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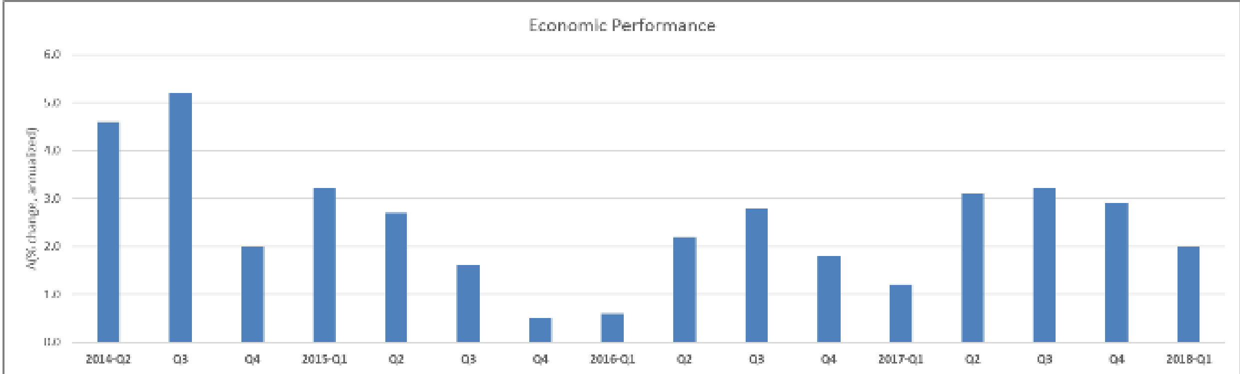
Advocacy Investing®

A DUAL REALITY: TRADE WARS VS. GROWTH

- **Data releases provide a mixed, but overall positive picture**
- **Oil prices surge on geopolitical risks**
- **Another solid jobs report, with 213,000 jobs created in June**
- **Inflation picks up; the Fed is expected to stay the course towards monetary policy normalization**
- **Escalating trade tensions raise concerns about global growth**
- **The U.S. economy is poised to accelerate in the second quarter, but faces strong headwinds**
- **Trade tensions and Iran related geopolitical risks remain on the horizon**
- **Equity markets roiled by trade tensions**

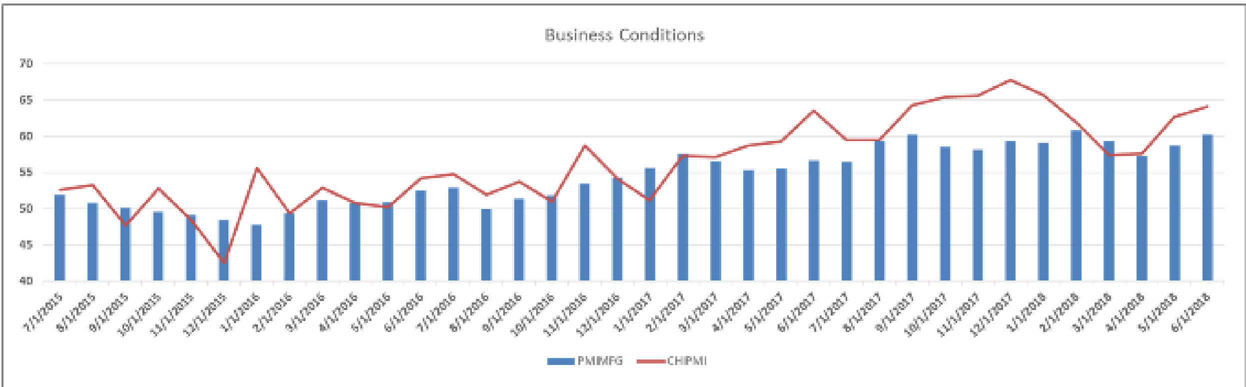
The release of the third (and final) estimate of first quarter economic activity showed that real GDP rose by 2.0% (annualized), down from the previous estimate of 2.2%. Private Consumption Expenditures (PCE), Non-Residential Investment and Government Expenditures provided positive contributions, while Residential investment, Private Inventory Investment and Net Exports remained in the negative column. The downward revision of economic growth was the result of a deceleration in both PCE and Government Expenditures, as well as a downturn in Residential Investment. Non-Residential Investment on the other hand, accelerated. Final Sales to Domestic Purchasers (which exclude Exports and Inventory Investment), rose by 2.0% (annualized) down from 4.5% the previous quarter.

