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Client Newsletter—Monday, April 23rd, 2018

Tariffs, Interest Rates and Synchronized Global Economic Growth

After experiencing generally upward trending markets from November, 2016 to February, 2018

- We've recently encountered a little turbulence.

The following represents my beliefs.

As I wrote in my last letter, during bull markets we often see volatile periods. They usually come around when <u>something changes</u>.

What Has Changed?

After domestic markets broadly moved to new highs during the first 3 weeks of this year:

1. I**nterest rates moved-up a bit earlier this year** – and many professionals found themselves on the wrong side of the market. Adjustments in portfolios have caused some volatility.
2. Lately, the administration has been "saber rattling" via **import tariffs** on certain imported goods due to unfair trade practices on the part of some of our trading partners in an effort to exert pressure to achieve more favorable trade terms.

<u>Interest Rates</u>

Although things can change at any time, after making a major bottom around June of 2016, interest rates have trended upward, <u>but they are still at historically low levels</u>, based on modern history.

For perspective:

- The 5-year government bond was recently yielding about **2.6%**
- The 10-year government bond was recently yielding about **2.8%**
- The 30-year government bond was recently yielding about **3.0%.**

And our rates have been considered to be *high* – in relation to interest rates in other developed countries.

Inflation

Interest rates are largely affected by inflation expectations. Although too much inflation can bring an end to a growth cycle, there are few signs of inflation at this time. Of course, things can change at any time.

<u>Tariffs and Trade Wars</u>

The US has proposed tariffs on Chinese goods imported into the US. Why?

Generally:

- China exports nearly 4 times as much in goods to the US, as the US exports to China.

- In addition, US leaders believe China allows the theft of US intellectual property – and forces the transfer of technology from US companies to Chinese competitors. China generally denies the allegations.

Economists Generally Do Not Like Tariffs
Many economists believe tariffs, on imported goods and services from other countries, reduce economic growth, which leads to less economic output, tax revenues and opportunity.

Also, economic historians are touchy about tariffs in light of the Smoot Hawley Tariff Act of 1930. Many economists believe those tariffs, which ignited a *major* global trade war, helped to turn what might have otherwise been a bad global recession – into something much worse.

It's Different Today
- Although things can change at any time, currently the global economy is broadly the strongest it's been in over a decade. We currently have rare "synchronized global economic growth" – i.e. all 45 major economies tracked by the Organization for Economic Cooperation and Development (OECD) have been growing at the same time. (1)

Our Trade with China

For Perspective:
- The US *exports* ~$130B of goods to China (which is only about ***2/3* of 1%** of our total gross domestic product – GDP – the value of goods and services the US produces).
- The US *imports* ~$505B of goods from China – nearly 4 times as much as we export to China. (2)

Also:
- Our leaders are insisting the proposed tariffs were meant to trigger a <u>negotiation</u>.
- Both sides have expressed that they recognize there are no winners in a trade war.

So, Why Have the Markets Been So Unsettled?
- When something changes, the worst is often assumed.
- When uncertainty is introduced, at the very least there is usually some kind of a market adjustment. And we've been getting an adjustment, but I believe it *feels* worse than it has been (more below).
- Markets have a tendency to go to extremes – due to changes in emotion, even if for no other reason.
- In a worst-case scenario, it's possible the tit for tat tariff retaliations could escalate and negatively affect our <u>industries</u> that export to China – and our <u>consumers</u> who benefit from cheap Chinese imports.

On Worst-Case Scenarios
As I've written before, most worst-case scenarios don't come to pass. Also, both sides have indicated a willingness to negotiate.

Recent Market Movements

For perspective:

- Stocks rose about 7% in the first 3 weeks of the year. We've mostly given those gains back.
- Although it seems most people don't have a sense for this, as I type, US stocks as measured by the Dow Jones Industrial Average (DJIA) are down **~3%** since the start of the year.
- Also, remember, market movements as measured by DJIA *points* are nearly meaningless. Assuming normal economic growth and higher markets in the future, DJIA point movements may continue become more pronounced, but this may not be a reflection of market volatility. In other words, when I first entered the business 34 years ago *today* (4/9/1984), a 100-point DJIA move represented about **8%.** Today a 100-point move represents about ***4/10ths* of 1%**!
- As I've written, percentages are the great equalizer.

In summary:

- Although there seems to be an upward bias to changes in interest rates, the bias has been very moderate – and orderly – to this point.
- Although some industries may be negatively affected, the goods on which tariffs are being proposed represent a very small portion of the US economy.
- Since the markets tend move on emotion, over the short-term more volatility is likely until the US and China reach a reasonable agreement.
- Since China exports more than $500B to the US it is also in their interest to negotiate with the US.
- It's possible the current posturing could devolve in a much larger trade conflict, but I believe this is unlikely at this point.
- The markets are broadly down about 3% since the start of the year, which I believe is less than current perception.
- Although things can change at any time, the global economy has been very strong as of late.

Let us keep our eye on the horizon.

As always, please call me with any questions or concerns.

Best!

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April 9, 2018

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Sources:
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2. March's Market Noise Continues, Mike Gibbs, Director of Portfolio and Technical Strategy, Raymond James and Associates

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