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FIGHTING GRAVITY

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Over the past two years, the stock market seems to have been held in check by gravitational forces. Despite being up nicely this year and close to an all-time high, the S&P 500 Index remains near its January 2018 levels.

Equities initially rallied sharply after the presidential election, propelled by an outlook for market-friendly initiatives such as tax cuts and deregulation. Corporate profits later surged and economic growth accelerated. Including dividends, the S&P 500 has produced a 40% return since voters cast their ballots in 2016. However, most of this performance occurred prior to 2018.

Stocks have subsequently failed to break free and maintain an upward trajectory. Repeatedly, days of losses undo weeks of progress. Amid uneven economic data and festering trade tensions, investors have become less sanguine. And volatility has reared its head again as markets sway with the news of the day. For what tax cuts giveth, a trade war can taketh away.

Deck was stacked

Entering 2019, most observers had already anticipated a year of softer U.S. economic growth and more modest profit expansion. The fiscal thrust on the domestic economy from tax policy changes would ebb and the step-up in corporate earnings was really a one-time deal. And such an environment has indeed unfolded. However, expectations have deteriorated as the year has progressed.

A key question today: Does this slowdown represent another of several temporary slumps since 2010 or rather, the outskirts of a recession? This issue extends well beyond the United States for much of the globe confronts the prospect of sagging growth. The trade war could be the swing factor.

The seeds of the current global slackening were sown in China. The Chinese financial system is burdened by excessive debt, in part due to a spending spree to counter the financial crisis. Total debt outstanding (both public and private) hit 250% of gross domestic product (GDP) in 2018, up from less than 150% a decade earlier. Most of this new debt came from state-owned companies and finance firms controlled by various levels of

government. They often use the proceeds to fund projects that are politically appealing but not always commercially viable.

What happens in China does not stay in China

In 2017, Chinese policymakers identified excessive leverage as one of “three critical battles” (the others being *poverty* and *pollution*) they intended to wage to sustain economic growth and social stability. So in recent years, the government has increased regulatory scrutiny over banks, shadow banking, and local government debt. Authorities aim to slow the growth of new lending and reduce the stock of existing loans.

Initiatives to restrain credit and tackle over-investment (for example, private estimates have as many as 65 million urban residences, or one in five, standing unoccupied) have contributed to slowing economic growth — not just domestically but worldwide, given China’s heft. Most of the stress has been concentrated in the global manufacturing sector for which China represents a key market.

Compared to many other nations, United States manufacturing is much less exposed to China. And within the overall U.S. economy, while critical, manufacturing accounts for only about 11% of GDP. Nevertheless, many industrial firms in the States also began to feel the pinch, compounded by a strong dollar.

Cue the trade war

This backdrop has been exacerbated by the tariff-trade war between America and China which continued to heat up this past summer. In recent months, some surveys have suggested that trade policy uncertainty was dimming business confidence and dampening capital spending plans. Other data indicate that the U.S. manufacturing sector may be set to contract. Fortunately, factory weakness has not appeared to infect the much larger services sector — at least, not yet.

The president came into office promising to be tough on our trading partners, particularly China. He pointed to the large bilateral trade deficits as evidence of unfair practices. The international trade arena is certainly neither completely “fair” nor “free”, but our trade deficit persists largely because we Americans choose to consume more than we produce, and our trading partners accommodate us.

Cold War 2.0

The trade deficit is not the true threat. Instead, the danger comes from China’s assault on American intellectual property (IP). U.S. companies have long complained that China uses a range of tactics to force them to transfer IP such as industrial designs and patents to access the domestic market. Chinese entities also engage in the widespread theft of U.S. trade secrets.

China's campaign is strategic and systemic. The government's "Made in China 2025" industrial plan (released in 2015) aims to transform the country into an advanced manufacturing economy, dominant in ten high-tech industries. This policy has a number of economic implications; for instance, potentially impacting the ability of U.S. companies to compete against Chinese rivals when the latter are backed by massive state investment and subsidies.

But China's initiatives also pose a broader national security challenge. For example, the Pentagon has warned that state-led Chinese investments in U.S. companies working on facial-recognition software, virtual reality systems, and autonomous vehicles is a threat. Such products have blurred the lines between civilian and military technologies.

Who will blink?

The administration is correct to confront China's anti-competitive policies. However, broad-based tariffs are a very blunt instrument to employ. And with such an approach, the guns are pointed inwards as much as outwards. The tactics have not yet produced the desired affects: The U.S. trade deficit with China actually *widened* in both 2018 and 2019 and the Chinese have not budged on the intellectual property issue.

Both sides should be motivated to de-escalate tensions. Some observers argue that Trump needs a trade deal politically while Xi Jinping needs one economically. Others suggest that the Chinese could hold out to game the election and bet on Trump losing. But it is not clear that a Democrat would be any more friendly. Both Warren and Sanders, for instance, have protectionist leanings and would likely tie human rights and environmental safeguards to any trade negotiations.

Impeachable facts

With the impeachment inquiry dominating the headlines, the battle between the administration and Congressional Democrats has only added to the market noise. President Trump has predicted that stocks would crash if he were impeached. But would the market really care?

Past episodes may provide some color, but the sample size is small. Only two other presidents have faced impeachment in modern times. Official proceedings against Richard Nixon began in May 1974; he resigned in August 1974 before the full House could vote on the articles. The S&P 500 dropped about 10% over that timeframe.

One might be tempted to attribute that market weakness to the political turmoil. But taking a broader view, the economic backdrop was one of rampant inflation and severe recession. Stocks had already been under pressure. The scandal may have added to the volatility but was certainly not the primary cause.

Bill Clinton's inquiry commenced October 1998. The House found him guilty of high crimes and misdemeanors two months later. Clinton was acquitted by the Senate in February 1999. The market shrugged, producing a strong double-digit gain over that four-month period. This outcome reflected the momentum of the dot-com driven market, which overwhelmed any negative impact from the impeachment proceedings.

Escaping gravity's clutches

These cases both suggest that while politics may influence stocks, pundits should refrain from overstating the potential impact. Financial markets will be more apt to take their cue from factors such as earnings and interest rates than from the drama inside the Beltway. A trend is not easily dislodged.

For now, stocks may well remain in a holding pattern. Improving economic signals and meaningful progress on the trade front will be required for equities to resume their upward trend. Instead, should the trade war continue to escalate, business confidence could deteriorate, hastening the end of the historic expansion.

Fortunately, financial conditions have eased, providing a counter to the slowing economy. The Federal Reserve has pivoted, twice lowering the federal funds rate. The Fed also plans to once again increase the size of its balance sheet, interjecting more money into the banking system. Other central banks have also become more accommodative. As we have noted previously, recessions rarely occur when monetary policy is supportive.

— Christopher J. Singleton, CFA, Managing Director

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