2Q2018 Market Commentary

July 2018

Has defeat been snatched from the jaws of victory? One might rightly wonder about this of late. After the victory with corporate tax reform in December along with the reduction in some regulatory burdens, couldn't the current administration just let the benefits flow through to the economy and financial markets? After all, with the economy having just finished possibly the strongest quarterly GDP growth (over 4%) in nearly four years, the policies are having their desired impact on jobs and income. Yet in the midst of such signs of prosperity, the president decided to change up all past conventions. Regardless of economic philosophy or party affiliation, we all have to recognize: Toto, we're not in Kansas anymore! None of the old rules seem to apply when it comes to trade negotiations under President Trump.

One of those old rules that still applies today, however, is that trade wars are bad for the U.S. and world economies. Herbert Hoover didn't exalt the passage of the Smoot-Hawley Tariff Act of 1930; he supposedly reluctantly signed it. Yet the president offers up trade broadside after broadside, proving he's adept at the game of brinksmanship; but can his tactics deliver a more level playing field? Since the market has no real clue, it is moving sideways at best for the time being. It's surprising that the S&P 500 even gained 3% in the quarter. Perhaps we should all go home and watch the World Cup instead.

The president's willingness to walk away from deals or to accept short-term pain to "win" a trade war could lead to good outcomes if he or his advisors step back from the brink at just the right time to accept a deal. What might that look like?

The North American Free Trade Agreement seems to be hung up (primarily) on the sunset provision. Trump wants it to be renegotiated in five years! Why would anyone accept this? How can companies plan for the long-term, knowing in five years the rules could be changed? As opposed to no sunset provision (as is NAFTA currently), 15-20 years could be acceptable and perhaps some intermediate ground can be reached.

It is time to take U.S. and European auto tariffs to zero. If this were agreed to (and a few other items), an agreement to end the new punitive tariffs could be reached quickly. Problem solved.

Negotiating with China poses the greatest challenge as China's forced transfer of intellectual property (IP) rights to Chinese-owned companies and its outright theft of IP are huge barriers to completing a deal. The devil is in the details on this, but if China shows signs of being willing to make changes, perhaps the tide can be turned away from protectionism.

After all, isn't Kim Jung-un our friend now….OK we'll pass on that one; just stay tuned.

The problem markets face seems to be the fear of binary outcomes. Negotiations could turn out really good or really bad. And even the good GDP growth news might not be as good as it looks at first glance. Due to the fears regarding trade wars and tariff costs (including retaliatory tariff actions), businesses have been stocking up on materials and intermediate goods inventory as fast as possible, and exporters have been madly shipping products out of the U.S. for the same reason. Such gains steal production and sales from future quarters.

Yet there is much good news in the midst of the confusion. The U.S. has become as much the swing producer of energy as Saudi Arabia. In the last week of June, U.S. oil exports hit an all-time high run rate of 3 million barrels per day, benefiting net exports. Profits of the energy sector are set to recover to more normal levels in 2018 as oil prices (WTI) have rebounded to the $65-$70 per barrel level we've maintained since the lows of 2016. Furthermore, the roughly 7% boost in corporate profits from the reduction in the statutory tax rate from 35% to 21%, along with the repatriation of foreign retained earnings of U.S. multinationals, is also boosting capital spending. Such gains would be even stronger were it not for the uncertainty created by trade policy.

We project that GDP growth could be sustained around 3% if the trade negotiations do not turn into an all-out trade war. If negative trade actions last for an extended period, however, 0.50% to 0.75% of GDP growth could be lopped off. Market valuations would likely experience some correction if this latter case occurs, but this wouldn't be the disaster markets seem to fear.

None of this geo-political theatre seems to have changed the Federal Reserve Board's resolve to continue boosting the Fed Funds Rate. The rate of price inflation is drifting higher relative to Fed targets, the economy is strong, corporate profits are booming, the big domestic banks all passed their CCAR capital ratio stress tests, and rising short-term rates force borrowers to rethink the excessive use of debt leverage. So staying on the current course appears likely.

While the yield on the one-year T-Bill climbed nearly 60 basis points in the first half of 2018, 30-year T-Bond yields rose only 25 basis points. This flattening of the yield curve (with short-term yields rising more than the long-end of the yield curve) has prognosticators worried about the potential for recession, though we disagree. Rising rates are restoring more normal bond market functions, and we aren't anywhere near the high absolute yield levels that might imply an inverted curve could trigger a recession. But the combination of the strong exchange value of the U.S. dollar and rising short-term yields has continued to make long-term Treasury bond yields attractive to foreign investors, hence the flattening. Trade fears exacerbate this problem as well because the dollar and Treasuries are the safe haven from many of the risks around the world.

Yet despite it all—or rather, as a result of the volatility, confusion and fear—we continue to find new opportunities in which to invest client assets. Environments fraught with uncertainty tend to offer up mis-pricings, the required raw material for our strategies' portfolio construction. The only thing constant is change.

The analysis and opinion expressed in this report are subject to change without notice.