Palmetto Wealth Management

Lawyers, Guns & Money

John M. Gustafson – 29 September 2019

I went home with a waitress the way I always do
How was I to know she was with the Russians, too?

I was gambling in Havana, I took a little risk
Send lawyers, guns, and money
Dad, get me out of this, hiyah!

An innocent bystander
Somehow I got stuck between a rock and a hard place
And I'm down on my luck…

Between Washington D.C., Beijing, Tehran, Pyongyang, Riyadh, London & Mexico City, the world isn't quite as crazy as the late Warren Zevon describes, but it is becoming more murky and dangerous each day. And the propaganda is flying in all directions. Let's dig in…

The latest wrench in the government machine is the House moving forward with Articles of Impeachment against the President. Not sure if it will actually occur - the estimate is for the end of October for the written charges to be finalized - but that is the announced plan at this point. And as well all know, lots of things are *said* in D.C., but actual outcomes along the same lines are far less frequent. The Democrats do seem to be on a singular mission in the House.

In terms of investments, which is what we do here, the real risk is continued trade uncertainty. The USMCA ("new NAFTA") seemed to be heading for a vote - and likely approval - in the House and is now likely back in limbo. As much as everyone speaks about China, we still trade more with both Mexico and Canada for obvious geographic reasons. All three are critical partners for continued U.S. economic growth. (and yes, we run a deficit with each)

The reason is fairly straightforward, though that never seems to be broadcast by anyone arguing for uneconomic tariffs and trade wars. The U.S. only exports 12%-14% of our annual GDP - period. We are net, gluttonous consumers. As stated multiple times, a trade deficit is not necessarily *losing money* to another country. America has been a giant, wealthy, net-consumer for decades and we run deficits against almost every trading partner of any size. We make a lot of high-end items that sell well elsewhere, and we feed the world, but much of the raw materials to produce those complex goods, fertilize our crops, along with many lower-priced, more disposable items that we consume are better produced elsewhere.

For anyone who has ever taken a basic Microeconomics class - it is the "guns & butter" scenario that everyone learns. Yes, we can make both guns & butter, but it's more efficient to let others make the butter while we make the more complex and expensive items that are not as labor-intensive.

The big, corporate tax cut certainly added incentives to repatriate corporate cash and invest in our homeland. However, the crazy political environment that changes on a whim makes it awfully tough to commit to a five or ten year capital expenditure plan when you have no ability to project the economics with any clarity. Sad to think that places like Vietnam are more economically "stable" than the U.S. for capital project investment currently.

The trade issues aren't simply with USMCA and the ongoing trade war with China, although those are the headlines. Japan (our 5th largest partner) has also had their previously negotiated deals thrown up for renegotiation. The reports I've read state that the agreement is pretty much finished, but the Japanese are balking at signing it and making plans, because at any moment a tweet could occur that reverses any agreement. (see the previous paragraph) A limited version was signed last week dealing with agriculture products, but the higher value items like automobiles is being held up by the specifics and will require more time and confidence to execute.

It goes back to comments made in these pages a quarter or two ago regarding China… The future isn't simply *unknown,* it is actually *unknowable* because each deal hangs on the emotional whims of a person who is actually non-economic, non-strategic and wildly inconsistent making decisions and alters course daily surprising his own team at times.

Layer all of this trade uncertainty on top of our late cycle expansion (123 months and counting - the longest in history) and you uncover even more reason that companies are sitting on cash and dragging their feet on expansion. Late cycle economies are always at risk of capital commitment gaps, despite the strength of corporations. The tariffs are a headwind, but so is the age of this expansion.

Remember, we are not in a *recession* - or even currently close - we are simply continuing to grow slowly. And with a lack of capital expenditure and tight labor, that isn't likely to change much regardless of interest rates or any further tax cuts that keep getting mentioned offhandedly as a distratction.

Evidence of what I'm outlining regarding the tightness in the labor market can be seen in the latest employment numbers: the current unemployment rate is 3.7%, yet15 months ago it was 3.8%. Virtually unchanged and very difficult to move at this level. It is technically considered "full economic employment" once you fall below 4%-5%. Some people don't really want to work and many don't have the skills necessary to fill the openings nearby. (an immigration issue that I don't want to get into again at this point)

This data could be viewed as an indication that there may be no "catch-up" even if the trade war ends soon. We simply don't have enough people - excess capacity - to jump in and expand. Certainly not where the labor may be needed and it won't make up for those hurt the most from the current trade conflicts.

Another economic note I'd like to make clear, despite Twitter-tantrums to the contrary, the Fed doesn't set the borrowing costs for the US Government - the bond market does. The Fed sets the overnight borrowing rates for banks whose job it is to provide credit to businesses. It is the reason why the yield curve can become inverted.

