Pressures are Building

Equity markets closed the week lower. The Dow (.47), S&P (.54), and the NASDAQ (.66). Investors wrestled with contradictory signals. Corporate earnings are in excellent shape, reports from companies' investor meetings are mostly upbeat and government releases show steady growth in GDP and employment, but there are signals that the future may not be so rosy. The dollar and interest rates are up and most analysts argue that all have some way to go before they top out. Both the dollar and interest rates are relief valves for the economy. Recessions are caused by the buildup of imbalances and *some sort of event or policy change that causes investors, consumers and businesses to become more risk averse*. Of course, imbalances can build longer than seems logical. It will be an interesting end to 2018. Earnings, interest rates and the economic releases of course reflect the past, and interest rates and currencies anticipate the future. We have written in the past that as a general rule, as the economy goes, so goes the market. There is certainly some lag, but equity markets have a hard time advancing in a recession. A useful way to look at markets, particularly financial markets, is Alexander Calder mobiles. These mobiles are social constructs. Their delicate balance can be disturbed by obvious stimuli, such as earnings or less obvious such as political attitudes. Anything that generates fear or comfort can set the mobile in motion. Life for investors would be a lot easier if, as a disturbed mobile, markets returned to their original positions post disturbance. Unfortunately, there is no reason for that to be true. Pressures and/or attitudes may be permanently altered.

What, if anything, is out there altering the delicate balance of that mobile we call the market? Lots of things, some economic, some not. One relates to the competition for investors' dollars. For years, the equity markets have held an advantage against the fixed income markets, for the attention of investors looking for cash flow. We even had the unusual situation where the dividend yield on the S&P 500 was higher than the ten year treasury. This was an enormous benefit to the equity market. That anomaly has changed and in time investors may shift the balance of their portfolios to reflect this change.

Concern over the fate of global trade is another. We have written many times that markets abhor uncertainty. Not only do investors have to worry about trade, but they must deal with the inconsistency coming out of Washington concerning NAFTA, China and the E.U. We wrote earlier about the disparate views of the team the administration sent to China. The Administration announced that China had agreed to reduce the budget deficit by 200 billion dollars, only to have it denied by China. Nothing has been said about the most grievous problem which is theft of intellectual property. The Administration has delayed reporting to Congress its plan for NAFTA, so no one knows whether anything can be done until after the mid-term elections.

The last point has to do with the apparent political stalemate we have been in for years. It appears very little can be accomplished in Congress. Interestingly, the problem was anticipated and warned about for at least two hundred years. It is the emergence of factions. David Hume argued "Factions subvert government, render laws impotent, and beget the fiercest animosities among men of the same nation."[1] Adam Smith, "of all corrupters of the moral sentiments . . . factions and fanaticism have always been by far the greatest."[2] The warning was clear from the scholars of the Scottish Enlightenment and forcefully restated by Mancur Olsen in 1999 in his book, Power and Prosperity.

We don't know how the problems with factions will end!

[1] David Hume, "Essays, Moral and Political" 1741.

[2] Adam Smith, "The Theory of Moral Sentiments" 1759

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