SOUND WEALTH MANAGEMENT GROUP OF RAYMOND JAMES®

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We hope this finds you well! It has, admittedly, been some time since our last *Sound Note*. The financial television pundits have confabulated story after story to ingratiate themselves with viewers – desperate to sensationalize even the most banal news – stretching to claim correlations between marble rye theft in the greater New York City Area with the S&P 500 (the market) performance. In this *Sound Note* we will address past market performance and analyze the historical results and ramifications of trade negotiations and tariffs. Why would anyone steal a marble rye?

The S&P 500 performance from President Trump's election to today [10/3/2018] has been an impressive +36.73% - or *has* it been impressive? Much has been said about the effectiveness and success of past administrations and when to give credit beyond a President's term(s). Please do not interpret this, or any other statements in this note to be an endorsement or censure of the current administration; we will only present historical facts and allow you to create your own correlations and opinions. Further, we deal in the world of finance, so any political views (expressed or implied) are only in the vein of finance and the "economy, stupid." – James Carville/Bill Clinton

When evaluating the market's performance, we need to pose a fundamental question: do we give credit from election, a calendar year, or inauguration date? A different start date can dramatically swing performance, and someone with a bias may choose which date to support their own narrative. Some might choose to point out presidents are handed problems from their predecessors (being born under a bad sign), but you could infer that every president has an equal opportunity for disadvantages and missteps. We have enough modern data to make some deductions.

From President Trump's election to inauguration the market appreciated 6.16%; since inauguration date to today (10/3/2018): over 30% **(returns exclude dividends). The difference between starting performance from election date and inauguration date is over 6 percentage points. Naturally, a commentator or political party will use the most convenient statistics to support their narrative, but the next question is: does it matter?

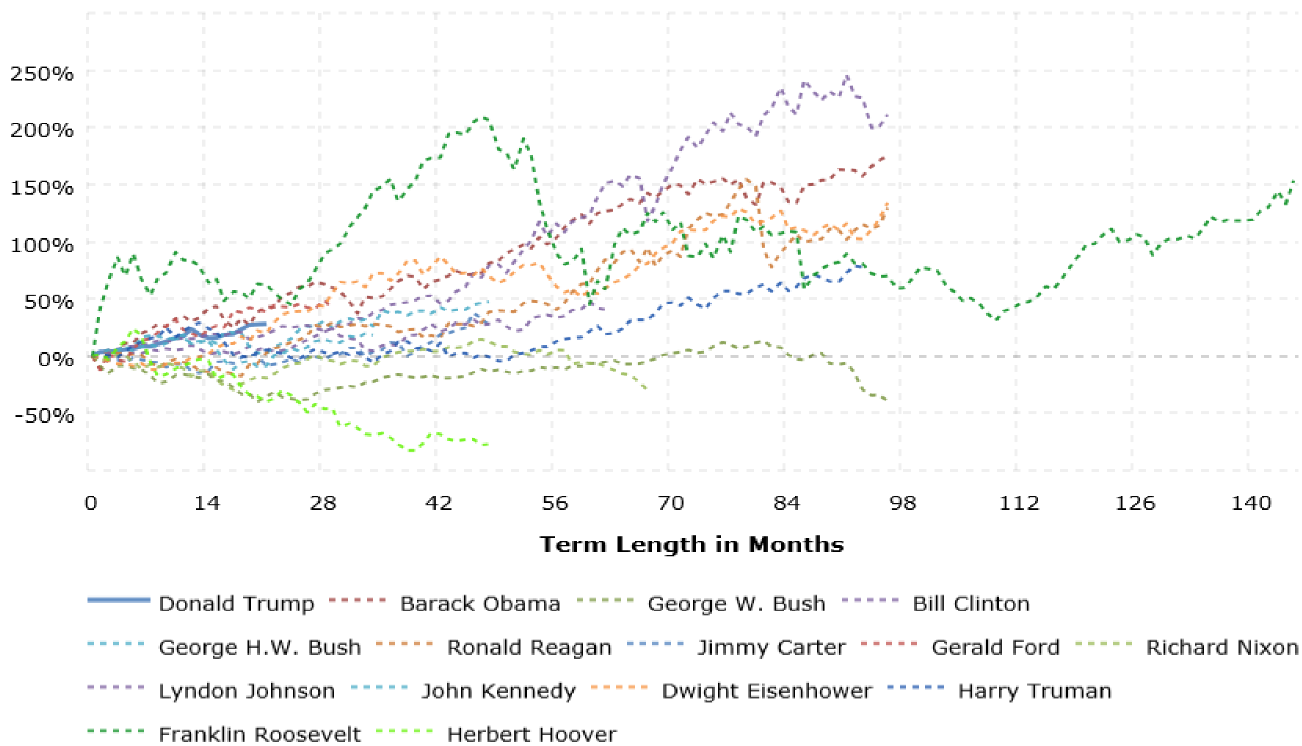

Chart 1 (macrotrends.net)

