Market Commentary

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Plenty to Worry About, but Not Much to Do

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Every summer for the past several decades I have organized a series of Friday lunches in eastern Long Island for serious investors. More than 100 people attend the four sessions, with 25–30 at each one. The participants include hedge fund, private equity and real estate billionaires, venture capitalists, an academic and some corporate leaders. I moderate a discussion of the key issues facing the financial markets for the better part of two hours. This year, several significant events occurred between the first two and the second two sessions. First, the Federal Reserve cut the Fed funds interest rate by a quarter of a percentage point; second President Trump announced a 10% tariff increase on $300 billion of Chinese goods; third, China allowed its currency, the renminbi, to decline to more than seven to the dollar; and fourth, the Hong Kong disturbance took place.

These events sent both the stock and bond markets into turmoil, rocking the complacency of investors throughout the world. The Standard & Poor's 500 dropped sharply from its high, the 10-year U.S. Treasury yield declined to below 1.6% and the prospect of a recession in 2020 increased. At the first two lunches, most investors were positive, thinking the S&P 500 would continue to make some modest progress through the end of the year and the next recession would not occur until 2021. At the two August lunches, many thought the market could lose ground in the final months of 2019 and that the likelihood of a recession was increasing for 2020. Investors had been assuming that a trade deal with China would be reached sometime prior to the 2020 election, but when Treasury Secretary Mnuchin and Trade Representative Lighthizer returned from Shanghai and told the president that talks with the Chinese had not gone well, Trump reacted strongly by announcing the new tariffs and the stock market began its long slide down. Yields on Treasury securities plummeted as the prospects for a recession in 2020 increased. The turbulence in the capital markets is sure to have an impact on the willingness of both consumers and corporations to make spending commitments. As a result, earnings estimates for companies and GDP estimates for the economy are likely to be adjusted downward. If the current negative conditions continue, Donald Trump's prospects for a second term will become darker, and that increases the likelihood that he will do something to reverse the trend. One step he could take is to defer the imposition of the new tariffs beyond the September 1st announced date and do everything possible to resume trade discussions with China on a positive basis. By the middle of August he had done just that on some goods covered in the tariff increase, thereby improving the prospects for renewed talks with China.

At three of the sessions, I went around the table asking, "What do you think is the most important issue facing the financial markets over the next twelve months?" Naturally, the trade war with China, a possible recession because of a monetary policy or other mistake, and the unpredictability of Donald Trump were often mentioned. What was seldom brought up in the discussion that followed was climate change, gun control, health care policy and the political polarization between the left and right around the world. There was some discussion of the high and growing level of government debt, but few believed that was a near-term problem. There was not much of an appetite for Bitcoin, Libra, or any other crypto-currency, but there was broad support for the significance and viability of blockchain technology.

The political situation in the United States was vigorously discussed at all four lunches. Most of the participants, regardless of party affiliation, thought Donald Trump would have a second term, although there was less enthusiasm for that point of view after the announcement of the tariff increases at the end of July. Notably, some long-time Democratic supporters were more concerned about Elizabeth Warren, Bernie Sanders or Kamala Harris winning the nomination and possibly the election than they were about a Trump second term. They felt that if a Democratic progressive took over the White House pushing for universal health care, a suspension of employer-based health insurance, free college for all and other costly programs, the damage to our fiscal condition, and ultimately to the party itself, would be serious. Critics of the president believed that his impetuous nature might hurt him to the point where some moderate Republicans would decide not to support him.

There was considerable focus on the states which were critical in the electoral process: Ohio, Pennsylvania, Wisconsin and Michigan. Many believed that Trump's support in those states was solid and not easily influenced by recent events. Everyone agreed it was early in the process. There was a general feeling that there was no Democrat who would be a formidable challenge to the president. A number believed that Joe Biden lacked the energy and enthusiasm needed to confront Trump, who has proven to be a very effective campaigner. Biden's recent gaffes have made some question his mental acuity. Trump could stress his success in achieving tax cuts, dismantling regulation, controlling immigration and preventing North Korea from hurling missiles at anyone. That might convince many in key states to vote for him. He has chosen to deemphasize health care, gun control and deficits, believing these issues were less important to his political base.

There was general agreement that the economy would be a key issue in the election. If the U.S. growth continues at around 2%, and inflation and interest rates remain low, Trump is likely to be reelected. History shows that an incumbent running for a second term in a favorable economy usually wins. If we are in a recession next year, Trump's chances would dim. One implication of a Trump second term is the composition of the Supreme Court. There are likely to be two more vacancies over the next five years, and if conservative associate justices are appointed, the character of rulings would likely change decisively. This is a potential issue that unsettled many of the participants at the lunches, especially as it pertains to the implications for Roe versus Wade, gun control legislation and voters' rights.

In spite of the late July / early August turbulence in the market, most were optimistic that the S&P 500 would make its way to 3000 by year end. More thought the yield on the 10-year Treasury would be above 2% but a good number expected it to tick below 1.5%. Most expected a deal with China sometime in the next twelve months. There was not much interest in buying gold if the stock market were headed higher. Most thought technology stocks like Google and Facebook would continue to perform. Few thought a recession before 2021 was likely.

