Building & Preserving Wealth by Design - Not by Chance

QUALITY FINANCIAL CONCEPTS

QFC's Insights

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Market Insights and Updates

"China Trade War(?) or Tit for Tat"

Any idea what I am expecting the market to continue to do for a while? Market volatility often reflects uncertainty in the near term. Recessions reflect market uncertainty for the midterm.

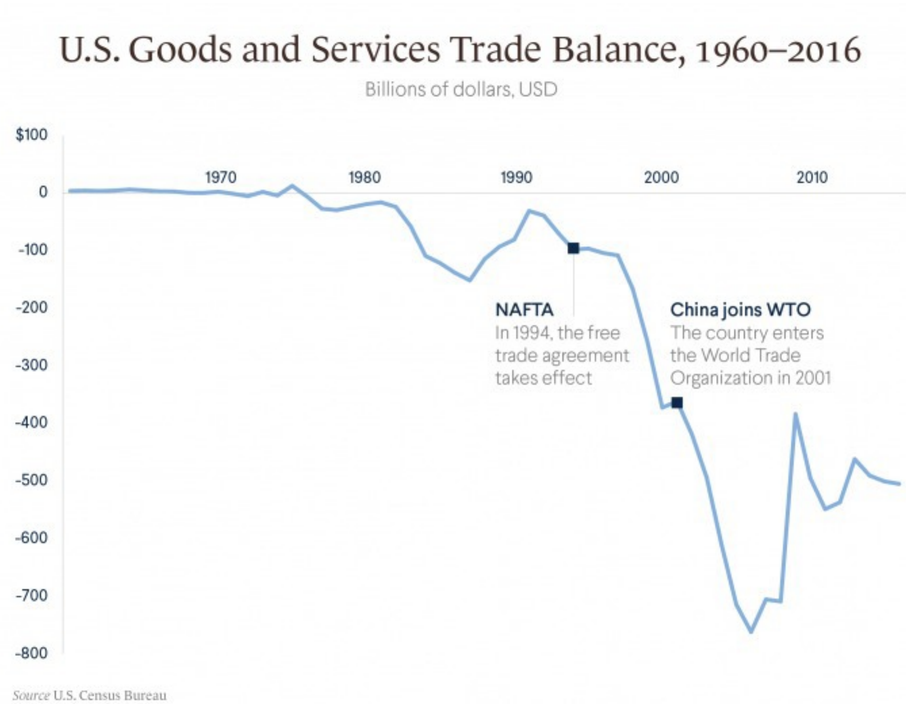
The trend of the U.S. economy has not changed since January. According to the Bureau of Economic Analysis, the fourth quarter GDP growth rate for the U.S. was 2.9% and 2.5% for all of 2017 which followed the 1.8% rate of 2016. The 2018 first quarter GDP growth rate of 2.3% compares to 1.2% for the same time last year, clearly an improving trend. The economic trend is intact and may strengthen considering the change in the corporate tax structure. The next two corporate reporting periods are expected to show increasing profits as corporations update their projections based upon the change in the tax code. Europe and other economies are also improving and thus most of the multi-national firms should also report increasing revenues and growing profits.

If the economy has not changed, then why all of the current concern/doubt (volatility) within the markets? Anytime a new conversation starts, the short-term money may change direction until the expectations are determined. Tariffs are the new conversation along with trade imbalances. If you are like most Americans, the terms tariff and trade imbalances or deficits are not new but knowing the potential impact to the markets may not be obvious.

The concern is the potential impact on corporate profits. As an example, the value of shares of Boeing and Caterpillar both dropped when the President announced tariffs on steel and aluminum and again when specific products from China were targeted for tariffs. The thought process was their manufacturing costs would increase as the price of raw materials increased due to the tariffs potentially reducing profits. While part of the concern was cost, there was also concern for the sales. In retaliation to President Trump's announced tariffs on numerous Chinese goods, China added tariffs to planes and heavy equipment which increases the sales price to their consumers and may result in fewer sales as China's consumer seek and consider other options. Naturally, fewer sales will lead to lower profits and lower share prices. For a President who appears to tie his success to the growth and direction of the markets, you might wonder why tackle tariffs and trade deficits if they create such volatility in the markets.

Trade imbalances and deficits have been a concern of nations not for decades, but for centuries. "We must always take heed that we buy no more from strangers than we sell them, for so should we impoverish ourselves and enrich them." An excerpt from Discourse of the Common Wealth of this Realm of England, 1549

"The ordinary means therefore to increase our wealth and treasure is by Foreign Trade, wherein we must ever observe this rule: to sell more to strangers yearly than we consume of theirs in value." - Thomas Mun, England's Treasure by Foreign Trade, 1684



According to the Council on Foreign Trade (CFT), the U.S. annual trade deficit has averaged $550 billion since 2000, clearly violating sound trade practices as stated in the previous quotes. Whether it is a person, state, or nation, one cannot continue to spend more money than they take in, or they will become bankrupt or the value of their currency will become worthless. The adjacent graph from CFT's site indicates the U.S. trade imbalances were not a significant issue until the mid-1990's. It also indicates when NAFTA was signed into law as well as when China joined the World Trade Organization.

