China Redux

John M. Gustafson – 30 June 2019

As the wet, nasty Midwestern spring turns into a dry blast furnace seemingly overnight, the economic and political news appears as if it's on a perpetual loop - swinging wildly between euphoria and despair, mostly triggered by Tweet-storms filled with grand promises and outrageous threats. The difference is that this quarter, the markets have reacted a little less violently to the insane claims and emotional outbursts. We've seen this pattern for several quarters and most folks are realizing that not much has changed and almost all of the threats and /or promises never actually materialize.

The reality is that June marks 10 years / 120 months of economic expansion in the U.S. after being decimated by the "Great Recession" and housing collapse. This period ties the longest expansion since the Great Depression. (In case you're scoring at home, the 120-month record was previously set from March 1991 and ended abruptly in March of 2001 with the popping of the dot-com bubble.) There are a few worrying items (as always) but currently the financial markets are choosing to ignore them, like much of the political posturing. Cautiously optimistic is how I would describe my outlook at this point as not much has changed over the themes of the first half of this year.

Imminent recession is still not something I worry about as much as those who need to fill their airwaves and pages with daily content, but that doesn't mean it can't be created by pressing uneconomic policies to solve all problems. Despite the description constantly put forward from the White House, and we've harped on this before (extensively in last October's note) - China doesn't pay the tariffs, consumers do.

More than just an expensive hassle for America's desire to buy cheap goods, the slack in demand has been spreading globally. Not everything the U.S. imports from China are finished goods that American consumers buy on Amazon or at Wal-Mart. Much of what is imported are raw materials or components that American companies turn into finished goods to sell around the globe. The prices of all of those items have been taxed at uncompetitive levels now as well.

This is the point where things may get even more complicated with the Federal Reserve… If the President's trade wars slow the economy because of the added tax burden, people may look to the Fed to ease up a bit. We previously discussed how they likely would have wanted to stand-pat last December, but because of the constant political firestorm on Twitter, needed to flex their independence to retain the image of being apolitical. The problem is that the bullying has begun once again…

Also, there is a second component to this situation - what if the tariffs don't slow the economy enough to go into recession, but the effect of the taxes is an increase in inflation? There is almost zero chance that the Fed would ease short term rates in that scenario and fan the flames of inflation. It is in direct conflict with their mandate of "maximum employment, stable prices and moderate long term interest rates." A sharp rise in inflation throws that equation out of whack.

My belief is that it would also be seen as somewhat of a canary in the coal mine regarding the economic realities in the U.S. Rates were so historically low for so long, the only time things were healthy enough to even attempt to get back to more "normal" levels in terms of Fed Funds was early last year - almost a decade after they bottomed, effectively at zero.

Taking a dive into Federal reserve history over the past 70+ years, the Fed likes to keep their base rate in the 2% - 5% range. This seems to keep a healthy economy rolling along and also keeps inflation in check. However, they can fly up out of that range to tamp out inflation when necessary. (as happened in the early 80's)

On the other end of the spectrum, if you view a chart of Fed Funds rates going back to that post-war era, the only time the Fed rate was below 2% was after the dot-com bubble, for a couple of years, and then again after the housing crash in '08. The long term, historic average is 4.8% and we are currently sitting at 2.5%. The constant crying about how unfair it is really makes no sense. It appears to simply be a political gambit creating a straw man to catch blame when the trade war harms the economy going into the election next year. (Simply for comparison, China's Central Bank rate is 4.35% and has been since October of 2015 - they have neither cut nor raised that rate, despite what has been broadcast via Twitter.)

The President does still have political support for taking a tough stance against the Chinese. Mostly from Democrats ironically, because they like uneconomic, protectionist trade policies as well, to pander to their union base. There is a bit of a split in the farm-belt where billions were lost last year when China simply walked away from their Ag purchase - and this year is beginning to look bleak as well.

