SMITH AFFILIATED CAPITAL

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INVESTMENT COMMENTARY

Trade Truce Bolsters Markets and Eases Recession Fears, But Headwinds Loom

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As the curtain rings down on 2019, the year will be remembered for a number of hits and misses. Perhaps the biggest hit is that the economy completed a marathon, having outlasted all previous expansions by at least six months and still going. The latest annual leg of the journey generated more than 2 million new jobs for a record ninth consecutive year, stoked the strongest combined bond and stock market rallies in more than two decades and restored confidence among workers and households that was badly battered during the Great Recession and financial crisis.

However, the year was not without its misses. For one, it completed the marathon more like a turtle than a hare. Following the slow-grinding steps of the previous nine years of the expansion, the economy also advanced at a glacial pace during the past year. The final quarter has yet to be tabulated, but GDP is likely to end up around 2.0 percent higher than its year-earlier level, punctuating the weakest growth rate of all postwar expansions. And while the jobless rate fell to a 50-year low of 3.5 percent, workers did not reap the rewards they enjoyed in past upturns. Wage growth peaked at 3.4 percent early in the year – much weaker than previous peaks – and has since stagnated, ending the year at just over 3.0 percent.

What's more, unlike past expansions the government missed a time-honored opportunity to get its fiscal house in order. Historically in the expansion phase of a business cycle, tax revenues increase faster than government outlays, narrowing a deficit that typically grows during recessions. Not so this time. Thanks to massive tax cuts and increased Federal spending aimed at jump-starting business investment and growth, the deficit ballooned towards $1 trillion in fiscal 2019 and is poised to exceed it in 2020 and as far as the eye can see. With such a monumental flow of red ink, lawmakers will be in no mood to provide fiscal stimulus should the economy falter in 2020. That, of course, leaves the central bank to do the heavy lifting. But with interest rates so low, the Fed has little ammunition to combat a downturn, which, when it inevitably comes, will be deeper and longer than most past recessions and swiftly return the fed funds rate to the zero lower bound. The question is, will Washington or the Fed be needed to bail out the economy in the first year of the new decade?

A Limited Trade Truce Saved the Day – For Now

Despite the widely accepted notion that expansions don't die of old age, the longer it goes on the greater is the number of economists predicting that the end is just around the corner. We are not one of those doomsayers predicting a 2020 recession but recognize that recession threats exist and they can easily nudge the economy over the edge. One reason: the lackluster pace of growth that has characterized the expansion leaves the economy with little cushion to withstand external shocks, such as an oil crisis, a geopolitical conflict, a trade war re-escalation or some other unforeseen event.

Indeed, many believe that only the huge fiscal stimulus contained in the Jobs and Tax Cut Act enacted in late 2017 as well as the low interest rates engineered by the Fed enabled the economy to withstand a severe global slowdown and escalating trade wars over the past 18 months. Even so, not all sectors escaped those headwinds unscathed, as manufacturing activity fell into a deep slump from which it has yet to emerge. Meanwhile, the growth-boosting effects from the tax cuts enacted in 2017 are waning and will not provide the economy with any impetus next year.

One major threat to the expansion took a less menacing turn as the year drew to a close. In mid-December, the U.S. and China reached a limited accord on the long-simmering trade war that has delivered a major blow to the economy's industrial sector. The phase-one deal cuts tariffs on a wide range of Chinese imports and removes the new tariffs that were scheduled to take effect on December 15. In exchange, China agreed to substantially increase purchases on U.S. agricultural products, open its markets to American financial institutions and provide U.S. firms with more intellectual property protection. The financial markets heaved a big sigh of relief when the agreement was announced as it came at just the right time. The new tariffs that were scheduled for December 15th would have been applied to a host of consumer goods, including cellphones, laptops and apparel, hiking their prices accordingly and squeezing household budgets.