Politics aside, including whether you like or dislike our current President, the trend of our trade deficit is alarming. As our nation's economy continues to improve, the trade deficit will only increase. This is due to the improved economics of our citizens who as most Americans do, purchase more goods and services when things are going well. Unless the U.S. economy changes, we as a nation are not producing many of the goods Americans are buying resulting in increasing imports to meet demand, but as a result, more of our financial assets are sent to other nations, primarily China and Japan. NAFTA, perhaps the start of our deficit trend, permitted many of the U.S. manufacturers to move part or all of their operations to either Mexico or Canada reducing either labor or material costs or perhaps both and then import the now produced item back into the U.S. at minimal cost. While NAFTA was intended to enhance free trade between our two closest trading partners, the results and most likely unintended consequence in my opinion are the large trade deficits created by this agreement and the reduction or loss of American manufacturing jobs.

According to recent reports by CNBC, Mexico's automobile production has grown from less than 2 million to almost 4 million vehicles with approximately 2.1 million being imported into the U.S. While the 2.1 million vehicles is part of the trade deficit with Mexico and represents the loss of hundreds if not thousands of jobs, it is also the loss of the economic impact wages always provide to the communities and state where those employees reside.

Whether the deficits are with neighboring allies or with nations across the world like China or Japan, continued deficits of the current size will eventually create issues perhaps too large to resolve. Every two years on average, $1.1 Trillion dollars is taken out of circulation and sent to a variety of foreign nations. Without change, it will not take long for this deficit to expand from being a number in a report, to a large snowball rolling downhill with a potentially large negative impact on the American economy.

Whether it is this President, or one in the future, tariffs are one of the tools any nation uses to impact trade imbalances. By adding a tariff on the goods of one nation which is being imported, the result raises the price of those goods. As long as the imported product is not the only option for the consumer, then a shift of purchasing may result with the intent of the government's action for the consumer to purchase locally produced items. The ideal result reduces imports and perhaps a trade deficit with that nation and 'protects' or creates domestic jobs.

As discussions and talks continue with China, Canada, and Mexico, the potential result is unknown. The markets are usually less volatile when there is less speculation on pending items impacting profits. Not knowing whether a better agreement will be reached regarding NAFTA, or whether a full-scale trade war will result with China, very large volumes of money is moving in and out of the markets resulting in large swings in the value of the indexes. Like any storm, the best result is keeping focused on getting through the storm rather than the storm itself. Clearly, trade negotiations are more public this time than in years past often causing investors to rethink their short-term objectives. I anticipate the markets to set new highs later this year as the next two quarterly profit reporting seasons progress.

Many networks and financial reporters are pronouncing the slow death of this bull market. Most reports include a reference to its age and thus, by age alone, it must be near its death. Surprise events can always have an impact and thus change the current direction of the markets. For me, while this bull market is clearly senior in age compared to most, I expect continued growth for the next two to three years. Naturally, this is subject to revaluation as additional and new data is received. But, why should this bull market continue?

For the last five to nine years, corporations have had the opportunity to restructure their balance sheets, particularly the short and long-term debt. Corporate debt often is issued with constraints regarding refinancing or other covenants which may impact the borrower. With the amount of time passing since the financial crisis, both new and old debt in 2009, may now have reached its maturity. This has afforded corporations the opportunity to refinance at more favorable terms and in many cases longer terms which reduces future impact of rate increases. As the Federal Funds rate continues to be increased, in my opinion its impact on corporate profits will not be as significant as in decades past. Some new projects may be placed on hold as the increasing cost of financing alters the viability of the project. However, while interest expense may be on the rise, the income tax expense is falling based upon the new tax legislation. Clearly the markets reacted positively once the law was signed, however, the full extent of the impact is not yet known. With rising wages for many, lower taxes, and reduced outstanding shares as buyback programs continue, corporate profits will continue to increase and may beat the expected earnings projections by the analysts during the next two or three reporting periods.

Insights Continued:

If earnings continue to increase, so will the share values.

Another impact on market volatility is the move of the 10-year Treasury yield from the 2.8% range to the 3.0% range. A change of 0.2% is immaterial for most businesses, but the transition of rates from the 2% to 3% is more psychological than material. A business with $50 million in short term debt, may incur an additional $100,000 of interest expense in a year. This amount would be immaterial for most firms with $50 million or more in short term debt. Considering the change in income tax rates, and the resulting added interest expense still may not offset the savings from the lower tax rates.

Please remember, headlines and other short-term events can easily cause long term investors to lose focus. It may also cause some investors to make decisions based upon temporary issues or concerns, whereby they may miss the long-term gains which provides for their financial security.

