SPECIAL REPORT

WORLD FINANCIAL MARKETS TRAPPED IN A HIGH-RISK ZONE

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Domestic political pressures continue to build as the 2020 election comes into sharper focus. A combination of spreading economic weakness, cumulative equity market losses, and plunging business confidence is a toxic sequence of events that would very likely undermine Trump's prospects for re-election. Perhaps most worrisome for Trump is evidence of a widening crack in his political base. Recent surveys show clear signs of a marked decline in confidence within the Republican Party.

Summary and Major Conclusions:

- World financial markets remain trapped in a high-risk zone that appears likely to persist. Risks abound in all aspects of the investment arena: The world economy, the domestic economy, trade policy, and geopolitics.

- An outright trade war is the number one threat to the global economy and financial markets. Protectionist risks continue to escalate, as new US tariffs on Chinese imports scheduled for September 1 meet a persistently retaliatory response from China.

- Economic conditions in Europe, Japan, and emerging market economies continue to deteriorate, as world trade and economic growth continue to lose momentum. These regions have been negatively affected by trade tensions to a far greater magnitude than the US.

- The crucial macroeconomic question is the extent to which the healthy sectors of the US economy can withstand spreading weakness in manufacturing and trade across the world economy. In principle, the domestic economy is insulated from global economic pressures, but subject to finite limits.

- Job creation is the key to the US economy. Business hiring is the transmission mechanism between the sharp deterioration in business confidence and the broad economy. Widespread cutbacks in hiring would undermine consumer confidence and spending and greatly increase the probability of a US recession.

- Although the Federal Reserve would almost certainly respond aggressively to growing weakness in employment, the question becomes whether or not it would matter. An evaluation of the relative influence of monetary policy versus trade policy strongly suggests that trade would be the dominant force.

- Political pressures continue to build for President Trump as the 2020 election comes into sharper focus. The combination of spreading economic weakness, cumulative equity market losses, and plunging business confidence is a toxic sequence of events that would likely undermine Trump's prospects for re-election.

- The dispute between China and the US is the primary threat to economic growth. The key question for investors is whether growing political pressures will force at least a partial deal before the world economy slips into recession.

- Progressive slowing in China's economic growth has been a major contributor to the profound weakness in the global economy. China is the major engine of growth for the international economy, responsible for 35% of annual growth in world GDP.

- Chinese leaders face a major dilemma: Their economy desperately needs short-term stimulus, but its most serious long-term problem is excessive debt levels. Dangerous debt levels have constrained policymakers, causing them to administer stimulus at a measured pace.

- Europe, Japan, and emerging Asia are heavily dependent upon exports to China. A recovery in world trade is highly unlikely absent a solid recovery in Chinese import demand.

- Continued strength in the US dollar could inadvertently culminate in a world recession in a vicious circle. The enormous strength in the dollar has tightened world financial conditions, adding further weakness to the world economy. In turn, weakness in the world economy exerts upward pressure on the dollar, further undermining the world economy.

- Because the world economy is unlikely to improve until there is a trade deal, US company earnings are unlikely to rebound until 2020. A sustained rally in the domestic equity market is highly unlikely without a sustained recovery in corporate earnings.

US and world financial markets remain trapped in a high-risk zone that appears likely to persist for a while longer. Risks abound in all aspects of the investment arena: The world economy, the domestic economy, trade policy, and geopolitics. The result has been a stampede into perceived safe-haven assets, most notably US Treasury bonds, high-quality sovereign debt, and gold.

- Economic conditions in Europe, Japan, and emerging market economies continue to deteriorate, as world trade and economic growth continue to lose momentum. These regions have been negatively affected by trade tensions to a far greater degree than the US economy.

- China's economy has not yet responded to stimulus measures implemented over the past year as spending and output remain depressed, and financial risk remains elevated. Policymakers are fearful that excessive monetary stimulus will exacerbate China's debt problems.

- The US economy has been relatively stable and resilient, led by strength in personal consumption, services, and employment. However, *the domestic economy will remain at increased risk to a spillover of weakness from the manufacturing and trade sectors into currently healthy sectors*.

- The US dollar (USD) is near an all-time high and continues to strengthen, acting as a major headwind to the global economy.

