



Friday Morning Coffee

Nr. 58 — Wounded in Action

Wounded in Action (WIA) describes combatants who have been wounded while fighting in a combat zone during wartime but have not been killed. Is Huawei now, in the trade war statistics, appearing in this category ? The company saw key executives arrested, it got excluded from 5G telco infrastructure and mobile sales by some operators, it is no longer getting Android operating system licences from Google for its phones and now, as of this Thursday morning, the company sees the UK chipmaker ARM withdrawing its key tech licence for the processors widely used in Huawei phones. To us, it appears the soldier Huawei is not only lightly wounded but needs an immediate evacuation by helicopter from the war zone. And a big aircraft would probably be required as Huawei is one of the biggest technology companies in the world with revenues slightly below Microsoft's.

This example clearly shows that the current trade war is much more than just a sabre rattling between Donald Trump and Xi Jinping to negotiate a good trade deal. It is also the case of Mr. Trump showing his power (which should not be underestimated) and a rally to win the next US presidential election under the banner "Make America Great Again".

In its leader this week, the Economist compares the current trade war to a new Cold War that eventually brought the Soviet Union to its knees. However this time around, and unlike in the Cold War, the risk of economic collateral damage is substantial as the world economies have changed due to globalisation and supply chains have become much more integrated. The Soviet-American trade in the late 80's represented 2 bn USD in value of goods and services a year while the trade between America and China represents 2 bn USD a day ! (source: The Economist, Leader, May 18th, A new kind of cold war).

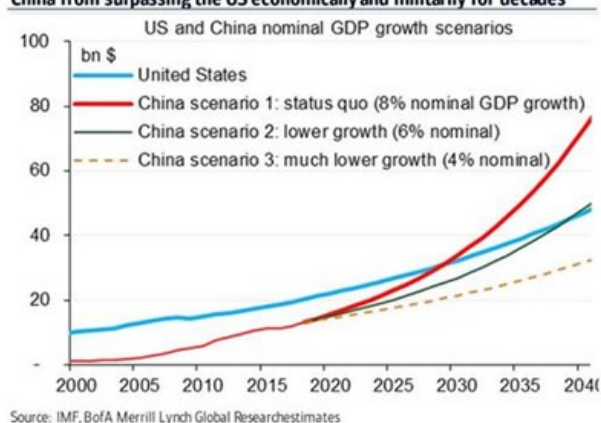
The term of War is in our opinion not exaggerated as we suspect that the main strategic goal for USA is to curb the rise of China and to preserve the country's role as the dominant superpower. The collateral damages of the current trade war are the benefits of globalisation. Goldman Sachs has measured the benefit of globalisation on the net profit margins of US companies: lower sourcing costs, hence lower cost of goods sold have contributed to almost ½ of the margin increase over the last 15 years (left hand graph). A good part of this lower COGS is the result of globalisation.

Chart 26: Globalization has been a big contributor to S&P500 net margin expansion in the past 15 years



Source: FactSet, BofA Merrill Lynch US Equity & US Quant Strategy

Chart 27: A modest drop in the Chinese GDP growth rate would prevent China from surpassing the US economically and militarily for decades



Source: IMF, BofA Merrill Lynch Global Research estimates



Friday Morning Coffee Nr. 58 — Wounded in Action

The political focus of the Trump administration is however on the graph on the right side. If the US, due to the trade war, is able to bring down the growth rate of the Chinese economy by a couple of percentage points, the US will keep its economic status as N°1 economic power for many years to come, at least for the next Presidential term.

In our opinion, **it would be naïve to conclude that Trump will let go easily and withdraw from the trade battlefield without major concessions from China. It would also be naïve to conclude that China will abandon its project to become a superpower.** The risk we have is that we are in for more battlefield action till the damages are high enough to force both parties to compromise.

What does this mean for our European value portfolio ? First, investor sentiment could remain subdued for as long Twitter messages hit the headlines or Chinese companies are being attacked. Secondly, certain sectors like the automotive industry will continue to be under fire as the attention of the US will turn at one stage to that corner. We have currently only 1 investment left in that space namely the German Duerr.

The opportunity lies in the fact that high noise levels and investor uncertainty leads to mis-pricings in the stock market as good, solid businesses are being sold down with the market or simply due to their lower liquidity. This creates opportunities for the long term contrarian and disciplined investors we are : so no time to take a nap on the battle field.

I wish you a nice weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
May 24th, 2019

European Capital Partners (Luxembourg) SA ("ECP") is responsible for the publication of this promotional document. ECP is an asset management company based in Luxembourg, registered at JF Kennedy avenue 35a, L-1855 Luxembourg (RCS Luxembourg, B 134.746) authorized as an Alternative Investment Fund Manager ("AIFM") of the Luxembourg law of 12 July 2013 and supervised by the Commission de Surveillance du Secteur Financier (CSSF). This document is published for information purposes only and gives the opinion of the Investment team at the time of the publication. It does not constitute an offer to buy or sell financial instruments or investment advice and does not confirm any transaction unless expressly agreed otherwise. Although ECP carefully selects the data and sources used, errors or omissions cannot be excluded a priori. ECP cannot be held liable for any direct or indirect damage resulting from the use of this document. The intellectual property rights of ECP must be respected at all times; The contents of this document may not be reproduced without prior written consent. Any investment involves risks, such as the risk of loss of initial capital. Please read the Prospectus of Selected Funds, their Key Investor Information Documents (KIIDs) and financial reports before making an investment decision to understand their specific risks, costs and conditions. Those documents are available on www.ecp.lu. Past performance does not guarantee future performance. Please refer to an independent tax advisor for country tax information that can change at any time and analyze the tax impacts of any investment on your personal situation.