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A Silk Road, A Trade War, and Stock Market Valuations

Recap and Outlook:

- ***As anticipated in my last investment letter:***
  - ***The stock market has entered a correction, bringing equity prices and valuations lower. Investors should expect further corrections as valuations remain significantly elevated above long-term averages.***
  - ***The Fed has raised interest rates, furthering the bear market in bonds and weighing on stocks. Expect the Fed to raise rates several times throughout the year.***
- ***Increasing international trade tensions are contributing to the stock market's fear of a recession, fueling the stock market correction as well as the weakness in the U.S. dollar. Tariffs appear to be mostly posturing at this point and may have little effect on actual corporate earnings.***
- ***With the beneficial effects of the new tax law taking effect, S&P 500 consensus earnings estimates for 2018 have risen. Barring a harmful trade war that pushes the economy into a recession, corporate earnings could rise more than 18% this year.***

Essential to successful investing is the ability to take a long-term view, and to understand short-term activity in a larger context. In that spirit, let's step back and consider the general state of the U.S. economy and earnings prospects, the chief engines of the stock market, and also examine a global geo-political development that has long-term implications for investors.

Stocks are Correcting

In last quarter's investment letter I anticipated that the the Fed would raise interest rates and that the stock market would enter a correction. Both have happened since then. The stock market has had a bumpy downward ride since the end of January and now stands 6% below its all time high of January 26th. The Federal Reserve Bank has increased interest rates by 0.25% to 1.75% as it acts to moderate the strong economy. The Fed has indicated that additional rate hikes are possible this year if the economy continues to push higher. Rising interest rates will eventually pose a greater threat to the stock market as higher yields on newer bonds make fixed income investing more attractive than equities for some conservative investors, such as seniors. The Fed's low interest rate policy for almost the past 10 years has encouraged many conservative investors to seek higher yields in blue chip stocks. That has partly fueled the demand for equities during that period, but may now revert to normal as rates rise.

The Economy is Strong

Despite the stock market's recent weakness, the broad economic backdrop in the first quarter continued to be good. The national unemployment rate continued to be low at 4.1%. Consumer sentiment was at a 10 year high, registering at 127 on the Conference Board's index. Consumer spending was healthy, rising by 0.2% in recent months after registering at 4% increase in the fourth quarter of 2017. Inflation was moderate, in the 2% to 2.4% range. GDP growth was nearly 3%, and the Conference Board's Leading Economic Indicators measure was presaging continued economic expansion, registering at 109 at the end of March. The recently enacted tax bill will put more money into the pockets of the average taxpayer over the next year, and will lower corporate taxes by a significant margin. The overall outcome should be healthier corporate earnings results that, in turn, should drive stock prices higher over time. At the moment, with the data we have at hand, a recession that would lead to a full-blown bear market in stocks does not appear to be imminent.

Corporate Earnings Estimates Continue to Rise

According to Factset Research, the consensus bottom-up S&P 500 earnings per share (EPS) figure for calendar year 2018 is almost $158. If that figure materializes at the end of the year, it would represent an 18% increase over 2017's earnings. Analysts on average currently expect the S&P 500's bottom-up revenue growth to log in at an increase of +6.7%. By comparison, the S&P's median long-term EPS growth rate has been approximately 12% with its median long-term sales growth rate at roughly 4% (source: multipl.com). The benefits of the new tax law, as well as the weak U.S. dollar, should boost EPS on a year-over-year basis. The term "bottom-up" means that these figures are the average of all the earnings and revenue estimates of each individual S&P 500 stock.

Risks to the 2009 Bull Market: Valuations, Interest Rates and a Potential Trade War

The current correction has brought equity valuations down from their recent peaks. However, by historical levels, valuations still remain elevated. The Shiller P/E stood at about 34 during its recent high. It now stands at 32 after the correction. Its long-term average is 16. If not for increasing earnings that bolster share prices, any burst of negative news affecting corporate earnings could push the S&P lower because of its lofty valuation level. Rising interest rates could be part of that news mix, although rate increases are now expected by investors and anticipated by the Fed.

