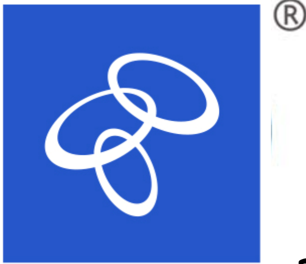


Paragon Monthly

JULY 2018

2018 Mid-Year Review & Outlook: A Tug of War

As discussed last month in our piece titled, *Diverging Paths Are Creating Global Turmoil,* the world economies and capital markets are not synchronized. This unfortunate circumstance is partly of our making and has significant ramifications for investing going forward. Like a game of "tug of war," markets are being pulled back and forth by the positive force of strong fiscal stimulus and deregulation, while being buffeted by the economic drag of a potential trade war. Which force will win?

Source: www.123rf.com

In addition, the tug of war is being fought on precariously rocky high ground. Exhibit 1 illustrates the current relative positions of the major world economies after 10 years in this business cycle. As shown, most of the world's economies have passed their peak growth rates and are now experiencing a gradual slowdown. For example, the U.S. is at or close to full employment and would normally be about to slowdown. But it's not.

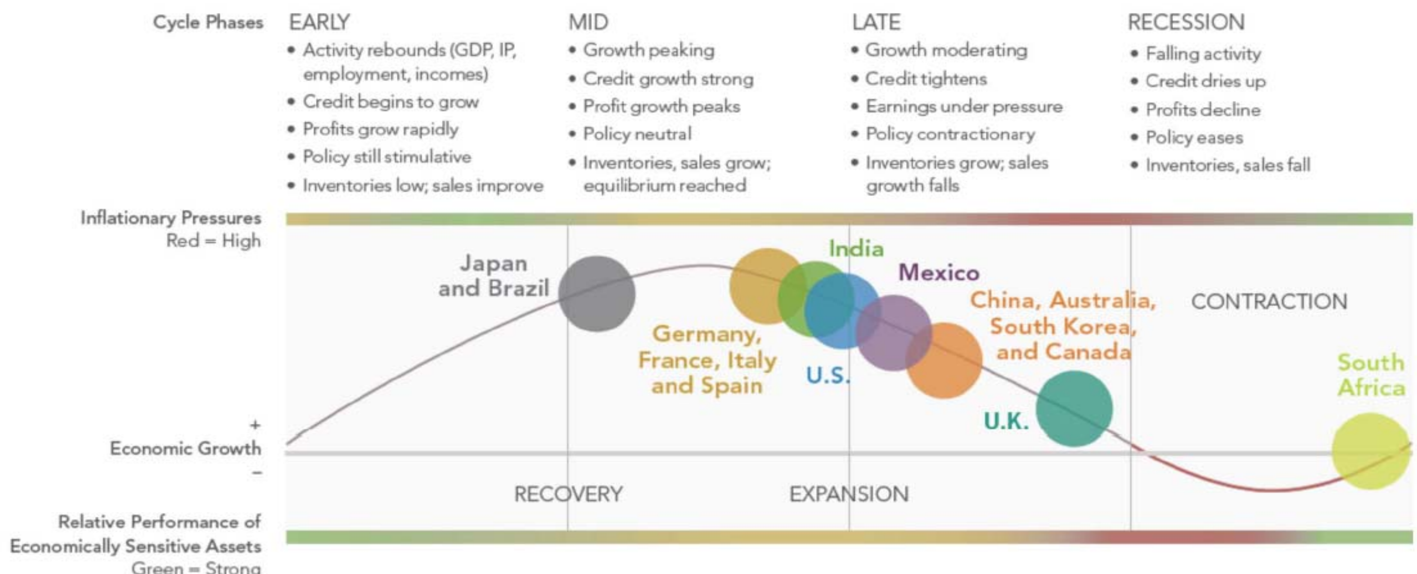
This is because the U.S. passed a huge $1.5 trillion 10-year tax cut (primarily for corporations) in late 2017, along with an additional special boost of $300 billion. By implementing such a large fiscal stimulus at this late stage of the business cycle, the effect will "super-charge" the U.S. economy at a particularly precarious time.

Along with boosting our GDP, the stimulus will also strengthen the U.S. dollar, increase the likelihood of price increases, worsen the U.S.'s fiscal debt condition, and confound the Federal Reserve's attempts to normalize interest rates.

In 2018, world capital markets are reflecting the crosscurrents from our new policies and have become much more volatile. Let's review the first six months before we discuss how we expect the rest of the year to play out.

UNITED CAPITAL
SEATTLE
1420 Fifth Avenue
Suite 3020
Seattle, WA 98101
206-583-8300
PARAGON@UNITEDCP.COM
WWW.SEATTLE.UNITEDCP.COM

Exhibit 1: Stages of the Business Cycle and Where The Major Countries Stand



Note: The diagram above is a hypothetical illustration of the business cycle. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one. Source: Fidelity Investments (AART), as of March 5, 2018.