In an attempt to remain consistent for our analysis, we started the presidential performance at the beginning of each president's inaugural month to evaluate performance (note: not every President started in January) See Chart 1 above. Here are some interesting findings: 40% of the time, the market was down in the first 12 months – yet the arithmetic average first year return was 10.49%; our sampling had a down first term 21.4% of the time but averaged annualized returns of 9.99%; two-term Presidents annualized a 10.70% return; F.D.R. (four-term President) annualized at 12.81%. There were three Presidents who left the market lower than when they started: Hoover, Nixon, and George W. Bush. Although it is enough data to incite either major political party, the data shows 'time' has been the ruler for positive returns.

Generally, the worse the market pull-back, the better the market recovery – most don't think of March 2009 as a good period for the market, but it proved to be a buying opportunity of unrivaled proportions. All of the aforementioned presidents presided while the Standard & Poors existed, and the market has averaged 10.09%[1] since (dividends reinvested; not adjusted for CPI). The S&P 500 (including the 500 largest companies by capitalization) began in 1957, so the modern index excludes: Truman, FDR, and Hoover, and increases the annualized performance to 10.26% (dividends reinvested; not adjusted for CPI). Chances are you will outlive a president's term, and should be focusing on the long-term while considering how to tactically manage the current environment. Basically, we may fret about certain actions of a sitting president, but we have also seen 180 degree changes in policy with new administrations. We have also seen these positive long-term results with varying control of the House of Representatives and Senate, and plenty of geopolitical turmoil (trade, combat wars, recessions, etc.) under every combination of the Executive Branch. If you would like a deeper dive into long-term result and want an interesting look into how investing at the worst times (market peaks) performed, please look at our education piece: *Tim the Market Timer*. We anticipate heightened volatility in the weeks to come as we head into the mid-term elections. *Tim the Market Timer* stands as a great reference for snap reactions, the elevated probability of making investment mistakes as the frequency of reviewing a portfolio increases, and the *Dunning-Kruger Effect* (for more on Dunning-Kruger, please refer to *Tim the Market Timer)* – among other important topics.

While vacationing down at Phase II of the Pines of Mar Gables – where the scarves are a dime a dozen – the scuttlebutt has been engulfed by the trade war with NAFTA, and more specifically China. So, let us discuss our trade with China…

Since we will be dealing in hundreds of billions of dollars (that is 11 zeros after a number) we hope you will allow us some liberty to round our figures. According to the WTO, the trade between the United States and China is approximately $800,000,000,000.00 USD, and, on the surface that sounds like a big trade partner, but, it is not an even deal. Remember, the United States is a service based economy, and China is a manufacturing based economy. The trade breaks down to roughly 75/25 – where the US purchases $600 billion from China and China purchases $200 billion from the US. In this, once China taxes (or penalizes) $200 Billion worth of goods from the U.S.A. going to China, it runs out of things to place tariffs on. On the other hand, the US can levy taxes and tariffs on an additional $400,000,000,000.00 of goods coming from China to America – meaning things made in China become more expensive and force goods to be made elsewhere – from the current administration's trade talks, ideally in the United States. However, the existing Executive Branch and consumer might find it just as effective to have it made anywhere where the US is getting a better (more fair) trade agreement. A full 25% tariff on all imports from China would equate to about 0.7% reduction in US GDP, but this assumes consumers do not shift purchases to goods made elsewhere. At the June 2018 G-7 summit President Trump even posed to all G-7 nations a new trade deal where there are no tariffs at all ("No tariffs, no barriers, that's the way it should be — and no subsidies" – Donald Trump); no one else signed-on for that one, because they would not be able to function without levies and taxes on their exports and protecting their domestic products. An egregious example that has made headlines is Canada's milk export which carries a 270% tariff (holy cow!)… kind of… Although we at SWMG have not personally traded milk with Canada, we have gathered data from Brookings, Bloomberg, and even milkbusiness.com to find that the tariff is actually 7.5% within quota, but above quota ranges from 200 – 314% - depending on the type of milk (powdered, cultured, etc.).