Inequality was an important topic of discussion. Many were concerned about the declining ability of the United States public school system to educate our children effectively. There was a consensus that the process had to start in pre-school. There was also support for corporate-sponsored apprenticeships and junior college scholarships for indigent students. There was widespread concern that artificial intelligence would eliminate a number of jobs, but the technology experts attending the sessions were less worried about that risk. They were convinced that greater availability of information in healthcare, for example, would create job opportunities as new therapies for diseases evolved. Others were worried that wages had stagnated over the past decade and the situation was likely to get worse with the challenges of artificial intelligence. Some argued that given that artificial intelligence had been around for years and had crept into the economy with a minimum of disruption, concern about it was excessive.

The rapid expansion of sovereign debt around the world was a problem for many. The U.S. Federal debt was $6 trillion in 2000; it is $22 trillion now. The debt service in 2000 was $360 billion when the blended interest rate on Treasury debt was 6%; with the current blended interest rate a little above 2%, the debt service is $450 billion, or an increase of 25% in debt service for an overall debt that has exploded to almost four times the level in 2000. Everyone agreed this cannot go on forever. To be sure, interest rates in the U.S. are higher than they are for sovereign debt almost everywhere else, our credit has always been good and institutions still want to buy our Treasurys. Nobody knows when these conditions will change, but everyone thinks that they will. There was not much conviction that Modern Monetary Theory would save us from a coming calamity, even though we have been able to dramatically increase our debt without serious negative implications. Having our own currency (which is also the reserve currency for the world) certainly has helped make this situation possible thus far.

Populism was also discussed. Over the past decade, the world has become a mosaic of independent nations. Many global alliances, like the Paris Climate Accord and the Iran agreement, have broken down. Nationalism has risen and the idea that nations of the world are interdependent and interconnected and should strive for cooperation has become unpopular. Political parties of both the extreme left and right have risen, making the world a less stable place. Recessions in some European countries have endangered the European Union’s long-term prospects, although all the participants agreed that having a single currency had been a positive across the continent. Most expected the October 31 deadline for a Brexit Deal would come and go without a definitive agreement. If another referendum were held in the U.K., the vote would probably still be to leave, which is a change from the expectations over the past few years. This means we are likely to see a hard Brexit, which is probably not good for Britain or Europe, but some thought the pound would decline as a result, thus creating opportunities.

The protests in Hong Kong have escalated to the point where unrest on the mainland has become a possibility. Some participants thought that the economy in China is weaker that what has been reported, and that Xi Jinping is becoming unpopular. Bans on Huawei and China’s dependence on American computer chips is a big issue. China is doing everything possible to close the semi-conductor gap, and the country’s reliance on US products is a major impediment to Xi’s goal of becoming a leader in technology by 2025. One close observer of China said we should keep an eye on Macau revenues. If they were soft, it is a sign that the economy is worse than what is being reported. We should also not lose sight of China’s long-term demographic problems. Doing a trade deal with the U.S. should help Chinese growth, since exports to U.S. account for 4% of total Chinese GDP. I have long thought that China needs a trade deal economically and Trump needs one politically. On that basis one should expect a deal to be reached, but China thinks long-term and its people have endured prolonged periods of suffering. If Xi decides it would be to China’s advantage to delay a deal, he will do so. This is particularly true if he concludes that a Democrat has a chance of defeating Trump given the conventional wisdom that such an outcome would be favorable for China.

There was a definite feeling that there had been a shift to the left in political thinking in the United

States. This was particularly true among millennials whose favored causes include climate change, income inequality, universal health care, free college education and even, possibly, a guaranteed annual income. Some participants expressed concern about anti-capitalist rhetoric among certain political candidates who want to tax wealthy individuals and corporations heavily to pay for social programs.

In spite of the tight labor market, confirmed by the low level of unemployment, inflation has remained tame throughout this cycle. Globalization and technology, together with slow growth everywhere, are generally given as reasons for this condition. We are starting to get some indication that inflation could be heading higher. Recent figures on personal consumption expenditures show a sharp rise, but it is too early to say that a major change in trend is taking place.

The attendees clearly thought that Donald Trump wanted to achieve several goals over the next year: (a) a trade deal of some sort with China; (b) avoiding military conflict with North Korea or Iran, but making some progress on pulling back the nuclear programs of both; and (c) keeping the economy growing at 2% at least. While a major agreement was unlikely to be made with North Korea or Iran, few believed either country's economy was strong enough to support a military conflict. While they were both in Russia's sphere, Putin was not likely to provide the backing they would need in a confrontation with the United States.

At the beginning of the year we thought the S&P 500 would appreciate by 15% in 2019, taking it to 2850. That is about where we are now and sentiment is becoming very pessimistic, as it usually does at market lows. If the world avoids a widespread recession, there is positive momentum on trade talks with China, and the Hong Kong protests quiet down, we may be in a bottoming area for the markets. The inverted yield curve is, however, arguing that this view is too optimistic.

Looking across the conversations at all four lunches, there was a sense that the problems being discussed would mostly work out for the best. The China trade issue would result in an agreement but the long-term intellectual property issues would remain. Growth around the world would be slow over the next decade. This is also what the low level of interest rates is signaling. Debt around the world is a long-term problem but not an immediate one. In a nuclear world nobody really wants to go to war with anyone. India was the only country that some investors wanted to buy. There is nobody running for President of the United States that anyone is really enthusiastic about and none of the candidates has a program for economic growth. Somehow we would all be sitting at these lunches a year from now with a little more net worth, but similarly confused about what the future might hold for our grandchildren.