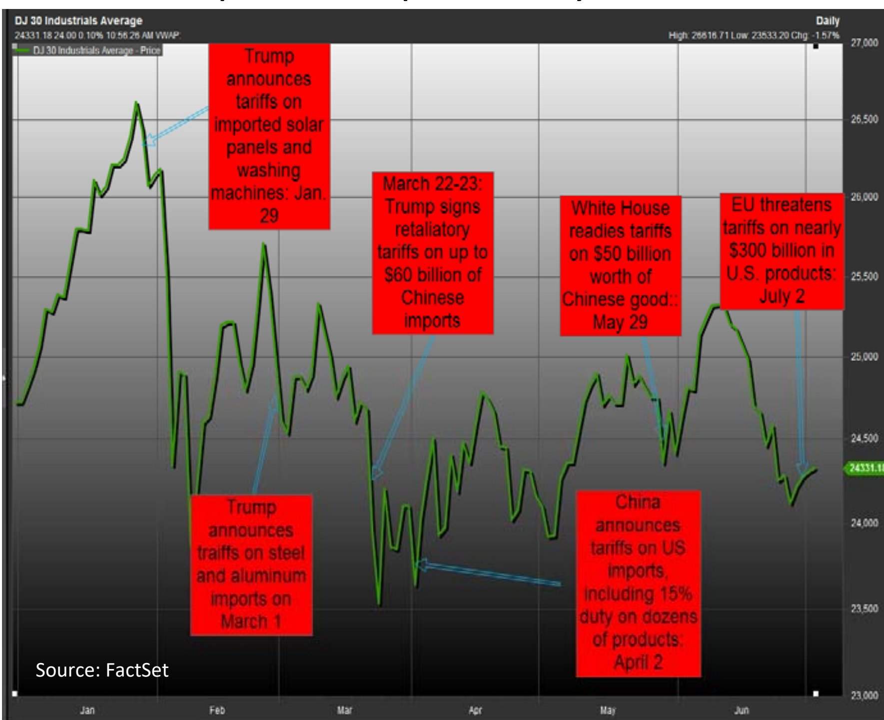
Exhibit 2: S&P 500 Price Performance Since Jan. 1, 2018

Exhibit 3: First Half Asset Returns and S&P EPS est.

Index	Total Return
S&P 500 Index	2.65%
MSCI All Word (ex. U.S.) Stock Index	-3.77%
Barclay's Intermed/Gov/Credit Bond Index	-0.97%
ML 3-7 year Muni Bond Index	0.27%
Earnings Estimates and P/Es	
S&P 500 2017 Operating EPS act.	$133/share
S&P 500 2018 Operating EPS est.[1]	$161/share
S&P 500 2019 Operating EPS est.[1]	$177/share
S&P 500 2018 P/E est.	16X
S&P 500 2019 P/E est.	17X

Source: All Return Data from Bloomberg, (6/029/2018) 1= Estimates are provided by FactSet (June 20, 2018)

Exhibit 4: The Sequence of Trump Tariff Activity in 2018



A Six Month Review—Volatility Increased

Exhibit 2 illustrates the volatility that characterized the S&P 500 Index during the first six months of 2018. Despite that, the S&P 500 eked out a paltry total return of 2.65% for the half-year (Exhibit 3). Stock markets around the world faired less well. The MSCI All World Index (ex. U.S.) returned –3.77%. Not surprisingly, most U.S. longer-term bond portfolios also exhibited negative returns due primarily to the Federal Reserve raising short-term interest rates.

Behind the curtain of stock market volatility has been significant rotation amongst sectors and companies, as investors have attempted to anticipate and react to rising short-term interest rates, a strengthening dollar, abnormally strong corporate profits growth (+20% due to the tax cut), improving economic conditions in the U.S., declining economic conditions in Europe and China, and rising political uncertainty around the world. Especially notable in Europe was the election of two populist parties in Italy (The Five Star Movement and The League) who both have expressed interest in leaving the European Union (EU). This is renewing worries about the future political stability of the EU.

On balance, U.S. capital markets have benefited from global uncertainty as world-wide capital flows turned toward the U.S. on the margin. As uncertainty prevails, some of the financially weaker countries have begun to lose capital to the perceived "safe haven" of U.S. Treasuries. This is forcing foreign governments to raise their interest rates to protect their currencies from tumbling, or implementing financial incentives or improvements in order to attract business and capital.

A New Uncertainty Factor: Will There Be A Trade War?