Lately, the threat of a trade war has been looming large on the markets and has helped fuel the correction. The focus has primarily been on China and its perceived abuses of international trading norms. While a full-scale trade war has not yet materialized, the prospect of a trade war with all the economic instability it could bring, could continue to weigh on markets. A trade war complete with the tariffs and restrictions it would impose on imported and exported goods, would act as a counterweight to the tax cuts which Congress recently passed. Trade barriers would effectively impose a tax on each consumer and corporation, raising the cost of living and the cost of doing business.

While the prospect of a trade war may seem like a transitory risk limited mostly to headlines, it is important to consider in some depth why China matters for investors in the long-term, and why the U.S. is so concerned. Going forward, China could loom large in the investment picture.

China Rising

The potential trade war with China has many dimensions from the U.S. point of view; it is partly economic and partly strategic.

The implemented and proposed U.S. tariffs aim to remedy two issues that disadvantage the U.S. vis-a-vis China.

For decades, the U.S. has been running a trade deficit with China. We import more from them than we export to them. This has created a trade imbalance which Washington now views as a problem for the U.S., a sign to them that the Chinese are in a more advantageous position than we are. Proponents of free trade argue that the trade imbalance is a natural result of our strong economy and our consumer culture. Simply put, our consumer economy benefits from lower cost products made by the Chinese.

The second issue is Washington's assertion that China has been unfairly and disproportionately benefitting from U.S. intellectual property. This is a credible complaint and one that deserves attention as it has a direct and long-lasting impact on American companies.

It has been a long-lasting Chinese policy to require foreign companies to partner with Chinese companies if they wish to sell into the People's Republic of China (PRC). This arrangement forces foreign firms to turn over their intellectual property secrets, such as production methods and manufacturing processes, to those Chinese companies. Many of those joint venture Chinese firms are either state-owned or have close ties to the state. To one degree or another, the state is their strong backer, if not their outright owner.

The practice of requiring companies to divulge their trade secrets and IP is not unusual for many governments around the world. Generally it is done to ensure consumer safety or compliance with local laws. What is unusual in this case is that in China these trade secrets are actively used by the government and their associated companies to exploit IP for the benefit of the Chinese economy at virtually no cost. There may be exceptions to this practice, but for the most part American intellectual property assets are a source of free innovation for the PRC. Washington's proposed tariffs are meant to punish China for this practice and to change their behavior.

Generally speaking, tariffs are a double-edged sword in trade dealings. They are unlikely to fully remedy China's trading imbalances and unfair IP practices with the United States, and they may be ineffective from the U.S. point of view. A bilateral trade war in a multilateral world would allow China to seek alternative sources for the goods they buy from America. Further, China's burgeoning state sponsored capitalist system is prompting the Chinese to themselves tighten IP standards to international levels of protection.

The Chinese, initially threatened retaliatory tariffs on American goods, including autos, aeronautical equipment and parts, as well as agricultural produce such as wheat, soybeans, and livestock, but have backed off to some extent more recently. In the context of an annual trading relationship exceeding $350 billion, with China importing $150 billion of U.S. goods, these bilateral threats matter to both sides. For U.S. investors, these back and forth threats have had real-life effects on the stock market even though they qualify only as "headline risk" - a full trade war would have more serious consequences.

The Underlying Threat to the U.S.: A Dominant China and an Internationalized Renminbi

We have heard a great deal from Washington about the trading issues the U.S. has had with China, but we have not heard in convincing detail why these issues are fundamentally a problem for America beyond the immediate economic imbalances.

The crux of the problem has more to do with America's place in the world order and our economic strength, and perhaps less to do with unfair practices.

Since Bretton Woods in 1944, the U.S. dollar has been the preeminent currency globally. Today, the dollar represents about 62% of international reserve currency holdings. The Euro is second at about 20%, and the Japanese Yen is a distant third at roughly 4%. The international use of the

U.S. dollar is a boon to the United States as it allows us to trade in our own currency. It also allows us to have significant influence throughout the world.

