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Trade and Fed Policy at a Critical Inflection Point

The market faces two nagging questions today: the aggressiveness of Federal Reserve policy and increasing trade tensions with China. We received some clarity on the former following comments by Chair Powell on Wednesday, and investors are eagerly anticipating news on the latter as we await the outcome of the much anticipated meeting between President Trump and Premier Xi tomorrow. I'll share my thoughts on each separately:

1) Federal Reserve Policy: Chair Powell's comments this week that interest rates are "just below the broad range of estimates of the level that would be neutral for the economy" is a dramatic change from his previous statement that rates were a "long way" from a so-called neutral rate and set off Wednesday's 2.3% rise in the S&P 500®. To me, the market's reaction makes total sense. The change in language now gives the Federal Reserve the latitude to be data dependent, especially if the economy hits a slow patch. For most of the year, the pace of Fed hikes was well received by the market until Powell made his "long way from neutral" comment. I believe this was a rookie mistake and the open-ended nature of that comment implied an open-ended number of rate increases. This introduced a level of uncertainty that was too much for stocks to absorb and contributed to the weakness in equities that started at the beginning of October. Chair Powell's more recent comments not only lifted that uncertainty, providing a boost to equities, but also had an impact on the dollar, which fell the most since November 1st. The strong dollar has been a headwind for multinational corporate profits in 2018; however, this headwind could diminish following Chair Powell's comments. In summary, rates are likely to move higher but not in a way that could cause a recession. While many economists seem to think we are at the end of the economic expansion, and some have actually stated we are about to enter a recession, I'd like to point out that recessions usually occur at the end of a tightening cycle—not at the beginning.

2) China and the G-20 Meeting: The upcoming G-20 meeting is probably more critical than Fed policy. As noted in my post-election note, the President has started his re-election campaign and knows a robust economy is critical to the success of his election efforts. The trade war has hurt China's economy; China's GDP grew 6.5% YoY in Q3—its slowest quarter of growth since 2009—but the psychological impact on the U.S. has also been damaging as economic wars can evolve into something far worse. A key feature of the 2018 U.S. Tax Cuts and Jobs Act was 100% expensing of capital items. For corporations to actually allocate capital to long-range investments, they need to feel comfortable about the long-term health of the economy and a war, be it cold, conventional or otherwise, is not going to stimulate investment. Already, CEO confidence has begun to drop as trade tensions have escalated. A capital investment cycle could extend economic growth for years and would translate into productivity growth as well. The good news about this trade conflict is that it was initiated by this Administration and it can be ended by this Administration. While I do not expect a deal will come out of the G-20, I do think the language will be softened considerably and that Trump could say something that could

postpone or even suspend current tariffs pending a fully executed trade agreement, thus buying him time to negotiate the best deal possible for the United States. This could have an even bigger positive impact on investor psychology than Powell's comments on Wednesday. However, if tones are anything but conciliatory coming out of the meeting, which I think has a low probability, markets are likely to react negatively in the short run.

The recent weakness in markets has over-shadowed the data pointing to higher stock prices after the mid-terms of a first term U.S. president. Historically, returns for the S&P average about 15.3% in the 12-month period after mid-terms, and I do not believe this period will be any different. Wednesday's shift by Powell is very significant and I believe the nuanced softening of his language displayed a level of pragmatism that has not always been present in previous Fed chairs. The G-20 meeting, which starts today, is possibly the most consequential summit in many years. The personal interaction between the leaders of the U.S. and China and the message coming from this meeting will be closely analyzed and will have an impact on the market. We will keep you apprised of any major developments.

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