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SEPTEMBER 2018 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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Trade Wars, The Economy & Markets

The month of September has continued to see further uncertainty generated by the escalation of the tariff conflict between the US and China. The White House announced that the US will move forward with implementation of tariffs on $200 billion of imports from China with the potential of future tariffs on the remaining balance of $267bn of imports. China responded by announcing plans to impose retaliatory tariffs starting in late September. Perhaps the only good news coming out of all of this noise was that the White House tariffs were only 10% rather than the 25% initially anticipated and that the Chinese tariffs will be 5%-10%, down from the 5%-25% originally proposed.

The lower tariffs suggests that this trade conflict will simmer down to a mere skirmish and that future tariffs will be smaller and trade negotiations more active. Because these trade issues have been a headline constant for several months it is easy to forget about the nearly record breaking economic boom occurring in the US. In fact, it is interesting to observe that the two indices that reflect US economic and trade uncertainty have actually fallen over the past two months as shown on the top half of Chart #1.

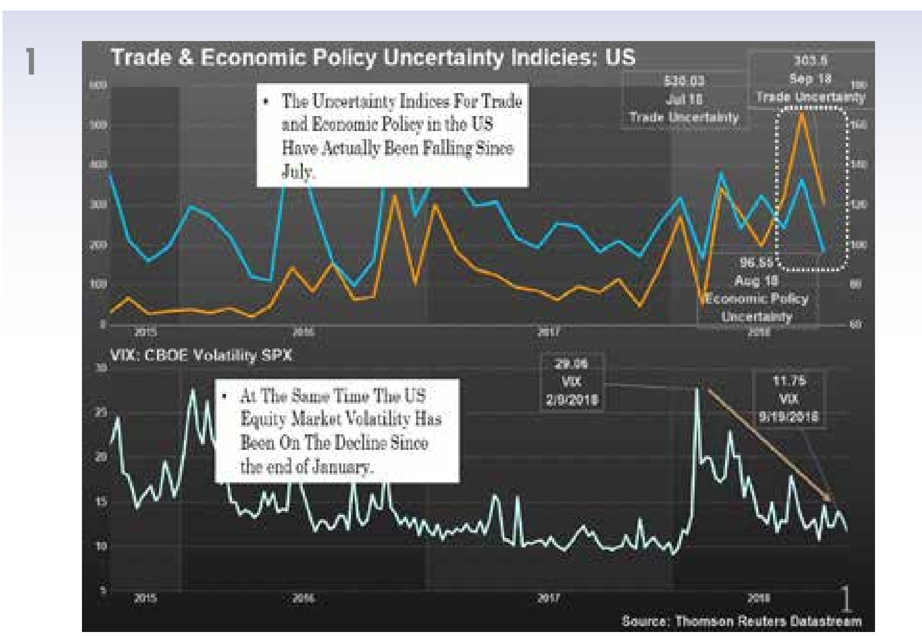

CHART 2

You will also notice that the volatility of the US stock market as represented in the bottom half of this chart has been steadily declining since the end of January. If the White House were to impose a 10% tariff on all $467 billion of Chinese imports it would amount to an increase in costs of $46.7 billion which is a proverbial drop in the bucket for the $20 trillion US economy! The talk and potential of trade wars do, however, have a larger effect on the economies outside of the US as shown in Chart #2. In this chart you can see that global economic uncertainty has risen to much higher levels than that of the US. This helps to explain why central banks in the Eurozone and Asia maintain an easing posture in contrast to the US Federal Reserve's ongoing tightening activity.

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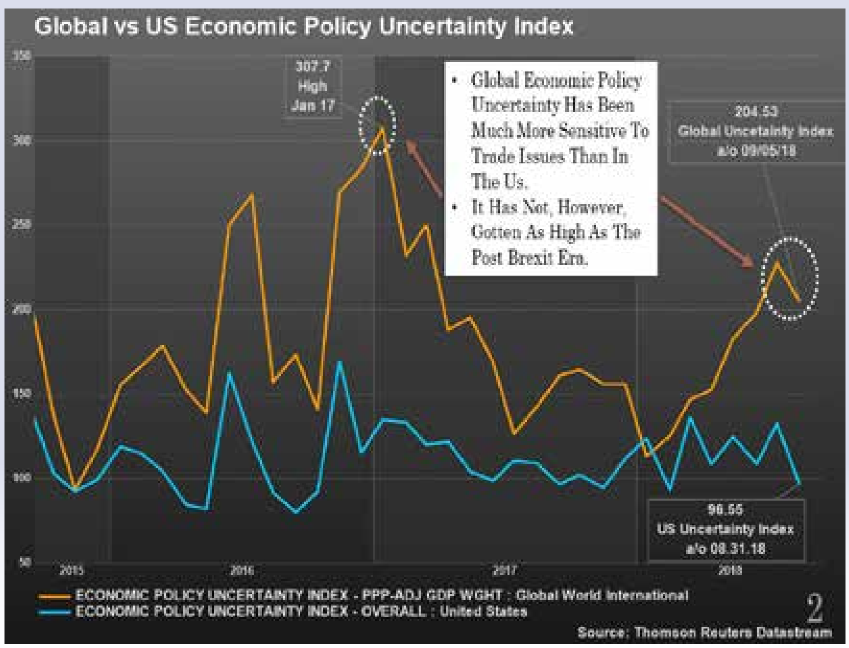