- Geopolitical risks are numerous and include social and political instability in Hong Kong, chaos in Italian politics, growing risks of a no-deal UK exit from the European Union (a "hard Brexit"), and ongoing tensions in both North Korea and the Middle East.

- Last but not least, protectionist risks continue to escalate, as new US tariffs on Chinese imports scheduled for September 1 are met with consistently retaliatory response from China.

- China announced plans to impose tariffs on $75 billion in US imported goods. China also added a 25% tariff on US cars and fixed the yuan at its weakest level since 2008. Trump retaliated by raising the tariff rate from 25% to 30% on $250 billion in imported goods. *An outright trade war is the number one threat to the global economy and financial markets*.

Offsetting Positive Forces: At the same time, these daunting challenges are offset by several important positive forces:

- The US economy continues to expand at a 2% annual rate, led by strength in the household and services sectors along with a healthy labor market.

- Inflation remains in check in the US and in most world economies.

- World central banks are engaged in a synchronized easing of monetary policy, resulting in a boom in ***global liquidity*** conditions.

- Borrowing costs have plunged to record lows: Mortgage rates (30-year fixed) have declined to a three-year low of 3.5%, while BBB-rated corporations are paying only 3.25% on newly issued debt with a ten-year maturity. The result has been a ***refinance boom***, helping to lower debt burdens for households and businesses.

The bottom line is that the economic outlook has become increasingly challenging as these crosscurrents become more pronounced. Global investors are struggling to gauge the relative importance of these competing forces. Because the most powerful force affecting the outlook pertains to trade tensions — which continue to intensify — financial markets are likely to be dominated by risk-off investment strategies for the foreseeable future, implying greater downside for common stocks and commodities along with increased volatility.

FIVE MAJOR RISKS FOR INVESTORS

[1] Manufacturing Contagion: The crucial macroeconomic question is the extent to which the US economy can withstand spreading weakness in manufacturing and trade across the world economy. In principle, the domestic economy is insulated from global economic pressures, but subject to limits. Outright recessions in Germany, Japan, South Korea, and the UK — along with a hard landing in China — would greatly increase the probability of a contraction in the US.

Transmission Mechanism: *The critical independent variable in the outlook is employment*. The transmission mechanism between the sharp deterioration in business confidence and the broad economy is ***business hiring***. Business firms continue to add to payrolls at a brisk pace, but have significantly reduced investment in plant and equipment. Widespread cutbacks in job creation would undermine consumer confidence and spending and greatly increase the probability of a US recession.

Federal Reserve: The Fed would almost certainly respond aggressively to weakness in employment, but the question becomes whether or not it would matter. The realistic answer is no, for two reasons: (1) Changes in monetary policy do not affect the economy immediately, but only after a time lag of six months; and (2) The primary headwind for the US economy is the contraction in business investment caused by the slump in business confidence. Credit conditions are already quite favorable and not an impediment to healthy economic growth. *An objective evaluation of the relative influence of monetary policy versus trade policy strongly suggests that trade is the dominant force*.

[2] Trade War: The tariff war between China and the US has evolved into a high-stakes game of chicken between Trump and Chinese President Xi Jinping. The situation is highly volatile because of the tendency of Trump to shift direction abruptly and unpredictably between a conciliatory and a hard-lined posture. At the same time, Xi appears to have adopted a more hardened position, favoring retaliation over reconciliation. However, both leaders face formidable constraints:

- **President Trump**: Domestic political pressures continue to build as the 2020 election comes into sharper focus. A combination of spreading economic weakness, cumulative equity market losses, and plunging business confidence is a toxic sequence of events that would likely undermine Trump's prospects for re-election.

    - **Republican Support**: Perhaps most worrisome for Trump is evidence of a widening crack in his political base. Recent surveys show clear signs of a marked decline in confidence within the Republican Party. In particular, economic pain has been greatest in those sectors that supported Trump in 2016: Manufacturing, agriculture, and energy. Pragmatic political considerations could trigger an abrupt reversal at any time.

- **President Xi**: Xi faces a number of political pressures, both internally and externally: Rising unemployment and social unrest; growing risk of a military crackdown in Hong Kong; and pressure to intimidate Taiwan before its election in January. In the long term, economic prosperity in China is highly dependent upon continuation of the symbiotic relationship with the US. It is not an exaggeration to argue that China owes its "economic miracle" of the past several decades to its close business connection with the US.

