Market Update
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FMA Advisory Market Update—Our thoughts on China Trade War

Media vs. Real Numbers—The real economic impact of a trade war with China is in the range of 0.2% to 0.5% of US GDP. At the low end, we do not see a trade war with China as serious risk to US growth. Europe and emerging markets will feel more pain and a global recession is possible if the trade war lingers—but that's not likely given our final point below.

Corporate Earnings and Stock Market Impact—We frequently highlight that the overall economy (expressed as GDP) and the stock market (as reflected by corporate earnings) do not always move in lock step. S&P 500 corporate earnings for the first quarter of 2019 are now expected to grow at 3 to 5% —far higher than the original estimates of -3%. Interest rates remain low with the 10-year UST Note at 2.40% and the Federal Reserve standing pat. We believe that disproportionate pain will be inflicted not on large multi-national companies and large US retailers, but on the much smaller companies that do not have leverage with their suppliers and must therefore pass along the tariff cost to their customers.

Saving Face—While there is wide agreement here in America on the overall objectives of properly rebalancing trade with China and the protection of our companies' intellectual property (IP), the tactics being utilized pose additional risks to achieving a deal. The prospect of the trade war escalating is linked to President Xi Jinping's ability to "save face" with the Chinese people - a task made more difficult after President Trump's tweets suggested that Xi has reneged on his word. Rather than badly damaging the overall economy, we see the most pronounced risk in this scenario as a Chinese consumer boycott of iconic American brands: companies like Apple, Starbucks, and McDonalds, to name a few. While a boycott would certainly impair these specific companies (temporarily), we believe the overall impact on S&P 500 earnings would be minimal.

Trump Put—The President's comments last night reinforced the notion of a "Trump Put," which essentially is a backstop to inflicting any further pain on his electoral base and primarily the farm industry. Soybeans are one of America's major exports to China, and the associated commodity futures have been pummeled. Accordingly, it was no surprise last night when the President tweeted that he will make it right for our farmers.

Putting it all together- We see continued stock market volatility as both administrations work toward a deal that allows China to avoid overhauling many of the laws they have had in place for decades. But the simple reality is that the Chinese form of "State Capitalism" is going to have to evolve significantly to level the playing field to achieve fair global trade on both sides. U.S. equity valuations remain fair with corporate earnings surprising on the upside in an environment of low interest rates. And there is no mistake that the Trump Put will be exercised at some point in this process, especially with an election looming next year.

Finally, to the extent that tariffs are imposed on many companies, those costs will likely be passed on to the American public. The initial estimates are about $750 per consumer. Economists and analysts are concerned that such costs are inflationary, and we concur. But we don't view those costs as the self-reinforcing, demand pull inflation that would compel the Federal Reserve to change course on interest rates.

So, for now, we see the current situation as simply another data point - one that we expect to see referenced on a future chart illustrating volatility-causing events in 2019. The ability to look through these episodes and continue to focus on valuation and earnings remains at the heart of our investment discipline.

Please feel free to call us or check in on any questions or concerns you might have.

Sincerely,

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