Amidst all the economic and portfolio shifts has been the disconcerting drumbeat and the initial implementation of protective trade tariffs by the Trump administration. As we wrote in our March "*A Primer on Tariffs and Trade*," despite Trump's tweet that "We can win a trade war," most economists agree, no one wins a trade war. Despite opposition, the President and his administration have been steadily escalating the rhetoric and executive actions to implement one. Exhibit 4 illustrates this year's sequence of tariff-related events. (The Dow Jones Index's price action is shown via a green line.) For example, on March 1st, Trump announced his intention to add a 25% tariff to imported steel and a 10% tariff on imported aluminum. On June 1st, those tariffs were implemented.

In response to President Trump's June announcement that he will impose a 25% tariffs on all imported cars if appropriate alterations or recompense in our trade terms are

not made, the European Commission sent a letter to the U.S. Department of Commerce, indicating that if the Trump administration went forward with such a tariff, the EU would slap a comparable tariff of ~$300 billion on U.S. imports. This is roughly the same amount the U.S. imports of autos and auto parts.

China Is The Main Target of the Trump Tariff Action
Most upsetting to the Trump administration is our trade relationship with China. He has stated that China has "stolen trillions" from us in intellectual property over the years and he intends to remedy this. To start that ball rolling, on his first day of office he signed an executive order to withdraw from the Trans-Pacific Partnership (TPP). On January 29th he announced tariffs on solar panels and washing machines (primarily made in China) and indicated in late March that he was planning on implementing a 25% tariff on an additional $60 billion of Chinese imports. On April 2nd, China retaliated with their intention to place additional tariffs on 128 American imported items including pork, wine and fruit.

In response, the Trump administration announced that the U.S. would impose a 25% tariff on $34 billion of Chinese technology products with future tariffs on another $16 billion of products. And again, China responded quickly with a proposed 25% tariff on $34 billion of U.S. imported products (automobiles, planes, and soy, etc) and an additional $16 billion of products (chemicals, coal, crude oil, and medical devices) on which tariffs are to be implemented later.

In an attempt to preclude the Chinese from retaliating further, Trump has said he will impose an additional 10% tariff on approximately $200 billion of Chinese goods and services if they retaliate. However, to address and anticipate that tactic, the Chinese leader Xi Jinping said on June 25th, "'In the West you have the notion that if somebody hits you on the left cheek, you turn the other cheek. In our culture we punch back."

On July 6th, both the U.S. and China implemented their intended tariffs on the $34 billion of goods and services. The trade war has officially begun.

Additional trade actions we should expect are: restricting direct investment, limiting travel, making visas for employment or educational purposes extremely difficult to acquire, prohibiting trade in specific technology products, and lowering the value of the currency.

China Is Going After Trump's Base
China's current strategy is to target products that are produced in Trump's home base states. By specifically targeting products this way, they are hoping to change the outcome of the November elections. Examples of products that are on this list are: soybeans, apples, cars, crude oil, pork, chicken and seafood.

So Far, The Trade Talk "Bark" Is Worse Than Its Bite
Until now, the enacted and announced tariffs and restrictive trade actions don't represent much of a damper on economic growth. Current estimates of the effects range from a .1% to .4% drag on GDP. However, further escalation could lead to a significant economic effects.

The reasons why tariffs impede trade are clear. Tariffs raise prices. As prices rise, disposable income can buy less and less. If a full-blown trade war does emerge, we would expect a recession to ensue, probably by the end of 2019. The stock market would decline far in advance. But, it is premature to assume that the current rhetoric and action is sufficient to seriously overwhelm our strong domestic fiscal stimulus. In that sense, Trump's tax cuts have generated strong support and a cover from which to negotiate. However, the cover that the Trump administration is using to renegotiate our trade terms with others is not as foolproof as they may think. Ironically, it has a fatal flaw that may become apparent soon.

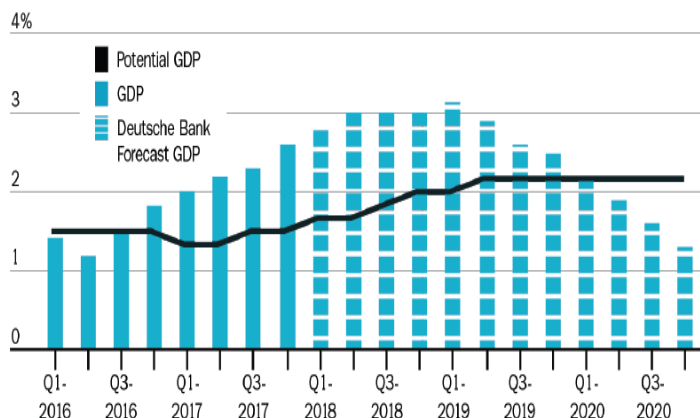
Assessing Trump's Two Conflicting Policies
The irony of the Trump administration's policies on trade and tax cuts is that they are contradictory. On one hand, Trump ran on a protectionist platform that offered a plan to protect U.S. industry and intellectual property. His administration believes that by protecting U.S. industry from foreign competition, it will provide the framework to restart and reward the virtues of American hard work and ingenuity. To deliver on that promise he and his advisors believe that we need to reduce the trade deficit. This can only be accomplished by exporting more and importing less. They believe that our trade balance with each country should be roughly zero. This sounds good at face value, but actually isn't the optimal strategy. As we pointed out in our March piece, *A Primer on Tariffs and Trade*, employing Ricardo's concept of comparative advantage to who we trade with and for which products offers a much wider and long lasting path toward producing wealth for our citizens.

