CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

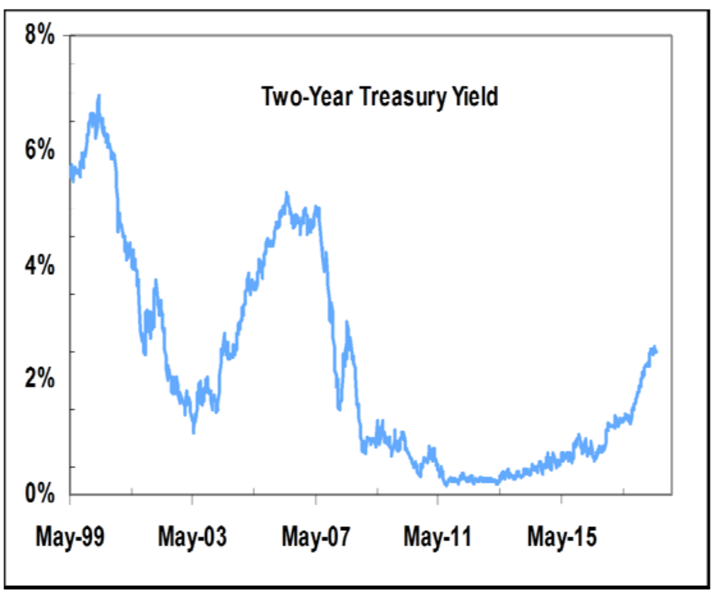
June 30, 2018

Politics Intrude

President Trump's recent actions and threats relating to tariffs on imported goods and other trade restraints cause selling in financial markets. After a first year in office when the administration's actions were generally deemed friendly to markets, things have turned darker.

Having expressed my personal views about our president just after the election and a few times since, I have generally abstained from further such comments in my letters. After all, these *Core Comments* are meant to discuss investments and the economy. No one pays Core to read my political commentary. And, as it happened, in the first year of Mr. Trump's administration, the actions of his administration and those of Congress, both houses of which are controlled by Republicans, were deemed salutary by many investors.

Despite the adverse effects of the tax legislation on residents of New York, California and New Jersey, subject to substantial property taxes and state income taxes, stock markets seemed to like tax 'reform' and bank deregulation. The US stock market responded positively: there was a strong correlation between stock prices in the latter part of 2017 (they rallied) with the increasing likelihood of the tax changes that were enacted in December. (Of course, we must remember that correlation is not causation.)



Recently, however, things have been changing. In his campaign and since, Mr. Trump has complained that the trade regime among most important nations disfavored US interests. That these trade agreements were largely designed by the United States and, in large part, benefit America, our president seems to ignore. Over recent months, he has threatened various tariff increases with Europe, China, Canada and elsewhere. As quickly as some were announced, they were withdrawn, usually for reasons left unexplained. Accordingly, the threats and proposed tariffs were mostly ignored by financial markets, on the notion that this was largely bluster, not actual policy.

However, tariffs on steel and aluminum were imposed and European countries retaliated by imposing tariffs on certain US goods. After tariffs on Chinese imports were imposed, the Chinese announced reciprocal trade restraints. Upon which, our president ordered even greater restrains against China. Quite recently, Harley Davidson, the motorcycle manufacturer, announced that it would have to move manufacture of its motorcycles destined for export to Europe to overseas facilities to avoid the European tariff. A US steel manufacturers trade association filed litigation on Wednesday challenging the administration's tariffs on steel imports. On Friday, General Motors reported that the tariffs would be likely to cost GM jobs in the US. In short,

By

Jack Mayberry

the administration's efforts to impose tariffs and restrain trade are meeting opposition from US companies and are depressing the US stock market.

Thus, despite my wishing to avoid writing about politics, the effects of recent and threatened actions directly impinge upon investments; discussion is now timely.

America's economic success and the vibrancy of financial markets here has been built on a foundation of respect for civil rights and civil liberties, the many global organizations founded at the instigation of the US after the Second World War, and the extraordinary web of world-wide alliances among nations that the US has fostered.

The administration appears to decry this history and to read it as failure.

Civil rights and civil liberties. Tariffs and other trade restraints put into focus the ways in which the incumbent administration attacks the foundations of American policies of the post-World War II period. Stepping back to look at things from a longer perspective is relevant to present US policies. I studied at the Yale Law School in the 1970s. In retrospect, the 1970s appear to mark the high-water mark of the recognition, the expansion, and the realization of civil rights and civil liberties in this country. I do not mean the social or actual apogee of such rights and liberties--we have seen great advances since then in our society. Consider, for example, the acceptance of gay marriage. But that decade indisputably represents the point at which the embodiment of those notions into constitutionally-prescribed law reached its unchallenged high point. When I was a student then attending my many courses on constitutional law, I thought--naively, it turns out--that the long arc of social justice would keep its upward ascent.

