Economic Outlook

Second Quarter 2018

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The Market Plot Takes a New Twist

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SEI recently released its second-quarter Economic Outlook. A summary of the conclusions is provided below:

- Investors were raging bulls at the beginning of 2018 as equity prices vaulted higher. That optimism faded dramatically as the news flow turned less favorable. This diminution in investor spirits can be interpreted as a good thing; the potential for a meaningful advance in equities is more significant when investors are pessimistic and bad news is already discounted in the price of riskier assets.

- If one believes, as we do, that the global economy is sound and the political uncertainties roiling markets will be contained, then the proper course is to maintain exposure to equities and other risk assets.

- If it weren't for fears of a trade war pitting America against foes and allies alike, it would be a wonderful life for investors, businesses and consumers. Corporate tax reform, tax cuts for households and modified regulation of various industries have led to record-high consumer and business confidence.

- Sabre-rattling between America and China, meanwhile, has deteriorated into actual skirmishing, and the latest back-and-forth suggests this spat could get worse before it gets better. The strategy of waging a trade war with China could prove to be the equivalent of cutting off one's nose to spite one's face.

- A trade war will lead to higher prices for consumers and hurt the bottom lines of companies that sell imported goods and depend on global supply chains in their production process. The result is a net loss for society. A small group of producers will probably benefit substantially from the trade impediments, while most consuming industries and households will suffer a decline in purchasing power that might be small at the level of the individual but adds up to a significant loss across the economy.

- Most important, the stoking of trade-war tensions by the U.S. threatens to undermine the very foundation of the system that has supported the global economy since the end of World War II. Although the actual trade actions to date have been modest, the impact on global supply chains bears close watching.

- We will be watching closely as this drama plays out in the months ahead. With any luck, the Trump Administration will shy away from ratcheting tensions up further. We must admit that doesn't seem to be in the cards in the near term.

- However, the economic fundamentals that drive the stock market appear stable, even in Europe and developing economies. Nor are interest rates at levels that will crunch global economic growth. The risks appear more political in nature. The escalation of trade tensions and the polarization of electorates over issues like immigration and fiscal sovereignty are the negatives. A still-solid global economy, strong momentum in corporate profits growth and equity valuations that still appear reasonable against the backdrop of still-low, albeit rising, interest rates are the positives.

- A broadening of the trade war with China or a U.S. pull-out from the North American Free Trade Agreement would have a sorely negative impact on the profitability of U.S. manufacturers, prompting a reassessment of our still-positive view. Impediments to trade also could lead to a higher inflation rate as domestic companies use the tariffs umbrella to raise their selling prices. The Fed may feel compelled to lean against this threat to price stability, thereby aggravating any economic shock arising from the disruption of global supply chains. This is how a bear market could develop.

- We want to emphasize that this is not our base-case scenario. We still think this old bull has some life left in it. That said, the risks to the equity market now seem more balanced rather than skewed to the bullish side.

A full-length paper is available if you wish to learn more about this timely topic.