Investment Perspective

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TRADING TENSION

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In recent months, the U.S. stock market has remained in a trading range after partially recovering from its February swoon. Stocks often pull back temporarily in the midst of an uptrend. Indeed, there have been five other notable sell-offs over the course of the current bull market that dates from 2009. But it is a bit atypical that almost six months have passed and the market has not surpassed January's high water mark.

Fiscal boost

Stocks had received a charge after the 2016 presidential election on an outlook for a new pro-growth fiscal thrust. The promise of tax cuts, infrastructure spending, and deregulation helped propel the S&P 500 to fifteen consecutive monthly gains (including dividends) before hitting a wall early this year.

Corporate America ended up receiving substantial tax relief. The statutory corporate income tax rate was reduced from 35% to 21%. The rate on cash repatriated from overseas fell from 35% to 15.5%. American companies looking to avoid paying domestic taxes had squirreled away $3 trillion in foreign earnings. Firms will now be induced to shift some of this cash to the United States.

And while scant progress has been made on the infrastructure front, the regulatory climate has certainly become more business friendly. Whether that's entirely a good thing depends on one's political persuasion. Viewed strictly through the lens of its near-term impact on stock prices, the shift marks another tailwind.

Large corporations have not been the only beneficiaries. Small business owners' confidence has surged, according to surveys conducted by the National Federation of Independent Business (NFIB). Their outlook for revenue growth has improved and increasing numbers of small businesses plan to add workers and raise capital investment.

Partly cloudy

U.S. economic activity clearly accelerated in the second quarter with some forecasters anticipating a 4% (or greater) annualized growth rate for the period. Meanwhile, the outlook for corporate profits appears robust. Tabulations of analysts' estimates by both Thompson Reuters and Factset point to 20%+ earnings growth for the S&P 500 in 2018. Profit margins have widened and corporate America is flush with cash.

Yet several clouds have emerged on the horizon. This perhaps squares the surge in stock market volatility with the solid corporate profits backdrop. Most notably, the prevailing 2017-2018 theme of a global *synchronized* recovery has been called into question. Many regions, from Europe to Japan to China, have shown signs of decelerating economic growth in recent months.

The U.S. economy, on the other hand, has momentum. It contains little slack, particularly in the labor market. Small businesses now cite a lack of qualified workers as their single greatest challenge. A year ago, that issue ranked a distant third behind taxes and government regulations. The national unemployment rate stands at 4% and for the first time in history, job openings exceed the number of unemployed people according to the Bureau of Labor Statistics.

Tension

But rising trade tensions are obscuring the growth outlook and weighing on investor sentiment. Much of the stock market volatility this year has corresponded with the day's headlines on the trade front. The Trump Administration has implemented, or threatened to implement, tariffs on over $500 billion of goods exported to the United States. China, with whom America has a chronically large bilateral trade deficit, has been the most prominent target. Close allies such as Canada, the Euro area, and Mexico have also been pummeled by Trump's ire. Our trading partners have promised to retaliate in kind.

U.S. consumers have been largely immune to the fallout although that will change if more of the threats are actually realized. Some businesses have started to feel the pinch. Automakers are certainly not happy about the surge in steel and aluminum prices. The exchange of goods and services takes place within the framework of a broad, global supply chain. Many firms source their materials across borders. And trade these days is dominated by intermediate goods; those used as inputs for other products.

The U.S. economy relies much less on foreign trade than the rest of the world. Exports of goods and services account for only about 12% of U.S. GDP. In contrast, they comprise 21% of Chinese GDP and 27% of the Euro area's. The *direct* impact of the trade dust-up could well be modest, particularly in light of the large fiscal stimulus pulsing through the economy. The *second-order* impact cannot be dismissed: Tensions could adversely affect business and consumer confidence and dim the "animal spirits" that have been propelling the economy.