Figure 1: **<u>Slowdown</u>**



The June data releases provided a mixed, but overall positive picture. On the real economy side, Industrial Production and Manufacturing fell by respectively 0.1% and 0.7% (month-on-month, m/m) in May. Durable Goods declined by 0.6% m/m—minus 0.3% ex-Transportation and minus 0.3% for Core Capital Goods. Factory Orders increased by 0.4% m/m. However, survey data was more positive. Mid-month surveys indicated that the Empire State Index rose to 25.0 in June from 20.1 a month earlier, while the Philadelphia measure fell from 34.4 to 19.9 over the same period. Late month surveys were also strong: the ISM-Manufacturing rose to 60.2 at the end of June from 58.7 the previous month, while the Markit PMI-Manufacturing fell slightly from 56.4 to 55.5 over the same period. The broad-based Chicago PMI increased from 62.7 to 64.1 over the same period.

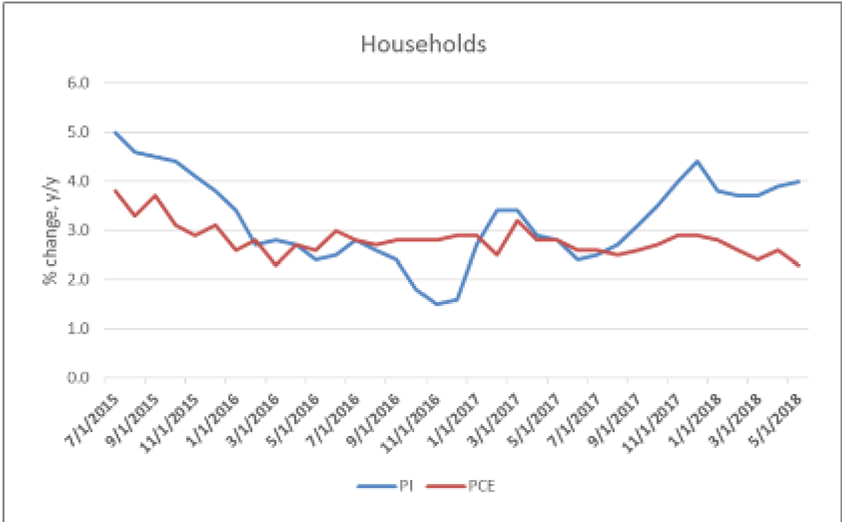
Figure 2: **<u>Robust Business Conditions</u>**



Consumer confidence moved sideways. The Conference Board Index fell to 126.0 at the end of June from 128.8 the previous month, while the University of Michigan-Reuters measure (always somewhat more cautious) fell from 99.3 to 98.2 over the same period. Retail Sales rose by 0.8% m/m in May—and by 0.8% ex-transportation and gasoline. Households are steady, but cautious: Personal Income and Personal Consumption Expenditures increased by respectively 0.4% and 0.2% m/m in May.

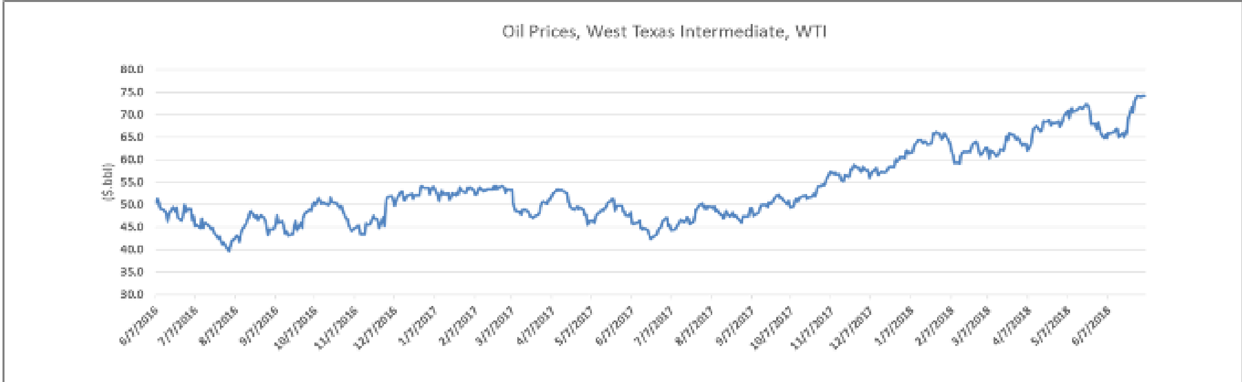
The trade deficit narrowed in May to $43.1 billion, with exports and imports rising by respectively 1.9% and 0.5%. The dollar gathered extra momentum in June, with the dollar index (DXY) rising by 1% and experiencing a 6% gain overall in second quarter (2Q18).