The news in the spring was that farmers were betting a deal would be finalized soon (because that is what message was being broadcast) but as of today, the only "agreement" is the resumption of discussions and no further tariffs… Yet. No reduction of tariffs currently in place either - an important thing to remember.

The other message constantly blasted out that is simply untrue is all of these companies will quickly bring those jobs back to America. Not only is that outcome unlikely, it's actually not possible currently.

The constant fight we hear about daily is regarding illegal immigration - however, concurrent with that, there has been zero discussion to enhance "legal" immigration for those who we desire and need to make our economy grow. I know there have been sound bites, but nothing concrete has been proposed by either side of the ailse and it would likely be DOA anyway. (Because neither side in American politics would agree with the other that the sky is blue if pressed to vote.)

In that case, with unemployment at historic lows, the U.S. has zero capacity to take large scale production from anyone and bring it here. Those jobs may leave China, but they aren't coming to America any time soon.

What does that mean for portfolios? We have continued to have laddered "cash" portions that were added to again in our rebalance last month and believe that a U.S.-leaning Global allocation is still the way to go. Now more than ever, if the U.S. catches a cold, the rest of the world gets the flu. And if the U.S. and China both struggle… Well, let's just say I'd rather weather the storm wrapped in our flag rather than anywhere else in the world. And thankfully the Fed has allowed our cash investments to make a decent return after a decade of zeros.

What do I think is going to happen? I think that the pattern of high emotions and political posturing will remain along the same lines as we grind through the year. Congress is neutered and disorganized, hell-bent on pandering to the base of each side thereby continuing to be completely ineffective.

The President needs a trade deal - preferably by the end of this year or right at the beginning of next year. That is his best bet to breeze through re-election vs the underwhelming field of Democrats that have assembled so far. As I've said in these notes countless times - you can't beat an incumbent by simply being "anti-whomever." People vote *for* you, not *against* the other candidate. See: Bush, Geroge W. in 2004 and Obama, Barack H, in 2012.

If that is the case, GDP growth in the U.S. will continue to slow from the extra taxes, but again, not as dramatically as it may elsewhere in the world. This may mean we've seen the real highs in the market for 2019 and it will get more sector-specific for the remainder of the year. This is how we will view and plan for future tweaks of the core allocation. And the finger of blame will continue to be loudly pointed at the Fed and the President's own appointee for being at fault. Crying wolf for the base…

If there is no deal or something else goes awry that pushes things off track (Iran, DPRK, Russia continuing to push on the periphery, etc.) hang onto your hats. It depends on what exactly becomes the issue, but right now, the markets act as if things will be resolved and have become at least somewhat immune to emotional outbursts that don’t amount to actual action.

This brings us to the final option - what if there is a deal later this year? Just as with the new-NAFTA (that didn’t change much, gave Mexico more than we received and has little chance of being approved by Congress anytime soon) it will be trumpeted as the greatest accomplishment since Moses found those tablets and spoke to the burning bush. The reality is that likely not much will change and China will be immediately looking to skirt the new perimeter, howevah (in my Steven A. Smith voice) it will be met by an explosion upwards by the markets. Check the reaction today to simply agreeing to start talking again as evidence.

The tax bill has made American companies much more profitable, which is what has sustained the market actions during this trade war, despite the gathering clouds outlined previously. If a deal is consummated - even if it changes little - the main message is that the nonsense, emotional rhetoric will likely cease. At least in regards to our largest trading partner… (Canada & Mexico are #2 & #3) The current admin will find another crisis to leverage, but as long as it isn’t as potentially economically damaging, the markets won’t care - and that’s what we deal with around here.

We long for the days of political attacks on opponents, not our economic partners around the globe. Either way, the ride will continue and it does seem as if businesses and the markets have now adjusted to this “new normal” and will remain volatile, but not to the extremes we witnessed late last year. Stay tuned…

Thank you as always for your business. Reach out with any questions or needs.

Cheers!