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Investment Outlook

Thoughts About The Trade War

American and Chinese officials have been raising hopes that the trade war will soon be settled. On April 4, President Trump told reporters "If it's not a great deal, we're not doing it, but it's going very well" and "if we have a deal, there will be a summit. I'd say we'll know over the next four weeks."

President Trump picked this fight, and he can settle it anytime he wishes. I assume he will pursue the course that will give him the best chance of re-election in November 2020. I do not like making predictions, but it seems there are more reasons for Mr. Trump to prolong the dispute than to settle now. Being a cautious investor, I favor preparing for the longer dispute.

If Mr. Trump settles now, and it appears by election time that the settlement changed little or nothing, he will get little credit at the ballot box. If he settles closer to election time, it will probably be a better deal for the U.S., it will be fresh in the minds of the electorate, and Trump need not worry about the effect of the deal, since that won't play out until after the election. Mr. Trump can tell voters he needs a second term, as he and only he will force China to honor its promises.

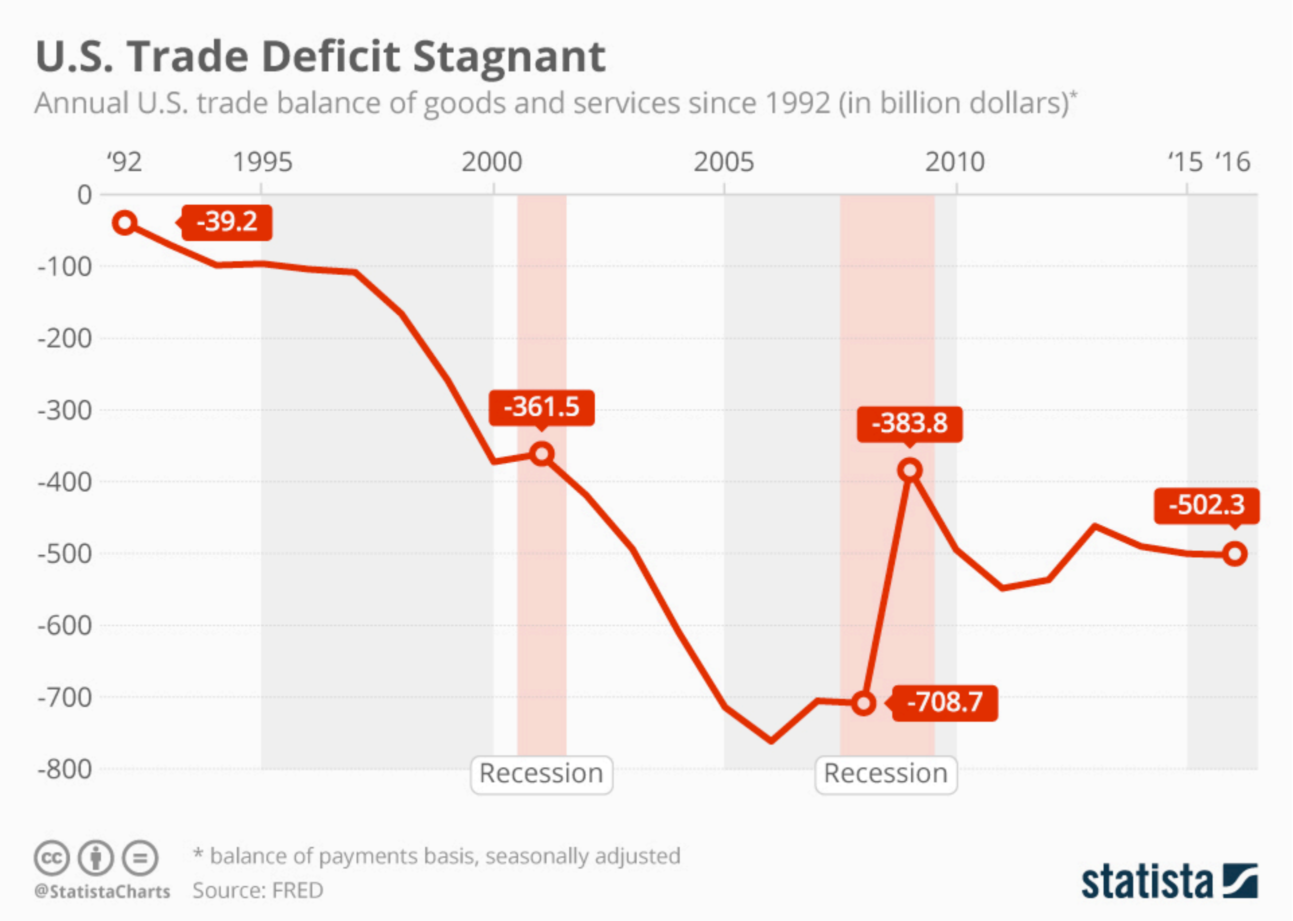
If he prolongs the dispute, he risks tipping the U.S. into a recession. I believe Mr. Trump is willing to take that risk. To voters, it is perhaps more important that Trump maintain his image as a tough guy and a fighter. Many of Trump's supporters are used to facing difficult economic conditions; a small recession should not erode his support (he hopes).

The U.S. imports about $500 billion of goods each year from China, but only exports about $200 billion. This leaves the U.S. with a $300 billion trade deficit, and leaves China with about $300 billion in U.S. dollars each year, which China mostly uses to buy U.S. investments. The U.S. ends up with consumer goods for tomorrow's landfill, while China ends up owning an increasing amount of U.S. real estate, U.S. companies, and U.S. securities.