Figure 3: <u>Households Steady</u>



The housing market showed signs of stability: Housing Starts, New Home Sales and Existing Home Sales were all slightly up in May. Construction Spending rose by 0.4%. The Case-Shiller 20-City Price Index increased by 0.2% m/m in April—6.6% (year-on-year, y/y).

Figure 4: <u>Oil Prices Surge</u>

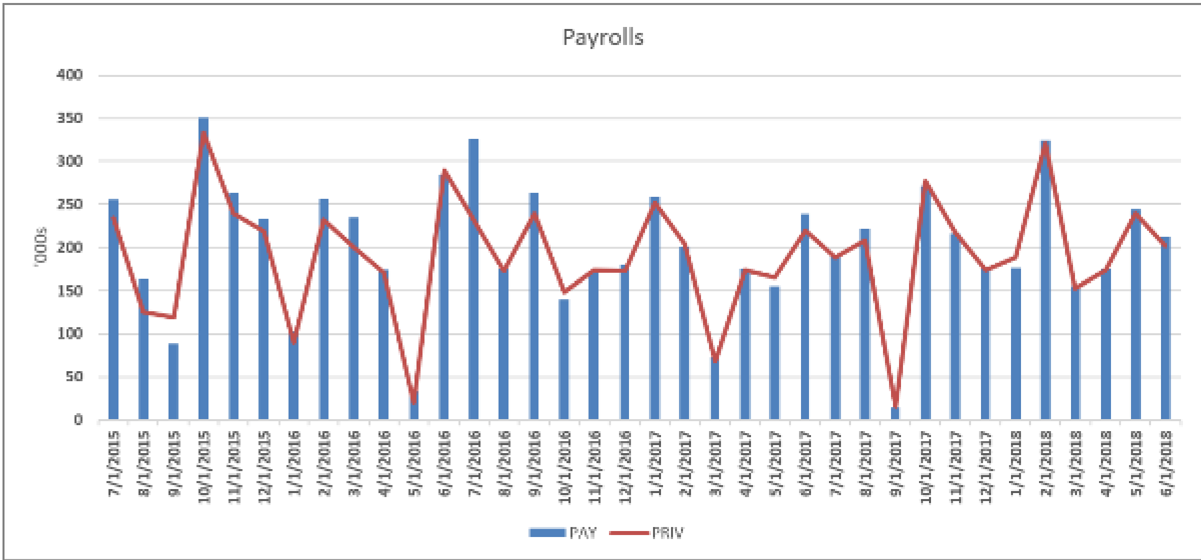


Oil prices (West Texas Intermediate, WTI) have surged by 12.7% in June, to reach a 44-month high of $74.15/barrel (bbl) at the end of the month. Brent also surged to close to $80/bbl. While the loss of Venezuelan production and temporary disruptions in Libya's crude output are the proximate cause of the oil price increase, conflicting policies of the Trump administration are at the center of the price surge. First, President Trump is pushing to shut off completely Iranian exports by November, threatening countries currently importing Iranian crude with secondary sanctions. Second, he is pushing (so far unsuccessfully) Saudi Arabia to increase production to full capacity (i.e. by two million barrels per day, mbd) to offset the potential loss of Iranian and Venezuelan output. However, oil importers are pushing back. In particular, India, Turkey and China have refused to comply with the U.S. requests. Furthermore, China and Europe, both involved in bitter trade disputes with the United States, are unlikely to willingly cede ground to the Trump administration. Furthermore, the typically confusing, aggressive and contradictory Trump approach to the issue is creating further uncertainties in an already nervous oil market. Oil prices have settled in the low 70s in the short term, and should stay in the $65-75/bbl range in 3Q18. The major test will come in November, with the threat of an interruption of Iranian crude.

