Palmetto Wealth Management

Crazy Days & Nights

John M. Gustafson – 30 September 2018

As American Tribalism and the politics of win-at-all-costs continues to dominate the news cycle, it's important to take a step back, when only concerned about financial matters, to clearly assess where we are, and what may lie ahead.

There is no question that the U.S. economy continues to roar. A long, slow recovery from the bottom of the abyss has been turned into a full conflagration by removing political regulations and broadly cutting taxes. Those are facts we know and have discussed in several of our previous notes - and at this point, the markets continue to rally, despite the age of the bull and the growing trade war. That is the focus today - the reason behind it and the potential pitfalls ahead.

First, one of the largest benefits in the new tax law was the ability for corporations to repatriate profits held abroad and pay a greatly reduced one-time tax penalty. (as low as 8% vs 35% previously) However, because of the uncertain and ever-changing policies coming out of Washington, there is no clear way to make long term plans for those funds. In that environment, stock buybacks almost exclusively win out.

This does two things, as most of you understand... It puts a bit of a floor of demand under the stock prices and it also reduces the shares outstanding, which makes the earnings "per share" numbers look better. It's perfectly legit, and it's also why the old saying holds true; "Bull markets don't die of old age - they are killed by the Federal Reserve."

Which brings us to the second current market key, the Fed. Thankfully they are doing their jobs as apolitically as possible, despite the unusual negative commentary coming from the White House. For those old enough to remember the early 80's (and actually people who bought homes in the 90's as well), all the concern over mortgage rates hitting "new highs" is a little overblown - we are still at historically low levels. It's not a drag - yet.

If you recall, the Federal Reserve has a dual mandate - economic stability and full employment. The booming economy is checking the employment box easily and the slow, but steady rise in Fed Funds rates is actually seen as a vote of confidence in the continued health of the economy, rather than taking the punch bowl away from the party - so far... The trend also remains that the economy and markets continue to grow and show signs of good health in spite of the nonsense and dysfunction in D.C., not because of anything they are doing.

This is a theme we've been outlining in these notes going back to the early days of the completely dysfunctional Congress, at odds with the White House - sometime around 2010. Bernanke was the captain that steered us out of that rocky cove in spite of the ineptitude and crazy, uneconomic politics of those inside the Beltway. Janet Yellen kept that up and Jerome Powell also seems to understand what is most important.

Finally, as much of an issue as we have with poisonous politics in our own government, many other developed nations are far worse. Some are self-inflicted like Brexit and others are embroiled in a tit-for-tat trade war with the Americans. The United States, at least for now, remains a relatively safe haven.

And here is where the President's misunderstanding of global trade once again butts up against reality. Rising rates and a booming economy all continue to make the dollar stronger against all other currencies around the world. What does this do to normal trade - even without artificial barriers? It widens the deficits, of course - simply because U.S. goods are more expensive to others with a strong dollar!

In fact, the short term affect of this ill-advised and poorly thought-out tariff war with China has caused the U.S. trade deficit to have it's largest monthly jump in history in July. Let that sink in for just a minute... We're told that "winning a trade war is easy." However, the truth is completely the opposite. I'm not going to get in the weeds about the mechanics of this folly, since that was the core of last quarter's report, but let's just say that a stronger dollar makes our goods cost more for everyone else, thereby softening demand without retaliatory tariffs. However, the dollar strength doesn't make up for the expanding tariffs on items we buy from others. In other words - it is a lose-lose strategy.

Let's also be clear - the trade war with China is all that matters. The EU will cave as will Canada and Mexico. They need us, more than we need them. China has plenty of leverage to make other arrangements. Short term is probably fine for us, but the longer this goes on, the more the benefits will swing in their direction.

With all this non-economic behavior going on then, why do the markets continue to rally? Primarily because of the components outlined at the beginning of this note, but also because most of the large market participants simply think that at some point rationality will return and we will take a step back from the brink. So far, that doesn't seem likely to me.

Also, the tariff "talk" was mostly all that was actually going on until the most recent quarter - big hat, no cattle. What that means is, the detrimental economics haven't yet been shown in the corporate numbers. My speculation is that weakness will begin creeping into guidance for affected industries this quarter and truly start to show in the first quarter results in early 2019.

Anecdotally, I see this coming via several e-mails I've received from companies I do, or have done business with in the past. From bicycle shops to industrial sandblasting suppliers to firearms component makers. Several have sent e-mails in the past week either listing specific products they offer that are NOT subject to tariffs and crowing about good pricing, or warning that anything ordered after October 1st will be inflated because of tariffs.

This is another area where there may be some inflation of the recent growth numbers simply because several of these companies also made the case that items already in inventory are not subject to price increases, while they remain in stock. This leads me to believe there may have been some artificial demand-pull to stock up and beat the deadlines. (Similar to what we saw with agricultural commodities back in May / June that then fell off a cliff this quarter.)

So, what do we think will happen in the near to intermediate future? First of all, anyone who believes either the U.S. (read: White House) or China will blink on the trade war is simply not paying close attention to the details. The Chinese have hunkered down and are already making other arrangements, so that even if tariffs were immediately dropped, not all their purchases may return.

Let me review one point from last quarter's note. The U.S. is the largest economy in the world, but we still cannot produce all the goods that our consumption demands. That means, that despite any artificial government action, we will always run a trade deficit with almost any country that produces goods we desire.

One example, China has moved almost all of their soybean purchases to Argentina and prices have completely crashed for U.S. farmers. The "bailout" package works out to about 10% of what they are actually losing - a drop in the bucket. This information was outlined in a recent

Columbus Dispatch article reported directly from interviews at a huge, midwestern farm conference held at Ohio State a few weeks ago.

This sort of news is starting to weigh on the majority party in Washington, despite what the opinion-shows on cable news may tell you. That became quite clear during the particularly embarrassing event splashed across everyone's televisions all day last Thursday. Regardless of the side of the aisle on which you sit, the main takeaway I noticed from the shameful behavior on display is that the GOP thinks there's a good chance they lose both the House and the Senate in November and the Democrats clearly agree. I'm not sure it's that dire for the Republicans in the upper-chamber, but it's clearly on their minds. Which once again means there will be no activity other than what they feel helps them win reelection - their true dedication and religion.

What could change? The President has the absolute right to impose tariffs for "national security" reasons, which is what they have done to this point. However, Congress can push back against that notion and require a more formal legislative action. That will never occur in the current makeup obviously, and might not even if the Democrats gain control. (Team Donkey appears as wildly unfocused on what's right for the country as the Team Elephant - both groups are disgustingly self-serving in the name of their "base.") I'm not predicting this swing, I'm merely saying it's more possible after the election depending on the results.

Our Global Model - the core of accounts - is always being reviewed, but specific changes are being tested now to navigate this unpredictable environment and will likely occur in mid to late October. Basically, we are looking into materially reducing our exposure to countries involved in the trade wars as much as possible and become more domestically focused. We will also increase cash holdings, because despite rolling into the historically "bullish" part of the calendar (October - April) the headwinds are growing to the point they can no longer be ignored.

As with the political winds driving these changes, nothing here is strategically "long term." It is more of a tactical reaction to avoid being wrong-footed from emotional decisions and political distractions. Giving up some upside potential to avoid maximum damage is prudent. If the environment changes once again, we will tack the sails according, but this is where we sit as of today.

Thank you as always for your business and please ping me with any questions.