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MARKET COMMENTARY

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Good News Continues Despite Trade War Threats

By Daniel Wildermuth

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As June drew to a close, the economic news in the U.S. remains quite good. The Federal Reserve Bank of Atlanta projected second quarter growth at 4.5% while Macroeconomic Advisers estimated GDP to hit a sizzling 5.3% annual rate. The strong growth numbers follow first quarter's normalized calculation of 2.8% growth, just a bit above the more recent average of 2.7% annual growth. (Note, first quarter numbers were generally reported at around 2.0% because of the way the government seasonally adjusted economic data.)

Corporate earnings growth, the primary driver of stock prices in the long-term, has continued to accelerate in recent quarters. The strong growth in earnings, the "E" in the price to earnings (P/E) ratio has pulled equity valuations down much closer to historical averages. According to FactSet, most analysts predict the earnings growth rate will decline a bit, dropping to around 19% in the second quarter, 21% in the third and 17% in the fourth. While some project earnings growth will slow to the single or low-double-digit range next year, others believe earnings can remain strong, partly driven by the tax overhaul and loosened regulation.

Many sectors of the U.S. economy are enjoying attractive growth. Within U.S. businesses, computer software sales and research & development increased, growing at the fastest pace in three years. Spending at U.S. retailers also soared in May, jumping 0.8%, the biggest jump in six months according to U.S. government data. Americans boosted spending on cars, building supplies, sporting goods, clothing, health products, healthcare and bar tabs (hopefully, the last two are not connected).

Unemployment reached an 18-year low, and job and wage growth is steady or even accelerating. For the first time since record-keeping began in 2000, the number of positions available exceeded the number of job seekers according to the Labor Department. The unemployment rate has not been lower since 1969 when the Vietnam War draft pulled men out of the workforce.

Outside of the U.S., the eurozone remains solid, but the region is no longer enjoying the strong growth that exceeded that of the U.S. for the last couple years. Expected region GDP growth for the second quarter has fallen to around 2.0%. Germany reported that factory orders dropped 2.5% in April. Italy suffered yet another political crisis and France is again struggling with labor strikes. Italy's problems particularly upset various financial markets by raising fears that the new populist government could push the country out of the eurozone. As a result, GDP growth projections for the eurozone were lowered to 2.1% for the year. Still, confidence remains strong enough that the European Central Bank is planning to phase out its bond-purchase program, known as quantitative easing.

Beyond the Eurozone, emerging markets equities have struggled in 2018 after a stellar 2017. The strengthening dollar has weakened local current returns and reduced investment flows. A higher Fed fund's rate also adds costs to servicing debt which is usually dollar denominated. Still, neither headwind should derail emerging markets for long, as economic fundamentals remain solid.

Against a backdrop of ongoing good news, a couple of worries persist. The highest profile concerns center on the very public threats of a U.S. trade war with various countries. President Trump recently backed away from earlier high profile plans to levy tough new restrictions on Chinese investments in the U.S. and U.S. technology exports to China.

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The news cheered financial markets that had been rattled by increased saber rattling by both sides.

Still, trade concerns remain because of the costs a trade war would add to all kinds of goods and services. For decades, companies have focused on optimally locating various creation and manufacturing inputs ranging from labor to know-how to infrastructure, a trend that accelerated in the post WWII explosion of free-trade. Now, various companies are making plans to move manufacturing elsewhere to localize production. As an example, Harley-Davidson is planning on moving production out of U.S. to avoid European Union retaliatory duties. The impact globally is also multi-faceted. While the U.S. stock market declined slightly on threats of a trade war, equity shares in Chinese markets have plummeted, nearing bear market territory.

Another potential investor concern centers on interest rates. Soaring corporate profits, spectacular job growth, and an ongoing expansion nearing the longest on record are all spurring the Federal Reserve to raise rates to keep the economy from overheating. Yet, the increase to 2.0% has had little impact on markets, and the Fed's indicated target of 2.75% has enabled bond markets and institutional investors to set expectations while pricing the rate change into various asset values. As a result, market reactions to Boston Fed President Eric Rosengren's late June announcement that the Fed will keep raising rates were muted.

Related to rising rates, some have noted that the yield curve is getting closer to inverting, meaning that short-term rates are close to exceeding long term rates. An inverted yield curve has been a fairly reliable indicator of a coming recession since WWII. Yet, historically, long term rates have also been much higher than today, so now it's much easier for the yield curve to invert. For now, long-term rates remain low, signaling much confidence in the future. It's a unique set of circumstances making much of the historical data somewhat irrelevant. Undoubtedly, we will have another recession at some time, but higher short-term rates may not be the signal.

Recessions are notoriously difficult to predict, and often hard to recognize even after they start. It took a year after the 2007 recession began for the National Bureau of Economic Research's to declare we were in a recession. Various pundits and forecasters incorrectly predicted recessions in 2011 and 2016.

For now, the good news continues, particularly in the U.S. The big leap in earnings has brought valuations down to levels nearing historical norms, making the market much less expensive. Still, many would argue that much or even all of the good news has likely been priced into current equity prices, making more modest return expectations prudent. The last few years have been very good, and the future still looks good, but future returns are unlikely to match the tremendous run-up since 2009.

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