Second Quarter Review

	Close	Total Returns	
		2nd	2018
	6/29/18	Quarter	Year-to-Date
Standard & Poor's 500 Index	2,718	+3.43%	+2.65%
Dow Jones Industrial Average	24,271	+1.26%	-0.73%
NASDAQ Composite Index	7,510	+6.61%	+9.37%
Dow Jones Global (ex U.S.)	254	-3.30%	-4.91%
Barclays Aggregate Bond Index	2,013	-0.16%	-1.62%

The U.S. stock market has bounced around this year encouraged by strong profits but anxious about rising interest rates, political upheaval in Europe, and intense trade haggling. Although the stock market embraced new tax legislation last year, it has been unnerved by unpredictable trade negotiations this year. Cutting corporate taxes is an unambiguous positive for U.S. companies. The effects of changing trade terms are less clear. Companies are uncertain about what tariffs the U.S. will enact and equally unsure how other countries might respond.

Despite the tariffs already imposed on our traditional allies, it is China that will ultimately be the target for major trade negotiations. A review of the plan, "Made in China 2025" (MIC2025), pinpoints why that nation is the real bullseye of this administration. This ambitious, detailed industrial policy plan, which China debuted in 2015, is one of the reasons U.S. trade negotiators are primarily focused there. In fact, the plan is so controversial to its current trading partners, Chinese leaders recently told the Chinese news media to no longer mention the MIC2025 plan.

Made in China 2025

So, what is MIC25 all about? First of all, it is a plan to transform China into an advanced manufacturing leader similar to Germany and Japan. Their goals are to increase Chinese manufacturing market shares at home and globally. Chinese leaders see higher level manufacturing, or "smart manufacturing", as an important step to compete against the U.S., Europe, South Korea, and Japan. It is a plan to dominate new technologies while at the same time protecting their existing, low cost manufacturing base. The plan is very specific about market share goals by 2020 and 2025, and in most industry segments the market share targets are in the 60-80% range, or as close to monopolies as possible.

If successful, MIC25 would threaten the competitive position of companies in the U.S. and Europe alike. The plan is a directive to private Chinese enterprises to move quickly in terms of developing more globally competitive technology products. The plan lists ten strategic initiatives that would transform China into an advanced manufacturing leader. These initiatives are in next generation information technology, robotics, aerospace, high tech ship and rail equipment and manufacturing, electric vehicles, agricultural and electrical equipment, new materials, biomedicine, and medical devices.

In contrast to the United States, the central government of China is playing an important role in helping private companies achieve these explicit goals by taking the following initiatives:

- Providing subsidies and tax rebates as well as direct cash injections for companies.
- Restricting foreign products at the national and local levels.
- Making foreign acquisitions of companies with intellectual capital and patents such as robotic companies.
- Direct investment in European companies -- mostly German, as well as some Italian and Spanish companies.
- Financing consolidations of Chinese companies to strengthen them.
- Issuing laws, regulations, and standards that handicap global competitors. Some technology standards and protocols, such as cyber security standards, are developed for China and are intentionally not compatible with global competitors.

Why is China executing such an ambitious plan? After decades of spectacular growth, the Chinese economy is slowing. Chinese leadership knew it could succeed with low cost labor, but its future economic growth depends on competing with global technology leaders in the U.S., Germany, and Japan. MIC25, in fact, was inspired by Germany's own public and privately funded plan launched in 2011 to consolidate Germany's leadership in mechanical engineering and smart manufacturing.

As ambitious as MIC25 is, there are many impediments that will make the plan difficult to succeed, particularly in their timeframe:

- Despite these government-funded plans, U.S. companies still have the comparative advantage in intellectual property. Whatever final agreements come out of these trade negotiations, the U.S. will make it harder for China to abscond with leading-edge technology.
- It is typically difficult for manufacturing companies to make quantum leaps in new processes instead of more gradual improvements that take more time. The more automated "smart manufacturing" processes will lead to layoffs and the possibility of a civil backlash.

- For the plan to be a national success, smaller companies need to become more competitive. However, most small companies are not politically connected and in line for favorable, state sponsored financing. Smaller companies also operate in low margin businesses and are hard pressed to afford new equipment.

Trade Skirmish or Trade War?

What is the probability that changes in global trade terms lead to significant negative economic and financial market reactions? The markets have vacillated daily in reaction to the tone of the administration's ever-changing public demands. We think markets would be lower if investors thought that the nonpublic negotiations would lead to an implementation of broader tariffs and full-out trade war. Financial markets would most likely react negatively to such an outcome since broad Chinese tariffs would lead to higher consumer prices and most likely higher interest rates.

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It is clear that the U.S. sees China's ascendance as a powerful competitive threat going forward. For multinational companies, China has been an extremely important region to grow their businesses. In fact, China has been the region with the fastest growth and we do not expect that to change in the next few years. However, if MIC25 is ultimately successful, and the Chinese have been successful in industrial policy initiatives such as high speed rail and smartphones, many U.S. companies will eventually have to readjust their global growth plans.

Financial Market Outlook

The investment climate in 2018 has changed from prior years. For the first time in a decade, short term interest rates are higher than dividend yields. And, short term rates will continue to go higher according to Federal Reserve plans. It is our experience, however, that the market always faces uncertainties and today's are no greater than prior years or decades. We think the hot and heavy negotiations with China should cool off by the Fall. If so, investors may conclude that the worst case outcome did not come to pass and may even be a net positive for the majority of U.S. companies. By the midterm elections, the major economic contentious priorities of the Trump administration -- lower taxes, less regulation, better trade terms -- will be largely finished. By year-end investors will know if the Federal Reserve will stay the course with plans for further rate increases in 2019 or back off due to weaker global growth.

Looking longer term, we know financial markets will periodically rattle the nerves of stock and bond investors alike. As we have mentioned in previous *Outlooks*, the bond market has completed a 30 year bull market and the stock market a nine year bull run. As a result, the valuation of bonds and stocks is not especially appealing in the short run. We see little harm, except for paying taxes, in booking some gains on those companies that have stretched valuations as we continue to patiently look for opportunities.

Bob Milnamow
President and
Chief Investment Officer
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The ***Standard & Poor's 500 Index*** *is an unmanaged broad-based index that is market weighted and used to represent the U.S. stock market. It includes 500 widely held stocks. Total return figures include the reinvestment of dividends. "S&P 500" is a trademark of Standard and Poor's Corporation.*
The ***Dow Jones Industrial Average*** *is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.*
The ***Nasdaq Composite Index*** *is the market capitalization-weighted index of approximately 4,000 common equities listed on the NASDAQ stock exchange. The index includes all Nasdaq-listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debenture securities.*
The ***Dow Jones Global (ex U.S.) BMI*** *(Broad Market Index) comprises the S&P Developed BMI and S&P Emerging BMI, and is a comprehensive, rules-based index measuring stock market performance globally, excluding the U.S.*
The ***Barclays Aggregate Bond Index*** *is a market capitalization-weighted index. Most U.S. traded investment grade bonds are represented. Municipal bonds and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues. The index includes Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S.*

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