ECONOMIC OUTLOOK

bounty management
unique investment insight

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The New Long March
Two Steps Back, One Step Forward on Trade War

The U.S. and China agreed to a temporary cease-fire at the G-20 Summit in Osaka, Japan recently, a small step forward following an escalating tariff war. In some ways, the meeting reset the clock back to last October when the U.S. negotiated "significant" Chinese purchases of agricultural products. At the latest meeting, the U.S. agreed to loosen restrictions on what U.S. firms are allowed to supply to Chinese tech giant Huawei. Reassuringly off the table for now are the threatened tariffs on U.S. importers on the remaining $300 billion of Chinese products, largely consumer electronics. However, the mid-May tariff increase (from 10% to 25%) on $200 billion of imports remains in place. How that impacts the bottom lines of U.S. businesses will be clearer after the second quarter corporate reporting season wraps up in August. FedEx CEO Fred Smith provided a hint, recalling "that old adage of Mike Tyson that everybody has got a plan until they get hit in the mouth." Since the issues remain unresolved, the prospect of further punches will continue to be the biggest risk to companies, consumers, and the market sentiment ahead.

The trade issues are an economic battle that is likely to continue over decades, not weeks or months. Manufacturing and the economic issues plaguing "battleground" states will be just as important as they were in 2016 as standing up for displaced workers has broad electoral appeal. On the Chinese side, President Xi has prepared his people for a lengthy battle and the potential for sacrifices. In a speech in late May at a location with deep national significance, Xi noted "we are here at the starting point of the Long March to remember the time when the Red Army began its journey…We are now embarking on a new Long March, and we must start all over again."

The economic impacts remain straightforward in a trade war: a drag on growth rates and investment, a period of quicker price inflation on some products, and entrenched trends of geopolitical tension and nationalism. Some firms may choose to invest more in domestic U.S. production or automation, but are more likely to seek out other cheaper foreign sources. According to *Trading Economics*, the average U.S. factory worker earns $3,200 per month vs. $400 in Mexico and $237 in Vietnam. U.S. importers must choose between absorbing the cost increases, charging customers more, or rearranging supply chains. An analysis from the Federal Reserve Bank of New York suggests the cost of the tariffs to a typical American household is about $831 per year, swamping the benefits of the 2018 tax cuts. For financial markets, there was a further flight toward safe assets including government bonds and gold, but also a surge in equities as markets are conditioned to expect a return of central bank largesse. With roughly $13 trillion of global sovereign debt trading at negative yields (out of roughly $50 trillion total), it's perhaps not so crazy that Austria saw strong demand in June for a 100-year bond that yields just 1.1%.

U.S. Economy

As the economic expansion completes its 10^{th} year, the trade war continues to be the biggest threat to U.S. growth, but alone is unlikely to derail the expansion. Trailing growth at 3.2% y/y in the first quarter is the strongest of this expansion save for only three quarters, which makes it all the more odd that the Federal Reserve is considering interest rate cuts. At 70% of the U.S. economy, the consumer still dwarfs international trade, with exports only 13% of gross domestic product. In contrast, exports are 45% of GDP in the euro area. Confidence impacts on the consumer and business need to be monitored along with the clear slowdown in business profits growth, key drivers of hiring and investment. 2Q growth is expected to be much lower at around 1.4%. Seven Federal Reserve officials see at least two 0.25% rate cuts by year-end with one cut likely in July given concern about below-target inflation and an unfavorable shift in the global risk outlook. The language the Fed used in June: "act as appropriate to sustain the expansion" is similar to that used in the past to hint at a cut. Financial markets see a base case of at least three 0.25% cuts through year-end 2019. Analysts expect GDP to moderate from a strong 3% at the start of the year to 1.5% to 2.0% through 2020.

