Basis Points

Weekly Market Commentary

# Basis Points – June 19, 2018

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**Above the Fold**

The equity market traded sharply lower this morning, after the Trump administration's latest threat to China increased fears of an impending trade war between the world's largest economies. Trump asked the United States Trade Representative to identify $200 billion worth of Chinese goods for additional tariffs, at a rate of 10 percent. If China "refuses to change its practices" and insists on continuing with the new tariffs it recently declared, then the additional levies would be imposed on China.

This news item is a continuation of the increase in trade tensions that we have seen over the past few months. The market has previously traded off sharply and then recovered as the administration has worked behind the scenes to make a deal. The S&P 500 is up 5 percent this year, in the face of weekly trade war tensions, so the market is able to look through these news items in the medium term. Shares of some of the biggest chipmakers are also lower today given their large exposure to China. Qualcomm, Advanced Micro Devices and Nvidia all dropped at least 1 percent. The administration has indicated that iPhones made in China will not be subject to new tariffs, probably because a tariff on steel or aluminum can be passed through to consumers without much angst, but an extra $100 for an iPhone may cause riots in our streets.

**Three Things**

**1.** There has been a lot of investor worry this year about rising interest rates, as rates seem to have completed a 36-year long-term rate decline cycle. However, in the recent past, there have been long periods when rates have risen steadily for a long time, and the stock market continued to advance. Such as 1949-1973, when the 10-year yield rose steadily from 2.3 percent up to 6.5 percent. The S&P 500 index rose from 15 to 98 over those 24 years, a 7 percent annualized gain.

**2.** With bigger paychecks from new lower payroll tax rates, American consumers went shopping in May, driving retail sales and economic growth sharply higher. The economy in the second quarter is tracking close to 4 percent growth, a level most thought was unlikely even a year ago. For now, a 4 percent forecast is close to coming true on a quarterly basis, after strong retail sales data pushed up tracking GDP growth for the second quarter to about double the first quarter's level. The economy grew by 2.2 percent in the first quarter. Retail sales in May were up 0.8 percent, double what some economists expected. If the economy hits that 4 percent growth rate, it would be the strongest growth since the third quarter of 2014. The primary source of the acceleration in growth this quarter is the consumer, which looks to be expanding real outlays at a 3.7 percent rate in Q2 following an anemic 1.0 percent pace last quarter. It looks like consumers wasted no time enjoying their tax windfall, as the Q2 savings rate looks like it will revisit the lows for the cycle.

**3.** There is an interesting study by John Bogle of Vanguard that he performed 25 years ago, and has updated it to the present day, that shows the source of return for bonds. While the sources of return from stocks come from corporate earnings growth, dividend payments and multiple expansion, the long-term return on bonds is much easier to predict. Bogle studied 10-year periods going back to 1906 and found that all you need to know to predict performance of bonds is the yield to maturity of a government or corporate bond on the day you buy it. He found that at least 91 percent of the subsequent return on a bond could be explained by their initial yield to maturity, so capital gains and losses barely register as a source of positive or negative performance over the long term. Today, the yield on the Barclays U.S. Aggregate Bond Index of government/corporate bonds is 3.35 percent, so that may be a very accurate prediction of performance over time if bought today.

**Did You Know**

The period of "synchronized global growth" that world economies enjoyed in 2017 may be ending. The obvious strength in the U.S. economy this year may be starting to diverge from other large developed areas such as Europe and China, who are much more cautious in their economic growth outlooks. The U.S. economy grew at a 2.2 percent annual rate in 1Q18 but seems to be ramping up further in the second quarter. Growth is on track to exceed a 4 percent pace in the three months ending in June, which would be the fastest of any quarter in almost four years. The U.S. economy is revving up just as Europe and other major economies lose steam. In an indication of growing economic vigor in the U.S., the Fed raised rates again, and signaled that it may quicken the pace of future rate increases because of a strengthening economy and tightening labor markets. However, the European Central Bank said they would hold interest rates steady through summer next year, a sign that they felt the eurozone economy remains fragile. Slower economic growth forecasts and flat interest rates caused the Euro to fall last week, having its worst day against the dollar in two years, falling 1.88 percent. Many investors thought a revitalized Europe would see strong growth in 2018, but recent labor strikes in France, political turmoil in Italy and softer economic data are causing investors to reign in those hopes. Germany last week reported that factory orders dropped 2.5 percent in April, and on Thursday the ECB revised down its eurozone growth expectations for this year to 2.1 percent, from 2.4 percent. China may be cooling down also, as the People's Bank of China this week also left short-term interest rates unchanged. New data showed business activity, including investment and retail sales, slowed in May, suggesting China is facing growing headwinds. In the U.S., meanwhile, recent data suggest an economic expansion that just became the second-longest in the nation's history is accelerating, rather than slowing down.