1919 INVESTMENT COUNSEL
Complexity to Clarity
100 YEARS

Special Edition

August 8, 2019

Bear market or bump in the road?

Investors are justifiably concerned about the financial markets following the spike in market volatility these past few days. The question they wrestle with: is this a bear market or temporary adjustment? Unfortunately, there is no absolute answer to that question but there are many things we can look at that help us make that decision.

Investors should look at the genesis of the problem and answer the journalists' mantra: who, what, why, and what can be done about it?

The immediate problem, of course, is the sudden drop in market prices. Although no one likes a fall in prices, the important question is why, and is this a temporary response or the start of something more serious? As most investors know, the financial markets have been on edge ever since the tariff/trade war between the United States and China began. The latest shock was Mr. Trump's announcement that he will impose a new more comprehensive set of tariffs on Chinese imports into the United States. That came on the heels of the Federal Reserve's announcement that they were easing monetary policy by 25 basis points. Both sent shock waves through financial markets.

We will try to answer these questions: will the tariff war escalate into a full blown trade war, will it morph into a currency war, is the U.S. economy weakening to the degree that a recession is near and, finally, is the Fed on the right track? The answers to these questions go a long way in answering the question we opened with, bear market or correction?

We have written quite a bit that it is highly unlikely the bear market will occur without a recession. When we analyze current U.S. economic statistics, it is difficult to see a recession in the next 6-18 months. The consumer, who is approximately 68% of GDP, is in very good shape. Consumer confidence is near record highs, as is retail sales. Family debt service ratios are at or near record lows. Also, employment and wages are rising.

What about the Trade/Currency war?

Most economists and market strategists agree that the economy is slowing from an unsustainable high growth path, but in the absence of an outside stimulus, a recession is not in the cards. The outside stimulus is the trade/currency war. We do not believe either country will allow the trade hostilities to morph into a recession. One of the most recent fears is the tariff war extending into a currency war. This is highly unlikely. The U.S. administration accused China of engaging in currency manipulation. This is not correct. The accusation started when the RMB (Renminbi) fell sharply against the U.S. dollar after Mr. Trump announced the imposition of new tariffs against Chinese exports in September. That fall in the RMB was not currency manipulation, but a natural market reaction to the belief that the Chinese economy would weaken relative to the U.S. economy. The fact is, the Chinese central bank did enter the currency market, but to raise the value of the RMB, not to lower it. The reason is simple -the Chinese fear capital flight a lot more than tariffs.

Why do we believe the tariff war will not get out of hand? We have written quite a bit about this. Both countries have strong domestic reasons to keep the dispute within manageable proportions. China is far more dependent on trade than the U.S. is, as mentioned earlier, and they want to prevent capital flight and resolve the current problems in Hong Kong. The United States has an election coming up and most political analysts believe Mr. Trump needs a strong economy and a strong stock market to be re-elected. Adding to that, it seems apparent that most members of his own party are against the new tariffs. The odds are in favor of a more moderate approach to tariffs on the part of the administration.

The Fed

Investors for some time believed the Federal Reserve was going to ease monetary policy by lowering interest rates. The only questions were by how much and how often. Would the Fed make its initial move 25 or 50 basis points and would they signal that this is just the beginning? But the Fed appeared to disappoint investors. The move was 25 basis points rather than 50, which was a big disappointment to market participants. We believe investors did not read Mr. Powell's report carefully. He wrote that the economy was not in danger of falling into recession, but was coming down from unsustainably high growth. The cut in rates was an insurance policy and investors should not bank on continued cuts, BUT that the Fed was prepared to cut further if the economy was in danger.

I was fortunate to be with James Bullard, President of the St. Louis Federal Reserve, this past Tuesday, and he confirmed the Fed's view that there was no immediate recession danger for the U.S. economy.

Outlook

For the reasons above, we don't feel the current market behavior is a harbinger of imminent recession or bear market. Most likely, it is a market correction accentuated by unstable politics. However, complacency is the enemy of good portfolio management! We continue to be vigilant and to keep you informed. A good lesson why investors should keep a close eye on asset allocation.

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