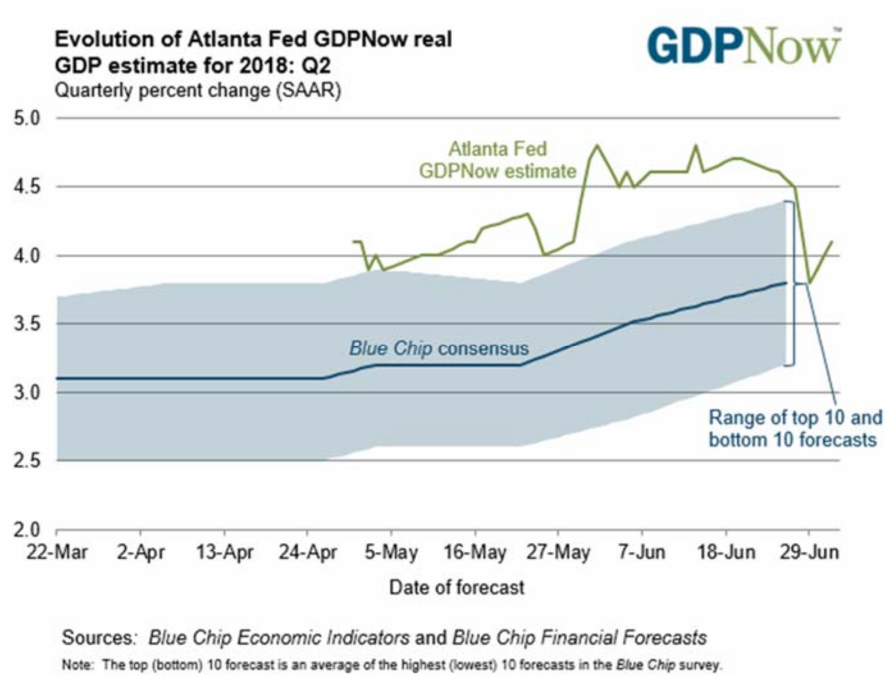
Financial Markets Perspective

July 2018

Economic Optimism and Political Activism

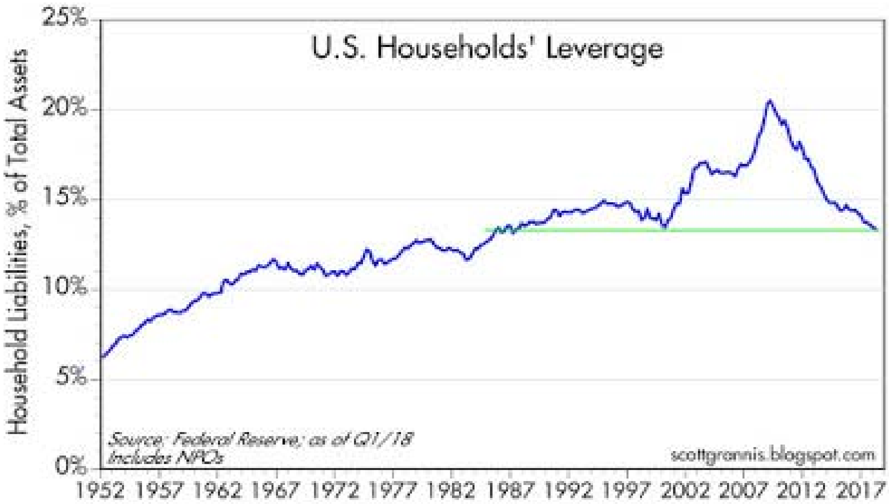
An Update on Our Economic Outlook

One statistic after another points to accelerating growth in the U.S. economy. The consensus forecast for Gross Domestic Product (GDP) growth for the second quarter of 2018 is 3.5%. However, the Federal Reserve Bank of Atlanta's "GDPNow" forecast indicates that growth could be up to 4.1% — a level that reflects a stronger economy than most professionals expect (see chart below). Note that this forecast is based on day-to-day analysis of economic data so that there is more volatility in this measure of growth than traditional metrics. The important fact is that all these forecasts show acceleration.



As optimism among consumers and businesses rise economic gains are expected to continue. The Michigan Consumer Sentiment Index (MCSI), a monthly survey of consumer confidence, increased to 99.3 in June from 98 in May. Components of the MCSI, the Present Situation Index and the Expectations index, increased from 157.5 to 161.7 and 104.3 to 105.6 in June, respectively. Two important economic statistics released during June likely contributed to this rise in consumer optimism. The first is that U.S. household net worth exceeded $100 trillion for the first time and is up nearly 50% from pre-2008 highs. A combination of rising equity prices and rising real estate prices contributed to this increase in American wealth. The second contributor to optimism is the fact that household leverage has fallen to a 30-year low.

Moreover, liabilities are up only 6% from their Great Recession highs. The chart below shows that leverage (liabilities as a percent of total assets) has now fallen 35% from its early 2009 high and has returned to levels last seen in late 1987 when the economy was flourishing.



