ECONOMIC RISK INCREASES ALONG WITH AN ESCALATION IN TRADE TENSIONS

by **Robert F. DeLucia, CFA**
Consulting Economist

It seems reasonable to assume that the trade war will worsen before a negotiated settlement is reached, implying continued short-term risks to global equities and strong demand for government bonds. However, massive synchronized central bank easing and an end to the global manufacturing downturn should eventually spark a revival in aggregate spending and output. Following a flat 2019, company earnings should post a solid recovery in 2020. Global equities should massively outperform global bonds over the next year.

Summary and Major Conclusions:

- There is an unusually large divergence among economists as to the direction of the US economy, with some forecasters describing the domestic economy as "booming," while others arguing that the economy is already in recession.

- The most accurate description of the US economy is neither weak nor strong, but rather mixed. Pockets of weakness in manufacturing, business capital investment, housing, and exports are offset by solid growth in household spending and business and consumer services.

- The current economic expansion has much further to run than generally assumed. Business cycles do not age chronologically; rather, expansions transition into recessions because of cyclical imbalances and excesses that develop as an expansion cycle matures.

- The US economy appears extremely balanced with very few signs of excess. Inflation is low, monetary conditions are expansionary, private sector debt is increasing at a moderate pace, and credit quality is stable.

- With the exception of business inventory investment and commercial construction, there is no evidence of physical spending excesses. In fact, there is evidence of pent-up demand in specific categories of capital formation. Assuming an amicable resolution of the trade war, the business expansion could persist into 2022.

- US economic growth prospects are almost exclusively predicated upon trade policy: Escalating trade tensions between China and the US will likely push growth lower, while a substantive agreement on trade would trigger an acceleration in growth.

- Tariffs are the equivalent of an excise tax, which typically results in higher inflation in the domestic economy. The mystery is that measured inflation for both imported goods and overall goods purchased has actually softened over the past year.

- US consumer inflation has declined from 2.1% to only 1.6%, and the index of US import prices has actually declined by 2% over the past year. The implication is that global deflationary forces are overwhelming the direct and indirect impact of tariffs.

- It is widely understood that rising interest rates and inflation are significant threats to sustained economic growth. However, investors appear to underestimate the powerful support for economic growth derived from low levels of inflation and interest rates.

- While contagion from manufacturing and trade sectors to the household and service sectors cannot be ruled out, the odds of such an occurrence are low. Manufacturing comprises only 11% of GDP and 9% of nonfarm payrolls.

- There is a low probability that contractions in key foreign economies will infect the US, resulting in a domestic recession. History reveals that world recessions are triggered by economic downturns that originate in the US. There has never been a US downturn triggered by an overseas recession.

- Yields on government bonds have plunged to multi-year lows, while risk assets such as common stocks and industrial commodities have come under intense selling pressure. Surveys of investor confidence reveal widespread aversion to common stocks — a positive from a contrarian perspective.

- It seems reasonable to assume that the trade war will worsen before a negotiated settlement is reached, implying continued short-term risks to global equities and strong demand for government bonds.

- Massive synchronized central bank easing and an end to the global manufacturing downturn should eventually spark a rebound in aggregate spending and output and improving growth in company earnings. Global equities should significantly outperform global bonds over the next year.

President Trump's recent threat of new tariffs on Chinese imports increases the vulnerability of the US and global economies, while raising risks to world financial markets. The critical challenge for investors is to accurately gauge the tipping point: What level of tariffs will push the world economy into recession? This week's Economic Perspective examines the critical issues faced by global financial markets.

THE US ECONOMY IS NEITHER WEAK NOR STRONG BUT BIFURCATED

The most accurate description of the US economy is neither weak nor strong, but bifurcated and mixed. Weakness in manufacturing, business capital investment, housing, and exports is offset by pockets of strength in household spending and business and consumer services. *When combined, these divergences reveal an economy that has expanded at a rate of 2.3% over the past year, adjusted for inflation, and down from a peak of 3.3% one year ago*.

US economic growth prospects are almost exclusively predicated upon trade policy: Escalating trade tensions between China and the US will likely push growth lower, while a substantive agreement on trade would trigger an acceleration in growth. Improving economic conditions in China and the US — which together comprise more than 40% of world GDP — would result in a strengthening global economy.

