Weekly Market Insights

June 10, 2019

The amazing Mexican fiasco!

U.S. equity markets made remarkable gains this past week. The Dow Industrials gained 4.71%, the S&P 500 +4.41% and the NASDAQ gained 3.88%. These were surprising gains considering the most recent economic news was far from encouraging. Job creation was very disappointing and a tariff threat by the United States against Mexico had investors and analysts concerned that the economy would suffer a more severe slowdown than anticipated. But in an interesting turn of events, investors put a positive spin on the news. If the employment reports were reversed, which would not be unusual, and the Mexican tariffs didn't materialize, then there was no reason to worry. However, if the tariffs did come to fruition, then the Fed would be forced to make a rate cut, lowering interest rates and making equities more attractive. The best of both worlds.

We won't know for a while whether the weak employment report was an aberration, but we do know the tariffs on Mexico have been put on hold. It does appear that even though future employment reports may reverse last week's disappointing report, investors are becoming more confident that the Federal Reserve will cut rates at least once before year end, and the combination of Mexican tariffs becoming more unlikely and investor beliefs that Fed easing is near makes for positive equity returns.

As we have written in the past, Chairman Powell and the Fed are in a very difficult position. No matter what they do, they will be accused of being political. The other dilemma they face is whether it is better to suffer the slings and arrows of political backlash, an economic slowdown or risk exasperating the difficulties of creating more financial liquidity in a system awash in cash.

This internal debate about liquidity is not just an academic matter; it affects markets, both real and financial. As we all know, Fed easing lowers interest rates which both lowers returns to savers and makes borrowing less expensive. This combination forces savers to seek out more and more risky assets in order to maintain their income. The flip side is lower interest costs allow investors to invest in projects or paper investments with lower and lower returns. The economy winds up with investors and savers in a position of low returns and high risk assets when the economy does turn down. This exacerbates the downturn and the Fed, because they have flooded the market with liquidity, has rendered monetary stimulus almost useless. The economy must then depend on fiscal stimulus, which acts far slower and depends on both Congress and the White House to act. Sound familiar, remember 2001 and 2009?

What course should the wise investor take? It seems to us - sorry that we continually repeat ourselves - with the equity markets strong, many investors' portfolios are out of balance with a heavier weighting in equities than their original allocation. A simple response is to rebalance and restructure the portfolio back to the original neutral position. Doing this reduces investors' risk to a downturn, but they still have enough exposure to profit if the market continues to make gains. They also capture some of the earlier gains. This is the whole purpose of asset allocation. Investors worked hard to establish an allocation that they feel comfortable with; it is a great tool and they should not hesitate to use it.

There has been a fair amount of press the last few days about Presidents Xi and Putin. At a much ballyhooed Russian economic conference, they announced several trade deals and the promise of economic cooperation. Much of the press made the point that the current administration was driving the two former adversaries together. This may be true but this is an unlikely and uneven pairing. China represents a very large, growing and reasonably vibrant economy. Russia, on the other hand, is a much smaller economy that is shrinking and only has weapons and energy to sell. With only a $4

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billion dollar GDP, Russia can never take the place of the United States, with a $19 billion GDP, as China's trading partner. Ultimately, China will not risk pushing the U.S. too far.

We wrote former adversaries. In truth, China and Russia have had an interesting past. During much of Mao's leadership of China, they were allies, Russia selling to China almost all of China's needs. The relation was such that Russia was clearly the dominant country.

Towards the end of Mao's reign, Russia started to liberalize and Mao became disenchanted with Russia and announced that Russia was abandoning its Marxist/Stalinist underpinnings. As readers may imagine, this did not lead to close relations. Eventually under the leadership of Deng Xiaoping, China herself liberalized its economy and rapidly surpassed Russia and the situation was reversed. China looked at Russia as a commodity exporting country and viewed herself as a growing industrial economy. That situation remains true today. The economic agreements negotiated appear to be directed at the United States rather than any long term agreement. The two things Russia may sell to China are energy and weapons. That is all they have. Can anyone remember buying anything with "Made in Russia" on the label? Probably not. In the end, both China and Russia are countries that believe they have had great empires taken from them by the West. China is an economy growing from poverty to strength, while Russia is a failing economy. Since both have the same imperial ambitions, the relationship does not seem made in heaven. I wouldn't be particularly concerned about this development

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