Financial Market Weekly

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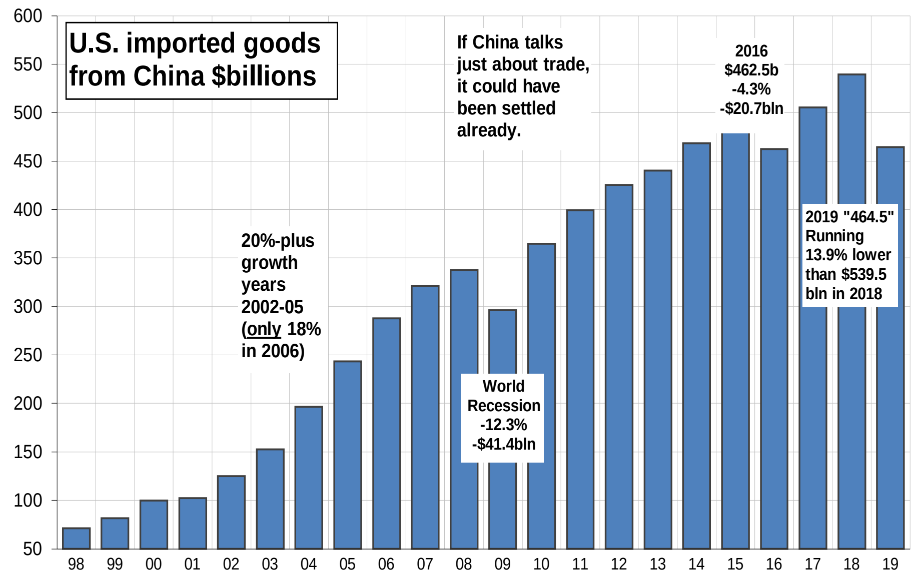
CHINA TRADE WAR IS BACK: MARKETS MORE CONFUSED THAN EVER



The President tweeted Friday morning that "tariffs will make our Country MUCH STRONGER, not weaker." Okay. Though every college economics textbook in the country says tariff duties discourages imports and increases prices to the domestic consumer. Bad. It protects relatively inefficient domestic producers. Bad. Free trade raises living standards around the globe. Good, Unquote. It is hard to write this week's newsletter on trade frictions given the uncertainty of the US-China talks, but we will review where things stand now. The stock market fell with the president's tweets threatening China with new tariffs on Sunday, May 5. Back in September the US slapped a 10% tariff on $200 billion more goods imports from China (check the list at the bottom of the link) which was set to go to 25% at the start of 2019. The 25% boost was postponed due to favorable talks, but now the 25% goes into effect at midnight Thursday night. The stock market has been like a yo-yo on the China US trade talk news this week. Dow stocks had been down as much as 4.4% from the April 23 record highs on Thursday morning, before Trump made comments at a press conference that rallied stocks back. Trump's comments were also pretty tough before the Canada trade agreement was made right at the bell of the deadline on September 30. Maybe his comments regarding China are also meant as a hard-ball negotiating tactic. You be the judge.

> Trump May 9: We were getting very close to a deal, then they started to renegotiate the deal. We can't have that. We can't have that.
> So our country can take in $120 billion a year in tariffs -- paid for mostly by China, by the way. Not by us.
> … And businesses will pour back into our country. So instead of making the product, it'll be the old-fashioned way, the way we used to do it. We made our own product.
> … our alternative is -- is an excellent one. It's an alternative I've spoken about for years. We'll take in well over $100 billion a year. We never took in 10 cents from China, not 10 cents. And it'll be a -- I think it'll be a very strong day, frankly. But we'll see. We'll see.

Sounds like the president is happy to put the tariffs on, collect customs duties, and have businesses come back to America. We checked the latest customs duties if it matters. In the first six months of fiscal year 2019 ending March, customs duties are $34.7 billion versus $18.4 billion in the prior year's first half. We misunderstood however, as an early Friday morning Trump tweet threatens to put 25% tariffs on all imports from China: "the process has begun to place additional Tariffs on the remaining 325 Billion Dollars."

