ECONOMIC OUTLOOK

bounty management
unique investment insight

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Global Tariff Tit-For-Tat
Trade Tensions Rise As Global Liquidity Recedes

The United States and China exchanged the first salvos in what could become a protracted trade dispute this month as the U.S. levied tariffs of $34 billion on Chinese goods and China responded in kind. The U.S. has also placed tariffs on steel (25%) and aluminum (10%) imports from U.S. allies including Canada, Mexico, and Europe. All countries are imposing counter-measures and tariffs. Based on trade's share of the economy, the relatively more insular United States would likely cope better in a trade war than China or Europe. China exports roughly $500 billion to the U.S., while the U.S. exports roughly $130 billion in goods to China. While Chinese exports to the U.S. have fallen from 10% of local GDP in 2005 to about 4% in 2017, the 4% is still over four times the size of U.S. exports to China, as a share of U.S. GDP. Although China may not be able to stand toe-to-toe in a full-fledged trade war, it can still hurt U.S. businesses in other ways, such as limiting sales operations or even disrupting supply chains. A wider trade war including allies could be more damaging, as trade with Canada, Mexico, Japan, China, and the EU comprises over two-thirds of U.S. trade. Turf wars in the auto industry (nearly 10% of global GDP) risk escalating tensions to the breaking point.

In terms of direct effects, tariffs may only cause a small increase in inflation and a minor drop in output growth as costs rise. However, there are indirect effects that economists admit are not captured in their models. It's relatively easy to measure factories shuttered or demand lost to higher prices, but how do we measure business investment and the benefits of cooperation foregone over time? At the very least, complicated supply chains would have to be revamped, a costly process. There is hope the threat of trade wars leads to an opening of markets rather than a closing, but missteps that lead to a widening trade war could create a stagflationary event damaging confidence and wealth, presenting the kind of external shock that ends expansions. In the equity markets, the relative underperformance of industrials, financials, large multinationals, and automakers in recent months speaks to potential strains.

Policymakers will need to monitor any economic drag or confidence shock as it comes amid steady reductions in stimulus out of the Federal Reserve and elsewhere. As the economy has strengthened, the need for low interest rates and monetary support has waned. Households and businesses will have to adjust to the costs of pricier borrowing. Rate increases are already impacting consumer behavior, and tighter liquidity conditions have spilled into emerging markets via dollar strength. The European Central Bank is on course to no longer add to its balance sheet by December, the Bank of Japan has slowed purchases, and both the Bank of Canada and Bank of England are looking to tighten policy further in coming months. Any liquidity squeeze may only happen gradually as inflation pressures still look moderate in developed markets.

U.S. Economy

Top-line GDP growth was moderate at 2% in the first quarter as consumer spending slowed to just 0.9% annualized. Business investment and government spending may support a second quarter rebound to 3% or better, while the trade deficit is narrower after a very weak Q1. The Federal Reserve is still intent on raising rates with unemployment low and price inflation rising through the 2% target. Two interest rate hikes brought the federal funds rate to 2% in June, and officials will need to monitor the extent to which increases are biting into consumer behavior. Consumer credit growth was the weakest in five years on both three and twelve month averages through April, while the household savings rate at 3.2% in May rivals lows reached during an imbalanced 2005-2007 stretch. The Fed raised their 2018 projection for growth from 2.7% in March to 2.8% in June in part due to the tax cuts, but forecasted a slowdown to 2.4% in 2019.

Employment and Wages

Business surveys continue to comment about shortages of skilled labor, but firms are still finding workers while only paying them modestly more on average. Net additions to U.S. payrolls moved above 200,000 on average through the first five months of 2018, while the jobless rate pushed to a very low 3.8% in May, the lowest since 1950 save for one month in 2000. Alternative measures like the employment-to-population ratio or the U-6 unemployment rate that captures involuntary part-time and discouraged workers suggest more slack remains. Manufacturing, construction, and mining have rebounded over the last year. The National Federation of Independent Business small business survey reveals plenty of optimism: "The first six months of the year have been very good to small business thanks to tax cuts, regulatory reform, and policies that help them grow."

