QUO VADIS CAPITAL
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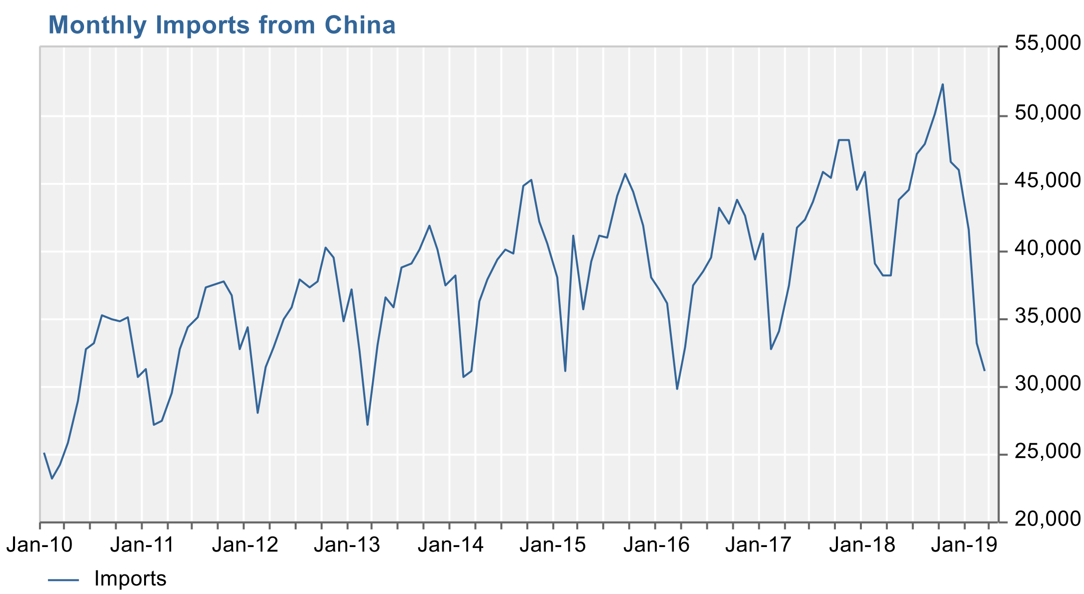
Trade War Torpedoes Market's Advance

Summary: Trade-related disputes and uncertainty will not derail economic growth, in our opinion. The market (the S&P500) has given back nearly 5% after hitting all time high levels on May 1 in response to the back-and-forth imposition of import tariffs between China and the U.S. The world's two largest economies bickering cannot be construed as a positive. However, contextualizing this dispute suggests that the risk to world economic growth is likely overstated, in our opinion. Our base assumption is that the negotiating process will cause some disruption but not overturn the current favorable momentum of the U.S. consumer and U.S. economy nor reverse the share gains of companies with superior strategies or technologies.

China Exports to the U.S. are 5x the Value of its Imports

In 2018 China exported about $549B of goods to the U.S. while the U.S sent back $120B. This works out to a $419B trade imbalance for 2018. This may sound like a large number, and the imbalance has clearly grown over the years, but let's contextualize it. Using the U.S. government figures, we calculate that China's exports to the U.S. are about 5% of its $13+ trillion annual GDP. Meanwhile the U.S.'s exports to China make up slightly less than half of 1% of the U.S.'s $20+ trillion annual GDP. These percentages tell us a couple of things. First, in our opinion, the administration is right to believe it has negotiating leverage, as China has more to lose than the U.S. if exports between both countries were to go to zero. Second, the overall amount of trade is not huge. Third, it is in neither country's interest for the dispute to drag on indefinitely. These all suggest that some agreement will be reached and that investors should not change strategies.

Figure 1. Imports to the U.S. from China (in $B) have grown nearly 50% since 2010.



The Companies We Follow Closely Are All Actively Moving Sourcing out of China

Bangladesh, India, Myanmar, and Vietnam are all happy to get this business. Much of the product destined for import to the U.S. from China comprises consumer goods including apparel, footwear, electronics and small appliances, among other items. The retail companies that we follow closely are thus concerned about the cost of these items rising 25% (due to tariffs) and whether they will be able to pass this expense along to consumers (and thus preserve their profit margins). The assumption that most are making is that they will not be able to hike prices to sufficiently offset this cost or make up for lost demand. The strategy has therefore generally been a combination of renegotiating contracts with Chinese suppliers and/ or seeking alternative markets to source product, all the while lobbying to dissuade the administration from imposing the tariffs in the first place. Helping somewhat, the Chinese currency has also depreciated vs. the U.S. dollar, effectively offsetting some of the initial tariffs. Three takeaways from our conversations with company management teams: 1) Should the 25% tariffs remain in place indefinitely U.S. based consumer companies will eventually be able offset or mitigate the impact, and 2) once companies move their sourcing to different countries, our guess is that it may stay there, which makes us believe 3) the pressure on Chinese companies and the Chinese leadership to get the tariffs removed is more intense than the reverse.