U.S. Imports of goods from China

Billions of dollars	2018	2017	2016	2015	2014
Cell phones and other household goods	71.815	70.360	61.474	64.538	64.103
Computers	47.323	45.515	40.405	43.805	46.247
Telecommunications equipment	33.948	33.491	28.912	27.085	22.538
Computer accessories	32.563	31.649	28.245	30.456	31.191
Toys, games, and sporting goods	28.225	26.751	25.049	26.355	24.433
Apparel, textiles, nonwool or cotton	25.161	24.137	24.165	25.645	23.925
Furniture, household goods, etc.	22.700	20.669	18.634	17.894	16.053
Other parts and accessories of vehicles	16.377	14.406	14.234	14.868	13.465
Household appliances	16.022	14.139	13.719	14.218	13.244
Electric apparatus	15.929	14.081	13.124	13.627	13.334
Apparel, household goods - cotton	12.406	12.273	12.708	14.410	14.738
Industrial machines, other	11.843	10.585	8.884	9.075	8.778
Televisions and video equipment	11.730	10.656	9.261	10.654	10.629
Footwear	11.436	11.537	12.006	14.182	14.295
Photo, service industry machinery	10.703	9.552	8.595	8.356	7.687
sub-total	368.181	349.801	319.414	335.170	324.659
Total	539.503	505.470	462.542	483.202	468.475

US China imports were still moving up in 2018 with an increase of 6.7% or $34.0 billion to $539.5 billion. The imported goods from China table covers major categories from 2014 to 2018. The major categories sub-total of $368.2 billion in 2018 is 68.2% of the $539.5 billion total. Every major category moved higher except for your dancing shoes. There have been news stories of shoe companies finding the logistics difficult to immediately move operations from China to the Philippines, or Vietnam, or Cambodia. (You notice they are not thinking of coming back to the USA.)

Trade War 2018

Trade deficit in goods

$ billions		Exports	Imports
China	419.2	120.3	539.5
EU	169.3	318.6	487.9
Germany	68.3	57.7	125.9
Mexico	81.5	265.0	346.5
Japan	67.6	75.0	142.6
Vietnam	39.5	9.7	49.2
South Korea	17.9	56.3	74.3
Canada	19.8	298.7	318.5
World	878.7	1,664.0	2,542.7

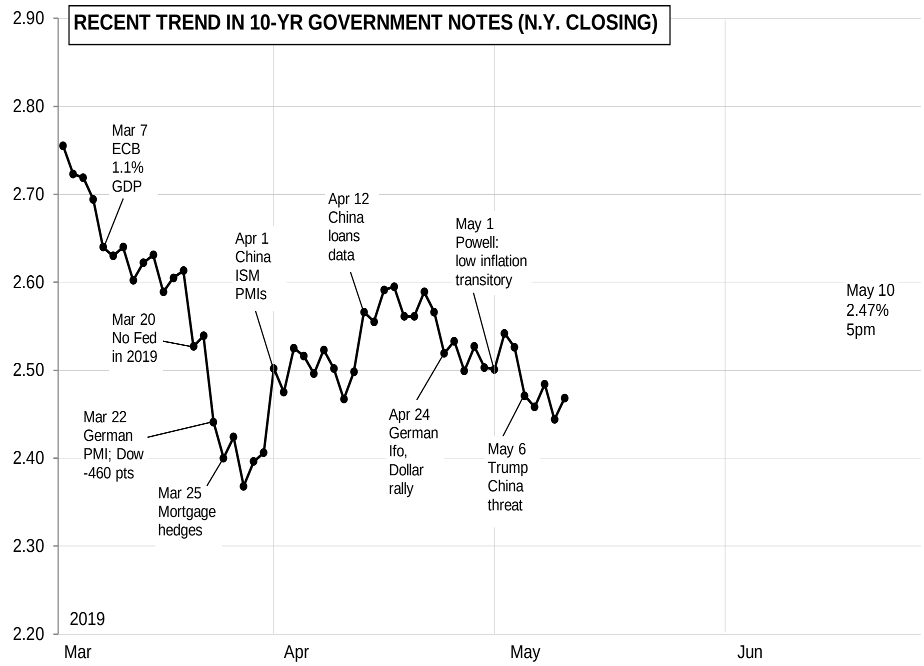
2019 Trade War Watch
Dow stocks Apr 23 high 26,695.96
May 10 low 25,469.86 -4.6%