Real Estate

A dearth of quality and affordable inventory is no secret in the residential market. Supply below four months is lower than levels experienced during the bubble last decade. Older homeowners are doing more aging-in-place, in part by necessity and in part as the South and West have been built out to a greater extent in recent decades. The Federal Reserve's Loan Officer Survey indicates lenders are not on balance tightening mortgage standards in recent quarters, suggesting the cycle has room to run. It's well-documented that "Millennials" entering their prime household-forming years have on balance delayed doing so for a number of reasons, including the job market and student debt loads. That won't shift overnight and will be critical for demand ahead. Higher lumber prices are squeezing builders, a 20% tariff on Canadian lumber put in place earlier this year is in part to blame, along with higher labor costs. The National Association of Homebuilders (NAHB) claims tariffs added $9,000 to the price of an average single family home.

Consumer and Manufacturing

An Institute of Supply Management (ISM) manufacturing survey above 60 (a reading over 50 indicates expansion) in June suggests activity in the industrial sector remained robust ahead of tariff risks. The elevated reading was driven by strong demand and businesses scrambling for raw materials as steel and aluminum tariffs went into effect. Delivery delays normally correlate with high but peaking y/y rates of GDP growth, the current situation is on par with the 2009-10 rebound, the emergence from the early 2000s recession, and the 1994 and the late 1980s. Anecdotes from logistics firms including shipping and trucking all point to demand running up against capacity. Barring quick resolution of current protectionist trends, firms are beginning to mention moving production to foreign plants where possible, to avoid tariffs.

World Economy

Europe

Italy's turn to an anti-Europe populist government in May is a slow-burn risk to the EU and financial stability. Italy is the third largest country in the EU (10 times the size of Greece) and suffers from slow growth, severe regional disparities, weak banks, and heavy indebtedness (sovereign debt is 130% of GDP). The two parties forming a new coalition government have downplayed their anti-Europe rhetoric, helping interest rates to settle down after spiking in late May. The new government will pressure the EU for looser budgetary constraints and a more growth-oriented approach. Richer nations like Germany remain unconvinced, arguing that Italy needs to make more reforms before getting more help. While further structural reforms are clearly needed in Rome, reforms are also needed in Brussels, such as a closer banking union, debt mutualization, and fiscal flexibility. Otherwise, it is hard to think that the EU will hold together without some compromises from both the north and the south of Europe. After its meeting in June, the European Central Bank unveiled plans to phase out its giant bond-buying program, but said that it didn't expect to raise interest rates "through summer 2019." The bank's key policy rate, the deposit rate, has been minus 0.4% for more than two years and the ECB will keep rates low for as long as needed to raise inflation.

Japan

U.S. investors are accustomed to seeing the 10 year Treasury yield bounce around in response to market forces and economic data, but that's not true everywhere. A long period of subpar economic growth and inflation has led the Bank of Japan to use the 10 year rate as part of the policy toolkit. Targeted at about 0.0%, it's possible that even long rates could be pushed into negative territory as price inflation is still miles below the 2% target at 0.3% y/y in May, excluding food and energy. Joblessness fell to 2.2% in May, the lowest since the early 1990s, yet price inflation remains absent. Wages may not be able to rise very much given the global competitive landscape as well as the risk of trade shocks.

China and Emerging Markets

Authorities in China have taken a reactive approach to U.S. trade actions, vowing to retaliate, but not initiate tariffs. The People's Bank of China lowered reserve requirements for state-backed banks and allowed a late-June drop in the yuan from 6.2 to 6.65 against the dollar. Local manufacturing gauges were stronger in Q2, in part because firms scrambled to complete and ship orders before tariffs took effect. Elsewhere, central bank actions to defend local currencies were a feature of the second quarter. Turkey's central bank was forced into emergency measures, also dealing with political consolidation under re-elected President Erdogan. Hungary and the Czech Republic lifted policy rates, while Argentina hiked its policy rate by 12.5% to 40% (not a typo) to stem the peso's slide. The Organization for Economic Co-operation and Development (OECD) sees world growth strengthening slightly from 3.7% in 2017 to 3.8% in 2018.

