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Dear Fellow Investors,

We wish the news were better, but the trade war is already affecting the global economy and we are now bracing for some rough waters ahead. It's not too late to avert a global trade disaster, but we are taking precautions in case there is one and we're taking a more conservative investment stance as trade tensions rise.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q2 2018	0.48%	3.43%	-2.95
2018 Year to Date	1.47%	2.64%	-1.17
Annualized Return Since Inception	10.33%	10.17%	+0.16
Total Return Since Inception	167.4%	163.3%	+4.1

Data reflect total returns (including dividends) net of fees as of 6/30/2018. Inception date is 7/1/2008. Returns are unaudited. Your individual returns reported on your statements may vary from the composite depending on when you invested and upon any special instructions or restrictions applicable to your account. The composite return is the time-weighted return of all our accounts added together into one big pool. We believe it is the best indication of how the average client fared during these time periods.

Front Lines of the Trade War

In our last letter we covered the topic of tariffs in depth and made the case that they are exceedingly bad for the global economy. We were on the brink of a global trade war and now the war has begun. We are not happy about these developments and believe the curtailment of global trade is bad for our investments. As investors, and as your advisors, we are increasingly worried that unwise trade policy decisions could push us into another recession. We are currently enjoying a strong economy with low unemployment and that tailwind is driving growth. However, we are already feeling the effects of the tariffs. Casualties to date include such large firms as Tyson Foods, Daimler, Harley-Davidson, Brown-Forman (maker of Jack Daniels Whiskey), Volvo, and General Motors.

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It's no coincidence that car companies are on this list. Cars are a textbook case of globalization. Car companies build their vehicles and source the components in countries across the globe, not just in their home markets. The best-selling U.S. auto exports to China are BMW and Mercedes models[1]. Six out of the top ten best-sellers are German cars built in American plants by American workers. This can get complicated quickly, but if we follow all the strings, China is putting tariffs on American car exports in retaliation for U.S. tariffs. That will hit BMW and Mercedes vehicles made by American workers. Chinese people will buy fewer cars, the German companies will have lower sales, and American workers will lose their jobs. General Motors warned Friday that the tariffs would lead to "less investment, fewer jobs, and lower wages"[2] at the iconic American company. They are a global company too. The most popular car Mexico exported last year was the Chevy Silverado. As we said in our last letter, there are no winners in a trade war, only losers.

Our analysis of the situation suggests that the global economy will be hurt by a trade war, perhaps badly hurt if President Trump persists with these policies. Therefore we have taken a more cautious and conservative stance on our investments. Other stock investors are getting nervous as well. The U.S. markets have managed small gains this year from momentum stocks like Amazon and Netflix, but we believe those will be the first bubbles to pop if the economy runs into trouble. Overseas markets are already falling. We're currently looking to keep our money in blue-chip companies or firms with hard assets like real estate.

If the situation does deteriorate, we'd look for opportunities to pick up high-quality companies at a discount and we'd like to have cash on hand for those eventualities. As always, we think the best way to get through a downturn is to own the best companies that will survive and thrive, rather than trying to time the market. There may also be opportunities to buy overseas if other countries use this opportunity to trade with each other directly and avoid the U.S. entirely. Of course, we hope that cooler heads will prevail and this act of self-sabotage will be averted. However, we need to be prepared for the rough weather that we now see on the horizon.

Trade Deficits are HUGE and BAD, right? Not So Fast….

We are getting fed up with the rhetoric around trade deficits and think it's time to set the record straight. President Trump uses our alleged trade imbalance with our trading partners (now portrayed as our adversaries) as a reason for the tariffs which are about to strangle our economy. We are tired of mere assertions being passed off as data and feel the need to explain what a scientific, data-driven analysis of trade imbalance might look like when you strip away the populist rhetoric.

Economists have done quite a bit of research on trade imbalances. Lest you think that this is just a partisan issue (conservative economist think one way, liberal economists another), this is not the case. Most economists do not see trade imbalances as a problem.[3] Those who do, from the left and the right, are actually

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[1] https://www.bloomberg.com/news/articles/2018-06-22/the-toll-of-trump-s-trade-war-more-damage-than-to-just-daimler

[2] https://www.nytimes.com/2018/06/29/business/automakers-tariffs-job-cuts.html

[3] https://www.nytimes.com/2018/03/05/us/politics/trade-deficit-tariffs-economists-trump.html

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united in their agreement that tariffs are not a solution to the problem. This is one instance where the science is pretty clear. So it is frustrating to hear the President make these claims about the trade deficit and see people nodding along. We think everyone – or at least our readers – should understand the basics of trade imbalances so they can come to an informed opinion about trade policy.

A trade imbalance is a difference between what a country imports and what it exports. A deficit implies we import more than we export. A "favorable" balance of trade means exports exceed imports. As Milton Freidman explains,[4] this terminology is misleading in that it implies one scenario is good and the other bad. On the contrary, it's much better for us if we can consume more while producing less. Say you had a job where you had to work extremely hard to produce a lot, but in return you were paid very little. Now consider the reverse – you work just a little but receive a huge paycheck. Which would we aspire to? The latter situation is analogous to our trade with China. We produce goods and services that China buys, but they are relatively high-value goods with high price tags. China can afford to buy some of these. Being the rich nation we are, we can afford to buy many more Chinese goods. Thanks to this imbalance, we enjoy a level of consumption that most Chinese people could only dream of. Do we want to switch places?