Conclusion: There are trade negotiations and there are the even more pressing concerns about U.S. companies doing business in China: greater access to the market there and protections for tech and trade secrets. Our guess is even if there is an agreement, the $250 billion of 25% tariffs will remain in force to ensure compliance. As far as just the trade issue, trying to redo the way, virtually overnight, that U.S. companies provide goods to American consumers and deliver the supply-chain inputs for factories will be a shock to the economy. You can try to change quickly what took place over twenty years, but it could backfire and create uncertainty. We never thought much of the argument that the economy would hit a brick wall upon reaching the time's up, record 10-year economic expansion of the Clinton years in the 90s, with a majority of CFOs and CEOs expecting a recession in the next two years, but the economic war with China could be a trigger for recession, and markets from this point forward should be on a recession alert. The stock market sell-off reaction to the U.S.-China economic isn't steep enough to trigger recession alarms with a maximum high-low loss of 4.6% for the Dow industrials. Last December the peak to trough selling in stocks was 19.4%. Despite the stock market's gyrations, there's no recession until companies lay off workers, and although weekly jobless claims are slightly elevated the last few weeks, they would have to go even higher to signal a significant slowdown in economic growth. The problem with monitoring the economy for signs of growth, or in this case not, is most recessions involve a sharp break that cannot be foreseen, where businesses and consumers suddenly stop their spending and break/brake the economy hard. If these China tariffs are going to slow the economy, it is likely to be more like a slow-moving train wreck over many months.

MARKETS OUTLOOK

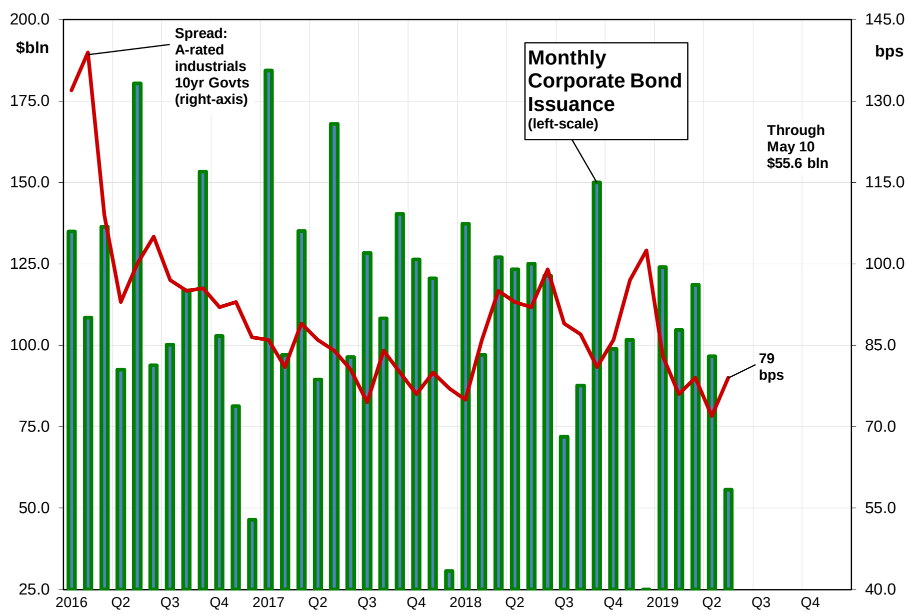
	29-Mar 2018	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	2.81	3.00	3.00	3.10	3.10	3.25	3.20	3.20
10-Yr Note	2.41	2.60	2.70	2.90	2.90	3.10	3.10	3.10
5-Yr Note	2.23	2.45	2.60	2.80	2.80	3.05	3.05	3.05
2-Yr Note	2.26	2.45	2.50	2.70	2.70	2.90	2.95	3.00
3-month Libor	2.60	2.60	2.60	2.90	2.90	3.10	3.10	3.10
Fed Funds Rate	2.50	2.50	2.50	2.75	2.75	3.00	3.00	3.00
2s/10s spread	15	15	20	20	20	20	15	10

Bond yields followed the stock market this week. By the end of the week, stock market traders may have had enough of just chasing their own tails following the news up and down from the trade tweets. A tweet from a Chinese newspaper Friday said the talks would continue. Trump tweeted at 314pm EDT that the talks had been constructive and his relationship with President Xi remains strong. Dow industrials had been down 358 points Friday morning, and closed up 114 points. The fact remains that there are 25% tariffs on $250 billion of China goods that Americans want to buy versus just 25% tariffs on $50 billion of goods last Friday. Fed rate cut odds to 2.25% this year were 92% Friday.