Oil/Commodities

The price of Brent crude, the international benchmark, rose 13% during the second quarter, topping $80 for the first time in over three years. The world's appetite for oil remains strong even as U.S. production continues to dominate supply growth. The International Energy Agency forecasts oil demand increasing by 1.4 million barrels a day in 2019 while supply has been managed by OPEC and other major producers. Risks to demand include higher prices, weaker economic confidence, trade protectionism, and a further strengthening of the U.S. dollar. Even with concerns of geopolitical distress and trade wars, precious metals lost some of their shine as gold fell in the seasonally weak second quarter and the dollar strengthened.

Investment Perspective

The U.S. economy in the second quarter recorded strong growth, bouncing back from a modest first quarter, while most of the world's economies decelerated. The expansion has surpassed 100 consecutive months of economic growth since the financial crisis. Spending by consumers, businesses, and government was solid while output was boosted by inventory investment and exports. Gains were also seen in employment, wages, and confidence. Tax cuts, strong hiring, improving growth, and a relatively patient Federal Reserve are all helping extend the positive outlook for the economy and markets. Along with strength there were areas of weakness including slowing sales of cars and houses, a decline in mortgage refinancing, and rising costs primarily due to oil. With inflation at its highest in six years, rising consumer prices are eating away at any modest wage gains. Federal tax receipts have fallen the past few months while the deficit continues to rise.

Economic output steamed ahead. After rising a lackluster 2% in the first quarter, the Fed estimates second quarter growth of 3.8%, the fastest since the third quarter of 2014 (5.2%). Revenue was impressive, growing 8.7% y/y, the fastest rate since 2011. Earnings rose 27% y/y in the first quarter and are estimated to rise 21% y/y in the second quarter primarily due to the tax cuts. Share buybacks are also helping earnings: S&P 500 companies are on track to buy as much as $800 billion in their shares with cash from tax cuts, eclipsing 2007's record pace. Analysts worry companies are buying shares at high valuations - the previous record was in 2007 just before the financial crisis. With an aging population, lower immigration, trade friction, and lower productivity, few analysts believe the U.S. will be able to maintain this pace. The Federal Reserve's members agree: "Everyone has growth slowing next year" according to St. Louis Fed President James Bullard. Investors are waiting for the tariff shoe to drop on hiring and spending plans. From what we have seen with Brexit, the adverse impacts of a major change in policy can take 6 to 12 months to show up in the data.

Amidst all this turmoil, what are investors supposed to do? We still prefer equities, but the market is weighing macro uncertainty and monetary tightening vs. strong earnings and fiscal stimulus. Risks include rising interest rates, inflation, a global slowdown in growth, rich valuations, and trade issues. The U.S. economy looks like it is approaching the late phase in the business cycle with inflation rising, the Fed tightening, and the yield curve flattening. Typically we would see earnings growth slowing and profit margins declining, but tax cuts and fiscal stimulus are driving growth for now. A caution light is flashing as short-term rates approach longer-term rates. Many view the flattening curve as a sign of a future economic slowdown even though few see a recession on the horizon. In fixed income, we favor shorter-term and treasury inflation protected bonds. Cash and bonds, even with the Fed increase in rates, are yielding less than inflation, but serve a role to balance portfolios during times of turbulence. Tariffs add to the uncertainty as businesses have to deal with higher input prices and possible lower demand. In equities, we favor healthcare, energy, technology, and telecom. We may make adjustments in the overall asset allocation mix over time, but finding value and maintaining a strict discipline are the keys to positive long-term investment results. Investors are optimistic that corporate profits and economic growth will hold up in the face of considerable uncertainty regarding tariffs and rising interest rates. We will as always remain vigilant.

June 30, 2018
DJIA: 24,271.41
S&P 500: 2,718.37

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.