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# Second Quarter Investment Commentary
# July 2018

*"When goods do not cross borders, soldiers will." - Frederic Bastiat, 19th century economist, writing about tariffs and trade barriers.*

## The Quarter

- Federal Reserve Bank increased short-term interest rates another 25 basis points (0.25%) to a target range of 1.75%-2.0%. It anticipates an additional two 25 basis point (0.25%) increases later this year.
- The European Central Bank (ECB) outlined plans to end its massive monetary stimulus, but also promised to keep short-term interest rates at their current levels through summer 2019.
- President Trump met with North Korean leader Kim Jong-Un, the first meeting of the leaders of these two countries.
- Trade tensions escalated, increasing uncertainty in financial markets.
- U.S. equities gained during the quarter, with small cap company stocks outperforming, benefitting from tax cuts and trade tensions. Smaller companies have less overseas exposure than larger companies, and are therefore less exposed to tariffs.
- The 10 year Treasury yield crossed 3.0%, before settling to 2.86% by the end of the quarter.
- Measures of inflation have gradually moved higher.
- Supreme Court Justice Anthony Kennedy announced his retirement, changing the future composition of the Supreme Court.

## Economic and Market Review and Update

Despite all of the pessimism, U.S. equities continued to eke out gains so far in 2018. This is in large part due to a domestic economy that is accelerating and expected to grow in the second quarter at the fastest annualized rate since 2014. Yes, at some point, there will be a recession and a bear market, but the data is not indicating one at this time.

- A new high for truck tonnage indicates there is no recession looming.
- By any measure, indices of transportation activity are booming, suggesting robust aggregate economic activity.
- The leading economic index is moving higher, and has not rolled over, which historically leads recession by over one year.
- Average hourly earnings (wages) have begun to accelerate, but not nearly at the pace that would precede a recession.
- Corporate earnings are solid.

- Financial conditions remain favorable.
- The yield curve (10 year less 2 year treasury rates) is still positive.
- Technically, the S&P 500 looks nothing like it did at the start of the last two bear markets. (In 2000 and 2007 multiple moving averages first flattened and then rolled over. That has not yet happened).

Although we are currently experiencing the second-longest economic expansion in U.S. history, it has also been the weakest. This weakness would indicate that many of the excesses that tend to build and cause recessions aren't yet present.

**Trade – a Different Look**

With this solid economic backdrop, perhaps this is a good time to be tough on trade. There are reasons why the U.S. should become more aggressive on trade. One would hope that the tension does not go so far as to disrupt the global economy and financial markets, especially with our current pro-business administration. At this point, investors do not anticipate trade tensions will become a full blown trade war. But trade concerns are having an impact on many measures of sentiment. Manufacturing companies are seeing the effects from steel tariffs and are worried about a potential trade war with China. The uncertainty is delaying some business activity, and ongoing trade disputes are likely to add to near-term volatility. The Trump administration's trade policies have the potential both to disrupt supply chains and increase costs.

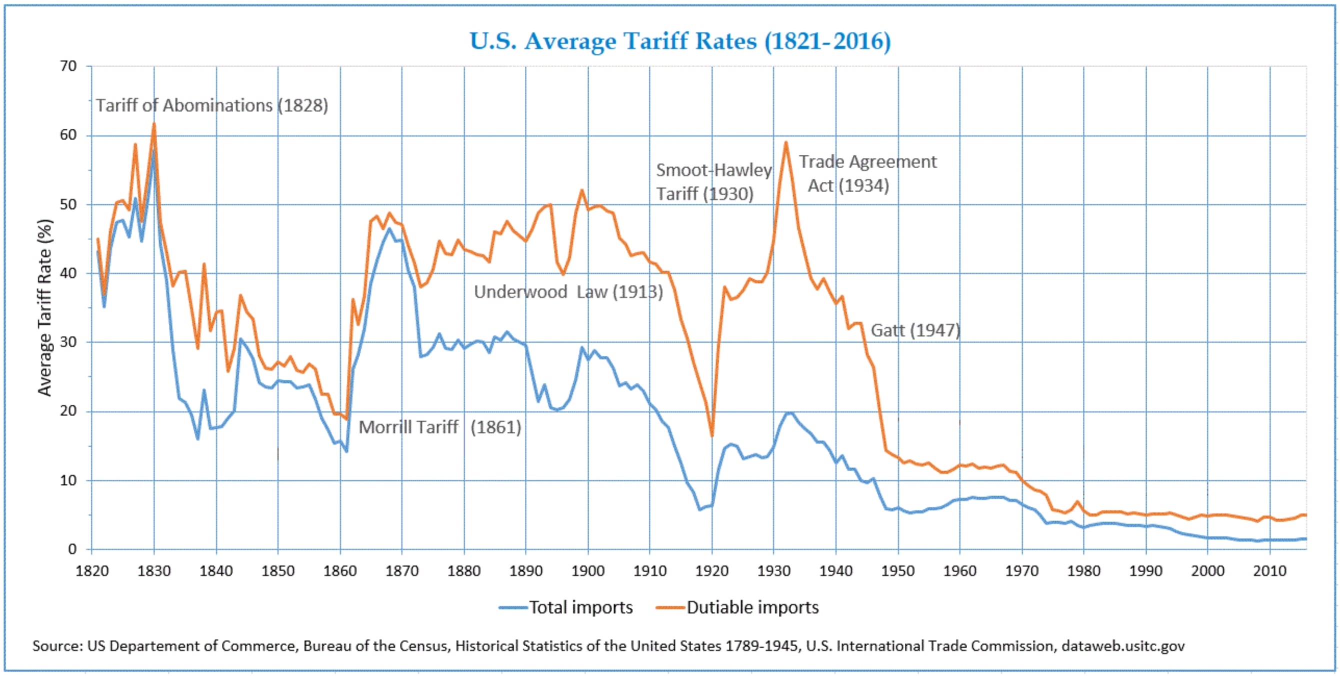
Increased tariffs will most likely not shrink the U.S. trade deficit to the degree it appears the administration would like, but it is time that the U.S. addresses the issue of "free trade". Many countries have long taken advantage of the U.S. and are provided much better access to the U.S. market than U.S. firms are provided access to their markets. The G6 (Canada, Germany, France, Italy, the UK and Japan) have run a trade surplus with the U.S. for over a decade. This is also true with China and many other Asian counties.