Putting this in context, the net value of the U.S. was estimated at $124 trillion back in 2014. So in 413 years China could own everything in the U.S.. If we include the U.S. trade deficit with all other nations, foreigners could end up owning the U.S. in 200 years. Viewed in this light, the trade deficit seems far less urgent than climate change or population growth.

Back in the 1980's, when Japanese bought Rockefeller Center, Pebble Beach and RCA Victor, it seemed Japan would someday own the U.S.. Then the Japanese bubble burst, and today Japan has its own problems, though still running a trade surplus with the U.S.. China may face the same fate, as it has a huge real estate bubble. Whether that bubble will burst is up for debate. But it seems the ruling Communist Party is scared of something, as it allows Xi Xinping to consolidate power to a degree not seen since the days of Chairman Mao.

What about the size of the trade deficit going forward? As you can see from the chart labelled "U.S. Trade Deficit Stagnant", the U.S trade balance has dipped deeper into the



* balance of payments basis, seasonally adjusted

Source: FRED

negative most every year from 1997 to 2006. But over the last ten years, the U.S. trade deficit has shrunk. The two main reasons for this are the 2008 recession and reduced oil imports.

Some scenarios could reduce future trade deficits. If the U.S. economy falters, as it did in 2008, demand for imports should shrink and trade deficits will fall. Or if the value of the dollar falls, imports become more expensive and exports become cheaper, so trade deficits will fall.

Many Americans believe trade deficits are the cause of job losses in the manufacturing sector. U.S. manufacturing jobs have dwindled from 20 million in the early 1980's to about 12 million at present. But most economists believe technological change is a much greater cause of the deindustrialization of America than trade deficits.

The U.S. is demanding China purchase more American goods. But with U.S. unemployment at record lows, it is hard to see how the U.S. could produce more than it presently does. If China increases it purchases from America, it will likely consist of goods with a low labor component such as oil, gas, and food, as opposed to manufactured goods such as clothing and furniture.

America also objects to China's systematic theft of U.S. intellectual property. U.S. companies wishing to sell goods in China are pressured to make those goods in China with Chinese partners. The resulting theft of American trade secrets is clearly unfair. However, when a Chinese company wants to buy a U.S. company in order to profit from its know-how, one can hardly label that as theft. To tell an American company it can sell intellectual property to France but not China really opens a quagmire, and will discourage innovative companies from locating in the U.S. As it is, the U.S. has made it much harder for foreigners to get U.S. work visas, so U.S. software companies are setting up shop in countries with easier immigration policies such as Canada and Mexico.

Trade policy is a complex topic; I can only scratch the surface in these few pages. So just to summarize: While there is hope of a trade deal soon, the President may drag it out, both to get better terms and to get more credit at the ballot box. The present trade deficit is depleting U.S. wealth, but at a very slow rate. The trade deficit will drop if the U.S. economy or the U.S. dollar weaken. If China increases purchases of U.S. goods, it likely will not be the types of goods that create lots of jobs. While theft of intellectual property should be stopped, prohibiting U.S. companies from selling intellectual property to China will discourage companies from locating in the U.S..

Here are some of our recent investment recommendations:

Comtech Telecommunications Corp. (CMTL) is a leading provider of secure wireless communications equipment. It sells all the equipment on the ground that makes satellite systems work. Satellites are a growth industry thanks to the advent of miniature satellites and private launch services.

Comtech is the #1 provider of Single Channel Per Carrier satellite earth station modems, and #1 provider of troposcatter products and systems. Troposcatter products send wireless signals over the horizon where satellite and traditional radio is unavailable. It has a 50% market share of wireless 911 calls, provides the backbone for text messaging, and is a leading provider of Command and Control Solutions for the military.

Key growth areas are cellular backhaul, high throughput satellites, upgrades to HDTV, in-flight entertainment, next generation 911, cyber security training, electronic warfare and jamming, and troposcatter products. Revenues have grown an average of 23% per year over the last three years. 2019 revenues are on track to exceed 2018 revenues by 14%.

The stock trades at about 9 times free cash flow. Debt is only 34% of equity. Annual dividend yield is 1.7%.

Office Properties Income Trust (OPI) is a Real Estate Investment Trust created from the December 2018 merger of Select Income Properties (SIR) and Government Properties Income Trust (GOV). We have been investing in SIR since 2013. OPI owns and operates 276 office buildings across the United States. Most buildings are occupied by single tenants. The U.S. Government leases 26% of OPI’s space. 65% of the tenants have investment grade credit ratings, while 25% are unrated.

The U.S. Government will be vacating a few buildings, most notably the IRS Service Center in Fresno. However these are a small portion of the overall portfolio. Barry Portnoy, the founder of SIR and GOV, passed away in February 2018. Total debt to gross assets is 55%, slightly above the REIT industry average. These negatives have weighed on the stock price, but I believe investor negativity is overdone.

The stock is trading at only 6.6 times normalized Funds from Operations and pays an 8% dividend. Most of the dividend is nontaxable, while the taxable portion qualifies for a 20% exclusion from taxable income. With a 6 year average remaining lease term and high quality tenants, OPI is well positioned for any downturn. Record high construction costs and rising interest rates should limit competition from new buildings.

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Client portfolios have fully recovered from the sharp downturn in the fourth quarter of 2018. Our technology holdings have been especially strong. Low inventories in the semiconductor industry are raising expectations for a strong second half in 2019.

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