Basis Points – July 16, 2019

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Above the Fold

Higher and Higher – Momentum continued late last week into Monday as the Dow Jones Industrial Average and S&P 500 climbed to new, all-time highs. The biggest drivers now are a much more dovish FOMC (Federal Open Market Committee), which is expected to cut rates by at least 25 basis points at the end of this month, and belief by many traders that a trade deal with China will get done. Ironically, it's been very poor economic data that's supporting this theory as Gross Domestic Product growth in China drops to a 27-year low. The thought is that China has few arrows in its stimulus quiver and will be more incented to get tariffs off the table so it doesn't lose its very lucrative production sub-economy.

Adding to the momentum is the fact that several very large U.S. companies are already shifting their supply chains out of China to avoid tariffs, maybe permanently. According to the Wall Street Journal, the companies that manufacture Crocs shoes, Roomba vacuums, GoPro cameras and Yeti coolers are now producing their goods in other countries to avoid tariffs. Many other companies have also shifted production to countries like Vietnam, India, Taiwan and Malaysia, and even Apple is considering shifting final assembly out of China to save millions of dollars in tariffs.

According to consulting firm A.T. Kearney, U.S. imports from Vietnam alone are expected to reach nearly $65 billion this year, up 36% from 2018.

While the tariffs may be a temporary penalty, the effects on China's economy may be more permanent as logistical supply chains cost money every time they are altered. It's not a cheap undertaking for a company to move a production line from China to Vietnam, as machinery, tooling, engineering, staff, training, boxing and shipping all need to be completely revamped.

It could be safe to say that both sides want a deal done, but as stated before, China seems to have much more to lose.

What's Ahead

The other major catalyst for U.S. stocks is earnings season which is already underway. Later this afternoon, we will hear more commentary from FOMC chair Powell, and member Charles Evans. Building permit data is due for release tomorrow a.m., with economists expecting 1.30 million new permits. And the Philadelphia Federal Manufacturing Index is expected early Thursday, with a reading of 5.0 expected — a big jump from last month's 0.3.

Three Things

1. *Not a Good Year for MAX* – The Boeing 737 MAX could remain grounded until early 2020 as the FAA and company executives expand their safety evaluations. All parties are examining a growing list of potential issues beyond the Maneuvering Characteristics Augmentation System (MCAS) software fix (which was completed months ago). Flaws in the MCAS are to blame for overpowering pilot inputs and pushing the 737's nose down, triggering a crash.
2. *Barry Bids Petroleum* – Though Barry's damage was limited, the first hurricane of the 2019 season managed to fuel prices of crude and distillates over the last week as inhabitants fueled their vehicles and off-shore rigs were evacuated. The good news is that no long-term effects on petrol prices are expected.
3. *Europeans Paying for Junk* – With European Union rates upside down, investors across the pond have to pay to own high-quality government or investment grade bonds. But in an unusual turn, about a dozen junk bonds, usually classified as high-yield because of their risk, are also costing investors money to own. Think of it as lending a risky company money, then paying interest (back to the company) on the money you've lent. The good news is that these anomalies are limited and there is some rationale behind it.

Did You Know?

One of the ways China's government stimulates its economy is by paying companies to build structures and even entire metropolises that won't have any occupants. These "Ghost Cities," some meant for hundreds of thousands of people, are built all over the country and many sit basically empty. Some estimates put the total number of ghost cities at 50 or more.

But on the outskirts of larger cities like Beijing and Shanghai, there are also large, vacant residential buildings with apartments that sit unoccupied. A great number of these apartments are actually purchased by consumers and held as investment properties with the hope of appreciation. Recent data suggest that roughly 65 million of these homes sit completely vacant, which is nearly a quarter of China’s total urban housing.