1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

July 30, 2018

Great GDP release, but…

The Commerce Department released the second quarter GDP number last week and it was excellent. Almost all the constituent parts were encouraging. Adding to the good news, the meeting between Mr. Trump and E.U. Commission President Jean-Claude Juncker was proclaimed by Mr. Trump as a great success. As one might imagine, investors reacted positively and the equity markets rallied. The Dow Jones Industrial Average was up 1.57%, the S&P +.61% while the NASDAQ fell 1.06% (mostly due to downside earnings surprises from the technology sector). Although the markets did respond positively, the week ended well below the high of the week. There were a number of reasons for this.

The principal one, in our view, is the disappointing explanation of what actually was accomplished at the Trump Juncker meeting. There were two very different stories. Mr. Trump spoke of an agreement where European agricultural tariffs would be lifted, Europe would be purchasing U.S. LNG, and the U.S. and Europe would work to reduce or eliminate both tariff and non-tariff barriers to trade. Mr. Trump even traveled to Iowa and told farmers that he had opened Europe to U.S. agriculture. The E.U. commission wasted no time in refuting these claims. Other than some purchases of Soy Beans, which they were doing anyway, agriculture was off the table, and there would be no negotiations. There was no real definitive agreement. Was the meeting positive? Yes, certainly. New tariffs were put on hold for the time being including tariffs on European cars and both parties agreed to work on lifting the U.S. tariffs on steel and aluminum. Rather than coming to a definitive conclusion, this agreement is more an outline for future meetings. This alone would have been welcomed by investors but it lost much of its steam as it turned out not to be as advertised. Adding to the confusion of the meeting's results is that the Administration has no clear, consistent message with Larry Kudlow being pro-trade and anti-tariff and Peter Navarro and Robert Lighthizer being firm protectionists. All this and we haven't really addressed the real offender, China. The president then promised $12 billion dollars in aid for farmers which, interestingly, has not been welcomed by the farming community.

Another concern investors have is related to the good economic news, interest rates. The exceptional economic growth will surely keep the FED on target with their monetary tightening program. This leads to two concerns: first, will the FED raise rates too fast and too high and end the economic expansion and second, will the FED's actions lead to an inverted yield curve, a harbinger of recession? No one knows, of course, but the FED's raising of interest rates makes economic sense. If the economy grows and rates remain abnormally low investors, lenders and business managers partake in increasingly risky projects in an attempt to capture yield and profits. This, of course, leads to excessive risk taking which can lead to a severe recession. If a recession occurs when the FED is already keeping interest rates low they don't have any monetary policy tools to try to stimulate the economy. So, in our view, the FED is doing the correct thing for the economy by cautiously raising interest rates.

We see no reason to alter our view that 2018 should remain positive but 2019 may produce storm clouds.

Michael

- Michael Olin Clark
moclark@1919ic.com