Basis Points

Weekly Market Commentary

Basis Points July 12, 2018

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Above the Fold

The NATO meeting in Brussels on Wednesday opened with disagreements among its members, as President Trump pressured Germany and other allies on the planned Nord Stream 2 natural gas pipeline and on the alliance's disproportionate reliance on the U.S. for military support. Despite apparent tensions, NATO Secretary General Jens Stoltenberg remains confident that the alliance remains strong. In trade, the White House has released another list of $200 billion worth of Chinese goods that could be saddled with a 10 percent tariff after claims that China has chosen to retaliate rather than address the U.S.'s IP theft concerns. This list would constitute a third wave of tariffs to be implemented after the planned second wave of $16 billion worth of Chinese imports. Domestically, the National Federation of Independent Businesses reports small business optimism at near-record highs after the nomination of Brett Kavanaugh to replace Justice Anthony Kennedy on the Supreme Court. Kavanaugh would be a marked shift to the right for the Supreme Court and is notable for his constitutionally conservative stance, claiming his "job is to interpret the law as written, and not make law or policy," and his suggestions about enhancing presidential protections from prosecution while in office, and his deregulatory stance on business.

Three Things

- House Republicans will introduce and vote on a "Phase 2" of tax reform that passed into law last year. What is in the new bill is important if the GOP is able to retain its hold on both houses of Congress after the midterm elections this fall. Chairman of the budget committee Kevin Brady said that he hopes to introduce a major tax bill by the end of the summer. GOP leaders are planning on voting on it prior to the midterm elections, to get everyone on the record where they stand. Key provisions would make permanent items that had a sunset provision in the first bill, such as making individual tax cuts permanent, extending depreciation tax provisions, and expanding tax incentives for HSAs. However, given house rules on increasing the deficit, only a bill with broad bipartisan support could pass both houses, so the bill may only deal with middle-class tax cuts and expansion of the private retirement savings system.

- The profit margin at UPS fell to 12.1 percent in 2017, down from 13.5 percent in 2013, even while adding over $6 billion in annual revenue over that period. UPS still works with very old equipment and processes, while its rival FedEx has spent considerable capex over the years on state-of-the-art sorting, tracking and shipping equipment that allows FedEx warehouses to employ half the number of employees as UPS. UPS says that half its packages are processed through automated facilities today, vs. 96 percent at FedEx. Trying now to play catch-up, UPS will spend $20 billion over the next three years for automation and technology upgrades, and hopes to be fully automated by 2022. FedEx employees are not members of a union, while 260,000 UPS employees are members of the Teamsters union, which has been very reluctant over the years to commit to upgrades that could cost the jobs of its members.
- The notes from the June 12 Fed meeting were released last week, and they show that the board reaffirmed their commitment to gradually raising the benchmark lending rate, while being cognizant of the rising risks from trade battles and emerging market turmoil that could curtail the tailwind from the tax reform bill. The next Fed meeting is on July 25, and the market anticipates that the board will next raise short rates at the September 19 meeting. The board should have much better information by that date of the negative economic effects of the tariffs and trade war turmoil that has been escalating since the beginning of the year.

Did You Know

Question heard at a 4th of July party: *Hey, I read that China owns U.S. government bonds worth $1 trillion and if they decided to dump them into the market it could spike interest rates overnight and crash the U.S. economy. Are you worried about that?*

Even for an equity guy, I believe in this old market maxim: Equity markets trade on hope, while fixed income markets trade on truth. There may be a myriad of opinions on the true value of Netflix stock, some may say $100 a share while others may say $1,000. Each opinion is based on a unique set of facts and viewpoints, and only in the future will some investors be proved correct and others widely off the mark. There is no “wrong” opinion on a stock at the current time, and investors buying stock at the current price are doing so while predicting or hoping that the valuation and stock price will be higher in the future. However, the credit markets are different and more sober, as lending is only based on current information about the borrower, and past actions that display creditworthiness. Although my 19-year-old son may be faster, better looking and have a bright future ahead of him, if he applied for a car loan by himself, he may get a 12 percent rate for a loan, while I may get a 6 percent rate if I applied myself. All that matters to those that loan money is the credit rating of the borrower, which is based on past actions showing creditworthiness. Greek government bonds traded at 15 percent in 2011 because the market judged that the chances for default were very high, and the market interest rate moved higher to reflect that fact. U.S. bonds trade at low rates today because the world's credit investors judge us to be very likely to repay our debts. There is no hope in all these judgments of borrowers, just truth.

With regard to the China question above, the simple reply has two parts: First, why would China do that? And second, what would they then do with the money? China does own a lot of U.S. government debt, but they are very smart people. By buying our bonds (i.e., loaning money to the U.S.), they are showing a high level of confidence in our ability to repay the debt at a future date. Money flows where it is treated best, and China must feel that the combination of high creditworthiness and a higher interest rate than they could get elsewhere relative to the risk, is a good deal for them. The second part of the answer is if they did dump U.S. bonds, what would they then do with the money? German bonds yielding 0.5 percent? Russian Ruble futures? Spanish government debt? Bitcoin? The lack of comparable alternatives to U.S. bonds is a powerful catalyst to stay put. For the U.S., the fact that many investors and countries around the world want to loan us money at a very reasonable rate is not a weakness, it is a strength, which displays the confidence that people have in us to repay our debts. Yes, our national debt is at an all-time high, but it is still very low as a percent of GDP. And the high debt number has not affected the world's view of our strong credit rating as reflected in our interest rates.