RIVERSTONE
ADVISORS, LLC

Riverstone Advisors Second Quarter 2018 Letter

July 2, 2018

It is July, and we are going swimming. When you go to the pool, you find many different personalities with different goals for the day. Some want to relax, some want to just have fun and others want to get a work out. The stock market is similar in that investors have assorted reasons for participating.

At the pool, first, there are kids splashing about and getting everyone wet. In market terms, these kids are the day traders. Second, there are the people sleeping and working on their tans. In the market, these are the set-it and forget-it crowd who think it does not matter whether you ever change your portfolio. Third, we have the thrill seekers doing cannonballs off the diving board. They hit the water, make a huge splash and get lots of attention. This is the news media. They stir investors up by hyping the impact of events large and small.

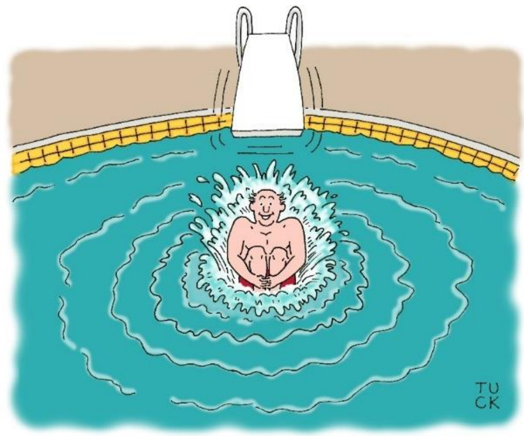
Finally, we have the lap swimmers. This is how we invest for our clients: with steady back and forth laps. We change their stroke periodically to suit market conditions. We concentrate on your goal of 50 laps. In other words, we keep our eye on the lane and don't get swayed by the craziness.

When the market seems crazy, remember that there are many participants in the market with interests divergent from yours.

<u>The "Cannonballers"</u>

The media likes to cannonball. You must remember that they use hyperbole to sell the news. This presents a conflict...

News hits the market and creates angst. Stocks jump around. Though the ripples start large, they dissipate in most cases. When we put pencil to paper or fingers on the keyboard to create an analytical spreadsheet, it usually becomes clear that the cannonball will not have a lasting impact. For investors, the questions around news always come back to *"will this impact the economy?"*, *"how will it change corporate earnings?"*, and *"which companies and/or industries will be affected?"*. These questions are mathematical. They are equations that we solve.



<u>Market Volatility</u>

As you know from last quarter's letter, the Federal Reserve's interest rate increases and Trump trade negotiations are causing elevated volatility. Before we dig into these topics, let's look at volatility historically by picking apart the chart below. Very quickly, we will see the ripple effect play out. In the figure below, the top graph shows volatility as measured by the VIX while the bottom graph shows the S&P 500 total return.

At first thought, most people equate volatility with poor market performance or recessions. In fact, volatility is healthy for markets. In the chart, you can see that 2017 was a period of abnormally low and stable volatility. See the mid-point between 2016 and 2018 in the top chart. Many investors began to think that this was normal. It isn't. This was simply the diminishing ripple effect of the market fear and news stories that came before.

In the volatility graph, the periods of high volatility in the last 10 years were in mid-2010, late-2011, late-2015, and the first part of 2018. It is during these volatile moments that the market reorganizes itself via resetting company valuations. Once these cannonballs have passed, the market begins to focus on economic data as the basis for future movement. There was also a cannonball in 2008 but this volatility was associated with a recession, not a normal economy as we had in the four periods mentioned above.

When you look at the periods listed above, you see the market began a steady move upward because the economic environment was steady. When volatility occurs, it is imperative to tamp down emotional reactions and stay the course if economic data is painting a promising picture, as it is now. Let's now dig into the two big events that have been driving volatility in 2018: interest rate increases and concerns about trade.

Will the Fed Cause the Next Recession?

The economy is firing on almost all cylinders. Unemployment is very low at 3.8%. There are more job openings than there are people looking for employment. It is amazing to think about how far we have come since June 2015 when the unemployment rate was 5.3%. At the time, it seemed we would never get out of that ditch.

Recessions are inevitable. Recession and growth are two sides of the same coin, hence, if we are in growth mode, then the next phase could be a recession. We have robust growth now but when will it fade? Given the current conditions, the most probable cause of a recession occurring is interest rate increases and/or inflation rising too much. We hope the Fed will correctly interpret conditions when deciding to raise rates. The Fed says they expect to raise rates two more times in 2018. If the Fed overshoots by raising rates too much, this could put the brakes on economic expansion and the market would sell-off.

We are closely watching economic indicators that could signal the economy is overheating. Harbingers of a recession are usually a flattening of the Treasury bond yield curve, too high interest rates, a reversal in unemployment rates from declining to increasing, an inflation rate over 2.2% and/or a decline of the Leading

Economic Indicator index to below zero. If /when we see these changes, we will reduce your stock exposure. For more on the yield curve, see our quarterly letter from one year ago, July 2017 or ask us for a copy.