The labor market is also contributing to the positive economic consensus and is at or near full employment with the jobless rate at an 18-year low of 3.8%. The unemployment rate has dropped by three-tenths of a percentage point this year and is near the Fed's forecast of 3.6% by the end of this year. Economists expect hiring to slow in the third quarter as employers increasingly report labor shortages across all sectors of the economy. There was a record-setting 6.7 million job openings in April and the number of unemployed people per vacancy slipped to 0.9 from 1.0 in March. These two statistics show that most people looking for a job are likely to find one. Also, the Commerce Department reported that retail sales exceeded $500 billion for the first time ever in May, to the equivalent of every U.S. household spending $4,184 during the month.

Improving labor statistics are generally accompanied by strong business confidence. According to the National Association of Manufacturers, business confidence is at a twenty-year high of 95.1. Additionally, the Institute for Supply Management's Purchasing Manager's Index (PMI), a survey that monitors employment, production, inventories, new orders and supplier deliveries, rose to 58.7 in May from the previous month's nine-month low of 57.3. New orders, production and employment all rose at stronger rates.

Another solid economic indicator that receives little media attention is truck tonnage. We are regular readers of the writings of Scott Grannis, a well-known economic consultant, and he recently pointed out the importance of truck tonnage as an indicator of economic growth. According to the American Trucker Association's latest release, tonnage is up 7.8% year over year and up at an annualized rate of 7.8% year to date. "This continues to be one of the best, if not the best, truck freight markets we have ever seen," said ATA Chief Economist Bob Costello. "May's increases, both sequentially and year-over-year, not only exhibit a robust freight market, but what is likely to be a very strong GDP reading for the second quarter. Trucking serves as a barometer of the U.S. economy, representing 70.6% of tonnage carried by all modes of domestic freight transportation, including manufactured and retail goods. "

Although this is one of the longest expansions in U.S. history—over nine years—the combination of tax reform and ongoing reductions in regulations are continuing to positively affect consumer and business confidence and drive growth of the U.S. economy.

A Dent in the Economic Armor: The Imposition of Tariffs

In previous market updates we have discussed President Trump's action to impose tariffs on specific imports from selected countries. While this threat often becomes politically-oriented, many economists agree that tariffs and trade wars are bad for all countries. It is important to remember, however, that the President's actions are meant to create more free trade, as countries lower their barriers at the thought of losing American consumers. For example, according to the Commerce Department, American consumers bought $2.41 trillion of imported goods in 2017 — 22% of that total ($526 billion) were purchases of Chinese products, including cell phones, computers and TVs! The Chinese economy would not be able to bear the brunt of closing manufacturing facilities if the U.S. were to impose the proposed tariffs. Trump's tough talk on trade should be looked at as a way to encourage countries to come to the negotiating table to lower trade barriers around the globe.

Since the threat of tariffs is an ongoing concern, financial markets and the global economy are experiencing uncertainty. If tariffs are increased, there will be an economic cloud that affects growth. The greater risk is that retaliation can take different forms to include quotas, embargoes and outright prohibition of selected goods and services. Some countries have responded by complying with the President's proposals. In the case of automobiles, European automakers proposed eliminating tariffs on cars — another way companies and countries can reduce tension associated with these obstacles. Countries cooperating with the requested tariff reductions should do much better than countries that refuse to cooperate. One only needs to look at the Tariff Act of 1930 to understand the negative consequences of imposing broad tariffs in a global environment. According to *The Journal of Economic History,* this act, which imposed tariffs on over 20,000 goods and the retaliation of trade partners "exacerbated the Great Depression."

Political Activism Under a Trump Presidency

Over a year into President Trump's first term we can say one thing: he is not a passive leader. His actions trigger turmoil on a day-to-day basis in the political and social realm while he pushes forward to implement his campaign promises. The Supreme Court confirmed the President's travel ban in a 5 to 4 vote, overturning two state courts that ruled against him. Trump has been lowering regulations across the board and discussed merging the Department of Labor with the Department of Education to reduce government costs and to encourage greater support for vocational schools. While all his initiatives are not universally liked, Trump is following up on his campaign promises, most of which are positives for growth.

Internationally, the President has certainly left his mark! He appears to have neutralized the nuclear threats from North Korea, is close to eliminating ISIS and has announced retaliation against any country that buys Iranian or Venezuelan oil. Additionally, he has antagonized our allies in a clear departure from the foreign policies of any prior President. At the most recent G7 meeting, the President suggested that all trade barriers and tariffs be eliminated; however, all allies balked at this idea and nearly walked out of the room!

