<u>The Outlook: Jan. 30, 2019</u>

Earnings season shines its clear light on the real world, as usual.

Quarterly Earnings Season always shows us <u>facts</u> about what's going on in the real economic world. Four times each year, for a few weeks at a time, we investors are like drivers who've been feeling our way along a foggy mountain road at night, when we suddenly rise out of the fogbank and find a bright moon lighting up our surroundings. Then Earnings Season ends and we spend the next two months groping through the fog again, trying to make sense from countless murky government surveys, statistics and other questionable clues. We're less than halfway through our time under the moonlight, this Season, but let's ask what we are seeing so far.

- <u>**The U.S. economy is still strong . . . and profits are two things: they're strong, and they're distinctly stronger than "the market" expected.**</u>

- <u>**The rest of the world is still muddling along.**</u>

  Despite plenty of anxiety about everything from the "yellow vests" to Brexit, and quite a few distinctly louder quarrels within Europe (mostly pitting France and Germany against several of the smaller EU members) business in Europe is still doing exactly what it's been doing for a long time: muddling along, trudging slowly forward, frequently stopping to catch its breath. More interesting is Asia, because <u>only China</u> is clearly "softer and weaker," and nearly everyone else is doing pretty well.

- <u>**China's economy is indeed softer and weaker . . . "softer and weaker,"** ***not*** **"falling apart."**</u>

  A couple of weeks ago Apple issued its warning about sharply-falling iPhone sales in China. These early days of Earnings Season have seen a flock of companies (so far) raise their hands and cry "Me too!" The difference between Apple and the "Me too!" flock, so far, is that the flock's China-market weaknesses have mostly been moderate, not "sharp" like Apple's.

  <u>*Here's the heart of the matter, on China.*</u>

  1. It is indeed a big engine behind worldwide economic growth. That's why the market—and countless expert commentators—are so quick to shout "sky is falling" warnings when they scrutinize China's plentiful weaknesses.

  2. But China's economy is <u>not</u> the same as the U.S., or Europe, or Latin America's shaky rollercoasters (Argentina and Brazil.) Its biggest difference, by far, is that it's less vulnerable to "falling apart" than the others. It's less vulnerable because of some of its major weaknesses—not despite them. Pretty strange?

     What a great many experts don't seem to grasp about China is that its spectacular 25 years of growth <u>would have been much more spectacular</u> without the heavy, often-blundering hand of "Communist" government smothering its potential. The rocket fuel in China's growth engine has been a limited dose of freedom and opportunity for a billion people. China's dictators have watered down that fuel from the beginning by favoring giant, lumbering and corrupt state-owned industries; by sharply restricting people's freedom to do whatever they wish with their money; and by sharply restricting foreigners' ability to do whatever they wish, in China, with <u>their</u> money. (Those are just a few of the usual staggering list of growth-smothering rules imposed by "big governments" which think they know how to "run" their economies.)

Such rules have sharply slowed China's growth these 25 years . . . but they've also cut down China's vulnerability to the only weakness of free markets: they "panic and run" from time to time, because anxiety and fear periodically sweep through crowds of people. It is their nature. When it happens, it always takes temporarily (and usually moderately) bad news and causes people to act as if it's catastrophic news. Rain will fall, sometimes. The sky never falls . . . but the crowd will act like it is, for a while.

The real economies of the U.S., Europe and the rest of the world are always vulnerable to this weakness of crowds, because the crowds are free to do anything they wish with their money—fast. Every serious economic downturn is exaggerated and deepened by the fear-prompted actions of the free-market crowd. But in China, by comparison, the crowd's hands are tied. The banks are an arm of the government and are not dependent on potentially fearful foreign money—so it fundamentally doesn't matter how weak or insolvent they might be; and fleeing to foreign banks and investment markets, while not impossible, is not very easy for most of the wealth in China. That might sound good, but it's not—it has cost China a lot of growth over these decades, which has simply been masked by the amazingly high growth created <u>despite</u> the rules.

Hence China's economy is "softer and weaker" but highly unlikely to "fall apart." It's possible that China's dictators grasp this, but it's certain that they're not happy about "softer and weaker," regardless. The President's hard line on the "trade war," so far, has certainly caused some of China's weakness—so a "deal" to end the war would certainly help China's growth. That doesn't mean there will be a deal any time soon, though, because while China's economy would absolutely be helped, China's dictators would risk losing face, which no doubt seems to them a high price to pay merely to help out a billion citizens.

That's what we're seeing under the clear light of this Earnings Season. And the market?

The Season's facts are not helping the market return to its October—December gloom. Despite the confirmation of pain in China, the Season is showing too much strength on Main Street USA (and elsewhere) to support a plunge back into the nightmare—especially when that strength rests on a foundation of stock valuations which are mostly excellent bargains, and often ridiculous bargains. Every position at Outlook falls into one of those two categories. We'll be holding and looking for chances to buy more, as always.

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