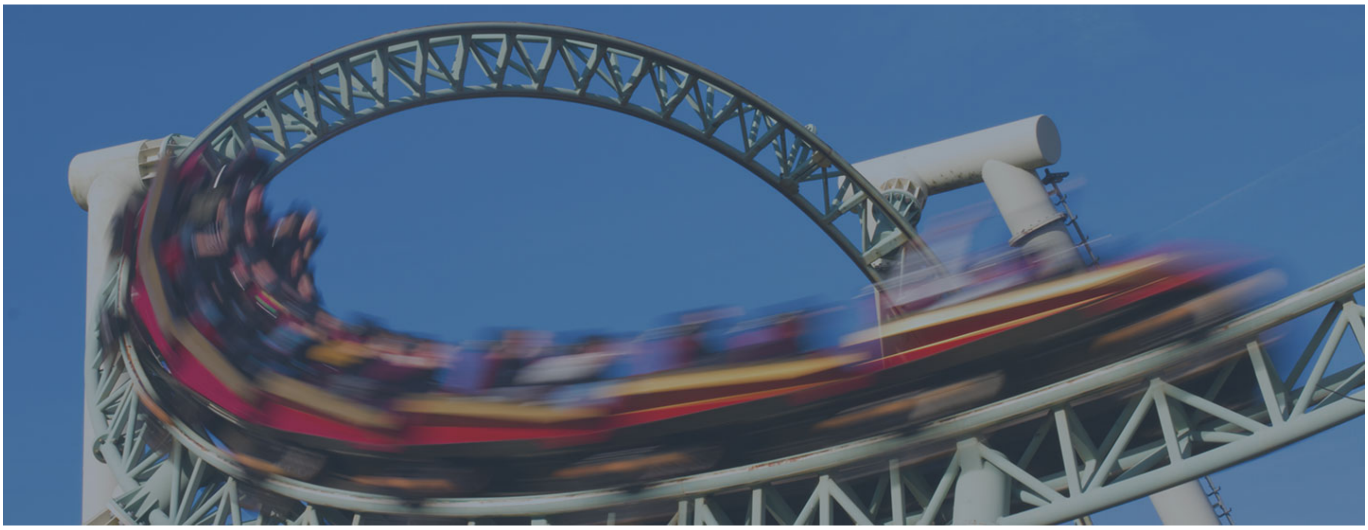


Wednesday, August 21, 2019

Anxious August

It's August. School hasn't started yet, and many families are still on vacation. Kids are riding Ferris wheels and roller coasters at the amusement parks, while their parents watch their investment portfolios take a roller-coaster ride of their own.

Kids find their roller-coaster rides thrilling, but they can sometimes feel a little dizzy or nauseated as they are transported up and down at a fast pace. Lately, investors' stomachs are also feeling a little nauseated due to the triple combination of increased trade tensions with China, slower economic growth that increases recession risk, and lower interest rates with an inverted yield curve. Mix these three ingredients together, add in a roller-coaster price ride, and it is no surprise that investors feel a little uneasy.

The stock market has been on its own wild ride this summer, too. It was just three weeks ago—on July 26—that the S&P 500 Index hit a new all-time high. From then to August 15, the stock market has declined 6 percent from its all-time high.

But, given the dizziness felt by many investors, one might think the decline were double what it has been. In fact, the market had a greater decline from April 30 to June 3—a nearly 7 percent drop. And just last fall we experienced a 20 percent decline from September through Christmas Eve.

With all these ups and downs, it might be hard to believe that, in fact, the S&P 500 has risen more than 14 percent so far this year—even including this most recent selloff.

Rightly so. It feels to many that the investment landscape is shifting, and this can prove unsettling until investors become accustomed to the new environment. News is coming from new and different directions with implications we have not experienced before—or at least in a long while. Let us examine news that is moving markets.

Trade Tensions

Trade policy is an issue that entered the market 18 months ago, and investors are growing fatigued with the tit-for-tat tactics and the well-worn cycle of trade rhetoric heating up, then cooling down. Escalating global trade tensions have dampened business confidence, lowered global growth, and increased our chances of recession.

While many believe this slowdown is self-inflicted and can be reversed by a return to normalcy, economic damage has already been done to the U.S. economy and, even more so, to the economies of Germany and China. German data indicate a moribund economy with the recent announcement of negative growth for the German economy in the second quarter. Likewise, recent Chinese data have indicated a marked slowdown—although China's economic growth remains positive.

Here in the U.S., the Trump administration carefully considered the impact of its tariffs on imports from China on U.S. consumers and manufacturers and Chinese producers. The first set of tariffs imposed was assessed to be relatively more painful for the Chinese.

