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Slowing but not Shrinking

Perspective on the Markets

It's been a pretty good year in the markets so far this year. Have you noticed? Sometimes, we can get focused on the short-term (the markets are off their highs) and miss the big picture (the S&P 500 is up over 18% YTD as of the beginning of September). However, the fourth quarter last year was so bad that much of the increase has been recovery from that loss. Still, it's been a good year to this point.

The temptation we all face is to take each market high as a signal to reduce our equity exposure for the next downturn. I think that would be a mistake at this point. Although most economists are forecasting a slowdown in GDP growth, most are also not seeing the next recession within the next year or so. This is a good time for proactive money managers with a strong track record through varied market cycles. Don't just assume that what worked before will continue to work going forward.

A History of Trade Tensions

When China opened its economy to outside investment, US companies moved quickly. It was viewed by both sides as mutually beneficial—China could modernize its industries while American companies gained access to over a billion new customers with low employment costs. Trade policy was profit-driven seeking free and open markets.

China, for their part, didn't want free and unfettered trade. They did not want to be seen as just a new market for exploitation but rather an economy worthy of investment. In order to do business, companies had to relocate significant headquarters functions. Chinese nationals had to be hired into the leadership structure. Secrets had to be shared. Companies put up with this for the profit opportunity.

During early trade talks, the goal was to maintain the status quo. American business interests wanted to maintain their Chinese foothold—Washington was admonished.

As China's economy matured and their middle-class developed, American businesses were seen more as rivals than benefactors. Chinese nationals took the training and secrets learned from their American employers and started competing companies. China was becoming a sapling superpower with open plans to challenge American interests.

Over time, American policy changed to engage China more as a trading and policy partner. They were invited to join world organizations as equal members… and their human rights abuses were ignored in favor of the status quo.

China is now a pre-superpower and the greatest rival in the world to the existing superpower… the United States. There is a new business dynamic as well. Companies that used to lobby Washington to maintain the status quo are calling for help to stop the abuse of their trade secrets and intellectual property. Profits are now lost to the rivals they helped create due to China's unfair trade policies.

When President Trump campaigned for office, one of his promises was to strike better trade deals. He was laughed at. Why would China, specifically, come to the negotiating table when they have all of the advantages already? Tariffs. President Trump initiated tariffs to force negotiation… and it is working. The goal is not to have high tariffs between our countries but rather to tear them down. They are reciprocal. The United States shouldn't fund its next superpower rival. As China grows, they should meet us on their own two feet.

Over the years, China had gotten used to trade deals that maintained the status quo. They are struggling to keep up with Trump's resistance and tactics. Although initially willing to make minor concessions, early this year they decided on a harder stance. There is a view that they might be looking forward to the next presidential election hoping to get back to the status quo they were used to. That would likely be a mistake on their part. As mentioned above, Chinese trade policy has largely been driven by business interests. That hasn't changed. The next president will feel the same pressure from US business interests in China to continue the course charted by President Trump. He increased tariffs to 15% on $300 billion of Chinese goods at the beginning of the month to make the waiting game that much harder. The status quo is no longer acceptable.

Are the tariff's helping? In a way, yes. They are demonstrating American resolve in the trade negotiations. China has the weaker hand. At least 20% of their GDP is driven by exports. 20% of those exports are to the US. That means that 4% of their GDP is affected by the tariffs. As they already have a debt to GDP ratio of over 250%, they aren't in a strong negotiating position.

The US is in a much stronger position. Exports to the whole world make up only 8% of US GDP. We have much greater latitude in our negotiations before damaging our

Continued from the front:

overall economy. There are pockets of pain, to be sure. However, short-term pain should lead to long-term gain, if negotiations bear fruit. Trade with China is so one-sided that any movement from the status quo will benefit the US.