The economy generated an above-expectations 213,000 jobs in June (+202,000 for the private sector), and the numbers for the previous two months were revised upwards by an aggregate 37,000. This brings the three-month moving average to 210,000 in 2Q18, roughly in line with the past twelve months' average. The job gains were broad: the Goods Producing sector added 53,000 positions (Mining, +4,000; construction, +13,000; and Manufacturing, +36,000); Private Services added 149,000 while Government added 11,000 jobs. The Labor Diffusion Index, which measures the breadth of the labor market changes, fell slightly to 65.5% from 69.9% the previous month, still a very strong number. In contrast, average hourly earnings gains remained modest (+0.2% m/m, 2.7% y/y). Average weekly hours worked remained at 34.5. In

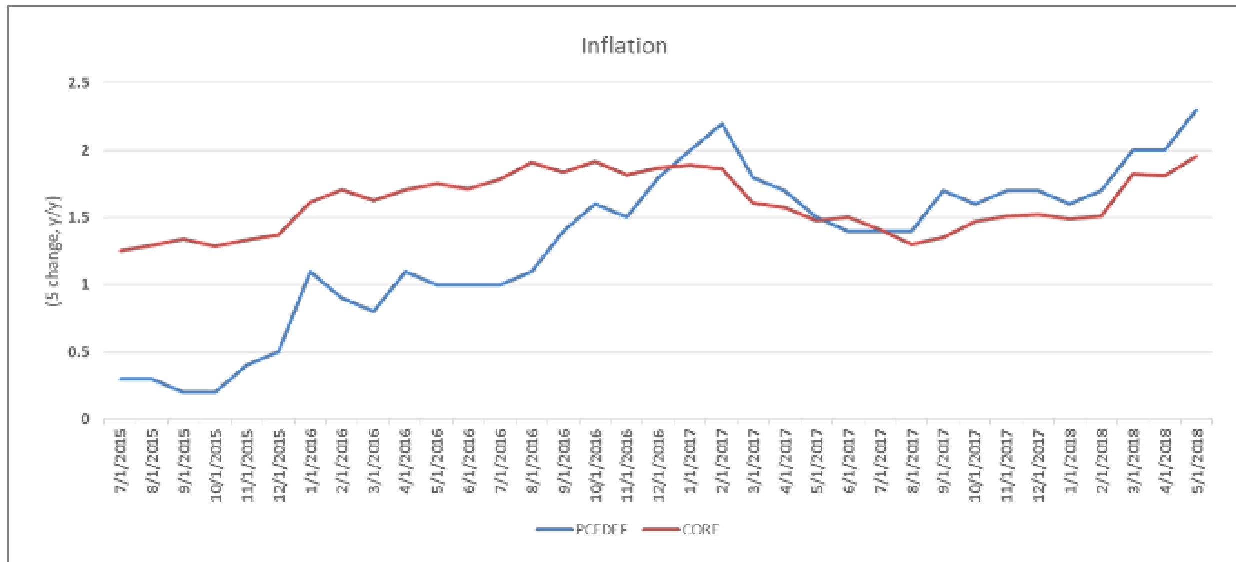
combination, the Labor income proxy rose by 5.0% (annualized). The separate Households' Survey showed an uptick of unemployment (U3) to 4.0% from 3.8% in May. Nevertheless, most of the increase was due to the rise in the labor participation rate to 62.9% from 62.7% in May, with the labor force growing by 600,000. However, this could be largely a seasonal effect stemming from the end of the school year, and we will need more data to verify if this is a sustainable trend. The broader unemployment and underemployment measure (U6) rose as well, to 7.8% from 7.6% the previous month. High frequency data continues to underscore the tight labor market, with the Initial Weekly Jobless Claims at 231,000 in the last week of June. Overall, we continue to see the labor market improvement, now in its eighth year, continuing over the medium term.