CHARTS 3-4

Although the potential for accelerating trade conflict remains modestly elevated the US economy and equity markets appear to have it fully discounted. In fact, the US economy is showing signs of accelerating as illustrated by the record high Leading Economic Indicators (LEI) shown in Chart #3. Historically, recessions haven't occurred until around 6 years after the current LEI exceeds the peak of the prior cycle. This implies that the next recession won't happen until the early 2020's. The lower half of the chart shows the ratio of the LEI to the Coincident Economic Indicator (CEI). You can see that in prior cycles this ratio has peaked well before the beginning of a recession. As of the most recent data release this ratio has yet to exceed that of the past cycle.

Further evidence of the economy's strength is reflected in the near record low initial unemployment claims and continuing claims, Chart #4.

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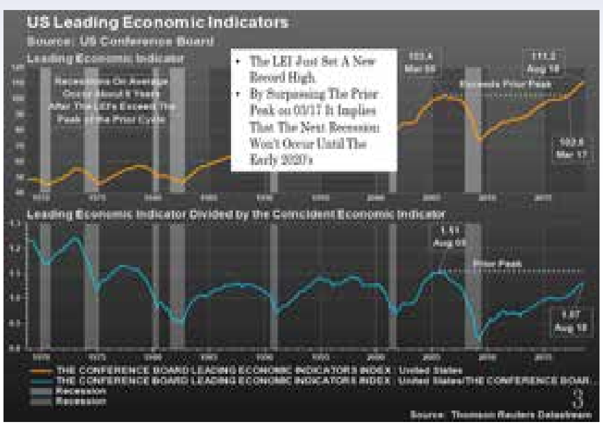

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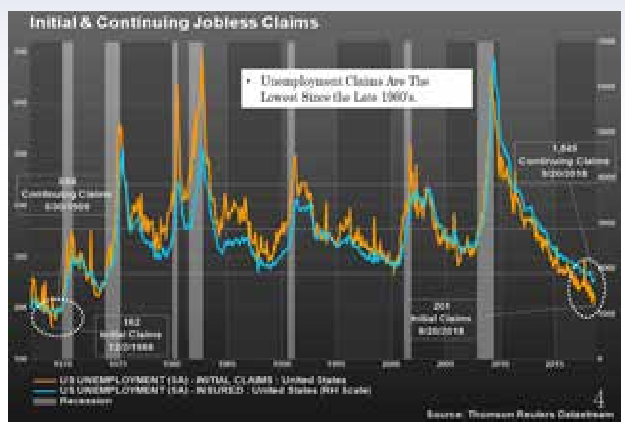

CHARTS 5-7

Also, as shown in Chart #5, the number of new job openings (JOLTS) has once again achieved a new record high. Wages are increasing as evidenced by the growth in the Average Hourly Earnings and the Atlanta Fed Wage Growth Tracker but their rate of growth remains well below the peaks achieved in the prior two recessions. This is positive for growth in personal consumption expenditures while at the same time remains a low threat to runaway inflation. Our leading indicators of inflation have remained muted over the past several months as shown in Chart #6 while the most recent inflation readings have come in below expectations, Chart #7.