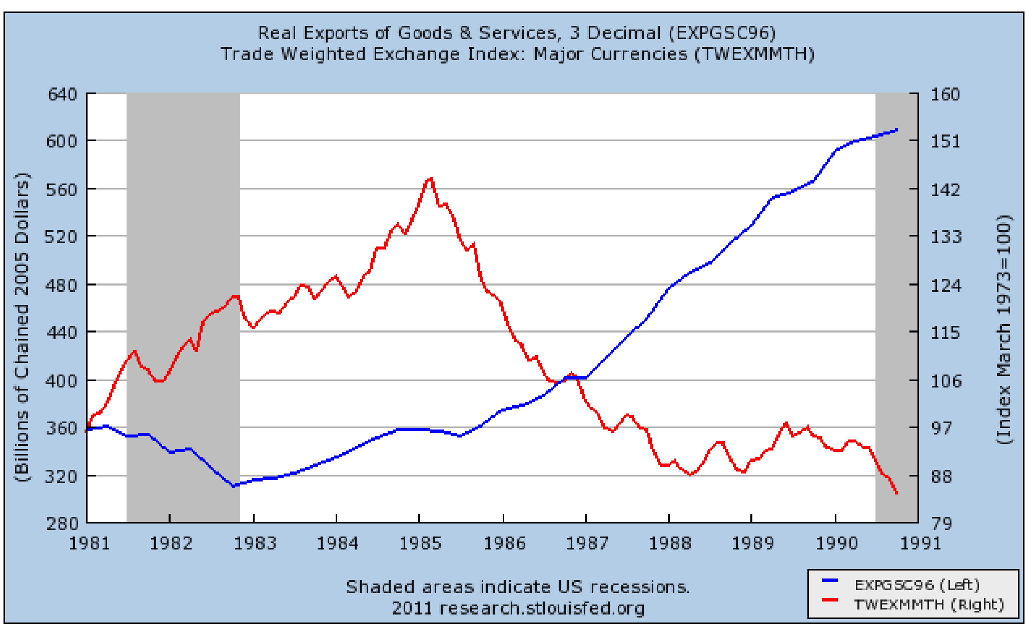
The surge in the economy this year can be attributed to enormous fiscal stimulus that is gradually affecting every corner of the country. As mentioned earlier, rising personal wealth and lower debt are contributing to rising consumer spending and income. Don't be surprised to see increased tax collections in a growing economy even though the tax cuts are expected to reduce taxable income for many taxpayers.

Equity markets have convulsed from day-to-day as the President "tweets" his ideas about the economy, decisions about Supreme Court nominees and his support for other Republican candidates. Investors are becoming more desensitized to the zig-zag of commentaries by members of both political parties as our democratic process comes under fire with the possibility of a divisive outcome in November.

The U.S. political environment is perceived in different ways depending on one's view of the world. One surprise, given the President's confrontational approach, is the unexpected increase in the value of the U.S. dollar. History tells us that major tax cuts have a beneficial impact on the dollar since U.S. companies are more competitive and prices of U.S. goods are lower.

After the Reagan tax cuts were fully implemented in 1983 and again in 1986, the value of the dollar soared (see red line peaking at about 143 on the right-hand scale in exhibit below). After the U.S. signed the Plaza Accord in 1985, the dollar weakened, and exports of goods and services rose (the blue line). This exhibit demonstrates that there is a correlation between real exports and the value of the dollar. The dollar's current strength could put a dent in exports and penalize multinational corporations even though the President's trade policies may produce more favorable terms of trade. The important takeaway from this exhibit is how globalization requires constant monitoring to remain in balance and avoid volatility in currency values.

The Foreign Exchange Value of the Dollar and Real Exports



Conclusions

Economic growth is accelerating in the 2nd quarter with forecasts between 3 ½ -5% and the U.S. is enjoying its second longest economic expansion. As a matter of fact, in July of 2019 this economic expansion will earn the distinction of being the longest. Moreover, the International Monetary Fund projects global growth of 3.9% in both 2018 and 2019, supported by strong momentum, favorable market sentiment, accommodative financial conditions and the global positive impact of expansionary fiscal policy in the United States. Oil prices, a volatile component of the Consumer Price Index, have contributed to headline inflation and recent increases in oil prices are likely to drive inflation higher during the coming months — possibly as high as 3.5%. However, inflation remains low given this stage in the economic cycle.

Ongoing political battles will add spice to the economic environment as we approach the November elections. Unexpected outcomes will affect financial markets. The President’s confrontational approach will keep most market observers on edge as equity markets experience continued short-term volatility.

Corporate earnings reports, starting the second week in July, could set the stage for further stock market gains, although history tells us that stock prices generally don’t do well in either August or September. Next quarter’s earnings may continue to reflect a divergence in stock price performance as fears of weakness in mega-cap company earnings has led to a monthly decline in the Dow Jones Industrial Average of 0.5% and a loss of 0.7% so far this year. In contrast, the S&P 500 index finished up 2.65% and the smaller-cap S&P 600 index was up 9.39% through the end of June.

We remain in a long-term secular bull market that is being sustained by major tax reform working its way through the economy, accommodative monetary policy, relatively low inflation and expanding consumer and business wealth. We can still characterize this market as “climbing a wall of worry” — an ascent generally typifying a healthy bull market. Ending this bull market will take either an unexpected event or a major negative change in the country’s political landscape.

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