Wasatch Capital Management Commentary
The Whole is Greater than the Sum of its Parts
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It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. **Adam Smith**

In *Metaphysics, Book 8*, Aristotle explained the concept of synergy as *the whole is greater than the sum of its parts*. He could well have been describing international trade. Free trade is, without a doubt, the most fantastic wealth creation scheme ever devised. Prior to the notion of free trade, the primary means of increasing a nation's wealth was plunder; a stronger nation would merely loot and pillage wealth from its weaker neighbor. This was far worse than a zero-sum game. Besides the horrible loss of life, it directed resources away from the production of goods and services to, instead, the safeguarding of treasures. The building of mighty fleets, impregnable fortresses, weaponry, and necessary manpower came at a great cost, diminishing each affected nation's productive capacity, and lowering the world's standard of living.

Free trade changed the paradigm. Instead of attacking one another nations, instead, quickly learned their former enemy was often a willing trading partner, ready to buy their goods and services and sell them theirs. No single country can produce everything it needs, and even if it could the law of comparative advantage dictates it would be a fool's errand to try. Free trade can *always* results in a higher standard of living for all parties, even when the trading agreement isn't necessarily fair. Why? As Adam Smith observed 242 years ago, the human condition is such that we make decisions based on self-interest. You see, we don't trade with China, or Mexico, or India because we like them. But, rather, because they can sell us stuff that's the same or better quality cheaper than we can buy locally. Likewise, Canada, Japan, & Germany don't buy American goods because we're besties, but because it's in their self-interest to do so.

Free market proponents understand that tariffs are a tax on consumers. If a government imposes a tax on imported widgets, it is protecting domestic widget manufacturers from foreign competition. This has several direct consequences: One, the consumer pays more for widgets. Companies don't pay taxes, their customers do, and when corporate taxes are raised, companies simply raise their prices. Two, it makes domestic producers less competitive. Three, it stifles innovation. Why invest in technology or new methods of manufacture when you have no competition and no consequences for making a shabby product? Lastly, you tick off your trading partners.

Why is President Trump so fixated on trade? I suspect it's due to his businessman nature. For better or worse, deal-making is in his DNA, I believe. He simply cannot stand the notion of the US not getting "the best deal" when it comes to trade, so he's willing to take a hardline approach with our trading partners; who also happen to be our staunchest allies. But as the old saying goes, *don't take any hostages you aren't willing to kill*, which is why the markets were spooked earlier this year over the thought of a trade war. Unlike military battle, no one wins a trade war. Everyone simply ends up with less. But the markets seem to be getting more comfortable (less uncomfortable?) with Trump's rather unorthodox negotiating tactics. He tends to start off with some unrealistic, oftentimes untenable objective but, in the end, comes to terms that are generally to our nation's benefit.

The 2018 G-7 Summit meeting is now ancient history, and ended in a rather acrimonious fashion, with Trump leaving Charlevoix, Quebec persona non grata. In fact, I almost titled this commentary "Table for Six, Please," but thought better of it. Trump has long-proclaimed the US gets the short-end of the stick when it comes to trade, but is he right? According to the World Trade Organization, average tariffs in the US are 3.5% compared to 5.2% in the EU, 9.9% in China, 4.1% in Canada and 7.0% in Mexico. Our fellow six G-7 members enjoy $200B[8] in annual trade surpluses to the US, largely due to unfavorable terms of trade. So, yeah, he does have a point. But even having the lowest duty of the bunch is akin to being a little pregnant; either you are, or you aren't. And if we believe tariffs are an impediment to free trade and global prosperity, then the right trade duty for all imports would be ZERO.

There are times, however, when punitive economic sanctions are the best course of action. Such was the case with Russia, North Korea, Syria and Iran. Limiting a bad neighbor's access to goods and capital will cripple a foe faster than tanks or bombs, and can force them to the negotiating table. The US may have the world's largest military but its economic might is oftentimes underappreciated in terms of political capital and negotiating leverage. Trump understands this better than most and clearly intends to use it to what he believes is our advantage. History will be the judge of his success or lack thereof. However, in the meantime the capital markets will be keeping a watchful, oftentimes wary eye, on our new president and will provide real-time feedback as to whether his economic and foreign policy agenda is accretive to the economy and, more importantly; earnings. We at Wasatch Capital Management, are constructive on equities, and believe stocks will move nicely higher over time. Albeit, in a non-linear fashion. Conversely, we expect bonds to continue to face headwinds from rising interest rates. As you'll see below, even with the rough patch that was February and March, stocks have outperformed bonds by nearly 7% year-to-date.

Item	Data point
Year-to-date S&P 500 Return[1]	4.85%
Year-to-date Bond Index Return[2]	-2.07%
Current unemployment rate[3]	3.80%
Personal Income Growth (annualized)[4]	3.80%
Current S&P 500 earnings growth[5]	26.60%
Expected inflation[6]	2.11%
2018 GDP (projected)[7]	2.90%

While there's always a reason to be fearful, shopping centers are bustling, restaurants are full, construction is booming, help wanted signs abound, and real wages are rising across the spectrum. It may not be all fluffy clouds and rainbows, but it's hard to not be optimistic about tomorrow.

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Source: [1]Bloomberg, 6/11/18, [2]Bloomberg, 6/11/18 (Barclay's Aggregate Bond Index*), [3]Bloomberg, 6/11/18, [4]Bureau of Economic Analysis, 6/11/18, [5]Thompson Reuters, 5/16/18, [6]Federal Reserve FRED, 6/11/18, [7]Wall Street Journal, 5/16/18, [8]Cumberland Advisors, Bob Brusca 06/12/2018