How We are Managing Our and Client Money:

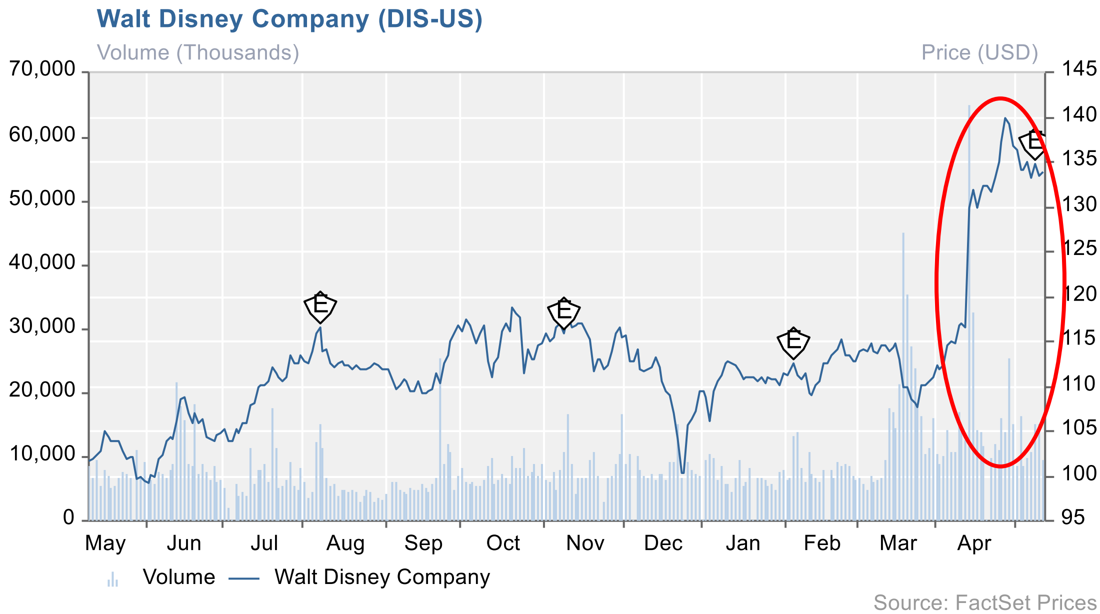
Our assumption is that our ability to forecast the overall market and macroeconomic conditions is highly limited. Accordingly, while we try to understand current conditions and trends, we try to make investment selections based on a long-term view and look for companies we can own throughout the economic cycle. The stocks of the best companies will still go down in a recession, but these businesses oftentimes benefit from challenging economic conditions as weaker competitors fail and cede share.

Selection from our model portfolio: Our approach is to own high-quality companies, bought opportunistically, and own them long-term with the intention to minimize trading costs and taxes. Our portfolio is concentrated (~20 positions) and generally we are favorably inclined towards companies we *know* or at least find easy to understand.

Walt Disney Company (DIS): We wrote about DIS in our November newsletter. You can read that write-up here. Disney, in our opinion, combines the world's most powerful entertainment content development engine, one of the best global brands, and now the leverage of a new digital global distribution capability (via Disney+ and EPSN+). At its recent analyst day the company shared its initial targets for these new distribution (streaming) services which are in the latter stages of development and introduction for the consumer. The bullish outlook sent the shares up $14 per share or 12% on the day to an all-time high of $130. Subsequently, the company's release of Avengers: Endgame broke global box-office records which provided additional gains for the stock.

Our view is that Disney's streaming service (and EPSN+) will probably become the largest subscriber service for content worldwide. If we look at Netflix (NFLX) as a guide, we can see that the company is currently forecasted to produce about $20B in revenues. The market is currently ascribing a $150B market value to NFLX based on its business model and global growth. This is 7.5x future revenue. If DIS can generate half of NFLX's revenues via the same streaming channels (and why wouldn't it? Disney has both a better brand and superior ability to produce content, in our opinion) and apply a Netflix-like valuation, we simplistically calculate that DIS's streaming nosiness could be worth $75B to the company's value, or $41 per share.

Figure 2. DIS shares jumped to all time highs following the company's analyst day meetings



This month I am not traveling. I continue to talk to company management teams and review results on a weekly basis to keep on top of trends in the consumer.

If you or someone you know is looking for help investing in the markets, please get in touch to discuss whether our equity portfolio is appropriate. An archive of our past newsletters can be found on our website [by clicking this link] .

Yours,

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The analyst who is the author of this report has a long position in Walt Disney Company (DIS). Quo Vadis prohibits analysts from trading in a way that is inconsistent with opinions expressed in reports [subject to exceptions for unanticipated significant changes in the personal financial circumstances of the analyst].

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