With their growing financial clout and their status as the world's second largest economy, soon perhaps to be the largest, the Chinese are aiming to supplant the U.S. dollar by internationalizing their currency, the Renminbi (RMB). The Renminbi is currently one of the smallest reserve currencies, accounting for a mere 1.8% of total international reserves.

A reserve currency has to reflect the economic strength and political stability of its issuing country so that it can be a stable store of value - its value cannot fluctuate widely over short periods of time. It also has to be freely convertible to allow for liquidity and ease of transactions, and it has to be accepted as a medium of exchange around the world for commodities, finished goods, services, and financial assets.

At the moment, the Renminbi has almost none of these characteristics. The Chinese Communist Party (CCP) is an authoritarian regime that aims to control the population and to preserve its own power. As a result, it lacks the genuinely inherent stability that comes from having the consent of the governed, as the U.S., Europe and Japan do. The challenge for the CCP is maintaining a high level of economic growth and lifting hundreds of millions of Chinese out of poverty, while simultaneously keeping control and stability, and a degree of innovation in their industries.

The Chinese Strategy for Internationalizing the Renminbi: "The Silk Road"

China's strategy to raise the profile of its currency to major reserve status is a clever one. "The "Silk Road Initiative", also known as the "Belt and Road Initiative" (BRI), is designed to peacefully extend Chinese influence throughout the world. The initiative is being implemented now and aims to extend China's economic and political reach beyond China, to Central Asia, Southeast Asia, the Middle East, Turkey, Africa, Eastern Europe, Western Europe, and South America. In the process China is building highways, railroads, power plants, ports, tunnels and bridges in these regions, all ostensibly designed to facilitate trade and to boost goodwill.

Their motivation beyond trade is to extend Chinese power and influence across a wide swath of the globe in order to internationalize the Renminbi. By building infrastructure abroad and encouraging use of their currency, the Chinese government would be enlisting local governments in various countries to internationalize the RMB. If they are successful, the practical effect would be a slow diminution of the U.S. dollar as the premier global currency, an objective that a number of countries, including Russia, have advocated for years. The Chinese government has aimed to internationalize the RMB for some time, and this may be the most effective way to do it.

However, this strategy is not without its challenges for the Chinese. Beyond the domestic issues facing the Communist government, fueling such an ambitious project to re-order the economic makeup of the planet requires international cooperation as well as confidence in the Chinese way of doing things. Both are lacking at the moment. Notably, India, Japan, and the United States stand in the way, and a host of historical and cultural differences make it difficult for a number of other countries to encourage Chinese influence. That does not offer the Chinese a smooth path to their objectives, though these are early days in their efforts.

The Fed Will Be Key to the Market's Performance This Year

Back in the present moment, the Federal Reserve Bank will likely continue to raise interest rates this year as long as the U.S. economy performs well. When all is said and done, by the end of this year or early next year, if the Fed does what it has said it may do, the Fed Funds Rate will be somewhere around the 2.25% level. While that is directionally higher than it is now, it is still far from levels that would stifle economic growth and hurt the stock market. We would need to see the Fed Funds Rate at a much higher level for that. As rates rise, bonds will continue to remain weak as higher rates on new issues are a more attractive alternative to lower rates on existing bonds.

Risk and Return: Seeking Balance

Market corrections test our investment strategies and make us ask the tough question: Do we have the right asset allocation mix, and the right securities to help us weather the turbulence?

The answer has a lot to do with forethought and planning and a sound process that aims to balance risk and return. Risk is a double-edged sword. It works like a charm on the way up, but can be painful on the way down.

As I have seen equity valuations rise into historically overextended territory over the past few years, my goal has been to seek a balance in my clients' portfolios that allows for growth without undue risk. This has not always been easy. When the markets rise, it seems foolish not to be fully invested. Having experienced a number of market cycles over the past 30 years of my career, I know that overextended markets eventually return to earth, sometimes in dramatic ways. Corrections come and go. The prudent strategy is always to take calculated risks, focusing on good fundamentals and reasonable valuations and to seek balance between risk and return.

V. Henry Astarjian

Shiller P/E (Source: multpl.com)

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