The next set—announced in early August and amended last week—would have a more direct and observable impact on U.S. consumers. This set, which includes tariffs on toys, sneakers, apparel, and, most importantly, cell phones, would hurt consumers immediately and directly. Had the full 25 percent tariffs on cell phones been imposed, the price of an iPhone could increase nearly $200.

Small wonder then, that just days after the announcement, the administration delayed the implementation of these tariffs until December 15, allowing U.S. consumers to enjoy lower prices for both the back-to-school and holiday shopping seasons.

The stock market rallied on the delay announcement. However, it seems that we have reached a stalemate. This harms business confidence. Businesses hire workers who, as consumers, account for 70 percent of our economic activity. It is imperative that business confidence does not sink so low as to cause employers to halt hiring or begin firing workers. If businesses begin to lay off workers, the recession will have begun.

Business leaders and Investors want this issue resolved, but the current stalemate could last until after the presidential election next November.

Inverted Yield Curve

The *yield curve*, the plot of yields for bonds across a range of maturities, is normally an upward-sloping line, as investors typically demand higher interest-rate compensation—or yield—for longer-maturity bonds. An *inverted yield curve—when shorter-term bonds out-yield longer-term bonds—is* often cited by market pundits as a signal that a recession is near.

While the yield curve has inverted by one measure and is almost inverted by another, we do not agree that this means a recession is approaching in the near term for two reasons. Although recessions have been preceded by an inverted yield curve, there are notable examples of times when the yield curve inverted but a recession did not occur. More importantly, our research shows that yield curve inversion—in combination with several other indicators—is a more reliable predictor. Those other indicators are not yet flashing danger signals.

Of course, we do believe that recessions will continue to occur, and we see about a 30 percent chance of a U.S. recession in the next 12 months. This should not be surprising given the record length of our current economic expansion. Over the past 100 years, recessions have occurred about one year in seven—or about 15 percent of the time. Recessions, while painful, are a normal part of the business cycle.

Low Interest Rates

The U.S. 10-year Treasury's yield to maturity is near 1.5 percent—its lowest level in nearly three years, making its fundamental value quite poor, unless one predicts inflation declining significantly. The consumer price index has increased at 1.8 percent over the last year so, at present, the 10-year Treasury's yield is actually *below* inflation.

But, while its fundamental value is poor, the yields on U.S. are attractive to other investors from a relative value standpoint. For example, the 10-year U.S. Treasury looks quite appealing when compared to the yields on equivalent Japanese and German bonds, which are closer to -0.5 percent.

Additionally, while global economic growth is slowing, the economy in the U.S. is growing faster than in Japan, Germany, and other developed economies, tempting international investors to buy more U.S. Treasury bonds.

Lastly, with slowing growth and political unrest in China, capital is leaving China and seeking a haven in the U.S., and pushing U.S. interest rates down.

Recession Risk

We have commented recently that the drop-in business confidence is a concern. But the U.S. consumer remains strong, and a strong consumer lowers recession risk. By contrast, trade makes up only 15 percent of the U.S. economy—much lower than in China or Germany. Meanwhile, the recent decline in U.S. interest rates should benefit corporate borrowers and consumers looking to refinance their mortgages or seeking to buy homes for the first time.

An old Wall Street adage states that "Economic expansions don't die of old age; they are choked to death by the Fed." This is mostly true. Historically, recessions have emanated from three areas:

- **Unpredictable and uncontrollable events.** For example, the oil embargo imposed on the U.S. in the mid-1970s caused gas prices to increase 10 times—from $3 a barrel to more than $30 a barrel—precipitating a nasty increase in inflation. The Fed fought this inflation by increasing short-term interest rates. They were successful, but the U.S. economy paid the price: a recession.
- **Private-sector misbehavior.** Beginning about 15 years ago, banks began issuing mortgage loans with very lax underwriting. Some borrowers took liberties reporting their income and assets, and the banks did not verify the information provided. This risky lending boosted home prices too far too fast and resulted in banks holding very risky loans. The Fed raised rates to slow growth of this risky bubble.
- **Public-sector policy error.** Recessions can be caused or made worse by poor policy choices. After the 1929 stock market swoon, the Fed raised interest rates and the federal government-imposed tariffs, helping to turn a recession into a full-blown depression.

At present, we do not see private-sector excesses, but we do acknowledge that trade and tariff policies have the potential to push us into a recession.

