



CUBIC ASSET MANAGEMENT, LLC

2018 2nd Quarter Stock Market Commentary

SNUBBING SANTAYANA

“Artificial intelligence is no match for natural stupidity.”

- Anonymous

In 1685 James II was coronated as the King of England. A devout Catholic, he nevertheless advocated civic equality between Roman Catholics and Protestants, and closer relations with traditional enemy France. This stance angered many of the Protestant Parliamentarians and merchants, who surreptitiously plotted a coup with James' Dutch nephew William, Prince of Orange, to overthrow the monarchy. In 1688, William crossed the North Sea and English Channel with a large invasion fleet, and after only two small battles (and several anti-Catholic riots) the government of James collapsed and William was coronated William III.

Upon his ascension to the throne, William decided that the English passion for French Wine was helping to support the French government, who levied an export tax on each bottle. He decided to impose a steep tariff on French wine, hoping the reduced consumption would hurt his enemy's finances while encouraging the development of a domestic liquor industry. In the latter effort he was quite successful. Beer and ale production rose, but most of the citizenry turned to gin. The death rate soared, as did chronic drunkenness, unemployment and crime. It was widely reported that some London women were so gin-soaked that they spontaneously combusted, making this the first event to combine a trade war with fake news.

Currently, there is the possibility that the United States is about to engage in a trade war with China, prompted largely by President Trump's dismay over Chinese trade practices. There is no question that the Chinese play by different rules than the West, and they have, in fact, always done so. As far back as the early 1700s the British were frustrated by China's insular approach to trade. At the time the British craved Chinese goods, such as silks and porcelain, and especially tea, with which the British had become enamored. But the Chinese did not desire any of the goods produced in Europe, and instead insisted on payment in silver. Moreover, all trade had to be conducted through the southern port of Canton.

In an attempt to eliminate the trade deficit, the British re-introduced opium, which had been declared illegal in China in 1729. They were so successful that it is estimated that 10% of the population became addicted to the drug. In retaliation, the Chinese Emperor sent an emissary to

Canton who blockaded the port and seized two and a half million tons of opium and dumped it into the Pearl River. After a failed attempt at negotiation, the British mobilized troops stationed in India, and went to war. The technological advantages of the British industrial revolution allowed them to overwhelm the Chinese defenses. The First Opium War ended in the signing of the Treaty of Nanking, opening up five other cities to trade, including Shanghai, and ceding Hong Kong to the British.

This illustrates one of the major lessons of history. **Trade wars, all too often, lead to shooting wars.** The infamous Smoot-Hayley Tariffs, passed in 1930, imposed tariffs on more than 20,000 items. Our trading partners retaliated, and the resulting collapse of trade intensified the Great Depression and was certainly a contributor to the tensions that led to World War II. There is a quotation attributed to 19th century French economist Bastiat, “When goods don’t cross borders, soldiers will.”

There is another lesson that can be drawn from a further examination of the above examples. After the imposition of the Smoot-Hawley Tariffs, certain key industrial goods were in short supply. Many of our previous trading partners, such as Italy, turned to Russia to supply them. Russia had been considered a Pariah after the Revolution of 1917, but the Smoot-Hawley Tariffs allowed them to restore lost trade. **The “winner” of a trade war is usually a country that did not participate in it.**

The same lesson could be derived from the resolution of the First Opium War. The hard-won access to Chinese markets granted to the British by the Treaty Nanking was also given to the Americans and Russians, neither of which was a party to the conflict.