CORPORATE BONDS: BRISTOL-MYERS SQUIBB, CON ED, AMERICAN WATER

Corporate offerings were $47.5 billion in the May 10 week versus $23.3 billion in the May 3 week. On Wednesday, IBM came with a $20.0 billion 8-part deal. It priced a $3.25 billion 3.5% 10-yr (m-w +20bp) at 105 bps (A1/A). The computer/technology company will use the proceeds to finance its proposed Red Hat acquisition. Corporate bond bond yields (10-yr Industrials rated A2) were 79 bps above 10-yr Treasuries this week versus 76 bps last Friday.



FEDERAL RESERVE POLICY

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	8-May	1-May	24-Apr	17-Apr	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2124.129	2123.954	2153.544	2153.409	479.782
Federal agency debt securities	2.347	2.347	2.347	2.347	0.000
Mortgage-backed securities (MBS)	1575.433	1575.433	1583.393	1587.938	0.000
Primary credit (Discount Window)	0.030	0.000	0.014	0.005	23.455
Term auction credit (TAF auctions)	0.000	0.000	0.000	0.000	150.000
Asset-backed TALF	0.000	0.000	0.000	0.000	
Maiden Lane (Bear)	0.000	0.000	0.000	0.000	29.287
Maiden Lane II (AIG)	0.000	0.000	0.000	0.000	0.000
Maiden Lane III (AIG)	0.000	0.000	0.000	0.000	
Central bank liquidity swaps	0.055	0.055	0.055	0.055	62.000
Federal Reserve Assets	3940.2	3937.4	3976.3	3979.7	961.7
3-month Libor %	2.55	2.58	2.59	2.59	2.82
Factors draining reserves					
Currency in circulation	1733.109	1730.760	1728.622	1728.061	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	0.021	0.027	9.515	0.015	0.000
Reserve Balances (Net Liquidity)	1490.680	1460.010	1472.812	1524.297	24.964
Treasuries within 15 days	38.475	38.475	31.746	31.746	14.955
Treasuries 16 to 90 days	63.116	43.808	82.182	82.182	31.549
Treasuries 91 days to 1 year	255.978	275.285	263.735	263.734	69.272
Treasuries over 1-yr to 5 years	902.527	902.502	908.702	908.683	170.807
Treasuries over 5-yrs to 10 years	258.739	258.659	262.007	249.260	91.863
Treasuries over 10-years	605.292	605.225	605.171	617.804	101.337

**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08

The Fed meets June 18-19 to consider its monetary policy. Right before this meeting, they have one of the stops on the policy framework review, magical mystery tour that seeks public input on just what they should be doing. We always expect them to lead on policy, and then we get to throw tomatoes when they get policy wrong, but now they want our input. There is a Conference on Monetary Policy Strategy, Tools, and Communication Practices (A Fed Listens Event) at the Chicago Fed on June 14-15, 2019. Big names. Big ideas. Big deal. We hope they don't come away with some crazy ideas like nominal GDP targeting, or average inflation targeting, where inflation that stays too long below target should be allowed to run an equal time above target (then they will never raise interest rates to normal again). How about money supply growth cones targeting? Maybe try to set the Fed funds rate off of M-2.

Quarles May 7, 2019
There is the issue that interest rates have been low, inflation has been low, on the other hand, inflation is difficult to measure precisely. I don't share the concern, that some have, that if we're at 1.8% inflation for a significant period of time, that this is a problem that necessarily needs to be fixed. From my point of view, 1.8 is 2. We said 2 is the target. We just don't measure inflation precisely enough to know that we aren't in fact hitting our target if we show 1.8, and so I would not undergo heroic efforts including rethinking our monetary policy framework or significant monetary policy stimulus in order to edge 1.8 up to 2. I just don't think that that level of heroism is necessary. Now if we were at 1.0 forever than you'd have a different issue....

Fed governor Brainard gave out some ideas at a "Fed Listens" confab at the Richmond Fed on Wednesday. New things the Fed might do if they needed to ease financial conditions because with interest rates so low they cannot cut them down far enough to support the economy. (Then maybe there's nothing you can do?) One idea was to target the yield on specific securities, where the Fed would "stand ready to use its balance sheet to hit the targeted interest rate." They would do enough QE in other words to push 1-yr or 2-yr yields down to zero basically, and hold them there. We wouldn't recommend doing that, pushing the entire yield curve to zero just like Japan and the ECB did to great effect.