Figure 5: <u>Payrolls on Trend</u>



Inflation picked up in May. Headline inflation (CPI) rose by 2.8% y/y in May, with Core inflation (which excludes the volatile food and energy items increased by 2.2%. The PCE Deflator rose by 2.3% y/y, while the PCE Deflator-Core (the preferred measure of the Fed) increased by 1.9%, closing in on the Fed's 2% target.

Figure 6: Inflation Makes a Comeback



The Fed under Chairman Powell is on a new path. The Federal Open Market Committee (FOMC) met on June 12th-13th, and raised the benchmark Fed Funds rate by 0.25% (25 bp) to a 1.75-2.0% range. The FOMC statement language reflected a more positive view of the economy: solid gains in the labor market, declining unemployment rates, and a pickup in both PCE and business investment. However, the Fed statement did not show immediate concerns about inflation. The recently released Minutes of the June FOMC meeting underscore further the shift in the Fed's thinking: a "very strong" economy and inflation at a "sustained 2%" level, both signify an end to monetary accommodation and a steady, albeit gradual return to historic levels of interest rates in the medium term. This change stands in contrast with previous statements stressing that interest rates would remain below historical levels for the time being. The most recent payrolls report is well within the Fed's expectations and is not likely to change the course of monetary policy.

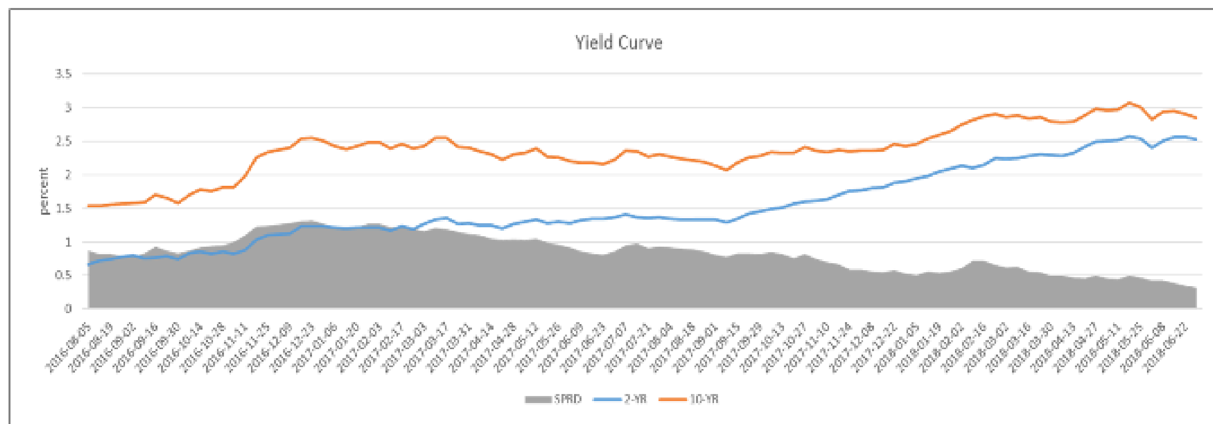
Table 1: FOMC Economic Projections (Central tendency)

Range (%)	2018	2019	2020
GDP Growth	2.7 - 3.0	2.2 - 2.6	1.8 - 2.0
Unemployment	3.6 - 3.7	3.4 - 3.5	3.4 - 3.7
Inflation PCE Core	1.9 - 2.0	2.0 - 2.2	2.1 - 2.2
Fed Funds*	2.1 - 2.4	2.8 - 3.4	3.1 - 3.6

*March projection

However, the Fed is not as bullish on the economy in the longer run, as indicated by its latest semi-annual economic projections. After expecting a spurt in growth in 2018, it projects a return to trend growth.

Figure 7: A Flattening Yield Curve



The bond markets showed some degree of stability in the past weeks, with 10-year Treasury yields at around 2.80-2.90%, down from their peak of 3.07% last May 18th. However, the yield curve continues to flatten as short-rates move up faster than the long ones. The 10-year/2-year Treasury spread has fallen to 0.32%, a 20 bp drop since the end of 2017. A flattening yield curve has usually been associated with an economic slowdown or recession, but other signs of such a trend reversal are so far lacking.