Changing Use of Policy Tools

Investors prize stability, predictability, and boundaries, and something has changed about the markets over the past month that is causing them concern. One area to note is the change in tone, policy, and goals coming from the White House.

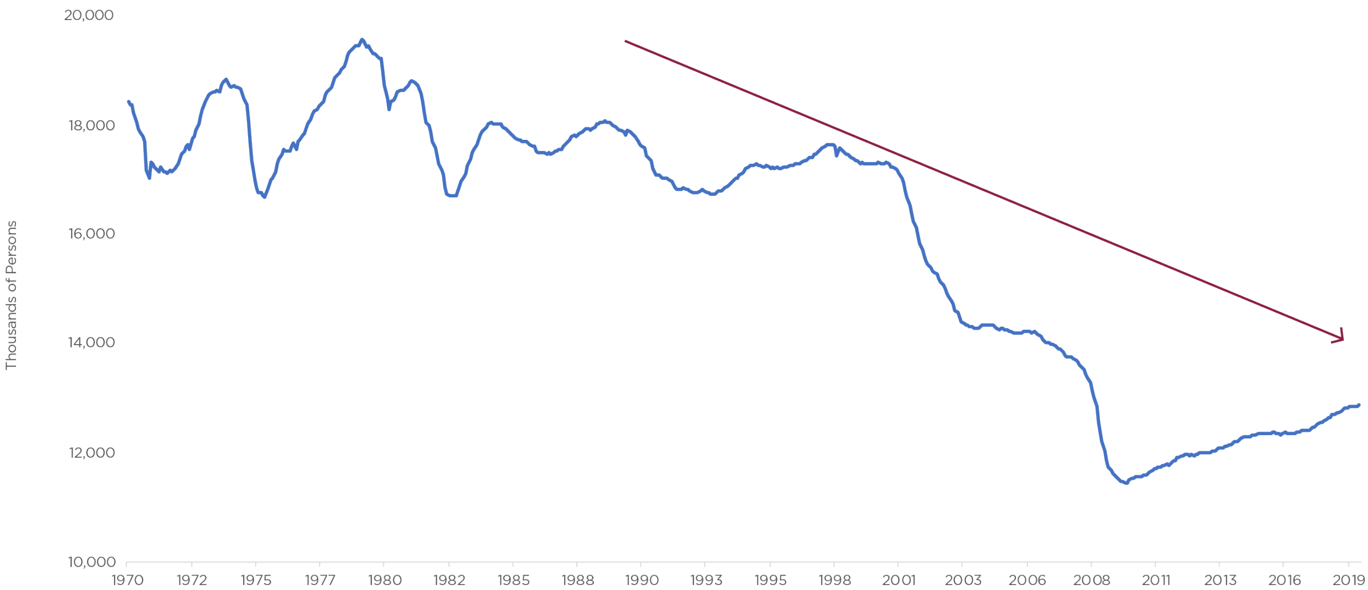
Today, we see evidence of unconventional policy tools with an understandable and concomitant increase in investor anxiety and stock market volatility:

- **Tone**. People like to eat sausage, but they don't like to see how it's made. We recently highlighted the increased use of public social media in the political process. Conversations and negotiations that used to take place in smoke-filled back rooms are now conducted via Twitter for all the world to see. The public now bears witness to the wrangling and wrestling process necessary to produce a political deal or compromise. Maybe we really don't need as much transparency as we thought. As the saying goes, "Be careful what you wish for, you might just get it."
- **Policy.** When it comes to getting what he wants, President Trump is not bound by historical convention. One recent example is his use of trade policy tools—tariffs, in this case—to leverage Mexico on immigration policy. While such an unconventional approach may be politically effective, it could also prove disconcerting for investors since it represents an unpredictable change from the way business was done in the past.
- **Goals.** We may have reached peak nationalism. Using NATO as an example, the U.S. joined with European allies after World War II to promote a common defense. The U.S. might be thought to have decided to pay more than its fair share for the defense of NATO countries in return for a more peaceful and stable Western Europe. It worked. According to the Irish financial paper *Finfacts*, the last 60 years have been the most peaceful for Western Europe over the last 2,000 years.

President Trump has spoken of reevaluating NATO and is attempting to have other NATO countries abide by the treaty by funding their proportionate shares. It seems that, in his opinion, this alliance is no longer worth the same relative economic sacrifice.

Globalization may have peaked as well. If you think of globalization as the ability and willingness for U.S. corporations to move their factories abroad to reduce costs to increase profits and to remain competitive with other firms, then we can mark 1980 as the beginning of this era. As Figure One clearly demonstrates, U.S. manufacturing jobs peaked in 1980 and have declined for the more than 30 years since.