How will this play out? I think the likely short-term outcome is a small mutual concession by both countries that reduces the tension. China's stubbornness will hurt them more than us if they dig their heals much deeper. Long-term solutions on human rights and intellectual property will take time. The old world superpower is working out its future relationship with the upcoming world superpower. There will be decades of negotiations on many issues… and many skirmishes both physical and philosophical. Hong Kong and Taiwan are current flashpoints. This is only the beginning.

The Yield Curve

If I had to choose one economic signal investors are watching closely right now, it would be the yield curve. This curve shows the interest paid at different durations of debt.

When the yield curve is positive, bonds on the long end of the curve pay more interest than those on the short end. Investors should be rewarded for taking on greater risks in a longer-term investment. When short-term debts pay higher interest than long-term debts, this is an inverted yield curve.

The Fed recently realized that they moved their short-term rate too far for the markets. They have reduced it once already and are forecast to reduce it again. This situation pushed the market toward a negative yield curve.

Why are investors concerned about a negative yield curve? This indicator has been a fairly reliable predictor of recessions. Over the most recent 35 years, it preceded each of three recessions. Going back further than that, inversions preceded the past seven recessions with two false positives.

Recognize what normally happens when the yield curve inverts. The Fed tightens rates on the short-end to combat rising inflation in a heating economy. They intend to "cool" things off a bit. On the long end of the curve, investors shift portfolios more to bonds recognizing that market trends may be preparing to reverse. These are actions taken in anticipation of the next recession. It can be self-fulfilling.

What we have now is a fairly unique scenario. The Fed Funds Rate is nowhere near its usual "tight" level you would see near the end of an economic expansion. Long-term rates remain at historic lows as fears lingering from the last recession haven't subsided. As the economic cycle continues, fears of the next recession grow.

Where are we in the economic cycle? If you believe, as I do, that the economy's recent decade of below-average growth is blossoming into more average, historical growth rates, you may see a current negative yield curve as a false positive. On the other hand, the predictive accuracy of this signal may be a self-fulfilling prophecy. If market participants believe this signal of impending recession, shifting investment dollars may prove them right. The surest way to recession is for capital to dry up. Only time will tell.

Greatest Risks

Right now, the greatest risks to the economy and the markets are the unknowns. The next crisis may be caused by political instability, bad actors, negative expectations, or acts of God. However, without those outside factors the current trend is one favorable to business, workers, and investors.

I am very wary of Europe. I have said for years that the EU is an artificial construct that can't survive for the long-term without true European unification. The economic stress levels are growing. Italian debt alone has the potential to sink the Euro. Contrarian investors who "buy on bad news" may see opportunity in these markets but I think it will get worse before it gets better. Will Brexit be hard or soft? Either way, it will happen and will affect overseas investments.

Although the global economy is forecast to slow a bit, there is opportunity overseas for domestic investors. A dollar forecasted to soften this year should boost overseas returns. Trade tensions aren't likely to result in a domestic recession but there is some risk in China and Emerging Markets. Productive trade talks will help stabilize global growth.

Economic forecasts are assumed relevant looking one year ahead. Beyond that, there are too many assumed variables to claim accuracy. Be skeptical of long-range forecasts.

Do Something

Investors should still remain vigilant with their portfolios and review their holdings. I believe this environment is where the best managers will have an edge over "passive" managers seeking to match index performance. Sit down with your financial advisor and ensure your investments are prepared for the future and consistent with your objectives.

Summary and Call to Action

My investment outlook favors equities over bonds. This is an environment for strong investment managers and careful stock selection. Income-oriented investments may struggle in a low interest rate environment. I think bonds have value as a diversifier for managing risk in a portfolio—as an asset class, I think chasing higher yields in weaker bonds may reduce much of the benefit of diversification.

What to do now? **Take the long view with your investment assets** and dust off financial plans. When was the last time you reviewed your plans? Your estate plan should be reviewed at least bi-annually and updated with every change of life. Most importantly, make sure you have carefully delegated who will execute your documents for you. To review existing documents, develop new plans, or do end-of-year planning, talk to an advisor soon.
