Daniel Wildermuth's
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Trade War Slowing Growth Back to the Mean, But Still Long-Term Positive

U.S. and global equity markets have struggled in May as concerns grow over a potential trade war and slowing global economies. While the market remains up over 11% on the year through May 30th, a loss of over 5% in May has taken some of the shine off of January through April's fabulous 17.5% gain (not even including dividends). Fresh memories of December's 10% plunge has probably further rattled many investors.

The timing of the trade skirmish and potential for ongoing escalation are more problematic because the U.S. is already very late in the current economic cycle and several trends are weakening. Debt levels have risen, corporate profits are falling, record employment levels present hiring challenges, and equity market valuations are somewhat rich. The steady decline in global growth adds another headwind to U.S. prospects and expectations.

GDP for first quarter growth was revised down to 3.1%. While growth above 3% appears fairly strong, the downward revision was more concerning because much of the growth resulted from temporary inventory buildup and a drop in the trade deficit. Sustainable underlying GDP growth estimates were estimated closer to 1.0 - 1.5%.

Domestically, the prospects of a trade war pile onto multiple areas showing weakness. Manufacturing, a great leading indicator given its high sensitivity to demand, is weakening. April durable goods orders — products designed to

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last at least three years, such as cars, appliances and commercial aircraft — tumbled 2.1% from the prior month according to the Commerce Department. The government also revised March numbers down to 1.7% from 2.6% illustrating weaker U.S. factory demand than anticipated. In April, the ISM manufacturing index fell 2.5 points to 52.8, the lowest level since October 2016. It is notable that these reports are from April, but the trade war did not accelerate until May, meaning there is very likely more weakness coming.

Commodities, the building blocks of construction and manufacturing also continue to slide. U.S. crude-oil prices and copper prices are down amid rising stockpiles, with both commodities off 10% or more from their 2019 peaks. While weaker commodity pricing could be blamed on a softening global economy, slackening demand is hard to ignore in the U.S. as corporate America remains the number one user of many major commodities.

Auto makers such as Ford and General Motors are also experiencing lower demand. The sector's announced job cuts are the highest since 2009, according to executive search firm Challenger, Gray & Christmas. Spending at U.S. retailers also fell, indicating that consumers may be showing some concerns. Home sales posted unexpected declines in April. The drop in spending is a bit puzzling because consumer sentiment hit a near 18-year high in May according to the Conference Board. While the report suggests that consumers, unlike investors, are not very concerned about the trade dispute, confidence is strangely absent in buying patterns.

Still, while markets may be reacting badly to recent challenges, the slowdown is hardly surprising. Many forecasters had projected that economic growth would slow from last year's pace, which was spurred by a strong labor market, tax cuts, and federal spending increases. It now appears that the slowdown projected for first quarter is arriving in second quarter. Macroeconomic Advisers is forecasting second quarter growth at 1.7%, the Atlanta Fed's GDPNow model is at 1.3% and J.P. Morgan significantly cut its

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estimate to 1.0% from 2.25%.

International economies reveal possibly greater challenges with the eurozone slowing sharply since the middle of last year. IHS Markit reported the eurozone's manufacturing and services sectors dropped to 0.4% quarter over quarter growth, half the level of the first three months of the year. Late May surveys recorded a further weakening of confidence among eurozone businesses. In Germany, the engine of the European economy, jobless claims rose unexpectedly in May, according to data from the Federal Employment Agency. Weaker demand for eurozone exports and the U.K.'s uncertain exit from the European Union also continue to act as a drag. Not surprisingly, minutes of the European Central Bank's April policy meeting revealed concerns that the eurozone's slowing could easily last longer than expected. While ECB officials emphasize their willingness to use all their policy tools to spur growth, their expected need to act decisively illustrates ongoing challenges.

In Asia, the theme of slowing growth continues. The Japanese government downgraded its view of industrial production and other key parts of the economy, highlighting concerns about the U.S.-China trade dispute. The monthly government report mentioned "weakness is seen recently in machinery investment" and that industrial production is "in a weak tone recently." Both phrases reflected a more negative view of the economy than noted in their April report. China's manufacturing PMI slipped to 49.4, below the 50 level indicating expansion. The bigger-than-expected drop was blamed on the trade spat with the US.

Still, against all this negatively trending data, it appears unlikely that slower growth is foreshadowing a U.S. recession. Rather, the economy appears to be reverting to its post-2008-recession mean. Estimates on the yearly GDP growth are mostly still above 2.0%. Rising productivity also offers encouragement. U.S. workers' efficiency improved during the past year at the best pace in nearly a decade, laying groundwork for stronger wage growth and continued economic expansion. Rising productivity could calm ongoing concerns over record low unemployment seen as a potential limit on the expansion potential of the U.S. economy.

While much of the news is trending negative, and various concerns have driven the market down a bit, the recent pullback is hardly surprising given the market's overly sharp rise through April. It seems very possible the market will continue to drop in the near-term as more modest growth assumptions are digested, but the longer-term trend should remain positive. Growth is softening, not ending.

Still, against this backdrop, an all-out trade-war could dramatically change expectations and market performance. China also appears very unlikely to make significant concessions before the next Presidential election, hoping for a new negotiating partner. The economy should continue moving forward and eventually drag the market along, but major political disruptions could quickly change the course.

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