The Economy, Earnings and Where Do We Go From Here?

The United States economy continues to show signs of strength. Employment is very strong, wages are rising, but certainly not out of control, and the Fed seems in no hurry to do anything dramatic with interest rates. On a more micro level, company earnings are remarkably strong. The equity markets, although not bad, seem somewhat restrained given this promising backdrop. Why is this? There are a number of things that are keeping portfolio managers and analysts up at night. Some are purely economic, road blocks which may occur during the course of a normal business cycle. Others are related to politics, both domestic and international.

The purely economic are easy to discuss but not so easy to forecast. As we wrote earlier, things look very good for the U.S. economy and there is the forecasting problem. Is the economy either over-heating now or about to do so? The economy is either at, above, or slightly below the level which leads to unwanted inflation. At first blush, it appears as if the economy is right at the brink of an inflationary level of employment. It depends on two things; both are unknown. First, will the labor participation rate[1] increase and will those who have dropped out come back into the market? Second, will there be an unexpected burst of productivity? Our answer to the first is unlikely. There are a number of reasons. Just two are the baby boomers retiring and the dramatic slow down of talent entering the country. As to a burst of productivity, it is almost impossible to predict. It then makes sense to assume the economy is at or just past the non-inflationary rate of unemployment.[2] Where does that leave us? When an open economy starts to overheat there are escape valves: interest rates, inflation, and currency valuations. Interest rates in the U.S. are clearly headed up, perhaps not dramatically at the moment, but the direction is clear. Inflation is also moving beyond the Fed's desired level and the U.S. dollar is also on the rise. This leaves analysts in a quandary. Is this the end of the cycle? If not, how much longer will the cycle go under these conditions? Unfortunately, no one knows, but it seems a good bet we are moving toward the end of the cycle. This may be the reason equity markets are not responding to the strong reported earnings, as one might expect.

We, and most other analysts, have written that markets hate uncertainty. These are certainly uncertain times. There is confusion about what direction the White House is going with trade, what will be the results of the mid-term elections, and a general malaise about the state of politics in general. A good example of confusion and the direction of trade talks is Mr. Trump's reaching out to China to help save an important Chinese firm, ZTE Corp., a firm in trouble because of punishment imposed by the Administration, Commerce Department, because of serious trade violations. Another is whether the Administration is fighting the correct battle. If the aim is exclusively to lower the trade deficit, then the war is won. Unfortunately, it is the wrong war. What must be addressed and solved is the theft of intellectual property, the fact that U.S. companies must partner with and share industrial information with Chinese companies in order to do business and are prevented from entering some industries. These are very damaging to the U.S.

If anyone is in doubt about what the aspirations of Mr. Xi are, please read his long comments on "Made in China 2025".

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[1] The **participation rate** is a measure of the active portion of an economy's **labor** force. It refers to the number of people who are either employed or are actively looking for work.

[2] The **non-accelerating inflation rate of unemployment** (Nairu) - also referred to as the long-run Phillips curve - is the specific level of **unemployment** that is evident in an economy that does not cause **inflation** to rise up. NAIRU often represents equilibrium between the state of the economy and the labor market.

-Michael Olin Clark
moclark@1919ic.com