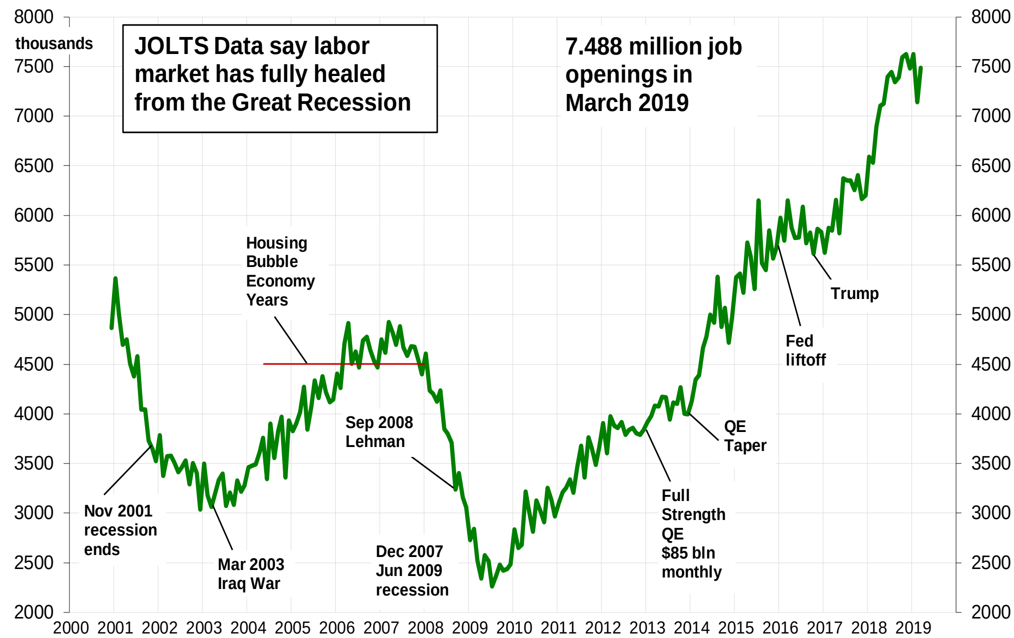
Luckily, Fed Vice Chairman for Supervision Quarles speaking at Yale on Tuesday seemed to have some common sense saying the review of their policy and practices didn't mean any change would come of it. He didn't think change in policy was needed to push inflation up to the 2% target anyway. Markets are you listening? Low inflation not a problem then, transitory as Powell said. Even New York Fed President Williams said Friday that he wasn't concerned by the latest 1.6% core PCE inflation reading. He said, "So far, the recent downward movement appears mostly to reflect normal volatility in inflation statistics. For example, if you look at my preferred measure of underlying inflation, called trimmed-mean inflation—which removes the most volatile price movements—it's been running at 2 percent. This measure of inflation hasn't shown any signs of trending up or down."

OTHER ECONOMIC NEWS THIS WEEK

Jolts say economy is in a good place (Tuesday)

Breaking economy news. If you are slaving away in your cubicle, and enjoying the experience less and less, cheer up, there are opportunities galore for new work, right outside the door. Job openings and labor turnover (Jolts) data for March show the February relative weakness in help wanted by US companies was temporary. Job openings fell from 7.625 million in January to 7.142 million in February and now back to 7.488 million in March. Let's get real. 7.1 million jobs available or 7.5 million jobs available, there are enough help wanted signs out there to put all of the nation's 5.824 million unemployed behind April's 3.6% unemployment rate back to work.

There is a massive mismatch in either skills or geography because clearly there is a lot of work out there that needs to be done. Washington has a lot of good ideas, but one wonders where on Earth the workers will come from to build the new $2 trillion in infrastructure projects. The construction industry already needs 360 thousand workers in March as it is.

