CONWAY • JARVIS LLC
Investment Outlook

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Investors Bide Their Time While Others Trade the Headlines

To say that this year, to date, has been eventful is an understatement. Following a horrendous close to 2018, the first four months of '19 brought us a market melt-up to a new record high (2945) for the S&P 500, courtesy of the Fed's policy shift into neutral. Soon after, trade "friction" between China and the US devolved into warfare with escalating tariffs as the weapons of choice. That took the S&P back down again almost 7%. Meanwhile, regime change has begun in the UK and a no-deal Brexit looms in October. A surprisingly robust 3.1% GDP growth number in Q1 quickly gave way to a Q2 estimate of roughly half that, prompting media types and the White House to lobby the Fed to lower key rates. The bond market concurred and, as you might expect, traders took the stock market once again into rally mode. Would the Fed abandon its neutral stance for a major pivot and reversal of its policy of only several months ago? Not a chance. So, what should an investor do in response to all these headlines? Nothing for now. It's time to play the waiting game.

Headlines, not the Economy, Are Driving the Market

The Fed's most recent policy shift to neutral *could* develop into a major pivot in policy later this year, but for reasons unrelated to the noise that's driving the stock market higher today. Chairman Powell's recent statement assuring appropriate action to sustain the expansion green-lighted the current rally. However, this advance belies the *slow* erosion of results generated by the Consumer and Industrial components of the US economy. Absent a change in US fiscal policy related to trade, that erosion could persist and holds the *potential* to trigger a change in Fed policy later in the year. While today's stock market welcomes that, the market of tomorrow may not embrace what actually triggers the Fed's reversal in policy.

No doubt, the uncertainty surrounding the effects of tariffs has lowered confidence within the Industrial/ Manufacturing sector and we're seeing that in the data. Proponents of a free-market economy all agree that tariffs are bad. Students of history will find that some tariffs are worse than others. Many point to the worst-case lesson of the Smoot-Hawley Tariff Act of 1930 that exacerbated the Great Depression that began in 1929. Enacting tariffs amid collapsing financial markets and record unemployment was a recipe for disaster. Initiating tariffs during a healthy expansion, with record low unemployment, liquid financial markets, and a diversified, technology-enabled global economy? Not so much.

The threat of tariffs, as in the case of Mexico, can be an effective negotiating tool. Tariffs used in the short-term can exact a minimal cost in pursuance of greater long-term economic benefits. However, tariffs that persist over time impose a substantially greater cost that can ultimately undermine the broader economy and minimize any gains. The key to utilizing tariffs is striking the proper balance between cost and benefit. The prospect of open-ended tariffs could explain the erosion in Industrial/Manufacturing sectors as evidenced by declines in the forward-looking surveys, Industrial Production, Factory Orders, and Durable Goods data. The woes of the Industrial side of the economy are compounded by waning consumption. Retail sales and housing have moderated significantly despite record-high Consumer Confidence and Sentiment numbers.

We’re about to enter year two of the trade war. We’re doubtful that China will acquiesce to any demand for enforcement of laws protecting intellectual property. Both parties are dug into their positions. A dearth of bi-partisan support on trade and a slowing US economy make it likely that China will wait until the current political cycle plays out in the hope that regime change in the US will bring about a different approach to negotiating.

In the meantime, the Fed will continue to rely on the data and pursue its mandate. Looking back, we saw Q2’18 GDP growth peak at 4.2% and then drop to 2.2% in Q4. That left 2018 growth at 2.9%, still well above the mandate of 2%. The first quarter of this year surprised to the upside at 3.1%. However, Q2 ’19 is estimated at roughly 1.5% for the reasons mentioned above. Seeing GDP growth remain below 2% beyond the current quarter as a result of trade policy could prompt the Fed to react with the cut in rates that the market is anticipating. It’s unlikely we’ll reach that point prior to the fourth quarter of this year. That makes it equally likely the market will look beyond today’s trade to the risk factors we’re monitoring and price in those anticipated outcomes. Stay tuned for more headlines and volatility.

Risks to the Economy

The Fed:
Remaining data-dependent and patient while standing ready to support the continuing expansion. We’re looking for an adjustment to the Fed’s balance sheet runoff rate that may precede a cut in key rates later this year. **We’ve reduced our risk level to Benign**

Trade War:
Conflict is unlikely to be resolved favorably in the current political cycle. No sign of a rollback in tariffs. A longer impasse threatens to undermine US GDP growth. **We raise our risk level to Significant**

Europe and the Global Economy:
New leadership for the UK increases probability of a Hard Brexit. A contentious EU threatens to extend Article 50 indefinitely since Brexit sets a precedent for other member nations to follow suit. Italy is about to issue a currency surrogate in violation of EU rules. A possible first step for any member abandoning the Euro and stimulating foreign investment. Any resulting contraction in Europe would be felt in China and the Emerging Markets. **We maintain our risk level at Significant.**

Political Cycle:
Election rhetoric and impeachment threats delight the media but distracts from real issues. Politics is displacing rational policy formation for many participants. Expect much more noise than substantive news until 2020. **Our risk level remains at Moderate.**

The Outlook

It’s a good time for investors to anchor portfolios to their long-term objectives and remain skeptical when watching CNBC or reading headlines about what *may* happen. Focus on what *is* happening within the economy. The US expansion continues but the data is starting to reflect the effects of trade policy. The next few months will be telling as to the resilience of the economy and the direction of the markets in the second half of 2019.

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