THE CURRENT EXPANSION CYCLE HAS MUCH FURTHER TO RUN THAN GENERALLY ASSUMED

As I have discussed on numerous occasions, business cycles do not age ***chronologically***. *Rather, expansions transition into recessions because of cyclical imbalances and excesses that develop as an expansion cycle matures*. Australia has not experienced a recession in 27 years, while the previous UK economic expansion that began in 1992 persisted until 2008.

The challenge for investors is to assess the extent of imbalances and excesses present in the American economy. On that score, the US economy appears extremely balanced with very few signs of excess. Inflation is low, monetary conditions are expansionary, private sector debt is increasing at a moderate pace, and credit quality is stable.

With the exception of business inventory investment and commercial construction, there is no evidence of spending excesses. Assuming an amicable resolution to the trade war, the business expansion could persist into 2022.

THE UNFAVORABLE EFFECTS OF TARIFFS ON DOMESTIC INFLATION HAVE BEEN MORE THAN OFFSET BY WORLD DEFLATIONARY FORCES

Economic theory is unambiguous with respect to the primary economic impact of a protective tariff on a domestic economy: The Trump tariffs are the equivalent of an ***excise tax*** on US businesses and consumers, which results in higher inflation:

- **Direct Impact**: The higher cost of imported goods has a direct impact on domestic inflation. Roughly one-third of goods purchased by domestic businesses and consumers are foreign imports.

- **Indirect Impact**: Rising prices on imported goods provide domestic competitors with a protective umbrella to match higher import costs by raising selling prices.

The mystery is that measured inflation for both imported goods and overall goods purchased has actually softened over the past year, despite the imposition of tariffs. *Specifically, since the middle of 2018, core consumer inflation has decelerated from 2.1% to 1.6%, while producer price inflation has declined from 3.5% to only 1.7%*. *More striking is the trend in import prices: An index of US import prices (non-oil) has **declined** by 2%; and the average price of Chinese imports has **declined** by 1.5%*. The inflation trends of the past year are counter to basic economic theory.

These trends could reverse with further passage of time, suggesting that a rising trend in inflation in coming months cannot be ruled out. This is especially true if the tariff war escalates, as currently appears likely. For now, the theoretical impact of tariffs on inflation appears to be in abeyance, suggesting that widespread global deflationary forces are overwhelming the direct and indirect impact of tariffs.

CONTINUED LOW LEVELS OF INTEREST RATES AND INFLATION ARE SUPPORTIVE OF SUSTAINED ECONOMIC GROWTH

It is widely understood that high and rising interest rates and inflation are significant threats to healthy and sustained economic growth. However, the converse is not true: Investors appear to *underestimate* the powerful support for economic growth emanating from low levels of interest rates and inflation:

- Low and stable inflation enhances consumer purchasing power
- Price stability encourages businesses to invest in plant and equipment
- Low inflation reduces the tendency toward destabilizing speculative behavior
- Low inflation enables central banks to maintain accommodative monetary policies
- Low interest rates provide stimulus for capital formation

The key point is that extremely low levels of inflation and interest rates should provide powerful tailwinds for US economic growth over the next year — a view apparently not taken into account by financial markets.

ESCALATING TARIFFS HAVE INCREASED THE LIKELIHOOD OF RECESSION, ALTHOUGH THE ODDS REMAIN BELOW 50%

Realistically, the only credible near-term threat to the US economic expansion is continued deterioration in trade relations with China. President Trump's recent threat to impose a 10% tariff on the remaining $300 billion in Chinese imports is worrisome and raises the odds of a US and global recession.

The following is an attempt to quantify the impact of tariffs on the US economy imposed over the past year:

- The tariff war has reduced US GDP by 0.3% over the past year.

- Employment has been reduced by roughly 250,000, approximately 10% of net new job creation over the past year and less than 0.2% of the total US labor force.

- Cumulative taxes imposed on US business importers amounts to nearly $70 billion, equivalent to roughly 0.3% of GDP.

- In the positive column, there has been no measurable impact on inflation, which has been stable at 1.6%. The average price of US imports has declined by 2% over the past year, while the average price on Chinese imports has also declined.

These data suggest that the tariff war has had only moderate impact on the US economy over the past year. However, the trade war continues to escalate, which means that the negative impact on GDP and company earnings will become increasingly onerous.

Moreover, what cannot be measured is the impact on business confidence and the willingness to commit capital to long-term investment in plant and equipment. The impact on housing is also impossible to gauge, as potential homebuyers postpone home purchases in the current uncertain economic climate.