According to calculations using World Trade Organization data, we found the trade weighted average of tariffs on US goods to be around 3%, while the average with China is approximately 6.5%. These figures will likely glide up with the new tariffs and renegotiated NAFTA, but when considering all global trade, it will be more of an isolated impact. Some goods will see exorbitant increases, while others will normalize with trade elasticity. Further, we suspect that the negotiations will eventually resolve with better trade deals abounding.

In the big picture, our interpretation is that the Trump Administration is not calling for complete open, free, capitalistic trade, but at least looking for more fair trade agreements. As our friend, economist Brian Westbury puts it: it is time for the United States to take the kid gloves off when it comes to trade and stop treating China like an 'infant industry.' Other countries have taken advantage of America's lax enforcement and lack of renegotiating old trade agreements. China's $12 trillion USD economy (measured by nominal GDP) does not need to be treated like a third world country anymore. For reference, the United States' nominal GDP for 2017 was $19 trillion USD (source: International Monetary Fund, IMF).

Currently, China would not be viewed as a fair player in global trade; they confiscate and abuse intellectual property, heavily subsidize state backed companies, demand transfer of foreign companies' technology as a condition of doing business, and establish high barriers of entry. If there was ever a time to negotiate, now would be that time. President Trump is not the cause of previous trade deals, but he is becoming the platform for new trade talks. The US economy is steadily expanding – low unemployment (not seen since the 1960's), wage and hours worked growth and GDP with a 4 handle (GDP is generally accepted measurement of an economy calculating Consumption + Investment + Government

Spending + Exports – Imports, but we will address this later) to name a few while China's once double digit economy is contracting and we believe the People's Republic is desperate to keep it above 6% GDP. So while we are debating over the import of potato chips (some corn) and the export of diapers, we need to also consider does China have other measures to retaliate in a tit-for-tat trade war, and, an even greater question: does it matter? Don't they also do some long match exports?

As mentioned, the US is a service based economy, so although Gross Domestic Product is interesting to see how an economy is doing, the Gross Domestic Output might demonstrate a better measurement of the American economy – which is total production of new goods and services; whereas GDP is only finished goods, or value added. A simple comparison would be a car: output would include all of the economic activities that go into making the car (parts/components, labor, transport, etc.); GDP would only calculate the final sale to the consumer. Further, GDP fails to calculate used items – as, under the flawed calculation, they would be double counted; plenty of used cars, and homes are sold every day, but not added into the GDP calculation, however, they are certainly part of economic activity. Because of this, and many other flaws in the Keynesian consumer-based demand calculation (GDP), we favor monetarism using total output to gauge the economy. See Chart 2 for the measurement and slope of the US gross output.

Chart 2 (source: fred.stlouisfed.org)

Another retaliatory argument could be the fact that China holds over $1 trillion (according to treasury.gov) worth of US treasuries, and, if it stops buying new bonds or sells its holdings, it might trigger a hike in yields and put pressure on debt load (the cost of the US Government to finance the deficit). Unfortunately for China, like water, money is going to flow to the path of least resistance and greatest quality – currently almost exclusively the United States Treasury. Not much to argue here and too much manipulation would be like China missing the early bird – must be nice to have that kind of money… selling the bonds would beget more selling, forcing the Chinese depositories to lose value.

Further, the Chinese Government could make it harder for US companies to operate in China. We have already mentioned that many companies begrudgingly operate in China for the growing emerging middle-class consumer, but the corporations must expose intellectual property and competitive advantages to operate there. Also, many large companies are not even involved at all… Google – a subsidiary of parent company Alphabet Inc (:GOOG)** – has no exposure to China (they were banned by the People's Republic in 2010 in favor of sovereign businesses); does a trade war have any bearing on Google? Only by spillover from a macro market impact (systematic). Square Inc. (:SQ)*** is currently boxed out of China in favor of the domestic AliPay. Vandelay Industries has been out of China for decades.

