

Trade Wars and Recessions: Investing Under Conditions of Uncertainty

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"At heart, uncertainty and investing are synonyms." -*The Intelligent Investor*, Benjamin Graham (1949)

Investors hate uncertainty. You hear it almost every day on CNBC. Some pundit saying a version of "we are cautious due to the high level of uncertainty." But as Benjamin Graham said 70 years ago in his now classic book *The Intelligent Investor*, investing is itself an exercise in making decisions under conditions of uncertainty. Looking back on my own investment career, I recall no time period in which pundits on CNBC proclaimed their bullishness due to the high level of certainty. There is no certainty in investing, only making the best possible decisions based on the information you have at hand.

So while we reject the idea that uncertainty today is somehow unique relative to history, we do think the primary sources of uncertainty today have crystallized into two critical issues; the ongoing US-China trade war and various warning signs that a recession may be on the horizon. In our post today, we'll describe how Ensemble Capital is thinking about each of these risks and how we are making decisions under these particular conditions of uncertainty.

Recession Risk

The current bout of recession worries began during the fourth quarter of 2018. In early November, we wrote [this post](#) explaining why even strong evidence supporting a relatively rare event does not actually make that event all that likely. We gave an example walking through why declining home sales, despite occurring before 75% of all recessions, only increased the odds of a recession occurring to about 25%. Our post highlighted an excerpt from professional forecaster Nate Silver's book *The Signal and The Noise* explaining that "when the underlying incidence of something in a population is low (truth in the sea of data), false positives can dominate the results." Since recessions only occur in 10%-15% of all years, we know that "false positives" will dominate.

Then after [explaining on CNBC](#) in the last week of December why we thought it was a good time to be buying stocks, we elaborated on our view of recession risk in our [January client call](#) saying:

"So, just as a general framing of the risk-reward that investors are facing today in US stocks, it seems there are three general possibilities.

If no recession occurs: The stock market generates very strong returns over the course of the next couple of years.

If a mild recession occurs: With the stock market already selling off by the magnitude that

would typically be associated with this outcome, there may be limited downside even if things play out this way.

If a severe recession occurs: In this event, there may be considerably more downside for US equity investors.”

But since that time, the market has rallied over 20%. Far from a recession starting in the first quarter, GDP grew over 5% vs the prior year with the sequential growth from the fourth to the first quarter being the fastest in four years.

With the fourth quarter panic subsiding, the market no longer appears to be discounting a near term recession. While we continue to think a recession is not the most likely economic outcome in the next year or so, we do continue to think that the risk of a recession is elevated. The most clear signal of this risk is the behavior of interest rates. While there are lots of ways to read interest rates, there is strong evidence that when the bond market is priced in such a way that implies the Federal Reserve is going to be cutting rates in the near term, the risk of a recession is quite high. As of today, 2-year treasury bonds yield less than the Federal Funds rate controlled by the Fed, which means the bond market expects the Fed to cut rates. This is a “yield curve inversion” and historically inversions of this sort that persist are followed by a recession, a fact the Fed themselves noted in [a paper](#) they publish last year.

Yet on the other hand, [studies](#) also show that unemployment rates tend to begin to rise materially over a period of months ahead of recessions. And today the unemployment rate is at the lowest level in 50 years (!) and unemployment claims, a weekly data set based on actual claims filed, not the surveys and estimates that underpin the unemployment rate calculation, are also at 50 year lows.

So why might the bond market be assuming the Fed lowers interest rates sharply even as US economic conditions are robust (GDP growing more quickly than it has for much of the last decade and unemployment at multi-generation lows)?

One reason may simply be that recessions almost always occur after periods of strong economic expansion. It might just be that today’s robust economy will roll over into recession before too long. While yield curve inversions do have a strong track record of forecasting recessions, they tend to precede recessions by one to two years (and interestingly for those worried about the inversion, stock markets tend to rally higher for much of the time period between inversion and a recession actually occurring).

The other reason...?

The US-China Trade War

We live in a global economy. While the Federal Reserve’s mandate is to nurture the US economy, this is not possible to do without accounting for the impact of foreign economies. That’s why the yield curve inverted and the Fed ended up cutting interest rates in 1998... but no recession occurred. Instead the market initially declined by almost 20%, just as it did in the fourth quarter last year, and then ripped higher by 60% over the next 18 months.

Economists across the political spectrum agree that a hot and extended US-China trade war would be negative for China, negative for the US and negative for the global economy. The negative economic impact of constraining trade was laid out in 2015 by the conservative economist Greg Mankiw who pointed out that this is one issue on which “economists actually

agree... international trade is fundamentally good for the U.S. economy... among economists, the issue is a no-brainer.” The next year, when the the University of Chicago polled 39 economists from across the political spectrum, every one of them [agreed](#) that tariffs are a bad idea.

Of course, there is also bipartisan agreement that China engages in unfair trade practices. It is an entirely reasonable point of view that tariffs might be the bitter medicine we all have to swallow as part of a longer term agenda of pursuing a more level economic playing field between the US and China. But it would be naive to think that such a policy can be pursued with zero side effects.