The U.S. is a consumer driven economy where two-thirds of economic growth comes from consumption. After World War II, international trade expanded rapidly. In part this was due to lower transportation costs, but it was also the U.S. leading the creation of the multilateral General Agreement on Tariffs and Trade (GATT) in their desire to integrate and rebuild the post-war economy. U.S. tariff rates fell and non-tariff barriers were reduced. Trade expansion was central to broader U.S. foreign policy. The U.S. financed the rebuilding and developing of foreign economies by buying the goods they produced. Consumption grew rapidly in the U.S. during this period.

This continued as China began to develop its economy. China used exports as an avenue to economic development, and its manufacturers gained market share from 1970 to 2000. In 2002, China was admitted to the World Trade Organization (WTO), further increasing its access to international markets. However, China did not open their economy to foreign goods as was intended. Over the past 30 years, tariffs around the world collapsed, but the Chinese sustained tariffs at relatively high levels. The government continues to own and influence many of their companies. It has also made it difficult for foreign companies to operate in China. It is estimated that Chinese theft of American intellectual property currently costs U.S. companies up to $600 billion annually.

The chart below shows the steep decline in tariff rates after WWII. The economic impact of a trade war is expected to be much less than in the Smoot-Hawley era. Woody Brock, President and founder of the economic think tank Strategic Economic Decisions, wrote "Furthermore, the incentive for both sides to have a trade war is less than it used to be. … China itself will lose jobs when it discriminates against American products that are partially produced within China. As a result, we suspect great efforts will be made by both sides to limit protectionism."

**Tariffs: a historical perspective**




Bob Brusca, Chief Economist of FAO Economics, wrote an analysis of U.S. trade issues and the pros and cons to the U.S. running continual trade deficits. He believes that countries have manipulated their currencies, not allowing their currencies to rise. As a result they stay too competitive while the U.S. remains uncompetitive. "Under Free Trade each country is supposed to produce according to its comparative advantage. But the U.S. is producing less; Asia is producing more; and the US is consuming more as the structural US current account gap leaches US income off and stimulates growth overseas while taking away from growth in the US. US spending stimulates growth abroad as US citizens buy imports (foreigners' exports) and their exporters thrive on these payments. This is NOT FREE TRADE." He does not think the announced tariffs will fix this, but "they do put the rest of the world on notice that the US is finally going to stick up for its firms."

## A look ahead

The current economic expansion is now nine years old and the second longest expansion in the post World War II era, only to be surpassed by the expansion in the 1990's and early 2000's. As discussed earlier in this commentary, many indicators are pointing to the expansion continuing for at least another year (barring some unforeseen event). It has taken awhile for excess capital and labor to be used, keeping inflation and interest rates at bay. But, the U.S. economy (as are other global economies) is beginning to push up against capacity constraints. One example is in the labor market. The monthly unemployment rate was 3.76% in May, the lowest rate in over 40 years. Wages have yet to increase at the same rate as they have historically at such a low unemployment rate, but are moving higher. More and more businesses of all sizes are reporting the difficulty in finding qualified labor, and for the first time in decades, there are more jobs available than there are people looking for work.

Economic downturns are usually preceded by a ramp up in inflation and interest rates, something that is not happening now on the same scale. It is reasonable to expect that as the labor market tightens, wages begin to increase at a faster pace, and the Federal Reserve pushes interest rates up to a point that restrains economic activity. We will be watching our economic and market indicators closely.

**Closing Comments**

*There are a million ways to get rich. But there's only one way to stay rich: Humility, often to the point of paranoia. The irony is that few things squash humility like getting rich in the first place.* – Morgan Housel

The other day Paul received a call from a relative of a client, with a question regarding a solicitation he had received from an investment newsletter. The author of the newsletter claimed that he had called the 1987 crash, the 2000 dot com bust and the 2008 financial crisis. There exists no humility in those claims. Paul and I wondered why, if the newsletter author had actually achieved this incredible trifecta, then why is he still publishing a newsletter rather than enjoying life in an enclave somewhere on a mountain/beach/locale of his choice? Legendary hedge fund investor Julian Robertson quietly retired to an estate in New Zealand. That sounds more appealing than soliciting newsletter subsribers.

I enjoy watching NFL games, but get annoyed with the celebrations that seem to come with every play, particularly on defense. Celebrating after a touchdown seems appropriate, but celebrating after a play, when on the next play you may get your helmet handed to you, seems a little too boastful to me. It is similar in investing. The financial markets often do not care about how smart you are, or may think you are, what your opinions are, or how often you have been right in the past. There will always be times when you are humbled. It is how you handle that humbling that is important. We understand that is the case.

Things are heating up here in KC, although unfortunately not for the Royals. Get out there and have some fun, take some trips and try to stay cool.

| Kevin | Paul | Matt | Diane |
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