INVESTMENT NOTES - May 29th, 2019

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Last week I promised a report from the Templeton Roundtable- where the investment managers of the Templeton Foundation meet to discuss their views on the market. They will remain anonymous, but there were very 'big guns' in the room.

The most interesting point for me is that all but one manager believed we were in disinflation if not deflation. The featured speaker, Dr. Mark Mobius, even has a new book coming out entitled, "The Myth of Inflation". However, I thought the manager that believed in inflation had the best argument- namely that the working population of the world is decreasing and especially so in places that have been key to lower prices, namely China due to their one child policy. He believed that this would lead to wage increases that would cause cost-push inflation.

His other point, was that the argument against this is greater productivity, but if one examines productivity numbers, they are not improving. This was mainly due to lack of investment as share buybacks and acquisitions have been the main use of corporate cash.

We tend to agree with this scenario which is given credence from the added cost of the trade wars. Liberty Street Economics published a report last Thursday which estimated the costs to U.S. households of the new China tariffs. They compared these tariffs to the 2018 tariffs which their study estimated added $414 to the annual costs of a US household. The 2018 tariffs had complete pass through to import costs of domestic households. Meaning Chinese importers did not reduce their prices to compensate for the tariffs. President Trump's argument is that this is being transferred from the consumers to government coffers where it can be redistributed.

Another possibility is that supply chains will be reorganized. It is President Trump's hope that some of these supply chains will be brought back to the United States. So far, we are seeing the Chinese move supply chains to places like Vietnam. However, this drives up prices in Vietnam so although the cost of the whole tariff is not transferred to US consumers, a large part is with the added problem that the US government does not receive any offsetting money. Of the $419 per household increased cost for the 2018 tariffs- $132 was this 'dead weight' cost leaving $282 of the cost which was offset by increased government revenue.

They estimate the total annual cost to a US household of the current tariffs is $831 using the same methodology. This does not take into account that the government offset is mainly going to US farmers who are not only suffering due to lower exports but also due to very bad planting weather in the Mid-West which has led to the highest corn prices seen in 3 years. This is also combined with the forced slaughter of hogs in China (the largest producer in the world) and the threat of the disease coming to the US.

In our mind, this all adds up to higher inflation. The market is now pricing in two Fed Rate cuts yet this year while the Fed has not indicated it has moved to a dovish stance. This is why the market has been relatively resilient in the face of the trade wars.

We have increased our cautionary stance with this in mind. We sold some of our European holdings and increased our holdings in both global and US TIPS. We also added a position in United Healthcare which has a defensive correlation. Lastly, we started a position in Taiwan Semiconductor as between it and Samsung they have an oligopoly on customized semiconductors which are increasing strongly in demand meanwhile the stock has been sold off and now trades at a P/E of 6x and less than 1x book value with a healthy dividend. We also shorted FCX- Freeport McMoran the copper producer as demand for copper continues to be weak and we do not see this reversing with the trade wars.