THERE IS A LOW PROBABILITY THAT WEAKNESS IN MANUFACTURING AND EXPORTS WILL PUSH THE US ECONOMY INTO RECESSION

While contagion from the manufacturing and trade sectors to the household and service sectors cannot be ruled out, the odds of such an occurrence are low. Manufacturing comprises only 11% of GDP and 9% of nonfarm payrolls. The US has evolved over many decades into a consumer and services economy, the combined total of which comprises more than 80% of GDP.

In addition, trends in the manufacturing sector over the past decade are also encouraging. *The US economy suffered manufacturing downturns in 2012 and 2015 and neither of these contractions ended in recession*. *Rather, the US economy rebounded strongly in 2014 and again in the 2017-18 period, despite the previous period of industrial weakness*.

Finally, history reveals that manufacturing activity tends to follow a three-year cycle, comprised of 18 months of both expansion and contraction. The decline in manufacturing began approximately one year ago, suggesting another six months of further declines. Of course, this pattern could be disrupted by US trade policy: Continued escalation in tariffs would likely lengthen the current down cycle into 2020. That said, the broad implication is that the current domestic and global manufacturing cycles are well advanced.

THERE IS AN EVEN LOWER PROBABILITY THAT RECESSIONS IN KEY ECONOMIES OUTSIDE THE US WILL TRIGGER A DOMESTIC RECESSION

In principle, the US economy plays a leadership role in the global economy. History reveals that world recessions are triggered by recessions that originate in the US. There has never been a US recession triggered by recessions overseas.

The US is essentially a closed economy, with exports comprising only 13% of GDP, which means that economic growth is dependent upon the remaining 87% of GDP encompassing domestic demand. US export levels are well below those in Germany (47%), China (25%), Korea (45%), Sweden (44%), and the UK (30%). This means that in the absence of progress on the trade front, the future direction of the US economy is predicated upon the following factors:

- **Personal Consumption**: Household sector finances are solid and consistent with continued trendline growth of 2.5%.
- **Business and Consumer Services**: Spending on services is the least cyclical sector of GDP and should continue to expand at a 2% annual rate.
- **Residential Construction**: Housing construction is poised for a sharp rebound sparked by a plunge in mortgage rates to the lowest levels in three years. Housing could augment GDP by 0.5% to 1% in 2020.
- **Federal Reserve Policy**: Monetary policy is already expansionary and is likely to become hyper-accommodative over the next year.
- **Fiscal Policy**: Fiscal policy has recently shifted from contractionary to expansionary, adding to GDP growth. And new tax and spending initiatives in an election year cannot be ruled out, should economic growth slow precipitously.

To reiterate, the primary catalyst for a US recession would be an all-out trade war instigated by the Trump administration. A full-scale trade war would encompass a 25% tariff on all $525 billion in Chinese imports along with a 25% tariff on all automobile imports from Europe and Japan. Under this alarming scenario, recessions in China, Germany, Korea, and Japan would be virtually assured. The US economy would be severely impacted, although a descent into an outright recession would be a close call.

INVESTMENT SUMMARY

As would be expected, market sentiment has turned decisively negative in the wake of the US threat of new tariffs on Chinese imports. The US and world economies are currently held hostage by US trade policy: Economic growth will continue to weaken in a policy environment of escalating trade tensions, while a breakthrough in trade negotiations would be followed by a revival in the global economy.

Market yields on US Treasury securities have plunged to a three-year low, and gold prices have spiked to multi-year highs. Risk assets — mainly common stocks and industrial commodities — have come under intense selling pressure. Surveys of investor confidence reveal widespread aversion to common stocks, a positive from a contrarian perspective. Individual investors, traditional institutional investors, and hedge funds have adopted highly defensive asset allocation strategies, favoring government bonds over common stocks.

It seems reasonable to assume that the trade war will worsen before a negotiated settlement is reached, implying continued short-term risks to global equities and strong demand for government bonds. However, massive synchronized central bank easing and an end to the global manufacturing downturn should eventually spark a revival in aggregate spending and output. Following a flat 2019, company earnings should post a solid recovery in 2020. Global equities should massively outperform global bonds over the next year.

Robert F. DeLucia, CFA, was formerly Senior Economist and Portfolio Manager for Prudential Retirement. Prior to that role, he spent 25 years at CIGNA Investment Management, most recently serving as Chief Economist and Senior Portfolio Manager. He currently serves as the Consulting Economist for Prudential Retirement. Bob has 45 years of investment experience.

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.