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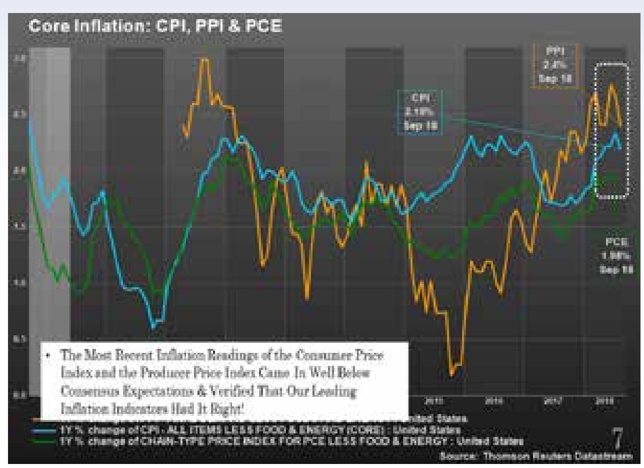

CHARTS 8-9

A strong economy with modest inflation is the “Goldilocks” scenario that has been described in past publications and which will keep the Federal Reserve on a modest path to interest rate increases, Chart #8.

A strong economy with modest inflation is a solid foundation for companies to grow their earnings. In Chart #9 you can clearly see the strong growth in the 12 month forward earnings estimates for the S&P500 that has been driven in part by the tax law changes and, more recently, by the strong economic outlook. The forward Price/Earnings ratio has stayed in the 16x to 17x range for most of the year meaning that the market’s advance has been fueled primarily by earnings growth.

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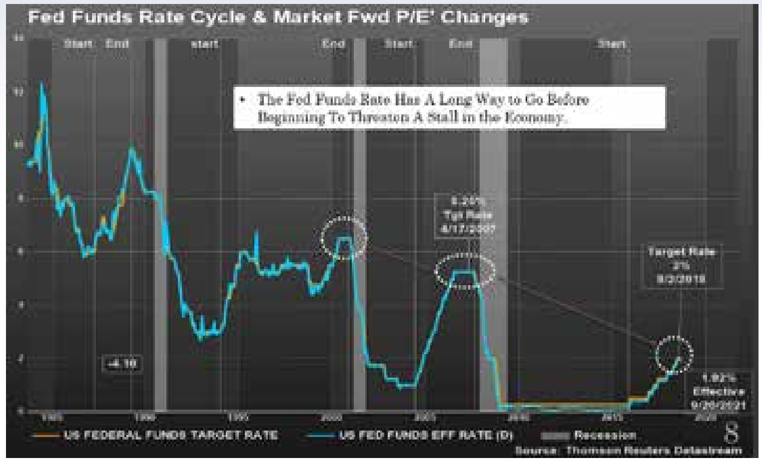

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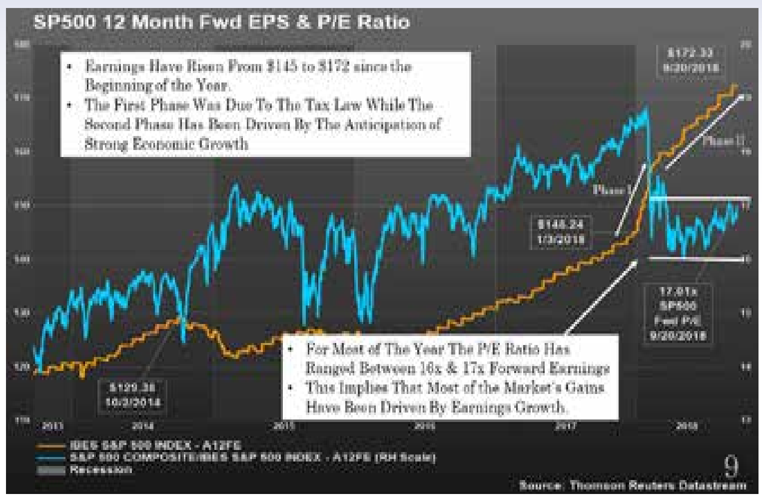

CHART 10

From a valuation perspective the US equity market remains moderately cheap when its earnings and dividend yield is compared to the yield on the 10 year US Treasury bond, Chart #10. Although not as cheap as it had been just after the last recession it remains above its 20 year average spread over the bond yield. During the prior two cycles you'll notice how the market's earnings yield traded below this average. This implies that if our current "Goldilocks" scenario persists then the markets could continue to appreciate over the next few years.

In conclusion, the trade and tariff issues are merely a skirmish and not a full-blown war and appear to have been fully discounted by the equity markets and a strong US economy. With inflation moderate and earnings still growing the US equity markets appear to be modestly undervalued. There are other clouds on the horizon that bear watching such as the growing US federal government debt; the high levels of US corporate debt; and, the risk that trade tensions could trigger a full blown global trade war.

Please speak with your investment advisor about how any of the above referenced topics might impact your portfolio.

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