The global economy seems to be back on track after a slow second quarter, with the JPMorgan Global PMI at a 4-month high. Survey data for the Eurozone point to a recovery, with the Markit PMI Composite at 54.5 at the end of June up from 54.1 the previous month. At the same time, we are witnessing a sharp rebound in manufacturing output in Germany, Europe's largest economy. The Chinese picture is mixed, with weak retail sales and a sharply lower currency. The Caixin PMI Manufacturing dropped to 51.0 at the end of June from 51.1 the previous month, while the Caixin PMI composite rose from 52.3 to 53.0 over the same period. Nevertheless, the Eurozone recovery remains fragile and emerging markets remain vulnerable. The main central banks remain on diverging monetary paths, with the United States well into tightening, the European Central Bank tapering off, and the Bank of Japan still in expansionary mode. However, downside risks to global growth have increased, with the main threat to global growth coming from rising trade tensions between the United States and its main trading partners. In particular, steep tariffs on $34 billion worth of Chinese imports to the United States came into force on July 6th, leading to Chinese retaliation.

The current economic expansion entered its 10th year in June, making it the longest postwar recovery. Early indications are that the U.S. economy will accelerate in the second and third quarters of 2018, with strong tail winds from the 2017 tax cuts and the surge in fiscal spending—GPD growth could reach 3.5-4.0% (annualized) in 2Q18, and 2.5-3.0% in 2H18. In the short and medium term, however, the economy faces a number of headwinds: higher oil prices, a tightening Fed, higher interest rates and the threat—which could soon be the reality—of a trade war. A trade war would affect the U.S. economy both directly—through its impact on the sectors affected by retaliatory tariffs—and indirectly—through the impact on the global supply chains, as well as on household and business confidence. Moreover, the supercharged growth comes at the expense of short and medium term fiscal sustainability. Despite wishful thinking by the Trump administration on supply-side effects, there is already evidence of widening deficits: so far this fiscal year, the budget deficit is running at $530 billion, almost $100 billion higher than in FY 2017. In the longer run, the latest report of the Congressional Budget Office on the long-term fiscal situation is sobering, projecting a rise of the federal debt held by the public from 78% of GDP today to 100% by 2030.

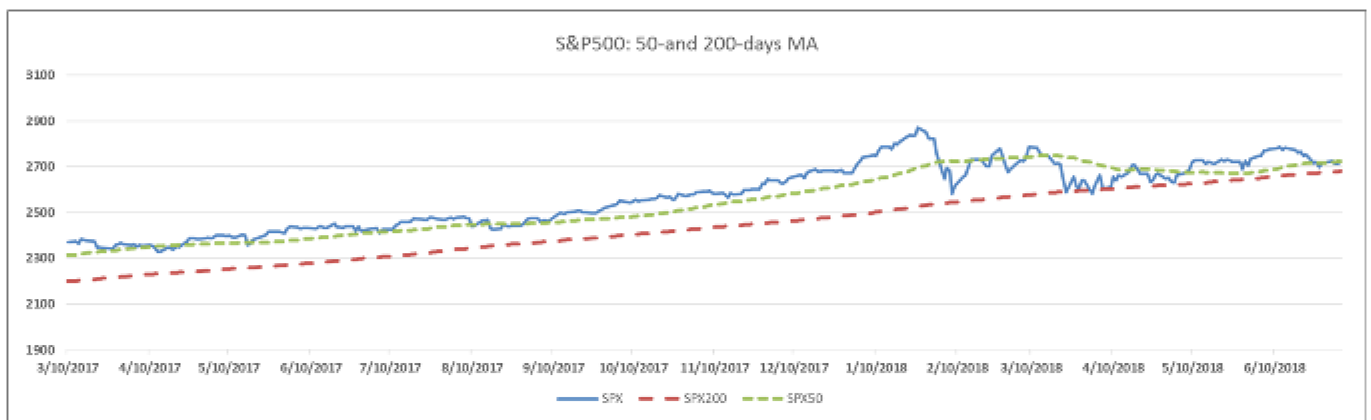
Global Risks:

Trade Wars: The aggressive, albeit somewhat impulsive and unpredictable trade policy of the Trump administration presents the main risk facing both the U.S. and global economies. An escalation of the tit-for-tat tariffs war with the United States and China on one hand, and the United States and the European Union on the other, coupled with rising personal animosity between President Trump and major world leaders, could ultimately affect hundreds of billions of dollars of global trade. The immediate adverse impact of tariffs on global economic growth could be modest initially, but is likely to build over time.