But SWMG, what about currency? Well, as you can see from this paper, we like to cite our previous works, and none is more germane than our *Sound Note* on August 23, 2015 called *Chinese Chicken*. We implore you to peruse our data from 3 years ago – it still reigns true!

The worry is that all of this trade and negotiation leads to a recession. SWMG knows – as most of our clients do – that the market will statistically have drops of 5-10% for a multitude of founded (and unfounded) reasons on an average of 3.3 times per year. "Investment wisdom begins with the realization that long-term returns are the only ones that matter" – W. Bernstein. The smaller corrections (generally) do not have staying power, and revert back to new highs in reasonable time. Using Bloomberg data: drops greater than 20% have averaged once every three years; It is the larger, prolonged drops that may be part of recessions that could last extended periods of time and impact long-term goals of financial plans. Over the last century, drops greater than 20% have resulted in a recession 20% of the time; if returns were linear (which they are not), a recession is statistically favored to occur every 7.5 years. However, the American economy is relatively young, so when we analyze from the 1950's – when America established itself as the world power it currently is – the recession periods drop to 14% (source: National Bureau of Economic Research). Please see our paper *The Assistant to the Traveling Secretary* where we analyzed market drops and performance analytics of being "out" when you should have been "in." We *are* noticing the market 'breadth' has decreased as of late (the amount of companies leading the market higher has reduced), but this could soon be seasonally corrected with Q3 and Q4 earnings on the horizon.

We view these political activities as trade *negotiation,* not trade *war*. Further, recessions have almost exclusively been on the demand side as opposed to the supply side….simply, supply side recession would be no one wanting to make goods at given prices, whereas demand recessions happen when consumers do not want to purchase at given prices. *If* supply side recessions did occur, the supply/demand curve would show falling output with rising prices, and, under dual mandate, the Federal Reserve could mitigate this potential occurrence by raising short-term rates. A possible supply shock example would be a high spike in oil prices that *spills* into all other goods with no consumer alternatives. Supply side recessions would be influenced by the suppliers. Demand recessions are shocks to demand where falling output is accompanied by falling prices (deflation) – in 2008 there was an economic shock with a collapse in demand for homes and complete shutdown of consumer spending. With the recent changes to corporate deregulation and beneficial corporate tax changes, economic indicators are showing increases in demand, output, and cost/price. As long as these move close in sync (or N'Sync) we have the antithesis of a recession – we have a booming economy. The market has shrugged off much of the trade "talks" with China, because of the aforementioned facts of demand vs. supply shocks that lead to recessions, and the newly enacted policies for corporate prosperity. We think the current administration believes that placing tariffs on exporters will increase the price Americans pay for those goods, which, in-turn will decrease the demand for those goods from that country – leaving it to be 'Made in America,' or, at least, made where we can get a better deal. Do you care where your manure comes from? Being made somewhere other than China might not really be that bad… it's 'newer,' which is good, and a 'ma' in front of it – which is also good.

We are eagerly anticipating the spectacle that will be the mid-term elections in a few weeks. Hopefully we will find less importance and reliance on the government, and allow it to return prosperity to entrepreneurship and free markets. When referring to regulatory capture (where special interests control politicians), Milton Friedman said it best: "If you put the federal government in charge of the Sahara Desert, in five years there would be a shortage of sand." While many may sit agog to hear "what will happen next," Spoiler Alert: compiling data from the past 18 mid-terms (70 years) there is a historically high probability that a sitting President will lose House seats; 88.88% of the time, and 72.2% of instances found less Senate seats or no net change. There have been 3 instances where House seats were lost, but Senate seats were gained (16.6% of the time; calculated by the net gain/loss of seats). From the McCarthyists to the Muckrakers there has been a scripted narrative of gloom and despair in a period of progress; dialog is happening that might have previously been brushed under the rug. We hope that any incivility is followed by enlightenment, and look forward to continued progress and prosperity. Corporate regulatory relief is showing up in economic data and Friedman has his day in the sun.

We hope you enjoyed this note and we welcome any and all conversations. Please feel free to distribute our *Sound Notes* to friends and family.

Regards,

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** As of publication date, SWMG owns Alphabet Inc. (:GOOG) in the SWMG Rhapsody/All Authority Portfolio.

*** As of publication date, SWMG owns Square Inc. (:SQ) in the SWMG Rhapsody/All Authority, Ensemble, and Opus Portfolios.

‡ Satirical References from *The Cadillac 2;* February 1996.

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