Fear of trade war rocks stocks, investor confidence

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The following is an excerpt from Kirr, Marbach & Co.'s first quarter client letter, available at www.kirrmar.com*.*

The U.S. and China have the two largest economies in the world. The total volume of world trade has nearly quadrupled since the early 1990s, which means the global economy is more interconnected than ever before. Additionally, we're finally experiencing a synchronized global economic expansion.

Any disruption to the flow of goods could wreak havoc on manufacturing supply chains (that can cross multiple borders) and have negative implications for growth, inflation, productivity and real incomes.

Protectionist campaign rhetoric has become policy, which has understandably made investors nervous and was a proximate cause for the market's swoon. The current trade spat began with the Trump administration's levying of tariffs on steel and aluminum product imports. This was soon followed by the announcement the U.S. would institute 25% tariffs on $50 billion of imports from China, which was immediately met by an announcement China would levy tariffs on $50 billion of imports from the U.S. Not to be outdone, the president announced by tweet the U.S. would double-down and target an additional $100 billion of imports from China.

Where it stops, nobody knows.

We hope/believe much of this talk is "saber-rattling" and posturing ahead of negotiations that will occur between the U.S. and China in the coming weeks, before tariffs are actually implemented. Nobody is suggesting the complaints against China's trade/industrial policies aren't legitimate. The Chinese government provides big subsidies to companies important to its state-led plan and is pretty loose regarding intellectual property protections. Additionally, China has an ambitious plan known as Made in China 2025, the goal of which is to dominate several cutting-edge technologies.

While the stock market has been subject to large swings depending on the temperature of that day's trade tensions, there is little evidence the current tit-for-tat spat has negatively impacted economic activity, ***yet***. Indeed, the Conference Board's Leading Economic Index remains in a strong uptrend. Thus far, this has been a display of brinksmanship and a high-stakes game of "chicken." ***If*** it stops here, the damage should be limited.

However, if the hardliners prevail and this spat turns into a war, all bets are off. In particular, Reuters pointed out China has the "nuclear option" as America's largest foreign creditor, with holdings of U.S. Treasury securities of about $1.17 ***trillion*** as of the end of January. That's a *huge* stick few are currently talking about.

"May you live in interesting times" is purported to be a translation of a traditional Chinese curse and may be appropriate now, on several levels. According to Bespoke, from Election Day 2016 through the S&P 500's all-time record high on January 26, the index added $6.3 trillion in market capitalization to take its total market cap to $25.5 trillion. Since then, the index has lost about $2.3 trillion (the 25 largest-cap S&P 500 stocks losing about $1 trillion, or 40% of the total loss), surrendering more than one-third of the post-election gains.

Like him or not, this president is all about the "ratings." As Benjamin Graham said, the stock market is a voting (or ratings) machine, over the short-term. We think the market is saying it favors certainty over uncertainty and cool over heat. We hope the rest of 2018 is less "interesting," but will be prepared for whatever happens.
