Weekly Market Flash

Carlyle, Tolstoy and the 2018 Investor

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History is simply a collection of the biographies of great people, the charismatic heroes and anti-heroes whose supreme self-confidence, fanatical drive and decisiveness write the chapters of the ages. So believed Thomas Carlyle, the 19th century Scottish philosopher and historian who penned works on Napoleon, Frederick II of Prussia and a "Great Man Theory of History" in general.

Or, history is actually not that at all. History enslaves all humankind, great and small alike, to bit-player roles in a complexity of events, near-events and non-events that evolve in ways unfathomable and inaccessible to simplistic storytelling. So believed the great Russian writer Tolstoy, who devoted over 1,000 pages to a novel, *War and Peace*, to make this point.

To read *War and Peace* is to read of the cacophony of random events, missed communications, uninformed decisions and human behavioral traps that ultimately shaped events like the battles of Austerlitz and Borodino – not the genius of Napoleon, nor the resolve of Tsar Alexander I, but those thousands of probable and improbable things that had nothing to do with the supposed destinies of great men. "The tsar" wrote Tolstoy "is but a slave to history." Outcomes have as much to do with weird supply-line hiccups, melting ice on river crossings and rioting prisoners as they do with those bold commands from the top generals.

Tolstoians Under Fire

Investment markets have been in a decidedly Tolstoian frame of mind for several years now. This view aligns with an understanding of the global economy as its own inscrutable, constantly evolving sea of complexity wherein rulers of nations and titans of industry float and bob like tiny specks on the surface. Geopolitical flare-ups happen; currency crises spring up in the Eurozone, citizens vote in seemingly irrational ways, but the global economy just keeps on keeping on. Real GDP keeps growing, corporate earnings grow even faster, job markets and consumer prices reassure us that there are no nasty recessions lurking around the corner. This mindset reached its high point in 2017, when volatility reached historically low levels no matter how crazy, dire or improbable the news of the day.

But this Tolstoian view has run into some stiff headwinds among investors in early 2018. There seems to be a newfound sense, among many, that humans vested with considerable power can, in fact, make consequential decisions that directly impact the value of portfolios of risk assets. The specific catalyst bringing out investors' inner Carlyle is the growing threat of a trade war. Thursday's reversal of 2.5 percent on major benchmark indexes was driven in large part by the latest show of bellicosity by the Trump administration and threats of retaliation by China, currently the primary intended target of a new round of punitive tariffs. Investors who were hoping for a quick V-shaped recovery from the original sell-off a few weeks ago can blame that original announcement of new tariffs on aluminum and steel for cutting off the nascent recovery in share prices.

Great (by which we mean "vested with lots of power," not to be confused with "good") leaders making bad decisions: a Carlyle-esque reprise of that ill-fated summer of 1914? Or, ultimately, a brief tempest that sooner or later will fall back into an inconsequential ripple on the ever-expanding sea of the global economy? Your own view of markets in 2018 may well be shaped by whether you are more inclined to agree with Carlyle or with Tolstoy.

The Corporate America Variable

If Trump and his inner circle continue to raise the stakes on a trade war, they will be due for an earful from many corners of Corporate America for whom such an outcome is the very opposite of their business growth models. S&P 500 corporations derive in the aggregate more than half their revenues from outside the US. Almost any major company that produces a good or service with a viable market in China is focused on that market for a considerable amount of its potential future growth. This doesn't just apply to the obvious names of retailers like Starbucks, Nike and Yum! Brands that have been in that market for years, but to firms in any industry from property & casualty insurance to pediatric nutrition to semiconductors. Sure, steel producers may cheer the prospects for protective tariffs in the short run, but their collective market cap weight is considerably less than that of those who forcefully champion more open trade.

So what will it be? Is the global economy, the creation of millions of random interactions of events and non-events and near-events over the past four decades, destined to simply keep evolving, too massive and too necessary in its current form for a sudden reversal into autarkic nation-states waging economic war on each other? Our general inclination is to take a Tolstoian view of things, and we think it likelier than not that the threat of $60 or even $100 billion in punitive tariffs and associated bellicose posturing will not have the power to topple a global economy worth more, in nominal GDP, than $85 trillion.

That is not to say that we have a Panglossian "best of all possible worlds" take on things. Tolstoy never said that history always works out for the best. Sometimes those random, incoherent things that happen or that don't happen lead to unhappy outcomes – see 1914, 1917 and 1933 as examples of this in the last century. Disciplined investing requires keeping emotions in check, but it also requires us to not rule out improbable, but possible, scenarios.

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