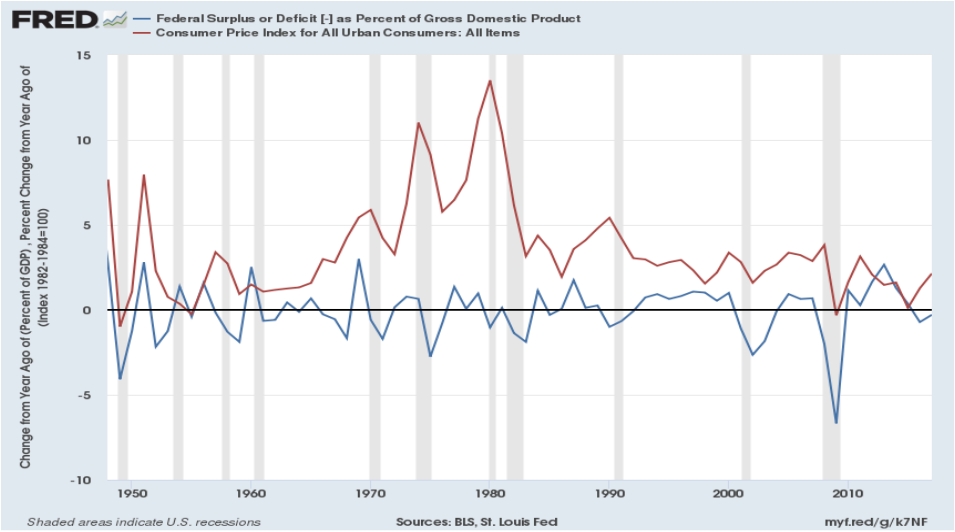
It's about 2019!

As we have written in the past, economic statistics indicate 2018 will continue to be a positive year for the U.S. economy. Economic growth appears to be accelerating, perhaps reaching 4% in the 3rd quarter of 2018. The tax package has a lot to do with this, along with growing global economic strength, but we do see clouds in the future. There are many developments that may derail the current growth story. The Federal Reserve announced another rate hike last week and indicated there would be more this year and most likely a few rate hikes in 2019. We remind investors that there is an unusual confluence of events about to take place in 2019. The United States will most likely run a record budget deficit while having a strong economy, rising inflation, increasing employment, tightening monetary policy, lower tax receipts and confusing trade relations. A growing economy should lead to larger government tax receipts, and lower government expenditures due to automatic stabilizers, leading to a smaller deficit. We have added a chart showing the relationship between the budget deficit and inflation. Logic tells us that the deficit should go down when inflation rises. As we explained above, in a strong economy inflation rises and the deficit decreases. This time it is different. Inflation is increasing while the budget deficit is also increasing. This is not good news. What happens when the economy turns down? The government will already be facing record deficits, so the economy will be dependent, just as in 2008, on monetary policy for all the stimulus.

International events will also be important factors going into 2019. Trade with China, NAFTA and the G-7 are all in danger. To be sure, the United States is less dependent on trade than most but if there are significant trade disruptions, they will significantly hurt some important industries.



The G-7 ended on a poor note. It was never going to be particularly pleasant nor productive, but at the end the members appeared to have come to a strong enough agreement to issue a modest joint communique. Mr. Trudeau then made a speech about the steel and aluminum tariffs imposed by the United States on Canada, particularly the use of national security as the reason. Mr. Trump, being offended, refused to sign the communique he had committed the country to. An interesting point, Trudeau was saying about Trump exactly what Trump was saying about Trudeau for the past year. It is interesting that Canada does impose a hefty tariff on U.S. milk exports, but the United States imposes a tariff on Canadian eggs in excess of 100%. Clearly, the G-7 meeting was not a rousing success. Far more in the news is Mr. Trump's trade friction with China. As we have written quite a bit, we agree that the United States, and the rest of the world, have serious economic problems with China. We think the U.S. is fighting the wrong battle. The trade deficit between the United States and China, although large, is not the problem. The problem, which we and almost everyone else in the country have written about, is more encompassing. Intellectual property theft, huge state subsidies for favored industries, forced technology hand-overs, use of state owned industries, just to mention

a few. It seems to most that the best way to handle this is to create a coalition of countries to collectively go after China. China historically does not like to stand alone. In the past, efforts like a coalition have worked. Unfortunately at the moment, the administration does not seem to be in a coalition building mood. The Government and global disarray mitigate against this type response.

A trade war will seriously hurt American farmers and industries with efficient supply chains. It will have an inflationary impact, hurt employment and weaken United States influence around the world.

Trade has never been an easy sell, even though it has brought millions out of poverty. In the United States, one of the reasons for the revolution and desire for independence was unfair tariff and trade restrictions imposed by England against the Colonies, as exemplified by the Navigation Acts. Adam Smith and David Hume both argued that free trade was beneficial to the common man, tariffs helping only specific business interests. Protectionist policies encourage inefficiencies which hurt domestic consumers. David Ricardo, an early 19th century economist who added to the economic theories coming out of the Scottish Enlightenment, developed the classical theory of comparative advantage in 1817, which added to the intellectual fervor for free trade. Nations should export what they do better than the rest and import what they don't do well. Not since the mid to late 18th century has there been a call for Mercantilist trade policy.

A good point to keep in mind is Frank Taussig's[1] pithy comment. "the Doctrine of free trade, however widely rejected in the world of politics, holds its own in the sphere of the intellect." The comment stands the test of time.

- Michael Olin. Clark
moclark@1919ic.com

[1]Frank William Taussig was an American economist and educator. Taussig is credited with creating the foundations of modern trade theory.