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Trade Update

With time running out, Team Trump and Canada came to terms on NAFTA 2.0. While that's not the official name (try USMCA!), NAFTA 2.0 is likely to stick. It'll take time to fully digest the actual language in the document, but it appears to address several of Trump's grievances. Briefly, it seeks to strengthen auto manufacturing jobs in North America relative to Mexico by setting minimum wages and production targets. It also purports to weaken protections for Canadian farm products from U.S. competition, an often repeated Trump gripe. Of course, there's other stuff in there too, and we'll need some time to figure out what's really changed, if anything. The treaty will have to make it through the respective legislative bodies—much depends upon the November elections. There's no way to exaggerate the degree and depth of contempt that Democrats have for everything Trump, but the auto stuff is absolutely pro-labor. If you're a political cynic, it'll be interesting to watch the Dem's contortions on this. And free-trade Republicans won't want to support it either, but auto jobs are political dynamite - handle with care.

The equity markets took the resolution as a positive sign. Perhaps there's some read-through to China. Perhaps not. We in the financial services industry love auto workers and farmers as much as anyone, but there's just not much to gain (economically) from bullying tiny, friendly neighbors about auto and farm jobs. By the way, they make cars in Mexico because wages are $5.00 an hour. We can't recall any voting block bellyaching for more expensive cars. And we have no idea where Canadian bacon is made, but if it's in Canada, don't mess with it--lean and delicious. Try it.

As for China, that trade conflict - the real show - escalated during the third quarter. On September 24th Trump placed a 10% tariff on $200 billion of Chinese goods. That tariff is set to rise to 25% at the end of the year if no deal is reached. Trump further threatened to hit another $260 billion in Chinese exports if China retaliates. China responded with tariffs 5%-10% on another $60 billion tranche of U.S. exports, substantially all remaining. Ten percent of $200 billion isn't much to worry about relative to our $20 trillion economy, but critical manufacturing supply chains for U.S. technology and industrial companies reside in China. Many of these businesses have led the U.S. stock market's long ascent. Several have already warned that tensions will have earnings consequences. Jack Ma, one of China's business elites, says a trade war could last twenty years. We simply don't know where this is going. We don't know what's in Trump's heart - campaign slogan or dead seriousness? It's one thing to get rough with Canada - something akin to picking on your little sister - but China has cities bigger than all of Canada, population-wise. Stay tuned.

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What Does the Market Know?

Millions of individual investment decisions made with no coherent view of the future push the markets this way and that every day. Out of something that from minute-to-minute mostly resembles chaos often comes a reasonable approximation of what is happening. Pundits say "the market knows." The third quarter produced strong equity returns while the 10-year Treasury yield finally climbed above the psychologically important 3.0% level and stayed there, although it's still close. A historical read of those two signals would suggest that the economy will remain strong in 2019, but not too strong. And yet the 2019 economic backdrop will be noticeably different. In no particular order, higher interest rates, slower housing, higher oil and gas, and tougher trade will conspire to slow the economy. The tax cut-induced earnings spike will be in the rearview mirror and federal spending, while high, won't accelerate. Our predictive powers are inexact so our guess is these forces are sufficient to slow growth. The degree by which it slows happens to be quite important. Seemingly modest changes (as measured on Main Street) in near-term economic growth can have significant consequences for market leadership. If growth falls back to around 2%, the market's infatuation with the mega-growth stocks could well continue, as exceptional growth will remain dear. Downshift further and investors might get spooked into the defensive, dividend payers, probably at the expense of mega-growth. But, if economic growth stays closer to 3%, participation could broaden considerably, lifting all boats - a welcome change. We're positioned for the 2-3% range. If that sounds like economist speak for 'hey, we don't really know, but we think growth will be ok', you'd be correct. In any case, somewhat slower growth would be healthy for this long bull market as the biggest danger today is economic overheating, causing the Fed to become more aggressive with rate hikes. To put it most plainly, you can jog a hell of a lot further than you can sprint.

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