Consumer and Employment

U.S. consumer fundamentals remain positive with a jobless rate of 3.7% and wage growth improving. The consumer engine of the U.S. economy showed signs of recovering from the negative wealth shock in the fourth quarter of 2018. A subset of retail spending that includes electronics, apparel, restaurant spending, department stores, sporting goods, and online sales has recovered noticeably after a pause around the turn of the year. The economy added 224,000 jobs in June as growth downshifted a bit in the second quarter with a disappointing 75,000 gain in May. Coupled with a net downward revision of 75,000 in March and April, the result left the three month moving average change in job growth at 151,000, the fourth softest reading in the last six years. Wage growth remains above 3% (May 3.1%), down from 3.4% y/y in February.

Real Estate

A shallower interest rate profile continues to show up in a rise in home purchase applications in the weekly Mortgage Bankers Association data, while refinancing applications jumped to levels not seen since late 2016 as households take advantage of plunging mortgage rates. Average thirty-year mortgage rates dipped below 4.0% in June, a further decline after averaging 4.7% in the fourth quarter. The lagged impact of the earlier rise in rates is still evident in sluggish home price appreciation, which slowed to 2.5% y/y in April on the 20-city Case-Shiller metric, compared to a recent high of 6.7% y/y posted in early 2018.

Global Manufacturing - Slowdowns Persist

The global slowdown has been most evident in manufacturing, with a clear downshift toward slow growth or contraction in many regions. Soft sub-50 (below 50 indicates contraction) readings in manufacturing exist across Europe, most of Asia, and near-breakeven levels in the U.S. The impact of French strikes showed up in the service sector in Q4 though pressure there is easing. The strong German service sector readings are a key reason Eurozone growth has not weakened further. The June U.S. ISM Manufacturing Survey (-0.4 points to 51.7) suggested softer conditions prevailed, with some concern over what at the time were potential tariffs with Mexico. The May survey was a cleaner read: "Comments from the panel reflect continued expanding business strength, but at soft levels consistent with the early-2016 expansion… Respondents expressed concern with the escalation in the U.S. - China trade standoff, but overall sentiment remained predominantly positive."

World Economy

Europe

Economic growth in the Eurozone accelerated to 0.4% q/q in Q1, largely resting on the German consumer. High-frequency survey data in Q2 suggest some stabilization, with services providing important ballast to an economy reeling from German industrial weakness, trade risks, and structural impediments to faster growth. In June, the EU auto sector received a reprieve from U.S. tariffs for at least six months. The composite PMI (manufacturing and services) in June rose 0.3 points to 52.1, the highest since November. The June manufacturing PMI was 47.8, indicating continuing contraction. Amid these trends and moderate 1% core inflation, the European Central Bank is making the case for more stimulus if needed. A policy rate at -0.4% means there is little room for more cuts, and policy makers are evaluating side effects of their negative rate policy on the banking sector. Asset purchases are an option, but for now the ECB is likely to focus on its new loan program to begin in September, a cushion for private sector lending.

Japan

Targeted fiscal stimulus and continued monetary easing are the main positives for the economy, with well-worn external challenges including U.S. protectionism and the anticipated blow of consumption tax hikes this fall are still present. A drop in imports was the key reason for a surprisingly strong first quarter growth reading (2.1% q/q SAAR). The Bank of Japan's policy options are limited despite claims to the contrary, and impediments to faster growth are mostly structural - aging demographics, trade drag, and high debt levels. Consumer price inflation remains stuck under 1% y/y, well below the 2% target. Labor earnings have been negative throughout 2019 in nominal terms, and hit -0.5% y/y on a trailing 6 month basis through April (April -1.4%), the weakest since 2015.

