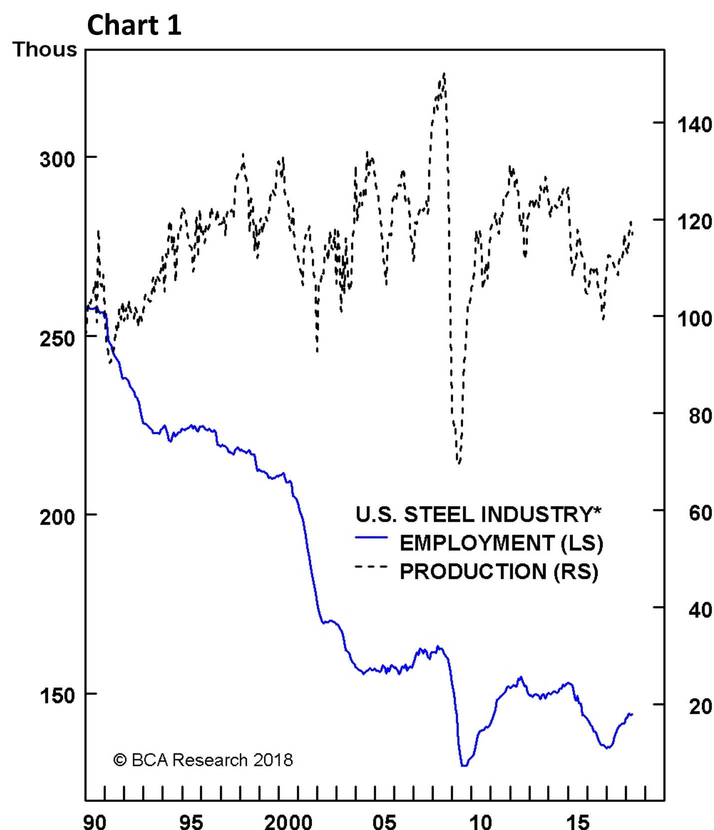
Notes From the North: Market Outlook

April, 2018

Investor confidence is once again being tested by news that the president approved tariffs on about $50 billion of Chinese goods. A trade war would hurt the U.S., but it would punish the rest of the world even more. Even Germany, the strongest economy in Europe, could be vulnerable because exports of goods and services account for 46% of the country's GDP. Investors need to hope that this is a negotiating tactic and not a new policy.

There is good reason to challenge China's policies regarding patents and intellectual property, but tariffs are likely not the best solution. Peter Berezin, chief global strategist for BCA, worries about the consequences of putting tariffs on intermediate goods, i.e. those that are raw materials for U.S. manufacturers. A 25% tariff on imported steel, for example, would be expected to increase domestic steel prices by 12.5%. Prices for American exported goods such as automobiles might then need to be increased to a point where foreign demand would decline. Ultimately, tariffs might lead to a higher trade deficit rather than a lower one.

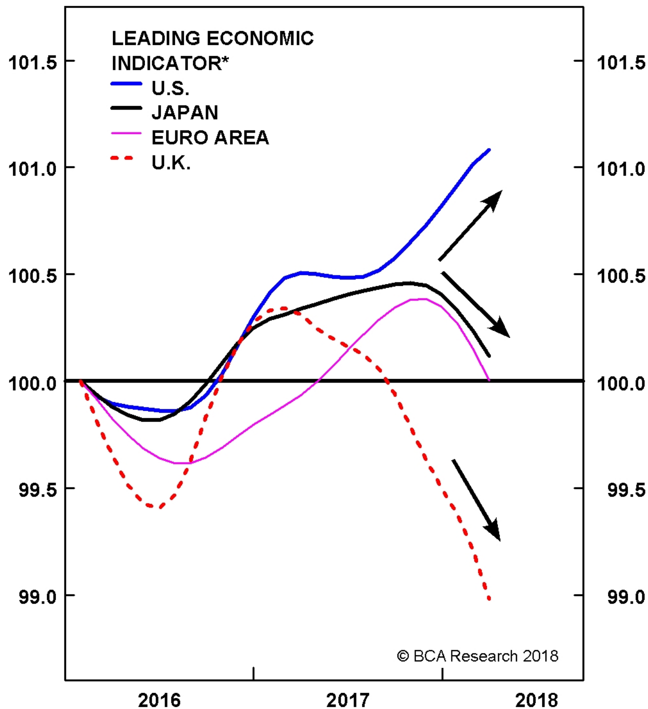
As you can see in Chart 1, right, between 2000 and 2017, employment in the U.S. steel industry declined by 30% (from 203,000 workers to 145,000). However, steel *production* (while volatile) has not declined at all. The decline in steel employment can be attributed more to *technological progress* that has increased the output per steelworker than to foreign competition. Nevertheless, a campaign promise to bring back manufacturing jobs is now being fulfilled with tariffs. Unfortunately, a tariff-based solution to preserving 145,000 steel-producing jobs will not only cause U.S. consumers to pay higher prices for products containing steel, but will likely negatively impact 2 million workers in steel-consuming manufacturing sectors. As with the trade deficit, tariffs may ultimately lead to the complete opposite of their desired goal; fewer overall manufacturing jobs rather than more.



Another development to monitor is the end of the globally-synchronized economic recovery that the world enjoyed through most of 2017.

Last month, business activity in the EuroZone fell to its lowest level in a year and a half. Certain countries such as Italy seem particularly vulnerable. Chart 2 (over) shows that although the outlook for the U.S. remains strong, leading indicators for Japan, Europe, and especially the United Kingdom are falling. Even China has witnessed some slowing in growth, partly the result of government actions designed to re-

Chart 2



duce the volume of risky loans and investments.

The U.S. continues to benefit at least temporarily from corporate tax cuts, less regulation, and fiscal stimulus. Valuations for U.S. stocks are clearly higher than those for overseas markets, but there continues to be a good reason why they are outperforming world indices.

The disparity between Europe and Japan on the one hand and the U.S. on the other hand extends to the outlook for interest rates. The European Central Bank has just promised to keep real interest rates at "extraordinarily low levels" for another 12 months while the U.S. Federal Reserve has announced that it plans to raise the Fed Funds rate two more times this year. If inflation rises as expected, further rate increases are in store for 2019.

Higher rates will widen the spread between U.S. interest rates and those of Europe, and would put further upward pressure on the dollar. All other things equal, a strong dollar is a headwind for U.S. exporters, whose product prices will become less competitive, and for multinationals, whose overseas earnings will be worth fewer dollars. Should rates rise sufficiently, interest rate-sensitive stocks such as home builders, REITS and utilities will suffer. At some point, bonds may become more competitive with stocks in general, especially on a risk-adjusted basis. Based on current projections, next summer might be a time be begin extending bond maturities to lock in returns from bonds.

The challenge for conservative money managers is to negotiate the rolling corrections that have caused a surprising number of stocks to fall 20% or more, while the overall market averages are being supported by continuing strength in large, but very high-multiple growth stocks such as Netflix and Amazon. Food stocks such as General Mills and Kraft Heinz; household product firms such as Proctor and Gamble and Colgate, healthcare stocks like CVS and Novartis; and manufacturers such as 3M, GE and Cummins Engine are significantly below their 52-week highs. No one will be surprised to hear that we are more inclined to sift through these types of blue chips in search of temporary declines that have produced a bargain than we are inclined to pile into the high momentum stocks.

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