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The View From The Top

When I assess investments, I spend my time looking at low-level details like financial statements and risk of product obsolescence. These low-level details are what paint my high-level view of the economy. Nevertheless, it is occasionally worth a few moments to step back and look at the forest, instead of at the trees.

Donald Trump's administration has created a number of economic curveballs. The most obvious of these curveballs are the multiple global trade wars, most notably with China. There are quite reasonable arguments that other nations have benefited economically from asymmetrical trade relationships with the US. In addition, nations, especially China, have stolen every piece of American intellectual property they can get their hands on. These are real problems, and they were not addressed by previous administrations.

Resolving such nation-vs-nation problems inevitably requires some sort of power struggle. Trump has chosen a trade war as his method of action. In this standoff, Trump has made crazy and changing demands while China drags its feet, waiting for the problem to go away. Is Trump negotiating the best deal for all of us? That remains to be seen. We will not know for sure until we look back years from now.

Game theory is a branch of mathematics devoted to analyzing strategies that deal with competitive situations. In many negotiating situations, game theory shows that the optimal negotiation strategy is to make crazy demands. After hearing the really crazy demands, the counterparty eventually caves in to a demand that is only moderately crazy. For instance, we all know of divorces where one individual made crazy demands and eventually came out with more than his or her fair share of the assets. At this point, there is not enough evidence to convince me if Trump is acting in a game-theory optimal way, or whether he is just acting crazy. Time will tell.

The trade wars are having real impacts. Companies large and small have created both supply chains and businesses based upon a set of rules and expectations. These rules and expectations included low trade barriers and cheap labor overseas. Suddenly, the future of these rules and expectations is in doubt. US businesses are hesitant to build factories overseas because they have no idea what future taxes and political climates will look like. Similarly, the Chinese question their future access to American technology, so they now face the dire problem of creating technology that does not rely on the US. This uncertainty will likely persist for many years, and it will destroy businesses on both sides.

The trade wars' suppressed investment and demand exacerbates what appear to be recessions in many parts of the world. Even before the trade war, China was struggling with a mountain of debt, and Europe never seemed to recover from the Great Recession. These recessions may make other nations more likely to negotiate on favorable terms, or they may just worsen the results of the trade war.

To cope with the economic slowing described above, the US Federal Reserve has returned to a stimulative policy of lowering interest rates. In fact, current short-term interest rates are 1.5%-1.75% while inflation is currently about 1.9%. That means that, on an inflation-adjusted basis, investors are losing about 0.3% per year by investing in bonds -- or in other words, negative real interest rates. In fact, 10-year inflation-adjusted interest rates are roughly 0%.

This stimulation is designed to avoid a US recession triggered by the trade war. While this sounds like a good idea, the piper must eventually be paid. The consequence of stimulative interest rates is that they drive risky financial behavior. This is very apparent in Colorado. I recently looked into real estate in Colorado ski towns. The entry price for a condo is about $400,000 -- the same price as a trailer house in those ski towns. Even calculating the economics with very optimistic rental assumptions, at these prices, the properties are cash-flow negative by about $20,000/year. That is not much of an investment, unless you assume that housing prices will continue charging higher. Similarly, businesses burning money by the trainload, such as WeWork, have investors willing to continue sending the next carload of cash.

We are late in the economic cycle, but the US economy still appears strong. A recession will eventually come here. There are certainly excesses within the system, but they do not appear as egregious or as focused on the banking system as in the previous recession. As a result, I expect that the next recession will be less catastrophic than the last.

When you look at the forest instead of the trees, remember what John D. Rockefeller told Henry Poor when Poor asked what was going to happen in the market. Rockefeller replied: "It will fluctuate." In the last 20 years, we have seen Y2K, the Dotcom bust, Enron, September 11th, the Iraq War, the Afghanistan War, the Great Recession, a banking crisis, a real estate bubble, massive wildfires, and even some major hurricanes. All the while, the market has roughly doubled.

At Cecropia, regardless of economic curveballs like trade wars, disrupted global supply chains, or negative real interest rates, our focus is always to buy above-average businesses at below-average prices. The market is our servant, not our master. We must remain patient and rational to profit from the market's folly.

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