The contradiction inherent in Trump's big tax cut is that it is actually going to increase our trade deficit! The Trump administration's macroeconomic policies are at odds with the intentions of his trade agenda. Let's see why.

Fiscal Stimulus Will Widen the Trade Deficit

1) A large fiscal stimulus package, as assembled and implemented last year, will boost GDP growth. This higher demand will show up as increased demand for both intermediate and final goods some of which will be imports.
2) With the economy already strong, the stimulus of the tax cut could soon result in an overheated economy. This would be expressed via rising wages and prices.
3) If prices start to rise at a faster pace and go beyond the Fed's stated range of "symmetrical around 2%," the Fed will raise short-term interest rates more aggressively

Exhibit 5: A Forecast of U.S. GDP by Quarters



Source: Deutsche Bank

than they otherwise would. This will raise the cost of new debt and overall interest costs.

4) Higher interest rates along with a strong economy will boost the dollar. A stronger dollar makes it cheaper to buy imported goods and services. This too will lead to a wider trade deficit.

The Timing Was Wrong to Stimulate The Economy

A strong fiscal policy is useful when the economy is operating at sub-par rates of growth. But, boosting fiscal stimulus in times of full employment is not recommended by most economists for the reasons given above.

Exhibit 5 illustrates Deutsche Bank's (DB) forecast for U.S. GDP by quarters over the next two and one-half years. Even though our GDP forecast is not exactly the same as theirs (2nd qtr. GDP is likely to be closer to 3.5-4%), we share the general shape described by the graph. The GDP projection illustrated in Exhibit 5 implies that U.S. growth will be accelerating into the second half of 2018 and early 2019, due to the Tax Cut stimulus. But after that we should expect a rather rapid decline in the rate of growth.

If GDP growth declines back to levels below 2% in 2020, corporate profits, which are growing at abnormally high rates today (+20%), will be slowing from here on, and could stall in 2020 as labor shortages, price increases and capacity bottlenecks put pressure on profit margins. The stock market would anticipate this by at least one year, so we are watching to see what policies the Fed, and or other Central Banks might employ to offset this.

Our Outlook

From the foregoing discussion about trade, tariffs, and the risks associated with stimulating an economy that is already close to full employment, the reader can detect the precarious and complex nature of the current economic environment. In order to sort out and balance this complexity, we list below some of the signposts that guide us regarding conditions and potential outcomes for the capital markets. Here is what we are paying attention to:

1) Tariff discussions between the Trump administration, Europe, China, Canada, and Mexico. These discussions might be resolved amicably later this year, or they might escalate, harming market valuations and future economic growth.
2) Price indices such as the CPI and PCE, both the headline and core rates. Numbers at or below 2% are perceived to be benign.
3) Wage gains and total compensation rates. So far, year-over-year rates of change have been below 2.5%. The exception was the January number of 2.9%, which we believe caused the large downturn in the stock market starting January 26th.
4) Oil prices. The latest run-up to $70+ /barrel has become the focus of the Trump administration as they publicly ask OPEC to curb prices. A price between $65/barrel and $75/barrel does not represent a serious impediment to U.S. growth.
5) China's GDP growth rate and fiscal activity. China and its satellite nations of Asia will continue to be an engine of growth in the world. A GDP growth rate below 6% will be perceived negatively by the world. China's stock market decline of over 20% from its peak suggests that a significant slowdown might lie ahead.
6) How our Federal Reserve adapts to all of the changes. Their desire to normalize interest rates will also be a dynamic process and subject to change.

There are many risks in the current geopolitical and economic environment. Exhibit 1 illustrates the changing nature of current global conditions. Predicting the exact timing of a global slowdown is always tricky, but we have found that a well diversified portfolio of high quality companies and high quality bonds can weather most environments. The global tug of war we are experiencing will produce either better terms of trade for the U.S. or an administration that learns to co-operate. Both outcomes are welcome.

MARKET STATS

S&P 500	2718
DOW JONES	24271
10 YR T-BOND	2.85%

As of 06/30/2018

Source: Bloomberg

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