19/19 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

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Strong Economics Versus an Uncertain Future

Investors were treated by excellent economic reports last week. The equity market responded as one would expect.

DJIA +.76, S&P 500 +1.52 and the NASDQ +2.37.

The employment report was better than most analysts expected. More jobs were created, earnings growth continued, but at a modest enough pace that inflation is not an immediate danger and, perhaps best, the labor force appears to be growing. More workers are rejoining the work force as jobs become more plentiful and wages move higher. A caveat is that most of those returning are in lower paid, low skilled work, which does nothing for the country's moribund productivity, but under any circumstances, this is good news. An important question is does this continue or does it last for just a few months?

The Federal Reserve minutes from their mid-June meeting highlighted two very real worries: inflation created by an overheated economy and what will happen to the U.S. economy if the trade war accelerates? They are very real questions that the Fed must deal with. The answer to the first is well known; it is the reason the Fed was created. As the economy heats up, the Fed tightens monetary policy, slowing the economy and reducing price pressures. The difficult question, as always, is when to start. The last thing any Fed governor wants is to risk a recession unnecessarily. The second is far more difficult. The Federal Reserve has no say regarding a trade war, which is strictly a political action. So the best they can do is use monetary policy to try to ease the pain. The Federal Reserve's two mandates are: keep inflation under control and maintain full, non-inflationary employment. The dilemma for the Fed is a trade war can create inflation and high unemployment at the same time. Each of these problems calls for opposite monetary responses. Rising inflation calls for monetary tightening, while rising unemployment calls for monetary easing. You easily see the Fed's dilemma. None of this is lost on investors.

Two interesting questions are: what are the common effects of a trade war and does a trade war necessarily mean a recession?

It's a little difficult to discuss the _common_ effects of a trade war because they can be so dangerous that they are seldom risked. Certainly, inflation increases. The reason for this is trade wars restrict supply and prevent the use of the most price efficient producers. Unemployment will increase as companies try to reestablish supply chains. Since the aforementioned inflation is caused by cost push rather than demand pull, inflation and unemployment can exist together and this can lead to a recession. This is a very unpleasant outcome. But does a trade war have to lead to a recession? No it doesn't have to. The great recession of 1929 and the passage of the Smoot-Hawley Act are often used to show that trade wars lead to recessions. The great stock market crash occurred on October 29, 1929. Smoot Hawley was passed June 17, 1930. It is unlikely that it actually caused the recession, but it made conditions much worse. There were a series of economic problems made by competing central banks which lead the world down the path to economic disaster. Today, central banks are far more sophisticated and independent.

Weekly Market Insights (cont'd)

Trade wars are indeed dangerous. We can think of no good that comes out of them. Saying they are not necessary and sufficient reasons for a recession is not the same as saying they are not terribly dangerous, or that a recession won't occur.

We continue to believe the economy will prosper for the remainder of 2018 but there are forces building which put 2019 in danger. We repeat our long held view that in times of uncertainty, investors should review their portfolios and make sure they are comfortable with their asset allocation.

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