Fortis Financial Group

Dear Clients and Partners:

We wanted to take a few minutes to reach out regarding the recent market action.
Since the tariffs were announced the markets have, obviously, reacted very negatively. A quick summary of what occurred.

President Trump announced his tariffs on Wednesday afternoon. Initial reports by a few news outlets were that there would be a 10% blanket tariff. The markets trade in the after hours until 5PM PST. The markets responded to these initial reports very favorably trading meaningfully higher.

As the press conference continued it became clear that there were going to be 10% tariffs, but that was going to be the floor not the ceiling. The ceiling, if there is currently a ceiling, was much higher especially for two of our main trading partners, China (34%) and the European Union (20%).

We are not going to discuss any of the strategy behind tariffs we are simply going to discuss the impacts.

We grew up reading Warren Buffett letters. There will not be a Warren Buffett platitude here (be greedy when others are fearful) but instead we are going to attempt to do what he does best, tell a small story to explain why the markets responded so negatively.

Simple Example

Let's say you own a firm that imports goods. Generally you have a good-sized mark up on those goods. For example, if you buy a good for $50, you will sell it for $100. This leaves you a $50 dollar profit or a 50% "margin" on that good. With that $50 you then pay all of the other expenses of the business. Many businesses that sell products will operate with around a 10% net margin once everything else has been paid (employees, transportation of products, storage, taxes, etc., etc.). This means the other expenses are around $40 or so per $100 of products sold leaving $10 of profit.

The market responded favorably to 10% because it is a manageable number for most businesses. It would not be fun, but it is manageable. Continuing our example from above a 10% tariff would increase the cost of the good by $5 (10% of $50 cost). The business owner, instead of having a $10 profit now has a $5 profit and the government has the other $5. To off-set this loss of $5 the business owner can (i) increase the price of their product by 5%, (ii) make adjustments to lower the other operating expenses, (iii) work with their suppliers to reduce the price of the product somewhat to "share" the tariff or (iv) simply make $5 less. Most businesses would likely do some combination of the above and profits would settle somewhere between the old $10 and the new $5.

A 20% tariff (or higher) creates very different business decisions. The cost of the product is now $60 ($50 product cost + $10 tariff). The operating expenses of $40 have not changed and therefore profit is now $0 or potentially a loss. In this scenario, where we currently find ourselves, business decisions have to be made quickly since tariffs are charged when the product lands not when you sell it which might be months later.
The tariff is not negotiable, it must be paid, so every other expense now must be scrutinized. Every expense for a business is someone else's "revenue". For the suppliers it is their revenue that they use to keep their business running, for employees it is their paycheck, etc.

The business owner can raise prices by 10% to offset the tariff ($110 selling price instead of $100) but how many customers will they lose? Will their competitors raise prices or take advantage of their price hikes by keeping their prices lower and taking "market share", especially if the competitors are larger businesses with a lot of funding and/or larger profit margins.

On top of this, the business owner now must plan for some sort of economic disruption, potentially a recession which will mean either lower sales or lower growth even if the business is still growing. Most firms try to plan many years ahead, especially capital-intensive ones. The rules have now changed for them.

All of this creates significant uncertainty.

The Markets and the Economy

This scenario, applied to millions of businesses, is where we find ourselves currently. People are fond of saying that the markets are not the economy. We don't necessarily agree with that argument.

Individual stocks are regularly mis-priced but overall the market is generally a pretty good indicator of the economy. We can tell you we have already seen the "belt tightening" having spoken with many clients. The more expensive vacation is being re-thought, remodels put on hold, etc. If the uncertainty continues for months, there is very little chance that this does not flow through to the economy, even if we avoid a recession. This is what is currently being reflected in the ~10% drawdown in markets the last few days. To the extent uncertainty is lifted (whether by countries negotiating lower rates, broad based reductions in tariff rates, the Fed coming out and providing some kind of backstop, etc.) the markets can find some solid footing and begin to reflect a more certain future. To the extent uncertainty increases (by tariff retaliations, escalating rhetoric, rapid changes to prior decisions made, etc.) markets likely remain challenging and volatile as they reflect uncertain economic outcomes.

What We Will Do

One of our favorite sayings comes from Charlie Munger, who was Warren Buffett's business partner. People would ask him how he structured his day given how much he had going on. His response was "do the work on your desk first". In other words, do the work you need to do that day before worrying about anything else.

Our work is to (i) pro-actively review your financial plan, (ii) reach out to check in, whether or not we recommend any adjustments and (iii) always be available to ensure the best decisions are made with the data available.

We have spoken with many of you in recent days / weeks but we will continue to reach out as we work through this period of uncertainty.

As always, please do not be shy about reaching out day or night,

Fortis Financial Group

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