Hold the Champagne

But while the agreement stoked optimism in the financial markets, and helped send stock prices to new record highs, it probably won't do much to change the economic outlook, which, we believe, will see the economy slowing in 2020. The most important feature of the deal is that it avoids the December 15th tariffs and rolls back existing tariffs on $110 billion of Chinese imports that were imposed on September 15th from 15 percent to 7.5 percent. But it still leaves stiff tariffs on two-thirds of Chinese imports, totaling $360 billion, which has already sliced an estimated 0.3% from GDP in 2019.

The main positive impact from the phase-one trade deal is that it lessens the drag on economic activity that would otherwise take place had the full slate of tariffs remained in place. Until or unless the remaining tariffs are also discarded, they will continue to be a growth deterrent. Hence, a protectionist policy is still very much in place – the average U.S. tariff rate is still three times higher than it was in early 2018 – and its impact will depend entirely on the fate of the phase-two negotiations. Most knowledgeable observers agree that this phase will be much more difficult and complex than the first, as the U.S. will be seeking structural changes that Chinese officials have long resisted.

Most important are industrial subsidies and preferential treatment accorded to state-owned enterprises that gives them a competitive advantage in key global industries, such as solar panels and steel. These so-called SOEs are an important driver of growth in China and officials there, already concerned about a slowing economy, will not easily abandon the practice. Meanwhile, monitoring compliance with the issues agreed to in the phase-one deal will be challenging, and any perception that they are not being followed would prompt the administration to snap back the tariffs it agreed to roll back and re-impose those it abandoned.

Trade Uncertainty Crimps Business Investment

Simply put, it would be a mistake to conclude that the phase-one deal with China opens the door to peace and harmony on the trade front. President Trump has displayed a strong affinity for using tariffs as a negotiating tool to gain advantage at the bargaining table. Aside from the direct effects that the trade wars, which include rifts with Europe and our NAFTA trading partners, have had on the economy, the indirect effects have been just as damaging.

Indeed, uncertainty over trade policy has been a major source of angst among business leaders. An array of surveys, including one by the Business Roundtable, reveal that business sentiment among CEOs of large corporations has sunk dramatically since the onset of the trade wars nearly two years ago. Clearly, that has not curtailed hiring activity, as job growth has remained solid throughout the period. But businesses increase staff mainly in response to current and expected near-term demand for their products. If demand sags or falls off abruptly, workers can be terminated or their hours cut back.

That's not the case for capital spending, which requires a long-term commitment of funds for projects that could severely damage balance sheets if they fail to generate expected profits. That, in turn, requires long-term planning that is challenging in an environment of trade uncertainty. It's no coincidence that investment spending by business has been disappointing in recent years despite the record length of the expansion and huge corporate tax breaks that were designed to stimulate such outlays.

Misguided Fed Hope for a Soft Landing

The tentative pact with China diffuses for the moment the long-simmering trade dispute that has not only impeded growth but also rattled the financial markets, causing wild swings in stock prices in response to the ebb and flow of trade negotiations. As well, the apparent agreement with Mexico and Canada on a revised NAFTA could also be a sign that trade disruptions will be less severe going forward. If so, the economy will avoid one of many possible external shocks that typically short-circuit an expansion.

Assuming that is the case, the odds of a recession occurring in 2020, which reached a fever pitch over the summer, looks to be lower now. With the job market still humming, household confidence high and trade risks receding, the Federal Reserve understandably moved to the sidelines at the December policy meeting, following three rate reductions in 2019. Indeed, the median forecast of the policy-setting committee suggests that the next move in rates will be up, not down, with the first projected to come in 2021. Simply put, the Fed believes that it has engineered a soft landing for the economy with its mid-cycle downward adjustment in rates, and the stage is set for it to resume normalizing rates in coming years. That's a heroic assumption, something that has rarely been accomplished in recent history. The three rate cuts during the slowdown in 1995 was one recent exception that succeeded in reinvigorating the expansion.

But the environment has changed significantly over the past 25 years, with the spread of globalization and populist policies that embrace protectionism as a means of gaining a competitive advantage over other nations.