Another way to think about the absurdity of "good" or "bad" trade imbalances is to put it in everyday terms. Say you buy your lunch each day at Dave's Deli. Dave makes a great sandwich and it saves you packing your lunch in the morning. Every day you give Dave $7 and all you get is that delicious sandwich. You have a massive trade deficit with Dave because Dave doesn't buy anything from you. You might be concerned that all your money is going to Dave and you need to restore balance. Should you get Dave to buy a lot of things from you (invite him to your garage sale??) or start making your own lunch? Let's say your job pays $25 per hour. Is it worth it to work one less hour to make your own lunch? It turns out that buying your sandwich saves you time and effort that could be better spent on your job.

Let's say you're still worried. Would slapping a tariff on Dave make things better? That's an absurd thought. You could ask your local alderman to place a $18 tax on all sandwiches. Now that sandwiches cost $25 it is worth your time to make your own lunch. That would probably put Dave out of business. Is anyone better off in this scenario? You are stuck making your own lunch, you lose one hour of paid work time each day, and Dave is out of a job entirely. There are no winners with tariffs in the end, only losers. Economic data do not support the notion that tariffs are a solution to trade deficits.

The situation around trade is also less black-and-white than President Trump makes out. While we do buy more goods from China than they buy from us, China buys more services from us. So we have a trade surplus when it comes to services. For example, the excellent colleges and universities in our countries attract Chinese students and the money they pay for an education is a U.S. export. So we're exporting things we do well (education, technology, etc.) and importing things like consumer goods which can be cheaply produced in China. That is very much in our favor.

For economist who worry about the trade imbalance, their focus is not on goods but on money. Some countries have manipulated their currencies to make their goods artificially cheaper and American exports artificially more expensive. However the biggest concern is the U.S. federal budget deficit. Because the government spends more than it collects, we have to borrow money. Much of this money comes from

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[4] Milton Freidman on Trade Balances and Tariffs. https://www.youtube.com/watch?v=zv5SiQpG6sg

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foreign countries who own more and more U.S. debt. Curtailing this massive debt could help reduce the trade imbalance. Currently we are doing the opposite: increasing our debt while curtailing consumption with trade restrictions. That's a recipe for disaster and we hope that cooler heads prevail before things get out of hand.

What a Difference Ten Years Makes

Looking back at the stocks we highlighted in our first letter (July 2008), we recall how different it was to invest in those days. Picking stocks sometimes feels like we're trying to guess the ending to a book having read only the first chapter. Even when we're right, the whole picture tends to evolve in ways we couldn't have expected. For our first five years, we found good companies like East West and Sotheby's that had been written off for dead. This is classic value investing. Things like low debt levels and fat profit margins keep companies afloat even in bad times and allow them to thrive in good times. About halfway through the decade though, the stock market started to care less about who was (or wasn't) going to die and focus more on companies with explosive growth. Wall Street gave us a new acronym around this time – FANG stocks, representing Facebook, Amazon, Netflix, and Google, sometimes adding another "A" for Apple. Below, we've put together a table showing growth in earnings per share (EPS)[5] compared to growth in share price over the past 10 years. (We own Sotheby's, East West, and Apple. We excluded Facebook because it wasn't a public company ten years ago.)

	Increase in Earnings per Share	Increase in Share Price (with reinvested dividends)
S&P 500	72%	148%
Amazon	438%	1,930%
Apple	1,296%	776%
Netflix	807%	5,866%
Alphabet (Google)	148%	263%
Sotheby's	-13%	102%
East West Bancorp	88%	280%

Change in Adjusted Earnings Per Share as reported by the company for the trailing 12 months ending March 31, 2008 and March 31, 2018, adjusted for the impact of tax-law changes where reported. Stock return is the 10-year total return through March 31, 2018. Source: Company Filings, Morningstar

What this table shows is the disconnect between growth in a company's earnings vs. its stock price. If Wall Street thinks tomorrow will be just like yesterday, then then stock returns should mirror earnings growth one-for-one as the P/E Ratio remains constant. The stock return exceeding EPS growth indicates the market thinks tomorrow will be better than yesterday. The reverse means the market believes the company's brightest days have passed.

Two names on this list make zero sense to us; they didn't make sense ten years ago, and they make less sense now. Amazon's adjusted earnings were about $1.20 for the 12 months ending March 31, 2008. They were

[5] Adjusted when possible to exclude the one-time impact of recent tax law changes.

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$6.45 for the past 12 months. Yet the stock price has increased by close to 2,000% and the P/E ratio presently sits close to 250. Netflix is even more confounding. Adjusted earnings there increased eight-fold while the stock rose *fifty-eight* fold. Its P/E ratio currently stands at 260. Remember the dot com bubble in the late 90s? The most egregiously overpriced stocks didn't have positive earnings making P/E meaningless. One that did was Cisco. Its P/E peaked around 200 before the stock dropped 86%.

Returning to our earlier analogy of guessing the ending of book based on what we read in the first chapter, we had some easy answers ten years ago. "Once upon a time, there was a poor, mistreated orphan…." You can bet the story ends with a handsome prince. We passed on Amazon and Netflix in 2008, yet they went on to trounce every stock we bought by a wide margin. We hope the story has a happy ending for everyone – those who own the stock and those who don't. But right now, the narrative for Amazon and Netflix reads something like, "Once upon a time, there was a perfect princess living a perfect life in a perfect kingdom…"

Your partners in investing,

Rachel Barnard, PhD, Todd Schrade, CPA, and the Midway Capital Team

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