But when following the back and forth on trade policy, it is critical to keep in mind that when two sides are engaged in intense, high stakes negotiation, you can't take all of their statements at face value. For instance, if you are negotiating to buy a car and the dealer tells you this is his lowest possible offer that doesn't mean it actually is. And when you storm out of the dealership that doesn't mean you don't plan to come back the next day to seal the deal at what you hope will be a better price.

Unlike the economic cycle, which plays out over multiyear time periods, the current US-China trade debate could just suddenly get resolved. It was only a couple weeks ago that the conventional wisdom was that the two sides were on the verge of a deal, until [apparently](#) miscalculations on both sides caused a breakdown in negotiations that neither side wanted or expected. If that's accurate, then negotiations may well be revived and brought to a positive conclusion.

But here's the thing; does anyone really expect that even the best possible trade war resolution will result in hunky dory US-China trade relations for the foreseeable future? We certainly don't. Rather, we expect that uncertainty in US-China trade policy and a persistent “cold” trade war that occasional flares “hot” is the the sort of uncertainty investors should expect over the next decade. But that doesn't mean we're bearish. Remember, “at heart, uncertainty and investing are synonyms.”

Uncertainty feels like a negative word. But uncertainty about the future also captures the possibility of unexpected, positive events. Such as the strong Q1 economic results in the US or the fact that unemployment is at amazingly low levels and yet inflation is nowhere to be found. Or the possibility we outlined in February explaining why [we might not get a recession for a long time](#).

So what are investors to do? What are we doing?

First and foremost, we think investors should accept uncertainty. Like the perennial advice that you can't solve a problem until you admit you have one, admitting and accepting that the future is uncertain is a prerequisite to being a successful investor.

Second, in a long only equity strategy like the one we offer (Ensemble also offers comprehensive wealth management services that include asset allocation advice to our private clients), we believe that once you accept that the future is uncertain you are best served by preparing for the inevitable negative events that are sure to come.

We do this by owning a portfolio of companies with strong competitive advantages; a “[moat](#)” that helps protect them from the unexpected. One of the key attributes of a moat is the “pricing power” it confers on a company. The power to raise prices as needed without losing

customers. This pricing power is particularly important during a tariff fueled trade war. If the price of a product is increased due to a tariff being levied directly on the product or on the inputs that are used to make that product, the ability for the company to raise the price to cover the cost of tariffs without losing customers is critical.

I [explained this concept](#) on CNBC earlier this month.

While we employ our own approach to this concept, McKinsey & Company recently published [an excellent look](#) at why resilient companies thrive during and after recessions. That doesn't mean competitively advantage companies don't see their stocks decline during a recession. But it does mean that since recessions are unpredictable, rather than try to predict them, you should own businesses that will thrive over the long term despite the fact that recessions will occur, as McKinsey puts it, "sure as the sun rises."

But while we do not think macroeconomics are highly forecastable, we do think it is critical for investor to be "macro aware". To understand the general parameters of reasonable future economic futures and to seek as best an understanding as possible about where in a cycle each company in your portfolio is operating. This is distinct from trying to predict when exactly a recession will occur. Rather being macro aware means understanding if you are investing in a company that is operating with a depressed, normal or elevated point in the economic cycle. This is why we [keep talking about](#) whether we are truly in a New Normal economy or if the New Normal is a false narrative and, in fact, we are in the midst of returning to the Old Normal.

For instance, while investing in trucking logistics company Landstar Systems over the past seven years, we tried to understand the state of the US manufacturing economy that drives demand for Landstar's services. Our belief in the 2015-2016 time period was that the weak demand was a result of recessionary conditions in manufacturing, despite the fact the overall US economy was not in recession. This led us to forecast in our valuation model, a steep increase in both the loads Landstar would haul over the medium to long term as well as a sustainable increase in the prices they could charge. But in the late summer of 2016, we simply had no idea that the cycle was about to turn and both loads and prices were about to explode higher. We never made a prediction that "called" the positive turn to the US manufacturing economy. But we were macro aware enough to have recognized that both load volumes and prices were depressed and thus our three to five year forecast should reflect stronger than average growth potential.

Today, we are working very hard to understand the macro context of the US and global economy and the impact the US-China trade war is likely to have. We are not foolish enough to think we can call the next recession. But we do think that while the most likely outcome is that a recession does not occur in the next year or two, the odds of a recession occurring are rising. Thus, we are systematically reviewing our portfolio holdings to ensure that our assumptions about future growth are neither too optimistic nor overly pessimistic.

As we began with a historical quote, so too shall we end:

"There is a Chinese curse which says "May he live in interesting times." Like it or not, we live in interesting times. They are times of danger and uncertainty; but they are also the most creative of any time in the history of mankind." Robert Kennedy (1966)

As it was 50 years ago, so it is today, and so it will be in 50 years.