Potential Positive Trade Actions: Looking beyond China, the Trump administration has several opportunities to make progress on the trade front: (1) Completing a trade deal with Japan, which appears imminent; (2) Ratifying the US-Mexico-Canada (USMCA) trade agreement, which hinges on support from moderate Democrats in Congress; and (3) Pulling back from threatened tariffs on European automotive imports.

Nonetheless, the trade dispute between China and the US is the primary threat to economic growth. The key question for investors is whether growing political pressure will force at least a partial deal before the world economy slips into recession. Unfortunately, there are no reliable signals or guidelines that would be helpful in answering this question, which suggests that world financial markets will remain extremely volatile with a strong preference for defensive investment strategies.

[3] Economic Weakness in China: Progressive slowing of China's economic growth has been a major contributor to the profound weakness in the global economy. *China is the major engine of growth for the international economy*. Although it comprises only 15% of world GDP — compared with 22% for the US — China is responsible for 35% of annual growth in world GDP.

Record Low GDP Growth: Weakness in the Chinese economy is evident in both internal and external demand. Industrial production is growing by less than 5%, the slowest pace in 17 years; investment in manufacturing is expanding by only 3%; and retail sales have been soft, led by weakness in the auto sector. Both exports and imports are ***declining*** at a 5% annual rate. Consequently, *GDP is expanding at the slowest pace in 27 years*.

Policymaker Dilemma: China's economic slump can be attributed to two forces: (1) The worsening trade war; and (2) The lagged economic effects of monetary tightening during 2017 aimed at curtailing credit growth. Policymakers reversed course one year ago with some monetary easing initiatives, but these have been too small to overcome the contractionary effects of trade. *Chinese leaders face a major dilemma: Their economy desperately needs **short-term** stimulus, but its most serious **long-term** problem is excessive debt levels*. Dangerous debt levels have constrained policymakers, causing them to administer stimulus at a measured pace.

Consequently, the Chinese economy has understandably failed to respond to the relatively weak stimulus administered to date. *Europe, Japan, and emerging Asia are heavily dependent upon exports to China*. *A recovery in world trade is highly unlikely absent a solid recovery in Chinese import demand*.

[4] Persistent US Dollar Strength: Continued strength in the USD could inadvertently culminate in a world recession. The most worrisome scenario would be a ***self-reinforcing vicious circle*** involving the dollar and world liquidity, as follows: The current weakness in the world economy has triggered a flight to safety among investors, which means increased accumulation of US dollars. The resulting rise in the value of the dollar has a tightening effect on world financial conditions, thereby exerting further downward pressure on the world economy.

Vicious Circle: The vicious self-reinforcing circle can be best understood as follows: Continued weakness in the world economy encourages risk-off asset allocation strategies, reinforcing upward pressure on the dollar. In turn, additional strength in the dollar creates further economic weakness, which drives the dollar higher. This vicious circle could persist for a considerable period — exerting progressive downward pressure on growth — until policymakers are forced to intervene with powerful ***fiscal stimulus measures*** to counter the vicious circle.

- **Base Case Scenario**: While this disaster scenario cannot be ruled out, the most likely outcome is that an ultimate recovery in the world economy will trigger a sustained reversal in the dollar. Global financial and liquidity conditions would benefit from dollar weakness, providing progressively stronger stimulus for world economic growth.

[5] US Corporate Earnings: Company earnings have been on a plateau since the end of last year, a trend that is likely to persist for the final two quarters of this year. *Profit weakness can be almost exclusively attributed to the tariff war and to the slump in world trade*. *Both revenues and profit margins have been impacted by spreading tariffs*. The divergence between the domestic and world economies is reflected in the profit data: Domestic profits have ***increased*** by an estimated 5%, while international earnings are ***contracting*** at an estimated 10% annual rate.

Because the world economy is unlikely to improve until there is a legitimate trade deal, US company earnings will not rebound until 2020. Consequently, a sustained rally in the domestic equity market appears unlikely in the absence of a sustained recovery in corporate earnings — which in turn will not occur until trade restrictions subside.

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Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid 1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.