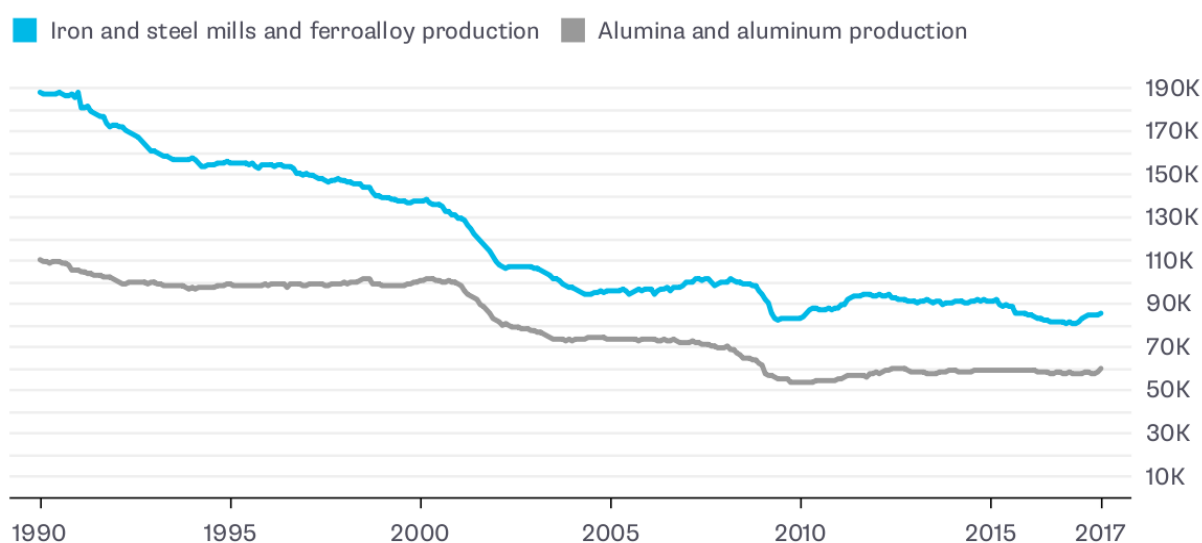
A less well-known example can be found in the late 19th century, when the United States and Canada fought a trade war in which both sides imposed steep tariffs. Canadian exports to the U.S. plummeted, and they turned to Britain as a trading partner. Once again, the beneficiary was a bystander. It is widely believed that any trade war between the United States and China would result in China buying more Brazilian soybeans and European airplanes, and the United States buying more clothes sewn in Vietnam.

The third lesson is that, by their nature, tariffs are discriminatory. They protect favored industries, like steel and aluminum production, at the expense of industries that consume those commodities, such as auto makers, construction companies, and aircraft manufacturers. Additionally, they discriminate amongst countries. Canada and Korea will likely be exempt from the proposed tariffs, while the 28 countries in the European Union will be subject to them. If challenged, it seems likely that these proposed tariffs will be ruled illegal under international law, since the World Trade Organization rules, to which the United States is a signatory, expressly state that countries cannot discriminate among their trading partners, except under certain exceptional circumstances. The Trump administration is claiming that these qualify for such an exemption, as these industries are essential for national defense. This seems like a difficult argument to make successfully, since 22 of the 28 countries in the European Union are also U.S. allies in the North Atlantic Treaty Organization (NATO).

President Trump is not the first president to try protect the steel industry. Presidents Lyndon B. Johnson, Richard M. Nixon, Jimmy Carter and Ronald Reagan all imposed import quotas and/or price floors for steel. George W. Bush enacted a tariff of 30% on imported steel in 2002, which were originally intended to last for three years. They were withdrawn soon after imposition when the World Trade Organization ruled them illegal. Barack Obama, who positioned himself as a proponent of global free trade, nevertheless imposed tariffs on Chinese steel of up to 522%. But despite the efforts of several administrations, employment in the steel industry (as well as the aluminum industry, another beneficiary of the Trump tariff proposal) continues its inexorable decline. See the chart below.

Steel Jobs and Aluminum Jobs

Payroll employment, seasonally adjusted



Source: U.S. Bureau of Labor Statistics

BloombergView

This is the fourth, and most important, of the lessons to be learned from a study of past trade wars and tariffs. **A protectionist country will never be better off by substituting inefficient, high-cost domestic production for efficient, low cost, foreign production.**

Suppose, for example, that cold rolled steel costs an average of \$850/ton on world markets. Imagine that with the addition of tariffs, American steel producers can charge \$950/ton, or \$100 per ton above the average price in other countries. This might allow the creation of 10,000 more jobs for steel workers, who of course will be much better off because of tariffs. But companies which buy steel, such as auto or appliance manufacturers, construction equipment suppliers or ship builders, will all have to raise the cost of their products. Those higher prices will, in turn, be passed through to millions of consumers, and will probably result in some modestly reduced sales. Each of those other industries may experience very small job losses, but this will be true for hundreds of different industries. In aggregate, the country imposing protectionist tariffs will always lose.

There is extensive literature about the fact that people are very bad at planning for rare events which would have devastating consequences if they occur. That is why the Japanese elected to build the Fukushima nuclear power plant in an area prone to tsunamis, and why residents of the big island of Hawaii chose to build homes on the slope of the active Kilauea volcano.

Currently the stock market is trading within hailing distance of its all-time high. Investors have chosen to ignore the possibility of a trade war occurring, despite the fact that such an event, though unlikely, would have devastating consequences for participants. Depending on how likely you judge the possibility of a trade war to be, there are two steps a conservative investor might consider. First, one could increase the allocation to small-cap companies. These tend to be domestically focused, and therefore less likely to be the target of punitive tariffs. Second, be prepared to reduce equity allocation to industries likely to be targeted if the rhetoric seems likely to result in action. It seems prudent to have a contingency plan. As philosopher George Santayana famously said, “Those who cannot remember the past are condemned to repeat it.”