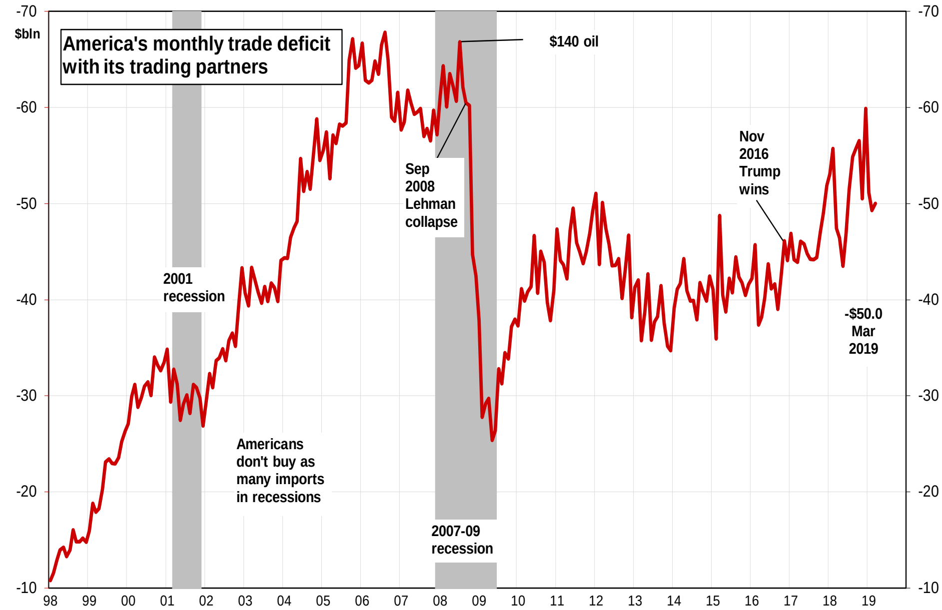


Net, net, the economy's well beyond full employment with businesses in need of 7.5 million workers. This is a staggering number and shows just how hot the labor market is right now where if you walk in the door and can fill out an employment form, you're hired. You need training. Companies will train you.

The risks right now for the economic outlook going forward is there is actually a danger that companies will run out of the help they need to produce goods or sell their services. The US economy has never faced a time when labor shortages might endanger or cut short a long economic expansion, but now it does. It is in Economics 101 where students learn an economy needs capital and labor to grow and right now there is a flood of capital looking for an investment opportunity, but the workers, where will the workers come from?

Parenthetically, this makes one question the Trump administration's all-out assault on its trading partners to level the playing field. Careful what you wish for, even if factories come back to the USA from overseas, there is no one to work the shop presses. There is no one to work in manufacturing plants today. In fact, right now manufacturers in today's report say they need to hire 476 thousand more workers. Stay tuned. Story developing.

Trade deficit $50 billion, more work to do, while inflation cools and joblessness elevated (Thursday)



Breaking economy news. The trade deficit remains narrower at $50.0 billion in March. The narrowing of trade added 1.0 percentage point to that 3.2% GDP growth in the first quarter, and it won't be doing that again, so economic growth is expected to slow back to 2%.

Unemployment claims remains slightly elevated at 228K in the May 4 week. We still expect jobless claims to fall back to the lowest level since 1969, the 193K reading in the April 12 week. If it's not just noise, there's a problem ahead for the economy. PPI inflation is out and looking cooler than last month's reading. Final demand PPI prices rose 0.2% in April after increasing 0.6% in March. Core PPI was just 0.1% in April following a 0.3% rise. Those trade tariffs don't seem to be boosting the prices that producer's pay to a measurable and worrisome degree yet. On balance, the mix of economic data on inflation, labor market, and trade show the economy remains in a good spot for now.

China's trade negotiators are back in Washington for two days of talks before tariffs on $200 billion of imported goods go up from 10% to 25%. The sword of trade tariffs swings both ways in a war however as China can match the U.S. with tariffs as well. U.S. Exports to China slowed 18.8% to $26.0 billion in the first three months of 2019 from $32.0 billion the first three months of 2018. We are winning however if you look at it the other way, where U.S. imports from China slowed 13.9% to $106.0 billion in the first three months of 2019 from $123.1 billion the first three months of 2018. Some of us are winning. No factories or manufacturing jobs have come back yet to America, but companies' supply-chain inputs for their domestic production have been turned upside down, and are even more costly, and U.S. consumers are paying a bigger bill for those cheaper goods coming in from overseas that they have got used to the last ten or twenty years. Refrigerators, TVs, computers, cell phones, soon.

