EPIC INVESTMENT MANAGEMENT

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Chatting with Stevie: Trade Talk, 2

Stevie was the neighborhood's precocious child who grew into a high school wiz-kid, then never stopped lapping the field until landing a job on a Wall Street bond desk. While probably not the brightest mind on Wall Street, Stevie may be the brightest one we know. We caught up recently.

Let's get right to it. Last year we spoke about trade just as the issue was coming to a head. You remarked that it was already a trade war, not just a hypothetical, and did not just apply to China and the US. What's your current thinking on it all?
Stevie: It has all intensified, particularly between the US and China, but not limited to the two. Taking it in reverse order, the White House threatened import tariffs on Mexico as leverage over the immigration issue; this after the two nations and Canada had reach preliminary agreement on a revision to NAFTA. And it will be no surprise if the Administration turns up the heat on Europe, especially Germany, which runs a huge trade surplus. We are also in a battle with India. It started with US tariffs on their steel and aluminum, and now has widened to India's tariffs on our almonds, apples, walnuts and who knows what else. Most people are aware of the trade war with China, but don't realize the breadth of our policy, picking fights wherever we can. It brings to mind the expression "when you are a hammer, everything else looks like a nail".

To good effect?
It's hard to see how ticking-off every US ally is in our long-term interest. Beyond that statement, most people's reaction will be driven by their political view. Democrats hate it all, while conservatives are willing to let it play out and see if the ends justify the means; not that we have much say in the matter.

And on China?
It's brinkmanship at work. We have levied tariffs on roughly half the goods they export to us, and are threatening to place tariffs on the other half. At a 25 percent rate, these are not nickel and dime levies. For most goods, and most companies importing them, it's a game-changing amount. On top of that, we are putting enormous pressure on the Chinese telecom equipment giant, Huawei. This included a ban on US suppliers selling to Huawei, with these firms including household names such as Qualcomm, Intel, and Micron. We are also prohibiting the purchase of Huawei equipment and pressuring foreign countries to do the same. As of last week, some of these restrictions have been lifted, which is to say, policy is fluid.

And the problem with Huawei is?
They lie, cheat and steal, basically, including our intellectual property. At least that is the accusation. Their telecom equipment might be used as a backdoor path to sensitive foreign government or corporate data. Also, it has been confirmed they work with China's military. If we see them not as an independent company, but as an extension of China's government, this is a sensible worry.

What is China's response to all this?
China is counter-punching, and it packs some power. They have already drummed up complaints against US companies, including Ford and FedEx, with these complaints likely to lead to tighter oversight, decreased business, or significant fines. The specifics don't really matter, as it is all a tit-for-tat negotiating ploy. China is also trying to forge stronger relations with other countries, and could always de-value their currency, although they have backed off on that threat for the time being. They want us to know they have some leverage and will fight back.

Is it just a bluff?
I wouldn't put it that way. China's leadership will not be pushed around, especially as their economic policy has long been based on trade surpluses. Even as their economy moves to a more internal, domestic model, this transition takes time.

Many people see a predictable timeline that brings this to a resolution.
For the Trump Administration, it is the 2020 election. There's no way Trump can go into the election with this trade war continuing after two years. Likewise for a recession, which is a risk. I'm not sure what China's timeline is.

China is seeing manufacturing move to other Asian nations. Companies leaving include Samsung, Nintendo, Foxconn, Sharp, and Google. Countries such as Taiwan, Vietnam, Indonesia, South Korea -- they all seem sure winners in this trade war. Once manufacturing moves out of China, it isn't going back. China's motivation is to halt the exodus.
It's not easy to pick up and move a manufacturing facility, its own supply chain and supporting infrastructure, but I see your point.

So is a resolution is sight?
Not that we know. Your timeline formulation makes sense, but then again, a rational analysis would have never brought us to this point. I certainly did not see it going this far, and no one I know saw it either. If it was irrational to reach this level, can we guess how and when it will end?