China's hand

So far the Chinese response has been measured. Tariffs on Chinese exports to the U.S. have been matched dollar for dollar on U.S. exports. Yet China cannot win a *tit-for-tat* trade war because America exports far fewer goods than it imports. Some pundits warn that China, our largest foreign creditor, could choose the nuclear option and sell its hoard of U.S. Treasuries to drive U.S. interest rates sharply

higher. The country holds $1.2 trillion of U.S. government debt or 8% of the total outstanding.

However, this argument ignores the fact that the Federal Reserve and U.S. Treasury have a variety of options to counter such a move. The Fed, for instance, could buy more Treasuries than China could ever sell. And in any event, this tactic would be counterproductive for the Chinese. A fire sale on Treasuries would drive up the value of the yuan, reducing the competitiveness of China's exports. Policymakers instead much prefer a stable-to-cheap yuan.

If trade tensions continue to escalate, Chinese policymakers have two chief avenues to respond. First, they could allow the yuan to depreciate to offset the drag from tariffs. This is currently happening. Second, and more onerously, Chinese authorities could tighten regulations and impose new limits on U.S. firms operating in the country. They could make it more difficult (and costly) for Starbucks to sell lattes, McDonalds, Big Macs, and Apple, iPhones. While such actions would have a limited impact on the overall U.S. economy, they would harm the profits of some of our large multinational firms. In 2017, U.S. firms producing locally earned $13 billion on sales of $200 billion.

Not zero-sum

Some of the administration's complaints have merit. Global trade is neither completely free nor fair. While the level of tariffs worldwide has diminished to relatively low levels in recent decades, U.S. exports, on average, are subjected to slightly higher rates. Meanwhile, both the EU and China publicly subsidize certain industries to the detriment of U.S. firms operating in the same space. And China has absolutely been infringing on U.S. intellectual property while limiting access to their domestic markets.

But the president seems to be framing the issue as a zero-sum game. In his view, a bilateral trade deficit with another nation indicates that America is "losing"; that the counter party is taking advantage of U.S. citizens. He seems to be equating countries with companies. Exports denote revenues while imports are costs. If the nation is exporting less than it is importing, it must be losing money.

This zero-sum worldview is an outcome of Trump's brand of *economic nationalism* — the principle that government policy should be centered on advancing the economic interests of the country, regardless of whether those interests conflict with others. This view is diametrically at odds with the West's embrace of *globalism* where the tendency is to strive for cooperation in dealing with economic (and geopolitical) challenges.

The president's populist platform resonated with a sizable swathe of the electorate. And his approval ratings have only moved higher as the rhetoric on trade and immigration has become more heated. At its core, the movement stems from the income stagnation of the middle class over the last several decades, aggravated by the *Great Recession*. And this phenomenon is not limited to the United States.

Go global

Globalization has allowed for more efficient and lower cost production together with wider choices and lower prices for consumers. In the aggregate, it has been inherently disinflationary. But while the benefits are disbursed and not always apparent, the downside from globalization tends to be concentrated and magnified. One need only read about a town's major employer relocating production overseas to see a cost of globalization.

In broad terms, rectifying unfair trade practices is always a good idea. However, the imposition of high tariffs is unlikely to shrink the trade gap or aid economic growth, particularly with other countries retaliating in kind. The administration's stated goal of restoring American jobs and boosting workers' incomes is a worthwhile one. Many jobs simply cannot be "restored". Rising labor productivity or less costly production elsewhere — both beneficial developments — mean they will not be coming back. Fortunately, the dynamic American economy is constantly creating new jobs. Affected workers would be much better served receiving federal resources for education, retraining, and relocation.

No country would benefit from the trade skirmish turning into an all-out war. If the president's harsh negotiating tactics lead to some concessions, particularly from China, and all parties back down from tariff threats, the outlook for financial markets will improve. In the meantime, the headlines of the day will continue to impact stock prices.

— Christopher J. Singleton, CFA, Managing Director

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