Historically, this type of mercantilist approach to spur growth has backfired, resulting in reduced trade and higher costs for companies with global supply chains. Those disruptions are already playing out and affecting the bottom line of U.S. multinational corporations. Corporate profits have declined for three consecutive quarters from year-earlier levels, and the earnings recession is expected to continue in coming quarters. What's more, despite the tentative truce with China, it is unlikely that trade uncertainty among business leaders will vanish overnight, given the perception that the administration would readily change course if it believes China is not living up to the deal.

Consumers Will Have Less Firepower

Against this backdrop, we expect consumers, emboldened by a solid job market, continue to be the sole engine driving the economy forward next year, which should keep the Federal Reserve on the sidelines for a while longer. But households cannot carry the load forever, and their firepower should steadily diminish as the year progresses.

The remarkable strength in the job market this year surprised everyone, including the Fed, by drawing undetected workers off the sidelines and sending the labor force participation rate higher than thought possible without igniting an inflation outbreak. No one knows precisely how deep the pool of sidelined workers is, but the valve is closing and a growing shortage of labor will soon curtail job growth. As fewer workers are added to payrolls, income growth will also slow and curb the spending power of households.

To be sure, the retarding impact on incomes from slowing job growth could be offset by stronger wage gains. Some pockets of wage acceleration will likely occur, particularly in industries facing a severe labor shortage where there is fierce competition for workers. But collectively, businesses are not in a good position to accommodate higher labor costs. Profits are already being squeezed and corporate pricing power is constrained by global competition, heightened price transparency enabled by the Internet and the strong dollar, which cheapens imports. These pincers will not ease their grip anytime soon and corporate resistance to wage demands should remain high.

With profits under pressure so too is the incentive to increase investment spending. As it is, the industrial sector has been hit hard by the trade wars and slowing global growth in 2018, a double whammy that has depressed production and opened up more capacity than needed. As noted, the phase one deal just struck with China is a hopeful sign that trade tensions will de-escalate and lower the level of uncertainty that has contributed to the pullback in investment spending. But that is more hope than reality given the volatile history of trade negotiations between China and the U.S. It is unlikely that the latest truce will anguish trade uncertainty and embolden companies to step up investment spending in the near term.

Simply put, the economy's growth engine is heading into the new decade running mainly on one cylinder - the consumer, which is poised to provide less torque in the year ahead. As momentum gradually cools, the Fed will be brought back into play sometime during the year, particularly if inflation remains stubbornly below the 2.0 percent target and shows no sign of picking up. Keep in mind that the annual rotation of regional bank presidents on the FOMC removes two hawks (Lester and Rosengren) and retains three who are either doves (Kashkari) or neutral (Kaplan and Williams). Not only is actual inflation still undershooting that target, inflation expectations are falling. According to the latest University of Michigan Survey, released on December 20th, consumer long-term inflation expectations fell to the lowest level since the survey started including that question in the 1970s.

The Boeing Depressant

From our lens, the Fed's next move will be down, not up. While the economy appears to have ended 2019 on a firm footing, it is poised to slow down as the new year gets underway. At least one unappreciated external shock will sap it of considerable strength as the curtain rises on 2020. Boeing's decision to halt production of the 737 Max starting in January will leave a considerable mark on the economy, as it poses another headwind for industrial activity. Using BEA data on business investment, exports and inventories of aircraft, engines and parts, we estimate the drag from the production interruption could slice as much as 0.5 percent from the annual GDP growth rate in the first quarter.

While the 737 Max is assembled at Boeing's Renton Washington facility, the inputs are sourced from approximately 900 firms spread across the country. For now, the 12,000 Boeing workers tied to the 737 MAX production have been temporarily reassigned and continue to be paid. However, the reassignment may well turn into a furlough in the future if the FAA does not recertify the aircraft for service. We estimate that direct lost wages will total $1.2 billion, if all employees are laid off for a full year. But that only tells part of the story; since Boeing's suspension of activities will ripple through its supply chain, estimates suggest that up to four jobs are indirectly tied to the 737 MAX production for every Boeing employee. Hence, the income loss would turn out to be a multiple of $1.2 billion at the national level. As the first quarter unfolds, asset values should stop moving in unison, as they had in 2019. While it isn't unusual for financial markets to deviate from developments in the economy – after all, markets are driven by expectations more than current events – a sustained wedge between market prices and fundamental drivers such as growth and inflation can represent a material risk to the economy. When valuations adjust rapidly, prices fall, and this has real economic impacts via wealth and confidence channels.