Here's a new twist on the timing: Trump wants the Federal Reserve to cut interest rates, whereas for the past four years they have been raising rates. The trade war is having a tangible effect on the economy, hitting the brakes hard. This has altered the Fed's stance; instead of considering additional rate hikes, they are expected to cut rates this summer. But if the US and China strike a trade deal, the global economy will re-accelerate, and the Fed will sit on its hands. Look for at least one interest rate cut before any trade deal is reached. Even then, is seems unlikely that a grand bargain will be attained. Maybe each side gets a little of what they want, declares victory at home, and the battles continue for years.

What are the market implications?
It's easier from the bond market perspective. The rate-hiking cycle is over, both in the US and globally. Economic activity is slowing and interest rates are collapsing around the world. It is not just Switzerland and Japan with negative yields on long-term sovereign debt, but also Germany, Denmark, and Holland. Last I looked, the count was up to nine European nations. Negative yields mean the government gets paid to borrow. It's insane.

Ireland can borrow for 10 years at a rate of seven basis points, Spain at 32 basis points, Portugal at 42 basis points. In Italy, yields are under two percent, while Greece is just above that level. These countries are not the icons of financial probity. Just a few years ago, some of them were considered basket cases. In a rational world, some of them still are.

All this in the context of a decade-long global expansion. What happens to government bond yields in a recession? They go lower still. The default condition is that central banks will be cutting rates and buying bonds, meaning government bond yields will remain depressed for a long time.

What about equities?
That's more complicated, as usual. The economic slowdown is real, and the threat of recession is higher than it has been throughout this entire expansion. The offset is easy money, yet again. We are right back to central banks fanning the flames, keeping the fire burning in both asset prices and economic activity. For whatever reason, they cannot resist. After all, it's not as if a recession would be devastating, or can be avoided forever. We've had a decade of sustained growth already, at some point a downturn is inevitable.

Likewise, we don't really know how effective easy-money policy has been in stimulating economies. If it works so well, why is global growth so slow? Right or wrong though, the game is still on -- central banks propping up asset prices, including stocks and bonds.

Chart du Mois

There was a time when an "inflation problem" was understood to mean prices rising too quickly. No longer.

If we trust the Federal Reserve's judgment that the Personal Consumption Expenditure deflator is the best measure of inflation, then on a core measure (ex food and energy), inflation in the US has not exceeded three percent, on a rolling 12-month basis, since 1992. Nor has it been above 2.5 percent since 2007.

Curiously, Fed economists tell us today's mild price gains are too low. In setting an inflation target, they want us to believe that a two percent annual loss of the dollar's purchasing power is good, while 1.6 percent is bad. If anyone can explain this while keeping a straight face, they deserve a seat on our central bank's Board of Governors, and maybe toss in a Fed-Chairman bobble-head doll as well.