Iran and Oil: The Trump policy regarding Iran is simple: force Iran into submission through the application of severe financial and oil sanctions. However, this policy is leading to string pushback for the other parties to the Iran nuclear deal (JCPOA), as well as threats from Iran to shut off the Straits of Hormuz.

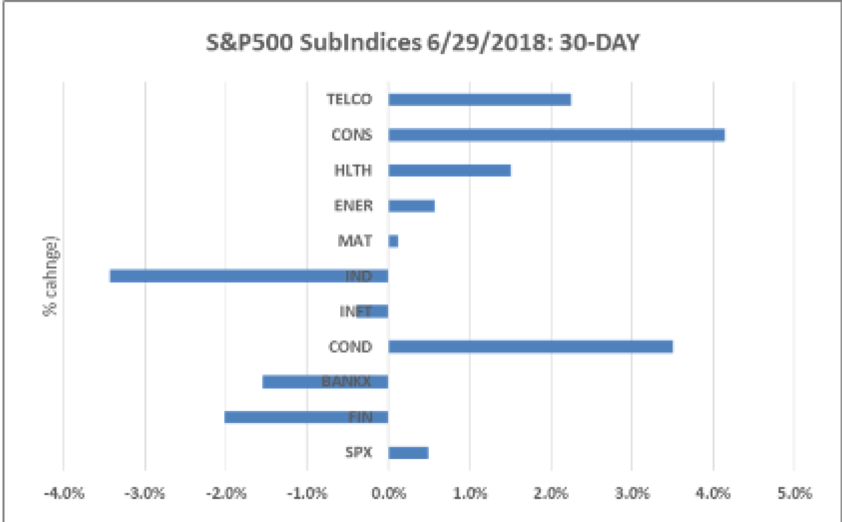
Alliances' Strain: The escalating attacks by President Trump on both the European Union and NATO have put a strain on the United States closest alliances. The upcoming NATO summit is expected to introduce further strains on one of the pillars of the post-World War Two global security architecture. Escalating tensions would undermine mutual confidence and spill over into areas of trade and financial cooperation.

Figure 8: <u>The S&P500 Bears</u>



Financial markets were roiled in June and early July by the rapidly escalating trade tensions. President Trump's fiery trade rhetoric, followed by the actual imposition of tariffs on China on July 6th, offset the impact of the flow of positive data releases. The S&P500 ended June essentially flat at 2,718, down from its 2Q18 peak of 2,786 on June 12th. International markets have also followed the same trend, with the MSCI-EAFE (developed countries ex-North America) and MSCI-EM (Emerging Markets) down by respectively 6.6% and 10.3% year-to-date (ytd). We also saw a decisive rotation in both the past 90 and 30 days from cyclicals to defensive stocks. However, markets have recovered somewhat since early July as the scale of the early trade skirmishes seem to be limited, at least in the short run.

Figure 9: S&P500 SubIndices, 1H18



The equity markets face a dual reality: robust economic growth vs. the threat of an escalating trade war. While the early July recovery provided a temporary lull, downside risks remain. Other risks facing the market come from the flattening yield curve (a slowdown signal?) and the stronger dollar. The 2Q18 earnings season is also under way, and, in combination with the first estimate of 2Q18 GDP (due at the end of July), should provide more direction. In the meantime, the S&P500 faces a resistance level at 2,800.

