QV UPDATE
Weekly Commentary | August 9, 2019
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QV Investors Inc.

Standoff

China's economic transformation over the past fifty years is an incredible success story. Hundreds of millions have been lifted out of poverty since the country moved from Mao's socialism to China's unique brand of state capitalism. Joining the World Trade Organization in 2001 was a further boon to China's export economy and solidified its status as a global super power. However, not everyone is celebrating China's success. A hollowed out American manufacturing base and middle class are the alleged casualties of China gaining unfair advantages, and more generally, globalization. President Trump was elected by the disenfranchised to address these grievances and to restore American industry to its former glory.

The President's ongoing trade dispute with China has been dramatic, with many tariffs threatened and imposed, and only occasional instances of genuine negotiation. President Trump and President Xi are in a standoff. It is unlikely that President Trump will back down in the lead up to the 2020 election. President Xi also cannot appear weak while positioning China for dominance with its Belt and Road strategy (large scale multi-national infrastructure investment, essentially modernizing the old "silk road" land and water trade routes).

On August 1st, the President announced further tariffs that will be effective September 1st. In response, China suspended purchases of US agricultural products. When the Chinese Yuan then dropped 2%, President Trump proclaimed that China was using their currency to "steal our businesses and factories, hurt our jobs, depress our workers' wages and harm our farmers' prices. Not anymore!"

The U.S. is retaliating against many perceived injustices over the years: industrial espionage, intellectual property theft, blocking foreign direct investment, currency manipulation and security threats, to name a few. If the newly announced tariffs go through, the US Treasury stands to tax U.S. importers to the tune of $100 billion[1] per year on Chinese goods. This is not an alarming figure for either country, given China and the U.S.'s GDP of $14 and $21 trillion, respectively. However, the cost of tariffs is not uniformly spread across the economy. Among the hardest hit in the U.S. are farmers, who also happen to comprise a significant portion of Trump's support base. As many American business owners face higher input costs, they will rationally seek out the next-cheapest suppliers around the world, which aren't likely in the U.S. And because undoing supply chains is a complex task, the costs to consumers ends up being more than the tariffs themselves.

Government bond yields have dropped precipitously since President Trump's announcement and stocks are experiencing elevated volatility. Investors aren't necessarily reacting to what is, but what could be. Trimming 0.5% from US GDP is one thing, but trade disputes could get much worse than this. They could expand to outright sanctions and capital controls. The fear is that a continued escalation could trigger a global recession. The knock-on effects of a trade-induced recession would be considerable, especially given the re-leveraging of households, businesses and governments in the decade since the global financial crisis. A silver lining is that the current situation is reminiscent of the cold war between the U.S. and the U.S.S.R. That might not sound comforting, but mutually assured destruction tends to make people sober. The current clash of egos will continue for some time, perhaps a long time, but there is a good chance there will eventually be a positive resolution. However, in a showdown of this magnitude, investors should avoid speculating on the outcome.

Investors can survive, and eventually thrive, provided they don't try to pick a winner in this trade war. A prudent strategy is to have exposure to all outcomes: (1) China wins, (2) U.S. wins, (3) both win, (4) both lose. A globally diversified portfolio of stocks will be profitable in the first three scenarios. An allocation to government bonds and other high-quality fixed income investments is insurance for the fourth scenario. Whatever happens, portfolio rebalancing is the best way to take advantage of elevated market volatility.

1. The Wall Street Journal