In 1976, while I was at Yale, the Supreme Court rendered its first opinion limiting federal laws that imposed restraints on campaign contributions in *Buckley vs. Valeo*, 424 U.S. 1 (1976). Neither my fellow students nor our eminent professors recognized what a milestone was *Buckley vs. Valeo.* But we know now whence came *Citizens United vs. Federal Election Commission,* 558 U.S. 10 (2010) and *McCutcheon v. Federal Election Commission,* 572 U.S. ___ (2014), both of which cases significantly limited restraints on corporate funding of election campaigns. Bought and paid for, one might say about our elections.

A functioning government. Apart from the judiciary, in the 1970s we observed the effective functioning of Congress and the Fourth Estate--the press--in upholding the governance institutions of our country. President Nixon sought to cover-up a burglary of Democratic Party offices during his 1972 presidential campaign. We need not rehearse Watergate history here, except to note that Congress, the federal courts, and the press, led by the New York Times and the Washington Post, ultimately did their duties as our Framers had intended. Our country's institutions were strengthened by Watergate and by what I refer to as the long arc of social and political justice. Until....

Global institutions for peace and economic well-being. After the Second World War, when Europe and Japan were largely destroyed by the successive global wars of the first half of the twentieth century, the United States, undamaged and in rude health, created a system of organizations to link the developed nations into self-reinforcing arrangements that fostered economic development of the war-torn regions and linked the countries so as to end the cycle of nation-state violence that gave rise to the wars of the nineteenth and the early decades of the twentieth centuries. The European Coal and Steel Community, the predecessor to the European Union, formed itself in 1951 while the ashes of the war were still warm. NATO, the United Nations, the World Bank, the International Monetary Fund and America's treaties and alliances with scores and scores of nations brought about extraordinary things: the economic resurgence of the western European nations and Japan, peace within the 'free nations' of Europe, the containment of the Soviet empire, and its ultimate collapse in 1989.

In these years after the Second World War, the United States pursued its own misadventures, in Iran, in Viet Nam and elsewhere. But during these misadventures, it maintained its alliances and the institutions it created and, as importantly, it stood for the values of civil liberties and civil rights. It advocated for such rights and liberties around the world and, in a faulting but forward-looking way, it pushed ahead the system of rights and of democratic government.

The charts on the first and last pages of this letter illustrate the actions of the Federal Reserve in raising short-term interest rates and the possible onset of the next recession and bear market.

The yields on the Treasury's two -year note gives a read on expectations of the Fed's actions with short-term rates. In the financial crisis and deep recession of 2008 to 2009, the Fed slashed short rates to zero and, until a couple of years ago, it kept short rates there. Recently the Fed has raised short rates every three months; two more are planned for this year. But two-year yields remain far below the levels reached in the late 1990s and before the Great Recession.

The yield curve chart on the next page shows that the spread between the 10 year and the 2 year Treasury yields shrinks toward zero. This happened just before the recessions and bear markets of 2000 to 2002 and 2008 to 2009. The 'inversion' of the yield curve, that is, when short-term interest rates become higher than long-term rates is a fair harbinger of recession. We are not there yet, but we're approaching.

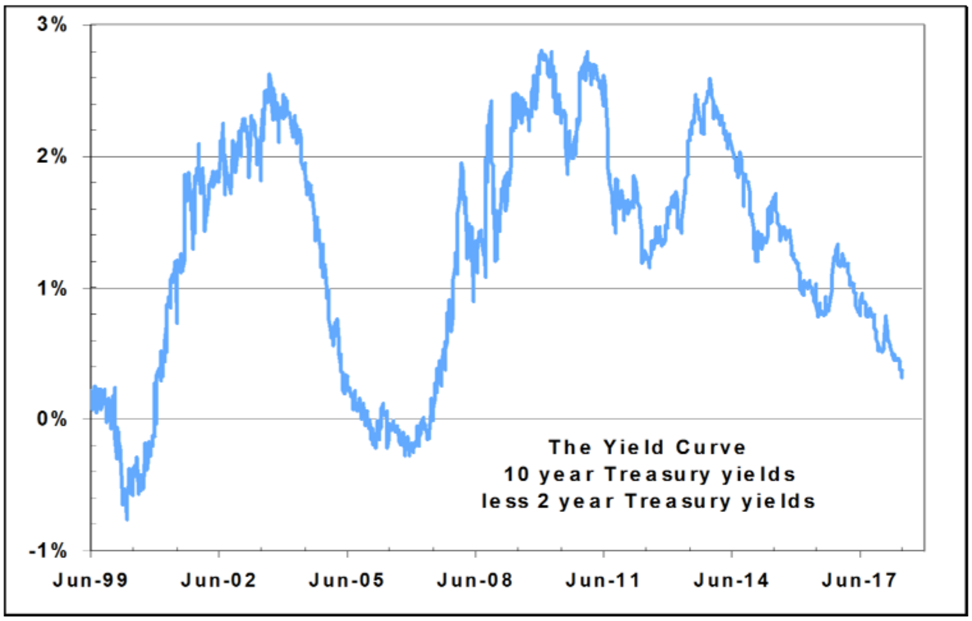
The relationship to investment matters. I am not discussing history or politics here. Instead I am trying to portray, in short form, the framework for the economic strength of the United States and for the vibrancy of its financial markets in the decades following the Second World War. The rule of law and the certainty of enforcement of contracts in America have attracted an untold amount of custom to our country. This custom, this business has brought economic activity here to an extent difficult to measure, but certainly enormous. Our present administration appears to have determined that pulling apart carefully-fostered alliances and the institutions that our country created will 'make America great again' and put 'America first.' Maybe. But our present administration does not explain how its actions will make America again great and first. Most of us did not notice America's fall from greatness, but enough voters did.

