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Weekly Market Insights

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Is there a recession on the way!

Equity markets ended the week down for the fifth consecutive week. The Dow ended the week down 0.69%, with the S&P 500 down 1.17% and the NASDAQ down 2.29%.

There are a number of reasons for investor concerns: an apparent slowing of the U.S. economy, a weakening of the European Union and Chinese economies, and most important, a growing tariff dispute with China. The four are related, but it may be wise to disentangle the three and see just how vulnerable the U.S. economy is.

The latest economic statistics released by the government do show a slowing of the U.S. economy. There are a number of reasons for this: the economy has been exceptionally strong in recent quarters and most economic studies suggest it was due for a slowdown, businesses have been hesitant to expand because of the earlier mentioned EU and China's weak economies, and the China-U.S. trade dispute. The answers to three questions are very important: 1) is the U.S. economic slowdown leading to a recession or a temporary adjustment? 2) are the EU and Chinese slowdowns powerful enough to seriously hurt the U.S. Economy? and 3) will China and the U.S. come to an accommodation, and, if not, are the consequences of no agreement powerful enough to destabilize the U.S. economy?

The answer to the first question, the U.S. economy is most likely going through an adjustment process. This is not unusual, and there are counter points to the weaker economic releases. We have written about them in the past, and they remain the same, the most important being a buoyant consumer. Employment, wages and consumer confidence remain strong and are a powerful force in keeping consumption on an upward trend.

The next two, the European and Chinese slowdown and the U.S.-China trade war are a bit more complicated.

The first thing to remember is the United States is one of the least dependent economies on international trade. In 2017, international trade accounted for approximately 12.5% of U.S. GDP.

The EU is going through a weak economic time. It will most likely not spring back anytime soon, but it is not likely to fall into an outright recession. The European Central Bank (ECB) has signaled loud and clear that it is prepared to accommodate even more monetary stimulus. The European Union's problem is very complicated and one of the most vexing is related to the common currency. Having a common currency allows the EU as a unit to use the normal adjustment process to work when trade adjustments are necessary, but it does not allow for an easy method of trade adjustment inside the EU. Rather than a currency adjustment, the country needing to adjust must do so by either having very high interest rates or rising unemployment. Neither is a very satisfactory way to adjust. A common currency does allow for a great reduction of the cost of intra-EU trade, all things being equal, but all things are not equal. Germany and Greece are not even close to being equal, very different efficiencies of capital and labor, so Greece has had to make all the sacrifices. This is not a good recipe for a collegial union. The EU may have a long way to go to right the ship, but the current slowdown should not be a strong enough shock to throw the U.S. economy into anything near a recession.

China is the big story. There are two concerns: the first is an economic slowdown, and second, the tariff dispute. We don't believe either is powerful enough to throw the U.S. economy into a recession. Analysts are not confident about what the economic growth rate is in

China. Unfortunately, their economic releases are very suspect. In any case, China is already taking steps to boost its economy. Whether they are the correct steps is a different question, but we don't think a serious Chinese recession is in the near future - 12 to 24 months.

The tariff dispute is an interesting question because it depends very much on human frailty. We wrote earlier that the U.S. economy was much less dependent on trade than China. In 2017, trade represented approximately 12.5% of GDP for the United States and 19.7% for China. China's GDP was $12 trillion while the U.S. was $19 trillion. Clearly, it makes sense to come to an accommodation, particularly for China but for the U.S. also. However, economic reasoning does not always win the day. Politics can force leaders into very odd decisions. President Xi feels he cannot show weakness, which is a little surprising for a dictator who controls all the media, but that is the case. In the U.S. the motivation is similar, but of course, the man and the job are different. We do believe an accommodation will be reached, but investors will have to endure quite a bit of gamesmanship before that.

The most likely outcome for the United States is continued economic growth somewhere between 1.5 and 2.25%. This growth rate along with any inflation due to tariff and wage increases is unlikely to be high enough to inspire a hike in interest rates this year. But investors must keep a close eye on growth and inflation. The Federal Reserve will not risk runaway inflation.

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