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Weekly Market Insights

February 19, 2020

The Fed, politics, coronavirus and the rest of the world

The equity markets continue on their record-breaking path, tossing aside any and all signs of trouble. The Dow Jones Industrials gained 1.02%, the S&P 500 was up 1.58% and the NASDAQ increased 2.21%.

There are many cross-currents for the market to overcome on its record advance. The most obvious is the fear of the coronavirus.

China

We have written that the United States economy is one of the least vulnerable to a serious setback due to the epidemic. However, some effects will still be felt. We continue to believe that the U.S. economy is resilient enough to continue its advance. The most obvious victim is China. Of course, this is stating the obvious, but it is important for investors and those interested in China to look at the cumulative effect of the many problems facing China today. We have written in detail about them in the past, so we will just list a few here: a slowing economy, a debt crisis, insurrection in Hong Kong, a growing Muslim problem and an increasingly autocratic government led by President Xi.

The EU and Brexit

After a brief period of apparent economic expansion, the EU appears to be slowing again. At the moment, the European Union appears to be in somewhat of a disarray.

It is way too early to early to write intelligently about the future of Britain, but it appears that, as in many countries, there is a strong attempt to increase the power and authority of the Prime Minister, President or Chancellor. We have argued in the past that two powerful events took place to disrupt the smooth functioning of the European Union – one intentional, the other bad fortune, but both revolve around sovereignty. The intentional point is the use of a common currency. At first blush, it appears to be a fine idea. It certainly encourages both internal and external trade. One could argue that it is efficient in the economic meaning and it solidifies the internal relationships. So what went wrong? Many things. First, in the broadest sense, the leaders didn't appear to realize how important it would be to have a common fiscal policy to balance the common currency. By ignoring that relationship, they removed an important tool for countries to balance their economies. Therefore, as trade imbalances occurred, the only ways the losing country could try to balance their account was through lower wages or higher unemployment. Both are unacceptable to the poorer country. Since there was no currency adjustment, the richer country continued to advance relative to the poorer country. This, of course, is a simplified explanation.

The second problem was, and remains, an accident of fate. The Arab spring and all the turmoil it caused along with prolonged Middle East wars created a massive influx of immigrants. Most European countries were in no position to accept the hundreds of thousands flowing into their countries. There was pushback against this. The real fallout came when they were forced into accepting the overwhelming number, not by their governments, but by the EU government in Brussels. This, of course, was a surprise to all and most likely could have been handled better.

The Fed

The Federal Reserve is back in the news and will become more prominent in the next week or so.

As readers may recall, a number of months ago the Administration sent two nominees to the Senate in hopes of being voted in as new Governors of the Federal Reserve Bank. Both had to withdraw from consideration when it became apparent that the President's own party would not accept their nomination. We now have two new nominees.

The two are Christopher Waller and Judy Shelton. Mr. Waller is a highly non-controversial candidate. He holds a PhD in Economics from Washington State University and is currently Executive Vice President of the St. Louis Federal Reserve Bank and Director of Research. He is also the author of books and articles on Monetary Policy.

Ms. Shelton is a different story. She was an advisor to the Trump campaign. She holds a PhD in Business Administration from University of Utah. She has been well known in the past, at least during the Obama Administration as a "gold bug," meaning the U.S. should go back to the gold standard. For those not familiar with it, people who are for the gold standard are almost always in favor of tight money and reasonably high interest rates. Ms. Shelton was true to her beliefs, arguing that during the recession, the Fed should raise interest rates. Lately, since the last presidential election, Ms. Shelton has become a believer in the Modern Monetary Theory (MMT). Most economists believe this to be neither new nor particularly strong, and since it is impossible to be both a believer in the gold standard and the MMT, we believe Ms. Shelton to be a convert to the latter. As such, she believes that the Fed, in conjunction with the Treasury, should be adding reserves to the system. This is an interesting reversal. When unemployment was high and there was a great amount of slack in the economy, she advocated tight monetary policy. Now, with record low unemployment and very little slack in the economy, she is recommending easy monetary policy. This style of money management confuses monetary policy, which is in the Fed's bailiwick, and fiscal policy, which is the Treasury's preserve. It clearly is an assault against the independence of the Fed.

Since the MMT will most likely be in the news, next week we will publish a detailed explanation.

Advance Monthly Sales for Retail and Food Services

The U.S. Census Bureau releases retail sales data monthly, reporting total sales in dollars as well as month-over-month and year-over-year growth or decline. The estimates are based on a random sample survey of approximately 5,500 retail and food services firms whose sales are then adjusted to represent the over three million retail and food services firms in the United States.[1] Given our persistent emphasis on consumption and its impact on U.S. economic growth, the importance of strong retail sales should be clear. Recall, consumption makes up around two-thirds of GDP, and while retail sales is just one component of this total, sales results can signal trends in personal consumption, and, consequentially, economic growth.

The Census Bureau presents retail sales data in a few different ways; however, the "core" measure excludes more volatile components like gasoline and auto sales. This is the variation most closely followed by economists, policy makers, and market participants, as it provides for a better gauge of true growth or decline as well as developing consumer trends. The report further breaks out sales numbers for specific types of retailers, including electronics, food and beverage, clothing, and non-store retailers. These measures are then adjusted for seasonal trends, making it easier to compare results from month to month.[2]

So, how should we interpret the retail sales release? As a leading economic indicator, retail sales numbers can help forecast future economic activity. As discussed previously, this includes GDP growth but also inflation expectations and developing consumer trends. Persistently strong retail sales may suggest an upward pressure on prices and increased inflation, as firms raise prices in response to increased demand. Additionally, the report's granularity in regards to sales by specific business categories is important in identifying changes in consumer behavior, like the shift from brick and mortar to online purchases. The report may help identify possible investment opportunities if certain retail sectors experience consistently strong sales growth.

Retail sales can be volatile, so one bad month does not necessarily dictate a trend. Labor market statistics like wage growth and the unemployment rate may provide a more holistic view of consumer strength, so do not place too much emphasis on a single retail sales report. Furthermore, be aware that retail sales numbers are nominal, meaning they are not adjusted for price changes. So, in a period where inflation is trending above the norm, recognize that large increases in retail sales may be the result of price increases rather than increased consumer demand.

The Census Bureau released its report for January this past Friday, indicating total sales of $529.8 billion, an increase of 0.3% from the prior month and 4.4% from the same period a year ago. The results were in line with consensus expectations and point to the continued strength of the U.S. consumer.

[1]The U.S. Census Bureau, Advance Monthly Retail Trade Report, February 14, 2020. https://www.census.gov/retail/index.html.
[2]Ibid.

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