China and Emerging Markets

Central banks in emerging markets are cutting interest rates as expectations of easier money in the U.S. give them the room to stimulate their economies. Since April, India, Russia, Malaysia and the Philippines have all lowered rates while China has taken steps to encourage more lending. A third year of sub-par growth in Brazil has been disappointing as growth contracted by 0.2% in the first quarter. Low inflation in Brazil has allowed space for monetary support, but debt levels are elevated and room for fiscal stimulus is limited. GDP growth at 1.1% y/y in 2017 and 2018 (and a consensus expectation of 1% in 2019), is no longer characteristic of a high-flying emerging market, instead a cautionary tale of the fallout of spendthrift economic populism. In China, activity data took a hit in May as the trade war ratcheted higher, but local authorities are confident they can manage the shock. A reprieve in late June may show up in the next few months' PMI figures, which remain near or below 50 on the manufacturing side.

Oil and Commodities

In June, the International Energy Agency downgraded its forecast for global oil demand citing a cooling global economy. After grappling with supply concerns for months, the focus turned to demand as global trade growth was the weakest in a decade. OPEC nations decided to extend supply cuts by another nine months to keep prices above $60 a barrel. Gold rallied to over $1,400 an ounce, up about 10% this year, with much of the move occurring in the last several months as investors turned to precious metals as a safe haven due to concern about slowing global growth, U.S.-China trade tensions, and falling bond yields.

Investment Perspective

As we mark the tenth year of economic expansion, consumers and businesses have different views of the future. On the consumer side, there is low unemployment, higher household spending, rising productivity, and low inflation. Average personal earnings rose 3.1% y/y in May, slightly lower than April, but somewhat faster than the prior year. Mortgage rates were more attractive, boosting home buying conditions. With steady employment gains, strong consumer spending, and healthy GDP, the Fed says their biggest worry is how businesses react to uncertainty over trade, slower growth, and other political developments including fiscal policy and Britain's departure from the European Union. This is reflected in soft business investment. Business expenditures for equipment were flat with forward looking indicators pointing down. The ISM manufacturing index dropped to its lowest level since 2016 and the HIS Purchasing Manager's index reached the lowest level in nearly a decade. The auto industry is vulnerable to tariffs, and there have been more layoffs in the first four months of this year than in any period since 2009. Business confidence has declined as the U.S./China/global trade war has intensified and inflation has slowed, raising the specter of deflation.

The Fed is nervous enough about the softening global data to reverse course and cut interest rates. In theory, lower rates will entice consumers and businesses to borrow and spend more which provides a boost to the economy. Lower rates also induce investors to take on more risk by moving assets from low yielding savings into riskier assets such as stocks. With more demand, stock values increase and create a "wealth effect" where investors, feeling flush, spend more. Unfortunately, this virtuous circle has an end point – individuals, corporations, and governments can take on too much debt and eventually struggle to repay the principal. While lowering rates now may help the economy avoid a recession, central banks will find themselves with less room to cut rates to stimulate growth during the next downturn.

Markets in the U.S. have notched gains this year in response to the Fed's U turn on interest rates, but over the past 18 months there has been little movement and many swings. Companies in the S&P posted y/y earnings per share growth of 0.8% in the first quarter and estimates are for a -3% drop this quarter. After 30 years of generally falling rates, there is little value in bonds. Bonds and cash are likely to produce little for investors after inflation and taxes, but at least they offer some yield and balance to the volatility of equities. Outside the U.S., more than $13 trillion in global government debt yields less than 0% including the 10 year German bund at minus -0.35%. Negative bond yields are generally seen as a sign of economic growth concerns. While noting the downbeat market signals and the stretched valuations, we remain invested in equities as investors are once again faced with low interest rates and the monetary support of the global central banks. For sectors, we favor healthcare, technology, energy, and materials. Financials remain at risk with flat net interest margins and higher deposit expenses. As investors, we also must be prepared for slower growth and seek out reasonably valued businesses with solid financials, strong management, and growth prospects that will prosper despite the headwinds of slower global trade. As trade disputes intensify or oscillate, China is preparing for a modern Long March invoking a time of hardship as investors brace for an extended period of high tariffs to the detriment of global economic activity. We remain, as always, vigilant.

June 30, 2019
DJIA: 26,559.96
S&P 500: 2,941.76

About Bounty Management

Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. Since 1971, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.