Trade Tantrum Facts

First, let's address why tariffs would matter to the stock market. Here are the facts:

- A tariff is a fee applied to imports coming into a country. In the U.S., they are typically collected at the port of entry and then sent to the U.S. Treasury.
- Tariffs are a two-way street. Our trading partners may put tariffs on goods we send to them while we may put tariffs on goods they send to us.
- Tariffs are applied only to goods, not services. For example, a U.S. company selling consulting services overseas will not see tariffs applied to their services.
- Tariffs are sometimes used to protect domestic industries from overseas competition.

Tariffs matter to the stock market and you as an investor because they have the potential to reduce company sales and company profits. Stock prices are a function of company profits. Hence, we care about tariffs.

Let's examine tariffs on imports. A tariff makes an imported item more expensive. Some say tariffs on incoming goods are certain to create higher prices for U.S. consumers. The thought is because there is reduced competition (higher priced foreign goods) and it allows domestic producers to justify price increases. This is too simplistic a view in that it overlooks the fact that currencies ebb and flow against each other. Presently, the U.S. dollar has strengthened 7% against other currencies in the last 5 months. A stronger U.S. dollar makes incoming goods cheaper and could offset higher tariffs on incoming goods. We will dig into this later.

Let's examine tariffs on our exports. If our trading partners retaliate and raise tariffs on U.S. goods coming into their countries, our goods are less likely to sell due to their prices being higher than domestic goods. This is already the case in some industries where certain product categories and/or companies are effectively blocked by countries. Higher tariffs imposed by our trading partners could lead to lower sales and lower profits for U.S. multi-national companies. Hence, their stocks could sag under this burden.

There are three likely outcomes for this tantrum: (1) tariffs ultimately stay the same, (2) tariffs increase across the board but the degree of differences remains the same, or (3) the

U.S. is successful in leveling trading relationships relative to its trading partners. Number 3 is the U.S. objective.

Trade Tantrum Details

Tariffs have been around since 1789. Most of us are unaware of existing tariffs. The following table shows us what-is-what. This table is from the Swiss U.S. Embassy.

	Tariffs applied by					
	U.S.	**China**	**EU**	**Japan**	**Mexico**	**Canada**
All goods (simple average MFN, 2016)[1]	3.5%	9.9%	5.2%	4.0%	7.0%	4.1%
Transportation equipment (average MFN applied duties, 2016)[1]	3.1% **2.5% for foreign autos**	11.4% **25% for U.S. autos**	4.3% **10% for U.S. autos**	0.0%	8.5%	5.7%
Agriculture (simple average, MFN applied, 2016)[1]	5.2%	15.5%	11.1%	13.1%	14.6%	15.6%
U.S. trade deficit with partner country (goods, 2017)[2]		**$376 billion**	**$151 billion**	**$69 billion**	**$71 billion**	**$17 billion**

1. *Source: WTO Country Tariff Profiles (http://stat.wto.org/TariffProfile/WSDBTariffPFView.aspx?Language=E&Country=E28,CN,JP,MX,US,CA)*
2. *Source: U.S. Census Bureau (census.gov)*

The nations shown are our largest trading partners and those with whom we have the largest trade deficits. These nations are known as MFN or Most Favored Nations.

Studying the table, you see that goods imported into the U.S. have an average tariff of 3.5% applied to them by the U.S. This is the lowest of our major trading partners. Closest to us are Canada at 4.1% and Japan at 4%. Highest are China at 9.9% and Mexico at 7%.

You can see that goods that leave the U.S. bound for China are marked up 9.9% by China before they are sold in China. You also see that China sells $376 billion more in goods to us than we sell to them. Tariffs plus the fact that wages in China average $3.6 per hour while U.S. wages average $24.17 per hour, help to create this large trade deficit by making Chinese goods much cheaper than U.S. goods. This makes U.S. goods expensive in China.

Also contributing is the fact that they keep their currency value low to make their goods prices very low. Demonstrating this is the Big Mac index maintained by the Economist magazine. The average price of a Big Mac in America in January 2018 was $5.28 while in China it was $3.17. This gap implies that the yuan was undervalued by 40% against the U.S. dollar at that time. The same metric shows Canadian Big Macs equal to the U.S. while Big Macs are 8% lower in the EU, 35% lower in Japan and 51% lower in Mexico. Mexico's peso is unusually low as it has been punished by talks of the U.S. exiting NAFTA. Perhaps the undervaluation is recognition by the markets that NAFTA is more beneficial to Mexico than to the U.S?

Next, look at the agricultural products numbers. They say that the U.S. charges our trading partners 5.2% for access to our food markets while they charge the U.S. double digit numbers for access to theirs.

What do these tariff talks mean for our clients? We have been consciously structuring portfolios to reduce exposure to companies that would be directly affected by trade wars. The companies that are affected are large multi-national companies whose costs and/or revenue stem from the purchase and sale of international goods.

Conclusion

The economy continues to be healthy, unemployment continues to be incredibly low and inflation continues to be under control. The stock market continues to show demand for stocks and stock sellers do not seem eager to cut their prices to engender sales. You should view the trade noise of the past few weeks as normal cannonball events. As we wrote in this letter, when you think through the cannonballs they shrink in concern. Perhaps the trade situation will ultimately upset the apple cart but at this time the numbers still say "Go". Please let us know if you have concerns we have not addressed.

Sincerely,

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Enclosures

[1] Sources: *Bank Credit Analyst*, *Morningstar*, *Economy.com, Barron's, Standard and Poor's, Lowry Research*