Personal Consumption Expenditure deflator, core, year-over-year percent change

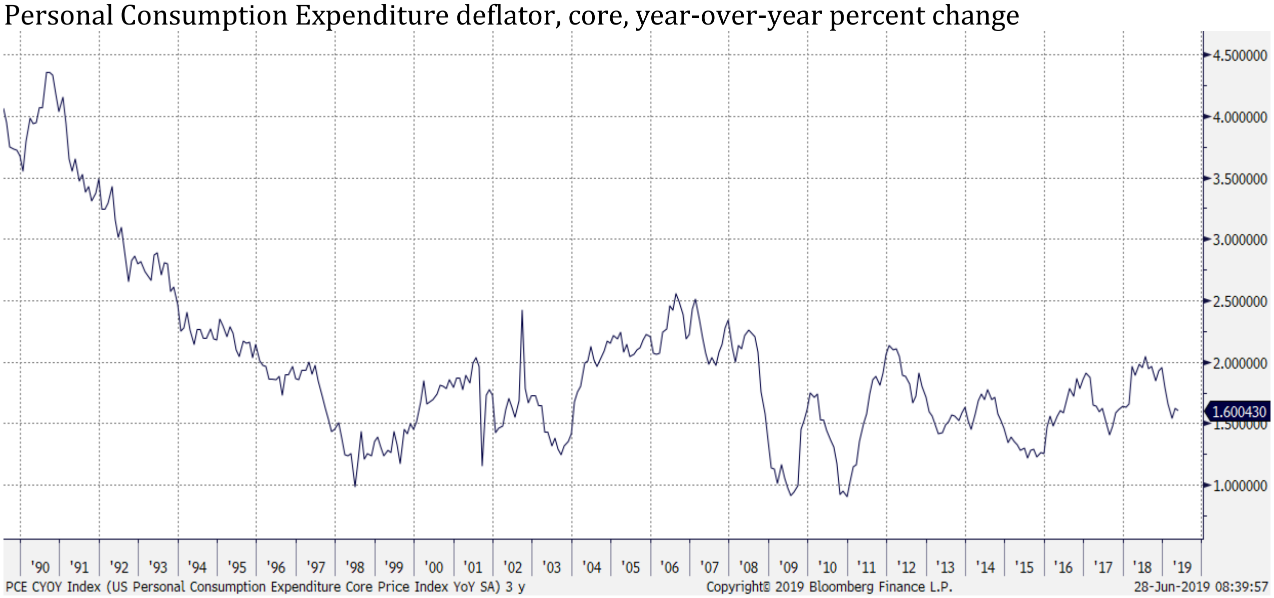


Chart du Mois, 2

The global sovereign bond market has gone nuts; nuts over negative yields. At last count, 13 trillion dollars of bills, notes and bonds around the world are priced to negative yields.

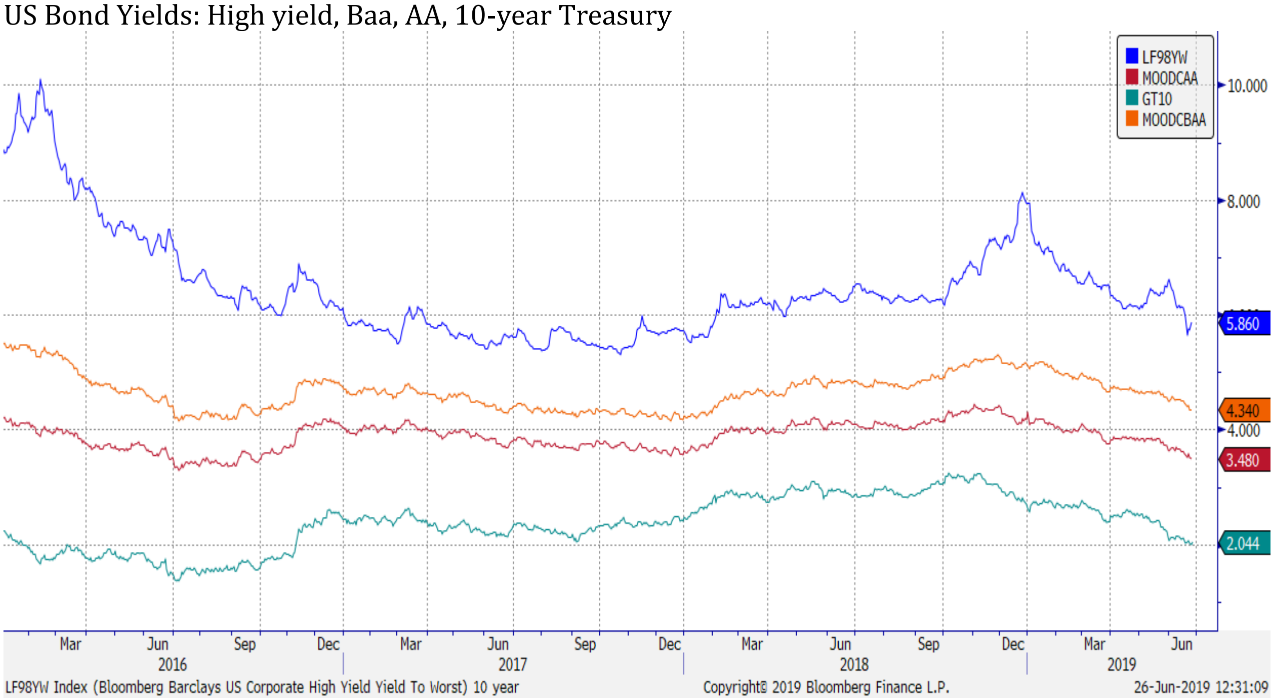
One interpretation of this condition is that the US and global economy are in bad shape, perhaps on the verge of recession, maybe something worse. The reasoning is that the global bond market represents the smart money, and that money is in a flight-to-safety mode.