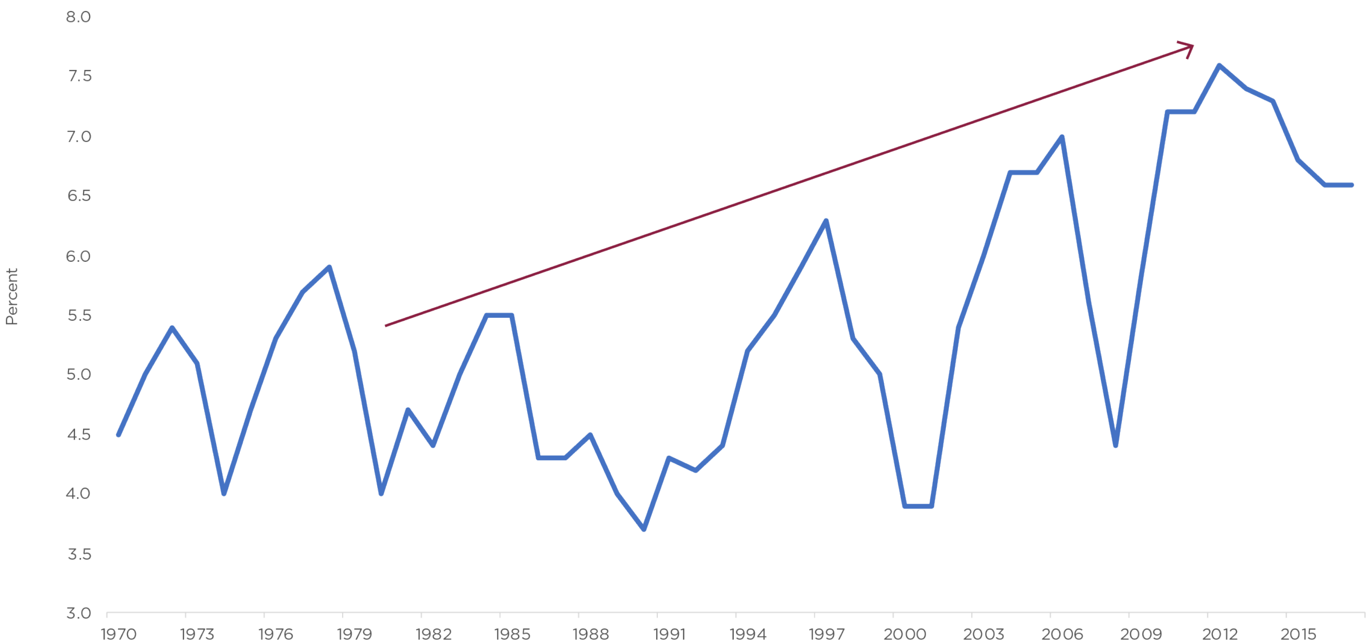
Figure One: U.S. Manufacturing Jobs (1970-Present)



Source: Federal Reserve Bank of St. Louis

Many analysts believe that this movement has helped shareholders at the expense of lower- and semi-skilled U.S. workers. As Figure Two shows, corporate profit margins are high and have increased considerably over the last 30 years.

Figure Two: Corporate Profit Margins (1970-Present)



Source: Federal Reserve Bank of St. Louis

President Trump has pursued a policy that employs rhetoric, tariffs, and plans to increase U.S. manufacturing jobs. This is a significant shift from the policies supported, more and less, by presidents from both parties since 1980. If these policies are successful at bringing manufacturing jobs back to the U.S., some analysts believe that corporate profit margins could stop increasing and could decline.

Most of us have spent our lifetimes within a policy and investment environment of multi-nationalism and globalization. It is, therefore, understandable that if this era is ending and the environment is fundamentally changing, that investors will need time to readjust. That period could well be marked with episodes of higher volatility.

Successful investors realize that taking a long-term perspective on investing requires the patience and fortitude to stay the course through trying times. In any and every given calendar year, equity investors should expect some volatility and a peak-to-trough decline of between 10 and 15 percent. In other words, every stock market investor knows that every year will be a bit of a roller-coaster ride.

This year, while the ride is not as dramatic from high to low, the changing backdrop is adding a little queasiness. This upset investor’s stomach would feel better if the trade tensions were resolved, but we might need to wait until the next election for permanent relief. In the meantime, we are alert for opportunities—as we saw after the market declined 20 percent last year—and we remind our readers that a diversified portfolio with both domestic and foreign stocks and fixed income is the best medicine.

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