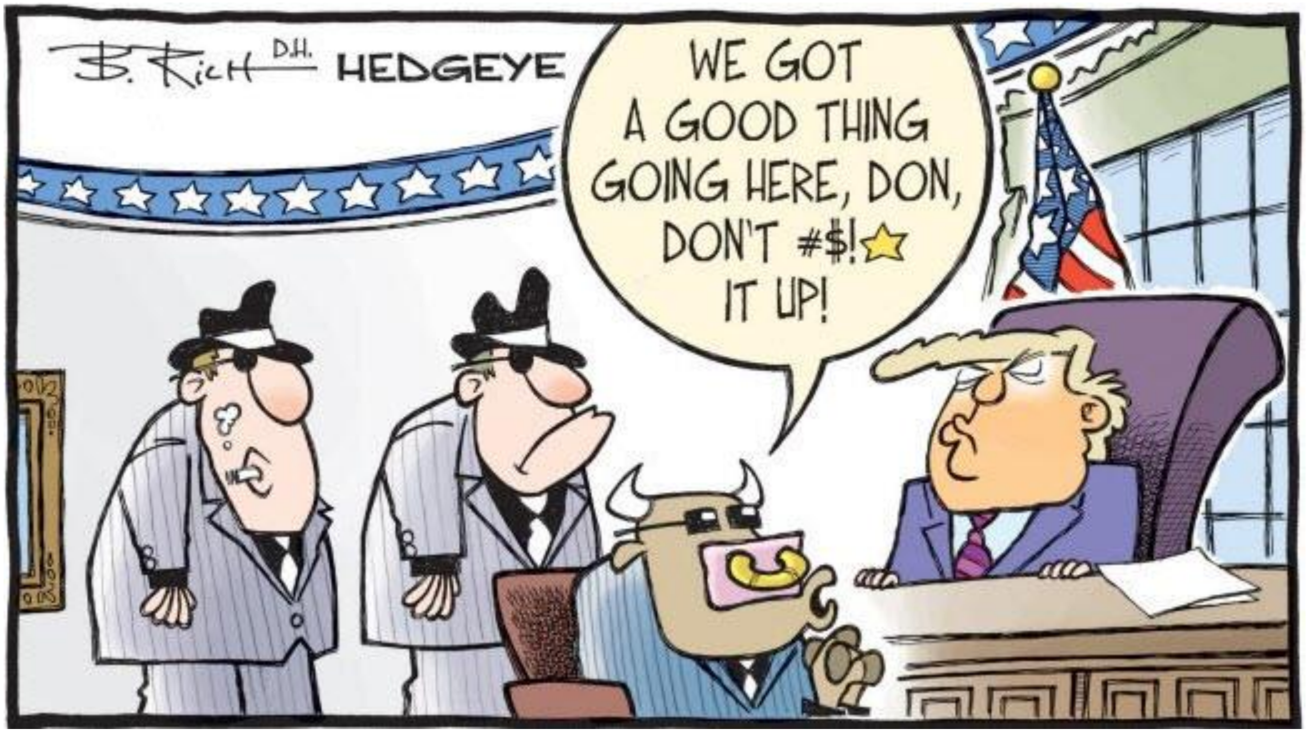
April 2018: From Thucydides to Carrie Mathison

Paraphrasing the saying “A picture is worth a thousand words,” we think the below cartoon neatly summarizes our current thoughts:



Unfortunately, with the recent tariff tantrum, President Trump may be “#@!★-ing it up.” After a largely financial market-friendly first year for the Trump Administration, the stock market has become stormy (daniels) without much hope (hicks) that things will settle down. Potential populist measures are threatening to upend the pro-business, pro-growth agenda that characterized Trump’s first year. Since its high on March 9th, the FAANG Index (Facebook, Apple, Amazon, Netflix and Google / Alphabet) is down approximately 10%[1] and the S&P 500 has stayed within a 200-point range (2,550 – 2,750) for the past few months.

Tech stocks are viewed as “long duration” assets and have greatly benefited from the low interest rate policy that has been in place for the past eight years. The outlook for tech stocks has dimmed recently with the rise in interest rates along with the potential for increased regulations[2], the Facebook data scandal and recent accidents involving autonomous vehicles. Some investors fear the FAANG stocks may repeat Microsoft’s sub-par price performance from the 2000s when that company was beset by anti-trust issues and platform shifts. Arguably valuations for Facebook, Google and other large cap tech stocks remain attractive as long as these companies continue to throw off a ton of cash.

We still like enterprise information technology (IT) companies and small cap biotech stocks in the genetics and cancer space. Earlier in the week, we attended a Bloomberg biotech innovation conference and remain excited about the prospects for the industry. We think certain small and mid-cap biotech companies focused on genetics and cellular therapies have a tailwind at their back. The Food and Drug Administration (FDA) under the lead of Dr. Scott Gottlieb is taking a far more aggressive approach in approving novel drugs and therapies than his predecessors at the agency and large cap biotech companies are beginning to pay substantial prices to acquire some of the smaller, more innovative companies. As an example, look at the purchase of Bannockburn-based AveXis by Novartis announced earlier in the week. We also remain excited about the prospects of the CRISPR stocks and found Bill Gates' recent article in Foreign Affairs, entitled "Gene Edit For Good: How CRISPR Could Transform Global Development," a nice support for our thesis.[3]

We are more concerned with systemic issues than company specific problems, which is causing us to become a tad more cautious than we have been. The current escalation in trade fears between China (a rising power) and the United States is particularly concerning to us. In May 2017, Graham Allison, a Harvard University professor, wrote a book entitled, *Destined for War: Can America and China Escape Thucydides's Trap?* Its premise is that rising powers and established powers have usually ended up in a fight to the death, mainly because each cannot help playing on the worst fears of the other.

Allison wrote, *"When a rising power is threatening to displace a ruling power, standard crises that would otherwise be contained, like the assassination of an archduke in 1914, can initiate a cascade of reactions that, in turn, produce outcomes none of the parties would otherwise have chosen."*[4] The current problems in Syria and the threatened trade war between the U.S. and China surely fall in the "standard crisis" category Allison feared. Nonetheless, we believe the trade issues will get resolved. This season the Showtime series "Homeland" is centered on the interference by a foreign power into the United States' domestic political agenda. In a quasi-Homeland twist, we believe the Chinese will "cave into" President Trump's demands and open up their markets and do a better job protecting intellectual property. See President Xi Jinping's speech on Tuesday at the Boao Forum for Asia as an example.

The reality is that doing so is in the long-term interest of the Chinese. If Allison is right, in a not-too-distant future, China just might supplant or join the United States as the global superpower. By agreeing to such trade terms, it will only help the Chinese when they the ascend to that position. Additionally, the Chinese may be quite happy that the Trump Administration is touting its "America First" agenda as it allows the Chinese to replace the U.S. in its "globalist" role. At the end of the day, China may want to do it all it can to help President Trump, as the Chinese see the U.S. withdrawal from the world stage as an opening. The investment ramifications continue to be that investors should diversify into foreign markets.

Sincerely,

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Citations and Disclosures

[1] Bloomberg, as of April 11, 2018 closing prices.
[2] Please see last month's letter "March 2018: Antitrust In The Internet Age," https://www.karmincapital.com/s/Antitrust-in-the-Internet-Age-dpzz.pdf
[3] https://www.foreignaffairs.com/articles/2018-04-10/gene-editing-good?cid=int-fls&pgtype=hpg
[4] https://www.theatlantic.com/international/archive/2015/09/united-states-china-war-thucydides-trap/406756/

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