But the US credit market is unimpressed. When investors seek a safe haven, risky assets suffer, driving stock prices lower and corporate bond yields higher.

Instead, the opposite has happened. The highest tranche of investment grade bond yields are at a three-year low. High yield rates have plunged from eight percent in December to less than six percent. If warning lights are flashing, the bond market does not see them.

More likely it is all just excess liquidity -- aided by central banks no doubt -- but nothing more.

US Bond Yields: High yield, Baa, AA, 10-year Treasury



Words of Wisdom

Home Depot co-founder and former chief executive Bernie Marcus, in an April video address, excerpted here:

“I love America. I do. I love America because it’s the greatest country in the world. I think there are two big reasons why this country is so great. The first is our Constitution, which guarantees a freedom of speech and expression. The second is our free market system.

The free market system has been the biggest creator of wealth and prosperity the world has ever known, lifting billions of people out of poverty and far more superior than any government program could ever be. The free market is the tool that allows money to reach out and grab hold of the American dream.

That’s why it pains me to see people in this country glorifying socialism. Young people especially have been indoctrinated into believing that free enterprise is immoral, because it enriches the greedy and depresses the poor. The reality is that the free market system has created the biggest middle-class population in the world. And while some may say socialism is well-intentioned, the fact is it robs people of their independence, their dignity, and their finances, leading to government dependence, suppression of ideas, and lower standards of living for those under its thumb.

Free enterprise just doesn’t create an environment where individuals have the opportunity to prosper, but makes charitable giving possible in the first place. It’s not a random occurrence that Americans are the most charitable people in the world. It’s a result of hard work, entrepreneurship, and, yes, a free market system -- because in order to give money you need to make money.”

Tidbits...

US economy shows surprisingly strong first quarter, yearly growth reaches highest level since 2015.
US unemployment rate drops to 3.6 percent, lowest since 1969.
US economic expansion reaches ten-year milestone, becomes longest advance on record.

International Monetary Fund cuts 2019 global growth forecast to 3.3 percent, slowest since 2009.

US housing prices advance at slowest pace since 2012, 3.5 percent year-over-year.
House flipping -- investors buying and selling within a two-year period -- approaches levels reached in mid-2000s housing boom.

Just before the bust, but lightning seldom strikes twice.

UK Brexit date of departure from European Union is extended to end of October.

Still seems like self-immolation by Britain, but no stopping them now.

US store closings already exceed totals for all of 2018, as traditional retail grapples with e-commerce.

US Senate considers raising nation's smoking age from 18 to 21.
San Francisco bans sale of e-cigarettes. Traditional cigarettes, alcohol, marijuana all okay.

Alphabet's drone-delivery, Wing Aviation, receives Federal Aviation Administration approval.
Amazon Go, cashier-less convenience store, opens in New York City.
Walmart to provide in home delivery straight to customers' refrigerators.

Green New Deal on steroids: New York City aims to halt development of high-rise, glass-clad buildings, eliminate autos by year 2050; also plans to ban hot dogs from city-run establishments.

Next up: apple pie

Volkswagen launches new electric vehicle in Europe, receives 10,000 orders in 24 hours.
Fiat Chrysler enters merger discussions with Renault in bid to form auto industry giant; French government gets involved, makes a mess of the deal.

Plus ca change…

Rocky Mountain High: Colorado aggregate tax revenue from legalized cannabis reaches one billion dollars.

Senator Bernie Sanders proposes tax on Wall Street transactions, with funds used to pay off student loans.

Shameless pandering.

Source:
Bloomberg
Breitbart.com
The Wall Street Journal