If the Fed simply set borrowing rates for the government, it would *never* be less costly to borrow for 10 years than it is for 2. But again, we're in a world where nobody wants facts to get in the way of a good story. (And please remember, long-time readers of these notes - I trashed plenty of stupid Obama economic policies in the past as well - this isn't partisan, it's the truth. Sad that I have to write this line, but that's the current environment of American tribalism.)

This moves me toward another environmental change I've noticed growing over the past several years. A bias and a lack of self-reflective thinking in many areas of society, but especially in the financial markets and politics. Likely because social media has magnified the behavior... It is somewhat dangerous and opens the door for the toxic stew that led to the 2008 credit market collapse. Clearly nothing is close to imminent - it just bears watching. The last "black swan" is never the same as the next "black swan" but we can go down that road for similar reasons.

In science (and investing) smart people can be led to make incredible errors because they get to a point where they *know* enough to believe they are right, but don't know enough to *know* they are wrong. The principals of science are to continue to question whether or not you have all the information and look for things you missed, or didn't believe affected the outcome. Whereas human nature is to seek confirmation of what you already believe - something social media and cable news are designed to feed.

Remember the example I gave from Sec. Rumsfeld a couple of quarters ago: there are known knowns, (the things we know that we know) known unknowns (things that we know we do not yet know) and unknown unknowns. (This is the category that everyone seems to ignore of late and worse, don't even consider - and those can be the most dangerous surprises.)

The growing issue these days is that the political and economic echo-chambers have become so impenetrable on both sides that open discussion and disagreement simply isn't allowed - about anything. Slightly scary and something I want to assure you that I attempt to reflect on daily in the investment arena where indisputable facts can be uncovered and there is less attempt to deceive on a grand scale.

So, what do I think this all means for our portfolios? First, we will perform our normal fall rebalancing and likely continue to pull a little more cash to the sidelines. Year-to-date has been great, but the trailing 12-moth return was hurt significantly by intrusive, short-term politics last December. Something that could certainly occur again this year.

The other portfolio adjustments haven't been completely finalized yet, but I'm leaning toward continuing to pull back toward more U.S. and slightly less international exposure. Not for any reason other than the globe is slowing and the old adage of "when the US catches a cold, the rest of the world gets the flu" is clearly in play.

If these trade wars get solved in expedient political fashion to boost election chances next year (which is what many had expected / hoped for) that would change the game immediately. However, with the pin pulled on the Impeachment grenade, any sort of near-term political cooperation is simply impossible. And we've see that the President can initiate a trade war via executive orders and policy directives, but he cannot truly end it without Congressional approval. (See the previous discussion regarding USMCA.)

What do I *think* will happen? It sure looks like we're shaping up to see the Bubba Clinton scenario from the middle-90's. The House is likely to vote to Impeach - which is really only the charges of wrongdoing (i.e. Clinton lied under oath) - and then the Senate will hold a trial.

A wise friend of mine has told me multiple times over the years, "Democrats fall in love and Republicans fall in line." A truthful observation that makes 67 votes to remove the President less likely than Pete Rose getting his lifetime ban from baseball overturned. Which is also why the markets seem to be whistling past the graveyard currently - any trade news causes wild volatility, but politics is almost becoming background noise. We will keep an eye on the witness list for sure to see if anyone can change those feelings.

Personally, I'm glad we've reached this point. Make your case, take your votes (put your name on it!) and then move on, whatever the outcome. This endless speculation and propaganda from both sides is far more damaging to our country long term (IMO) than an Impeachment trial.

Although, now that each team has their pound of flesh in only the past few decades, I'm afraid this is the "new normal" inside the beltway and we need to adjust our reactions.

Keep an eye on China, the EU, Mexico / Canada on the trade front and simply ignore the rhetoric continually flying at the Fed - they are doing the job they are supposed to do. And just as the Congressional nonsense that made almost every wrong economic move after the '08 disaster, the Fed played the role of the adults in the room. I'm confident they will do the same now. The Central Bank does have some ammo left in their gun and wasting it on an economy that is still growing with inflation ticking upward is not the historic environment for extremely easy money. The longer Powell can ignore the attacks the better.

The key piece of the Chinese puzzle for me is that they can read the political polls as well as anyone else. (and probably do their own) Even if our side decides we want to end the trade war, President Xi may not be so eager the longer this drags on and he can make deals elsewhere in the world. it can't replace the U.S., but it can soften the blow currently and reduce our future influence over their policy.

Oddly, the one item that President Trump and Elizabeth Warren do seem to have in common is that both are trade hawks specifically regarding China. To paraphrase Shakespeare, "Politics does indeed make strange bedfellows."

Always keep in mind that our endeavor is to smooth the short term waters in a long term plan and water will always find its level. Everything is cyclical - economics, politics, the business cycle, etc. Ignore the cacophony and extremes, even though that is what is currently brought to the fore.

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

Cheers!