June Data Releases

Economic Data Releases-June 2018	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP (1Q18 % Annualized, Final estimate)	2.2%	2.2%	2.3%	2.2%	2.3%
PCE Deflator (%, y/y) (May)	2.0%	22.0%	2.3%	2.2%	2.3%
Core PCE Deflator (%, y/y)	1.8%	1.9%	2.0%	1.9%	2.0%
CPI (%, y/y) (May)	2.5%	2.8%	2.8%	2.3%	2.8%
Core CPI (%, y/y)	2.1%	2.2%	2.2%	1.9%	2.3%
Employment					
First Time Claims ('000) (last week June)	228	223	231	220	225
Non-Farm Payrolls ('000), June	244	190	213	144	212
o/w Private Sector	239	182	202	142	209
Unemployment (U3, %) June	3.8%	3.8%	4.0%	3.7%	3.8%
Underemployment (U6, %)	7.6%		7.9%		
Labor Force Participation (%)	62.7%		62.9%		
Industrial & Manufacturing					
Corporate Profits (y/y) 2Q18	0.1%		2.7%		
Bus Inventories (m/m) (May)	-0.1%	0.3%	0.30%	0.2%	0.5%
Empire State (June)	20.1	19.1	25	17.0	22.5
Philadelphia (June)	34.4	28.0	19.9	20.0	33.1
Chicago PMI (June)	62.7	60.1	64.1	58.6	63.0
Markit PMI Mfg (June)	56.4	54.6	55.4	54.6	56.2
ISM Mfg (June)	58.7	58.5	60.2	57.0	60.0
Industrial Production (% m/m) (May)	0.9%	0.1%	-0.1%	-0.6%	0.5%
Manufacturing (% m/m) (May)	0.6%	1.1%	-0.7%	-0.8%	0.4%
Durable Goods (m/m) (May)	-1.0%	-0.6%	-0.6%	-2.4%	1.1%
Durable Goods, ex transp (m/m)	1.9%	0.5%	-0.3%	-2.4%	-1.2%
Durable Goods, Core Capital (m/m)	2.3%	0.2%	-0.2%	-0.2%	0.5%
Factory Orders (m/m) m/m May	-0.4%	0.0%	0.4%	-2.2%	0.5%
Services					
Markit PMI Services (June)	56.8	56.5	56.5	56.5	56.5
ISM Non-MFG (June)	56.8	58.4	59.1	56.0	59.0
Consumer Spending					
Retail Sales (% m/m) (May)	0.3%	0.4%	0.8%	0.2%	0.5%
UMich Consumer Sentiment (end-May)	98.5			98.5	99.3
ConfBd Consumer Confidence (end-Jun)	128.8	128.1	126	123.8	133.0
Personal Income (%, m/m) (May)	0.2%	0.4%	0.4%	0.3%	0.5%
Personal Consumption Expenditures (%, m/m) (May)	0.5%	0.4%	0.2%	0.3%	0.5%
Housing Market					
Housing Starts ('000) (May)	1,286	1320	1350	1,270	1,350
New Home Sale ('000) (May)	646	665	689	640	700
Existing Home Sales (MM) (May)	5.45	5.5	5.43	5,44	5.650
Construction Spending (%, m/m) (May)	0.9%	0.6%	0.4%	0.3%	1.2%
Case Shiller-20 City (%, m/m) (Jun)	0.4%	0.5%	0.2%	0.3%	0.6%
Case Shiller-20 City (%, y/y)	6.7%	6.8%	6.6%	6.6%	7.0%
Balance of Payments					
Trade Deficit $ billion (May)	$46.1	$43.7	$43.1	$42.7	$50.5
Exports (% m/m)	-0.5%		1.9%		
Imports (% m/m)	-0.5%		0.5%		
Current Account Deficit ($ billion, 1Q18)	$116.2	$129.3	$124.1	$123.0	$138.0
Dollar Index-eom (June)	93.98		94.47		
Oil Prices-eom (WTI, $/bbl) (June)	$67.04		$74.15		

Dr. Pakravan has been a senior economic strategist in global financial markets for over 25 years. Dr. Pakravan is a recognized specialist in leading-edge applied macroeconomic and financial research on currencies and emerging markets, country risk assessment and modeling in an enterprise-wide risk management context, as well as international financial architecture. Dr. Pakravan has a Ph.D. in Economics, University of Chicago, a M.Sc. in Econometrics and Mathematical Economies, London School of Economics, and a B.A. in Mathematical Economics, University of Geneva. He is the author of numerous publications and is an Associate Professor of Finance at the Kellstadt Graduate School of Management at DePaul University.

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