures we have to trade, make a judgment as to the impact of tariffs on these individual exposures, and make appropriate adjustments.

Trade is capturing the headlines, but a far more important factor in the health of the economy and in valuing the securities markets is the level of short and long-term interest rates. Trade disruptions effect different companies in different ways. Interest rate shifts—particularly dramatic ones—have much broader implications. The Federal Reserve is determined to bring short-term rates up to their long-term target level of 3% from the current 2%, and to reduce the size of the Fed's $4.4 trillion portfolio of securities. Both of these actions should put upward pressure on short and long-term interest rates. Higher borrowing costs tend to dampen demand for credit and slow economic growth, so the Fed is pursuing its strategy very slowly and carefully so as to provide the least shock possible to the economy. While the relationship between interest rates and stock prices is a complicated one, it's fair to say that, all else equal, rising interest rates are a drag on equities. Higher interest rates make bonds more appealing vis-à-vis stocks, drawing investment flows from stocks to bonds, and they increase the rate at which future cash flows are discounted when valuing companies and their shares.

While we think the commentary around trade offers more heat than light, more noise than news, we are watching interest rates and the forces which drive them (particularly inflation) very closely. The Fed has felt justified in raising short-term interest rates upward through the Federal Funds target rate and coaxing long-term rates upward through asset sales because the U.S. economy is firing on all cylinders: The unemployment rate reached 3.8% in May even as idle workers re-enter the job market; real GDP growth is expected to reach 4% in the second quarter; and core inflation rate remains a muted 2.2% versus the prior year. While this exceptional economic news struggles to capture headlines, the markets have noticed. Ultimately, corporate earnings drive stock prices. Even during the three decade period from 1951 to 1981, as long term treasuries marched upward from 2.6% to 15.3%, growth in corporate earnings lifted the stock market by over 1300%. Wall Street analysts project growth in S&P 500 operating earnings of roughly 21% in 2018 versus 2017, partly fueled by lower tax rates, but also by revenue growth of 8.5% and operating profit margin expansion of 1.7 percentage points. Against this backdrop, stocks trade at a price-to-earnings ("P/E") ratio of roughly 17x 2018 earnings, suggesting that stock valuations are anything but speculative. Every other valuation metric we use to evaluate the equities we hold in client accounts also suggest that stocks can be found at reasonable prices.

Q1 Portfolio Changes

Please keep in mind, these commentaries should not be construed as a recommendation to buy or sell the securities discussed. Such decisions are made only within the context of the market environment as we perceive it at the time of the decisions and the structure of the diversified portfolio of which the securities are a component.

General Motors (GM)

During the quarter, we exited our position in General Motors (GM).

When we first bought GM shares, the company had just emerged from bankruptcy with a lean cost structure and strong balance sheet. Our research indicated that GM was poised to benefit from a cyclical rebound in demand for US domestic cars and trucks, and we believed the stock was significantly undervalued.

Auto manufacturing is a competitive cyclical business that relies on healthy economic growth and easy access to consumer credit. Recently we have observed somewhat weaker trends for new car sales, which suggests that the cycle might be turning at a time when both interest rates and delinquencies on auto loans have started to rise.

With these risks in mind, after excitement surrounding Softbank's investment in GM's Cruise autonomous vehicle unit late in the quarter drove the stock up to our estimate of fair value, we took the opportunity to exit our position.

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