Investment Commentary

EQUIUM CAPITAL

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Trade Wars Are (Not) Good

At Equium Capital, we have been flagging U.S. trade policy as a risk for quite some time and President Trump finally threw down the gauntlet with the announcement of blanket steel and aluminum import tariffs of 25% and 10%, respectively. Although we had already seen minor moves against China and Canadian lumber imports, along with endless rhetoric against NAFTA, the consensus had clearly become complacent on the risk of a major global trade dispute leading to a negative reaction in markets.

We should be clear that, in our view, the intent of this trade action is not irrational. In fact, there is a legitimate case against the dumping of steel by China, which has been overproducing for years (Chart 1). Even the Chinese government has made efforts to curb the practice through consolidation and tighter environmental regulations. Moreover, the U.S. is one of the most open economies in the world and the EU has already slapped anti-dumping levies on Chinese steel, which hardly makes the U.S. a lone aggressor of anti-globalist policies.

As in investing, however, process matters and we find much lacking in the implementation of these tariffs. First, tariffs are taxes by any other name. Think about it this way, the U.S. consumes far more aluminum and steel than it produces, so the tariffs mean higher costs for producing goods within the U.S. Higher production costs translate into higher consumer prices for finished goods, particularly automobiles and machinery, meaning lower real sales, higher inflation and tighter interest rates. Also, this incentivizes domestic U.S. production to shift to more cost competitive countries. Similar to President Trump's protectionist coal industry policy, these tariffs appear more likely to support the few at a significant cost to the many (Chart 2).

Second, the tariffs will directly impact key export markets, such as Canada, Mexico, the EU and South Korea, while hardly impacting China at all (Chart 3). Retaliation is being openly discussed and, if implemented, could be effective in impairing U.S. economic growth and reducing overall global trade. Also, the negative impact on diplomacy should not be underestimated. Does the President really want South Korea's help containing Kim Jong Un? How about the EU's support in tightening sanctions on Iran? Mexico's aid in securing the southern border? It's hard to see how U.S. foreign policy interests are not negatively impacted by these moves.

Distilling these policies down to the impact on asset prices, the reality is that the policy efforts to-date do not seem sufficient to

Chart 1 | China Steel Demand & Production
source: World Steel Association, Equium Capital

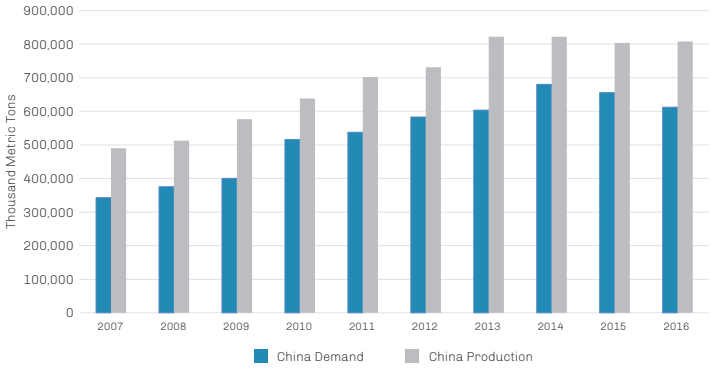


Chart 2 | U.S. Steel Consuming vs. Producing Employment
source: Bureau of Labor Statistics, Equium Capital