Shredding alliances, fawning on dictators, separating children from parents. After leaving early from a G7 meeting in Canada to attend his meeting with Kim Jung Un, our president delivered himself of a harsh criticism of his host in Canada, Justin Trudeau, and refused to have the US join the declaration at the end of the annual meeting of this important group of nations. Upon return from the Singapore meeting with North Korea's dictator, when he declared that North Korea is no longer a threat to the United States, our president seems to have turned his attention to asylum applicants from Mexico and Central America, complaining of the 'infestation' of America by such migrants. 'Infestation' is, at best, a loaded term, as we have learned from the 1930s and recently in the powerful graphic novel by Art Spiegelman called Maus. While in the business of separating incoming asylum applicants and illegal immigrants from their children, our president has decided to that a trade war with Europe and China is the best way to achieve the 'greatness' that he promises.

Financial markets are notable for lack of moral scruples and for dis-interest in the institutions and practices that have sustained financial markets in America, Western Europe and Japan over the last seven decades. Without discussing the day-to-day of all this, suffice it to say that threatened and actual tariffs and other trade restraints impel those countries targeted for these restraints themselves to impose their own tit-for-tat retaliatory measures. Thus arise consequences adverse to our country and to the rest of the world. If companies and people, here and in China, Europe, and elsewhere, could be sure that the public threats were merely the early staking-out of positions in a bargaining process, well and good. However, our president does not provide such clarity. As his process goes on, including the tariffs, the embrace of dictators, and the encouragement of anti-immigration zeal, one can be forgiven for wondering whether Mr. Trump's real target might be the destruction of American institutions of government, the Western alliance and the liberal ideals upon which these are based.

The chart below shows the narrowing difference between yields on two-year and ten-year Treasuries. The markets tell us that economic weakening lies ahead. Recessions typically following 'inverted yield curves. Then come bear markets. These may not be too far away.

Financial markets respond. One thing is clear: Mr. Market does not like the escalating threats and retaliatory measures. It is worth remembering that the very confident buying that marked the beginning of the new year in January gave way to intense selling in late January and early February. Although the US stock market has traded fairly quietly since then, within a range just below the late January highs, it has failed to set new highs. This is despite remarkably robust corporate earnings, the likes of which are rarely seen at this stage in the economic cycle. December's corporate tax cuts have been characterized as a 'sugar high' that will soon wear off as we roll toward upcoming corporate earnings reports. More than one respected economist doubts the sustainability of the very recent increase in corporate profits and questions the likelihood of continued strong economic growth in the second half of this year.



One might also consider the Smoot-Hawley legislation of 1930 that raised tariffs on imported goods and invited commensurate retaliation by America's trading partners. Smoot-Hawley is widely seen to have exacerbated the economic depression of the 1930s. Has Mr. Trump or have his advisers considered this quite prominent historical example of the effects of raising tariffs?

Core's actions. Of course, the outcome of all this is quite uncertain. A new set of tariff threats or of accommodations may happen at any moment. There is, one reads, discord within the administration on this question. What are Mr. Trump's views? That's what matters. Caution is in order. It is a long time since the 2009 bottom in the US economy and the stock market.

The yield curve flattens. As the Fed continues its steady increases in short-term interest rates, fears for the sustainability of American economic expansion grow. Such fears tend to depress long-term interest rates with the result that the difference between short rates and long rates shrinks toward zero, particularly now, when short-term rates rise. This feature, referred to as a 'flattening' yield curve, augurs poorly for the economy; indeed, an 'inverted' yield curve—the situation that obtains when long-term rates are lower than short-term rates—is a fair harbinger of recession and of a bear market in stocks. The graph on this page demonstrates where things stand at present. Not a favorable prognosis.

Core has reduced some foreign stock investments and bought some amount of US small company stocks. Small companies do not have much business overseas; thus are somewhat unaffected by appreciation of the dollar and by threatened new tariffs At present, we have a more defensive position in your portfolios than for a long time.

CORE Comments

CORE ASSET MANAGEMENT

PO Box 1629
108 Caledonia Street
Sausalito, California 94966
(415) 332-2000 • (800) 451-2240
fax (415) 332-2151
www.coreasset.com
info@coreasset.com