

the Connection

A Quarterly Review

1st Quarter 2018

THANKFUL FOR WEEKEND RESPITES

We are very thankful that markets shut down over the weekend. With all the news coming in daily from every angle, the ability to filter out the noise from investable information is increasingly important and time consuming. The most recent cause of jitters in the market is attributed to a trade war with China. Just prior to that was the unwinding of short volatility exchange traded notes. One thing is certain, there will be more headlines and investors will need time to digest the information before being able to make their own conclusions. We will discuss the two headlines above, and then outline a few others that we feel may come up in the next twelve months.

The late January market meltdown was caused by a few poorly structured and poorly understood Exchange Traded Notes that were long volatility (VIX). We don't want to get too far into how the VIX (volatility index) represents volatility, but the simple explanation is that volatility represents demand – how much is the market willing to pay for the ability to hedge their S&P 500 investments. The VIX is also just a measurement, it does not represent an actual investment (further complications). If you are long VIX, you believe that markets will get choppy, and if you are short VIX you think that markets will remain placid.

After heavy investment in double short VIX exchange traded notes were made, the first volatility spike happened, more than doubling the VIX measurement. Those instruments that were short VIX went insolvent – leading to forced sale of investments for any fund or individual who had leverage and short VIX instruments. Needless to say, there was a lot of selling to cover short term illiquidity (margin selling). The forced pressure downwards in the market caused a short term correction. This however was not permanent, as new buyers came in pretty rapidly and bought depressed equities. The underlying companies that were sold had not been affected, so the only downward pressure was volume selling, nothing fundamentally had changed and the market moved back upward by late February.

The potential trade war with China is confusing, on multiple levels. Yes, our trade deficit is widening (not always a bad thing). Yes, China does force foreign companies into joint ventures with Chinese companies to access Chinese markets. Yes, these joint ventures do create easy paths for industrial espionage or simple intellectual property right transfers into Chinese companies. China has a long history of violating

patent laws and intellectual property theft. How can the U.S. ensure there is protection of corporate intellectual capital? We do not believe arbitrary tariffs are the best answer. Tariffs create tension, and can reach beyond U.S. jurisdiction. They also create demarcation lines, because a trade war is a war. It causes other regions and countries to pick sides. Parts of Africa, Southeast Asia and Oceania are as dependent on trade with China as they are on the U.S.

It is unclear if we would actually win in a trade war with China. If ever-increasing tariffs cause a zero trade environment with China, they would be hard-pressed to feed their people at reasonable prices. The U.S. would be hard-pressed to create positive trade environments with the rest of the world to make up for the lost growth that China and their closest allies represent. There are other ways to attack this problem, key to which is working closely with our allies. Obviously a trade war would be bad, fortunately the Chinese government is aware of the true problems created from an extended trade war and are working to keep the peace.

One of the first notable actions taken in this presidency was actually a great first attempt at combatting a poor trade environment with China. Cutting corporate taxes – Allowing companies to take home more of the money earned allows them to do two things in regards to trade with China. First it allows them to invest in their own businesses, making them more competitive and innovative, thus keeping other companies (foreign rivals) behind the curve either in innovation or theft. Second, it spurs growth without the need to attack new markets. Companies can be patient with regard to trade, as they are not forced to accept poor joint venture deals to keep profit growing.

Corrections happen, they have happened numerous times even in this massive recovery since the Great Recession. Give and take in the market is a positive sign that markets are balanced and not over extended in either direction. It always behooves investors to think about what else could happen in the future. A few things we are monitoring that are not geopolitical include the following.

Retail is one area to keep an eye on. The Toys R Us bankruptcy, preceded by Sports Authority, True Religion and other retail oriented companies is concerning. The actual bankruptcy causes damage to creditors and suppliers (Sports Authority's bankruptcy really hurt Under Armour and Nike), but what will happen if there is a glut of vacated retail space. How

many holders of retail real estate will be impacted? Where will interest rates be when those retail and mall operators go to refinance their debt? Will store closures lead to liquidity problems that have nothing to do with retail? So far the impacts have been minimal, but with rising rates, this is certainly an area to keep an eye on.

Oil prices have been low now for several years. This has led to logistics and delivery companies to be more efficient and profitable. Can our rail, trucking, and shipping industries withstand oil prices above \$100? We don't know if oil will ever get back to over \$100 a barrel, but certainly markets have become complacent. Ford and GM have announced they will be making fewer fuel-efficient cars. The EPA is starting to relax standards on gasoline efficiency. People have short memories when it comes to economic pain. It may be short-sighted to rely on SUV and Truck fleets that were purchased when oil was at \$40-\$60 a barrel if oil starts to rally. All one has to do is look at the price of a gallon of gas in early 2008 to realize there was a reason Tesla started, and the Toyota Prius was a hot item.

We could talk about the rising budget deficit, tensions with Syria, Iran, Turkey, Russia, North Korea and the Philippines. We could also discuss NAFTA, NATO and the U.N. Hopefully we will not discuss this in the future. The Geo-political environment is not great. Good economies however have a way of fixing Geo-political events. We are in a good economic cycle, and it is hard to find systemic risks that could topple our economy. Thank *the* Gods for weekends, because if the market was open without a break, we would never have time to figure out what will happen next.

THE ACT OF GIVING

Below is an updated list of some organizations our clients are helping today.

All Local Food Banks
www.sfmfoodbank.org
www.shfb.org
www.foodbankccs.org
www.refb.org

Bloom Marin
www.bloom.org

Maya's Music Therapy
www.mayasmusic.org

Friends of the Urban Forest
www.fuf.net

Guide Dogs for the Blind
www.guidedogs.com

Doctors without Borders
www.doctorswithoutborders.org

The Nature Conservancy
www.nature.org

National Kidney Foundation
www.kidney.org

Guide Dogs of America
www.guidedogsofamerica.com

Golden Gate National Parks Conservancy
www.parkconservancy.org

Fine Arts Museums of San Francisco
www.famsf.org

Canine Companions for Independence
www.cci.org

Alzheimer's Association
www.alz.org

The Foundation for Rotary International
www.therotaryfoundation.org

Wildcare
www.wildcarebayarea.org

Homeward Bound of Marin
www.hbofm.org

Whistlestop
www.whistlestop.org

FINCA
www.finca.org

Sonoma Land Trust
www.sonomalandtrust.org

Friends of the Earth
www.foe.org

The American Friends Service Committee
www.afsc.org

Amnesty International
www.amnestyusa.org

Eastside College Prep
www.eastside.org

Northern Sierra Partnership
www.nothernsierrapartnership.org

American Bird Conservancy
www.abcbirds.org

The Cornell Lab of Ornithology
www.birds.cornell.edu

Mono Lake Committee
www.monolake.org

California Trout
www.caltrout.org

Tahoe Rim Trail
www.tahoerimtrail.org

Ocean Conservancy
www.oceanconservancy.org

Global Fund for Women
www.globalfundforwomen.org

Marine Applied Research & Exploration
www.maregroup.org

Marin Agricultural Land Trust
www.malt.org



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