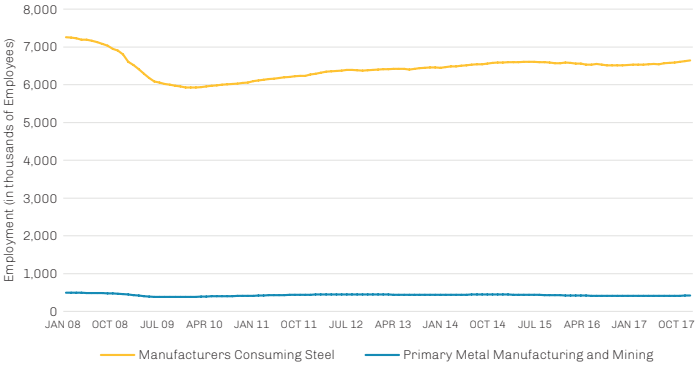
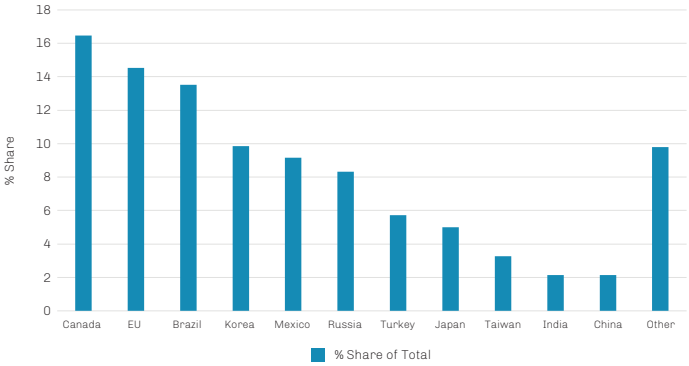


Chart 3 | U.S. Steel Imports, % Share by Country
source: U.S. Department of Commerce, Equium Capital



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justify a self-defeating trade war. Moreover, their direct impact on the overall U.S. economy, as presently envisioned, should be small with JPMorgan estimating a 0.05% increase in prices if higher costs are fully passed through to consumers. Therefore, our current asset allocation remains unchanged and we continue to manage your investments in accordance with our late cycle view of moderate growth, rising inflation and higher interest rates.

Looking further out, as investors we are prepared to watch markets, observe policy developments and act accordingly; however, as students of history we remain wary. The Great Depression had similar trade protectionism at its roots; Germany and the UK went to war even as they were each other's largest trading partners. Economic models assume rationality, but experience often proves otherwise. Given complex global supply chains, trillions of dollars in cross-border goods and services trade along with the international flow of capital that is critical to the financing of major credit markets, we would expect any further escalation in trade protectionism to result in higher volatility, reduced economic growth and lower asset prices. The exact nature of any portfolio changes would depend greatly on how these policies evolve; however, suffice it to say we will not blithely accept claims that rationality will prevail and will intently monitor these issues for signs of increased risk.

Europe: Strong but Fading

We have had a favourable view of European equities for some time; however, recent events led to a reduction in our overall exposure. From a technical perspective, the German market broke below its long-term trend line after several months of sideways relative performance, leading to our exit of the position (Chart 4). As a reminder, our technical process forces us to be unemotional, selling positions that demonstrate weak relative performance and break down through trend. Insofar as we are better able to protect capital from drawdowns and focus investments in areas of strength, the process should minimize volatility and still deliver long-term equity returns over the cycle.

At first glance, fundamentals appear positive as European growth and corporate earnings continue to be strong and Germany has finally formed a mainstream coalition government. However, populism has resurfaced in Italy with a majority supporting anti-establishment parties in the recent election and it remains to be seen whether the Merkel coalition will be able to effectively govern as its public support wanes. We would also add that European growth revisions have moderated and interest rates, while still very low, have increased materially year-to-date, thereby tightening financial conditions (Chart 5). For now, we remain overweight France and neutral Europe as a whole while we await further clarity on the trajectory for growth along with an improvement in the technical picture.

Chart 4 | German Equities Relative Price Performance
source: Bloomberg, Equium Capital

Chart 5 | Germany 10-Year Bond Yield
source: Bloomberg, Equium Capital

Table 1 | Investment Recommendation Snapshot
source: Equium Capital

	Sector	Region
Overweight	Equities Industrials Financial Services Health Care	U.S. France Emerging Markets
Underweight	Fixed Income Real Estate Staples Utilities	Australia Canada United Kingdom

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