GFG CAPITAL
A FAMILY OFFICE

VIEWS FROM THE BRICK

BOBBY FISCHER

The moves in the market last week carry much more weight in our eyes than what happened in February. February's market behavior was not the result of a single culprit, but instead a natural market breather attributable to a basket of reasons. This week's market tape is clearly being triggered by the beginning of a potential event that has significant adverse effects. (We wrote about trade wars for our blog a couple of weeks ago.)

STRATEGY

Bobby Fischer was a world renowned chess champion. The best to ever do it maybe. Chess is a game of premeditated strategy, each move connected to the three steps that will follow it. Nobody understood this strategy better than Mr. Fischer. Bobby knew he had an opponent defeated maybe a half-a-dozen moves before they did. Truly a man amongst boys. A similar game was extraordinarily popular in the 90's called Battleship. Less parts strategy, more parts guessing. The clear difference in these two games is that in one, a player is making calculated moves to take down their opponent slowly. In the other, essentially darts are being flung at a map hoping something works. Even the way the moves are announced carry profound differences. In chess, each move is stated deliberately "Bishop to F5." In Battleship, each move is a shot in the dark, a question posed to your opponent. "E6?" In which they reply "hit" or "miss." The current tariff discussion isn't too far removed from this in our eyes.

TARIFFS

The thing is, there's a lot of bark that's going to come from President Trump and his revolving administration door, and we think not as much bite. This is a clear negotiating tactic. He's coming out swinging to get the rest of the world to come meet him on his side of the middle. Hopefully, if that's all it is, then good on him. There are several aspects to current trade agreements that should be revisited, but tariffs are almost always not the answer. Especially wide sweeping ones.

Everyone has been singing the praises of global growth for a while and nobody wants to mess that up, so it's in their best interest to make a deal. But the Chinese aren't weak and arguably as strong as us, maybe stronger. And they know it. So, there's a certain amount of pride involved with President

Ping, as well as leverage.

China's initial reaction might come across as tame, placing a tariff on just $3B worth of goods ranging from fruit to recycled aluminum, but there's an important caveat: it was a response to the *aluminum and steel tariffs announced in February*, Trump's opening move (D5? Miss). Not the 301c claim by the U.S. on intellectual property, and the $60B tariff just announced. Noticeably missing from China's initial retaliation is soybeans and Boeing (BA) airplanes (Ping made a commitment to purchase BA planes during a visit to the U.S. last year[1]). Two moves that carry a more significant impact on the U.S. Soybeans translate to vegetable oil for China. Placing a tariff on this segment of agriculture would impact China on a miniscule scale from a domestic standpoint, but would hit half of the U.S. vegetable oil exports. Perhaps more strategically, Trump's base. So far, it seems as if one side is playing Battleship and the other is playing chess (Rook to F6, check).

International trade isn't as clear cut from a private sector standpoint as it appears to be in headline discussions from a political point of view. The global supply chain is a deeply tangled web in which not all companies report geographical inputs and revenues. Of the 48% of companies in the S&P that do reveal this information, 43% of sales were generated abroad in 2016[2]. The companies that do reveal more granular data indicated that Asia (not just China) accounted for 8.5% of foreign sales with Europe tallying 8.1%[3]. Energy, tech and materials are the three most globally exposed sectors within the index.

We don't think this goes away quickly and we reasonably expect to see a period of tariffs getting thrown around before a resolution, but a repeat of 1929 does not seem likely. History rhymes more often than repeats. So there's reason to believe some of the hype, but it's still partially noise at this point in our view.

TECH SELLOFF

Over 40% of imports from China to the U.S. are tech-related, computers being their single largest global export. But tracking U.S. imports from China isn't that easy. In 2014, $107B in tech products were perceived to be imported to the U.S. from China. But further research would show only $80B actually came from China, while the remainder originated from Japan and South Korea[4].

The tech story is a bit overblown to be honest, and we think the macro noise has given investors pause from rotating away from tech and into other sectors, which is the lifeblood of a bull market. Without the rotation between sectors, rallies end and markets either stagnate or head to bears. Typically when one falls out of favor buyers rotate into another (usually away from tech/discretionary into things like staples/finance/energy). But tech is getting blown up and the rotation isn't picking the market up: i.e. people aren't buying those other sectors.

When it comes to Facebook in particular, the implications/results can be reasonably spread across a few different levels:

Consumer: #DeleteYourAccount won't materialize into anything real. Consumers will try to pretend to care by getting hashtags to trend, but at the end of the day they don't have an alternative to the platform. The ones who claim they will exclusively use Instagram moving forward tend to forget that Facebook owns Instagram.

Corporate (Advertisers): You might see some companies come out and pull advertisements from the platform, but you're likely to see negative performance in their reports because of it. Online advertising is a duopoly (FB and GOOG) and companies, like consumers, don't have a better

SOURCE: This presentation is solely for informational purposes and should not be taken as investment advice. For further information, please contact one of our investment adviser representatives. GFG Capital strategies carry exposure to Facebook stock both directly and indirectly through pooled investment vehicles. [1] Reuter's. [2] Barron's. [3] Yardeni Associates Research. [4] Barron's. [5] Bloomberg.

alternative to the services today. Without a breakup of these institutions, advertisers will still have to play their game.

Government: Don't expect Washington to step in and take real corrective action in this situation. Why would they? The sitting President and administration are the beneficiaries of the modern-day Trojan horse. Any action taken would delegitimize their election victory. Don't be surprised to hear crickets on Capitol Hill, or at the most a sanctimonious response. On the other side of the pond it's a different story. Expect a harsh response from the European government on Facebook. Side note, Parliaments across Europe have already requested that Zuckerberg appear in person. European governments carry zero of the downside the U.S. faces in taking action against the service. This is the biggest risk in the entire scenario. If you stripped way all of the U.S. users of Facebook's platform, they'd still have 1.8B users worldwide. What's that mean? International fallout or regulations could be significant.

Facebook: Facebook (FB) struggled to acknowledge the issue by not calling the data breach a breach (which means no, Facebook didn't sell user information). They have also been slow to take responsibility; about a week and a half went by before Zuckerberg made any comments. He ultimately did apologize and acknowledge the mistake, and now MUST overcorrect the issue to save face, regardless of impact to shareholder value. We're still a long-term believer in Zuckerberg and his commitment to the users of the platforms. We do think an overcorrection will be eventually implemented, and yes, it might impact margins, but keep in mind that at operating margins in the neighborhood of 40%, they're head and shoulders above most other companies (i.e. GOOG carries operating margins of 25%)[5].

So the trade war conversation is spooking the market and has the potential to be a material impact to an extreme degree. Strip away the tariff conversation and we don't think we have the full-blown pullback we're seeing. So yes, fundamentally the evidence we have still is favorable of the economy's foundation. But we have our first true threat to that in quite a while. A recessionary environment isn't out of the question if you get a full-blown trade war. But we'll cross that bridge when we get to it, if it isn't burned.

LEGAL STUFF