Hence, when bond and equity returns move in unison, a common question is: Which market is right about the outlook? Higher bond returns imply a more pessimistic economic outlook and higher equity returns the opposite. Based on our relative pessimism on trend growth and inflation, current bond yields are closer to estimates of fair value. Conversely, we find it difficult to envisage an economic scenario over the near term that will deliver the kind of earnings growth that is currently priced into the equity markets. The prospect of a severe stock-market correction when investors reassess the balance of risks and rewards in an environment of low inflation, slowing growth and deteriorating profitability is another potential headwind confronting the economy in 2020.

RATES AND TOTAL RETURNS QUARTERLY AND ANNUAL COMPARISONS

U.S. Treasury Market	Yields (%)			Total Return (%)	
(Barclays TSY Bellwethers)	12/31/2018	9/30/2019	12/31/2019	Last Quarter	Last Year
6-Mo. Bill	2.48	1.82	1.57	0.53	2.55
2-Yr. Note	2.50	1.62	1.56	0.41	3.31
5-Yr. Note	2.51	1.55	1.68	-0.28	5.82
10-Yr. Note	2.69	1.67	1.91	-1.77	8.90
30-Yr. Note	3.02	2.12	2.38	-4.88	16.43

Municipal Bonds	Yields (%)			Total Return (%)	
	12/31/2018	9/30/2019	12/31/2019	Last Quarter	Last Year
Barclays GO Bond Index	2.54	1.73	1.64	0.81	7.30
Barclays State GO Bond Index	2.46	1.66	1.54	0.84	6.78
Barclays Local GO Bond Index	2.62	1.80	1.73	0.78	7.86
Barclays Revenue Bond Index	2.81	1.94	1.89	0.71	7.93

Equities	Levels			US $ Terms (%)	
	12/31/2018	9/30/2019	12/31/2019	Last Quarter	Last Year
S&P 500	2506.85	2976.74	3230.78	9.06	31.48
DJIA	23327.46	26916.83	28538.44	6.67	25.34
NIKKEI (Tokyo)	20014.77	21755.84	23656.62	8.14	22.37

Commodities	US $			Percent Change (%)	
	12/31/2018	9/30/2019	12/31/2019	Last Quarter	Last Year
COMEX Gold Active Monthly	1281.3	1465.7	1523.1	3.92	18.87
CRB Future Com. Pr. Index*	169.8018	173.9399	185.787	6.81	9.41
West Texas Intermediate Crude ($ per bbl.)	45.41	54.07	61.06	12.93	34.46

Currencies	Levels			Percent Change (%)	
	12/31/2018	9/30/2019	12/31/2019	Last Quarter	Last Year
Yen	109.69	108.08	108.61	-0.49	0.98
Sterling	1.2754	1.2289	1.3257	7.88	3.94
Euro	1.1467	1.0899	1.1213	2.88	-2.22

Global Bond Markets**	Levels			US Dollar Terms (%)	
	12/31/2018	9/30/2019	12/31/2019	Last Quarter	Last Year
German 10-Yr.Bond	0.09	-0.66	-0.28	-3.05	3.16
Japanese 10-Yr.+ Bond	-0.08	-0.32	-0.08	-1.90	0.16
UK 10-Yr.+ Bond	1.17	0.35	0.71	-2.41	4.77
Emerging Market (USD)	6.05	5.00	4.89	2.09	13.11

Source: Bloomberg Financial Data
*Thomson Reuters/Jefferies CRB Commodity Excess Return Index
** Global Bonds Represented by Bloomberg Barclays Indices