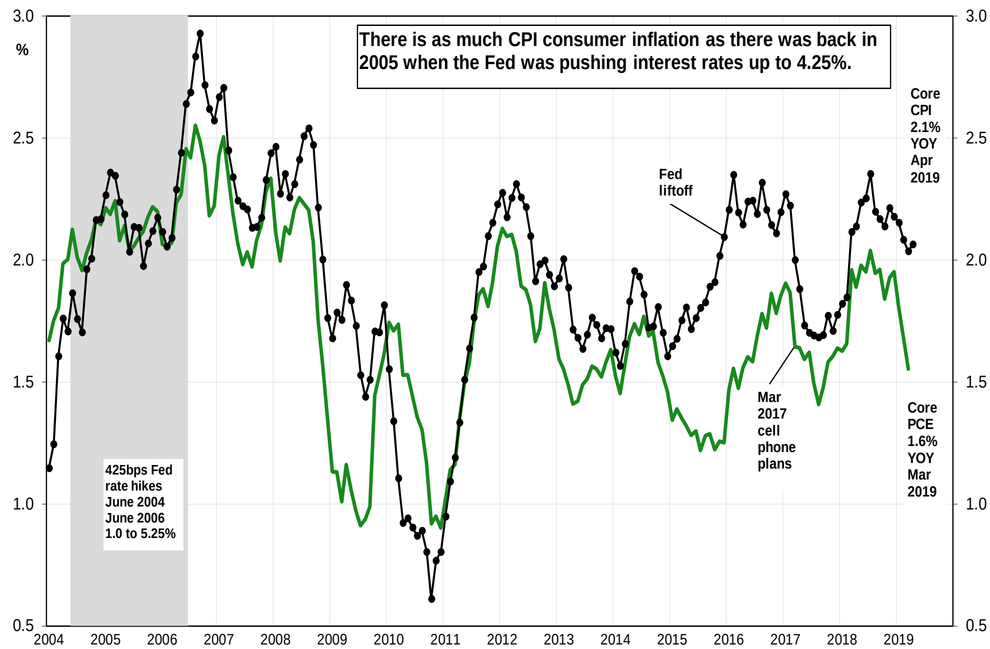
This trade war with America's trading partners is looking increasingly like it could be the straw that breaks this long economic expansion's back. Trump's economics team is telling the president that the economy is strong and this is the time to push harder in its trade negotiations to level the playing field. We just hope Team Trump hasn't taken these talks a bridge too far with the fallout being a global economic slowdown if not catastrophe. All we can see is that both China and the U.S. are losing in the terms of trade with exports and imports both suffering the consequences. This reduction in exports and imports, total trade, from the trade sanctions is exactly what you would expect to see when the world economy is on the brink of recession, and if China and the U.S. do not make peace soon and come to an agreement, it will take a miracle to keep the global economy from going off a cliff. Stay tuned. Story developing.

No inflation yet: will be tomorrow if 25% tariffs on $500 billion of China imports are coming (Friday)

Breaking economy news. CPI inflation rose 0.3% to 2.0% year-on-year in April. Core CPI up 0.1% to 2.1% year-on-year. Market isn't reacting because it is focusing on the US trade war with China. Just reading the latest from the president for guidance on whether to buy, buy, buy, or sell, sell, sell.

"Nobody's happy about it, but we're taking a good look and we'll see. We'll see," he said. "The relationship continues, but we'll see what happens. I know they want to negotiate, they're talking about negotiating, but I don't think they're ready to negotiate."
***Sorry, this was Trump's comment about the North Korea relationship, not, we repeat not, with his other good friend President Xi. We have to admit we are confused as the markets about this latest turn of events with China over the last week. The stock market hasn't even fallen 5% from the April record highs yet, so trade war isn't that bad for Wall Streeters yet.

Core inflation rose just 0.1% in April with another decline in apparel prices. Apparel prices fell 1.9% in March and 0.8% in April and are down 3.0% from prior year levels. Used cars and trucks prices fell a third straight month as well, down 1.3% in April. Meanwhile the price of putting a roof over your head is skyrocketing with Shelter prices up 0.4% each of the last two months.



Net, net, the economy isn't overheating with inflation pressures relatively benign for now, but this is likely to be the calm before the storm. The Trump administration just slapped 25% tariffs on $200 billion of China imports and the U.S. consumer is likely to be sent the bill. All those consumer cost savings in recent years on appliances, cell phones, flooring, air conditioners, are going out the window with the president saying he will put 25% tariffs on every imported good coming in from China. He says we will be winners, even though every economics textbook in the country says tariffs harm economies and reward inefficient producers.

No inflation today, but tomorrow is a different story. Costs of producers are going up and the consumer is going to have to be the one to pay. Powell says the soft inflation reports are transitory, but now we just got a third consecutive month of 0.1% core CPI inflation. With low inflation and an escalation in the China-US trade war, Fed officials could be on the sidelines for a longer time than we thought. Stay tuned. Story developing.

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