REFLECTIONS & PERCEPTIONS

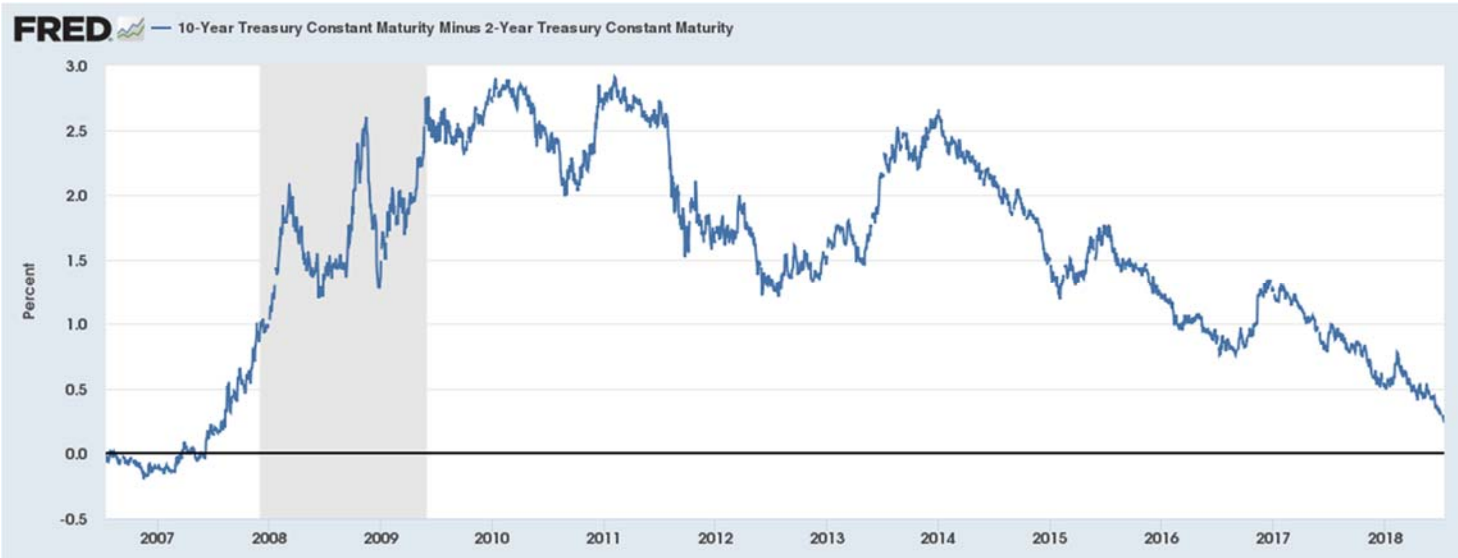
IT'S TIMES LIKE THESE

Two areas of concern that have been dogging investors recently are trade and the shape of the yield curve. Soured trade relations between the U.S. and its major trading partners have alarmed investors. The fear is that this episode of trade tensions could morph into a trade war that threatens the current pace of economic growth. The other area of concern revolves around the flattening yield curve and the ominous message it may be sending about future economic growth domestically.

Let's begin with tariffs. Tariffs are a sort of tax on imported goods from a trading partner or partners. They are not imposed necessarily to raise money as traditional taxes are meant to but instead are imposed to increase the price of foreign goods in order to make domestic competing products relatively cheaper. The goal of imposing tariffs is to protect domestic goods producers from global competition. June 1st marked the beginning of formal trade tensions as the U.S. imposed a 25% steel tariff and a 10% aluminum tariff on imports from Canada, Mexico and the European Union on grounds of national security. In turn, these countries retaliated by levying tariffs of their own on imported U.S. goods.

The U.S. has also targeted China with a 25% tariff on $34 billion of goods, signaling the start of a potential trade war between the world's two largest economies. As of 2017, China was the third largest export market for U.S. goods at $130 billion. Canada and Mexico remain our largest export markets at $282 billion and $243 billion, respectively. The U.S. imported $506 billion worth of goods from China in 2017. China retaliated by imposing a similar 25% tariff on 545 U.S. products, also worth a total of $34 billion. The U.S. cited the $375 billion trade deficit, China's intellectual property theft and the forced transfer of technology as motivation for the Chinese tariff announcement. Generally, companies that want to produce in China and sell into the Chinese market must enter into local

10-YEAR 2-YEAR YIELD DIFFERENTIAL



Shaded areas indicate U.S. recessions   Source: Federal Reserve Bank of St. Louis

joint ventures that result in their technology being turned over to their Chinese partners. The United States imposes no such reciprocal requirements. This is a major issue because China does not recognize U.S. intellectual property laws. As a result, it is estimated that U.S. companies operating in China lose hundreds of billions of dollars annually due to Chinese theft of American intellectual property. The U.S. has signaled that it could ultimately expand tariffs to $500 billion of Chinese goods if China does not take corrective action on these trade policies. The threat of increasing trade tension between the U.S. and China remains a real threat to global economic growth and will remain a thorn in the market's side for the foreseeable future.

Another area of investor concern has been the flattening of the yield curve. The yield curve measures differences in yields at varying maturities, with the most popular measure being the 10-year 2-year yield differential known as the 2s10s slope. Importantly, the slope of the yield curve is considered by many as a good predictor of future real economic activity. The 2s10s curve has reliably inverted heading into previous recessions and, as a result, is considered a harbinger of sharply slower economic growth or recession. The Federal Reserve has been increasing the fed funds rate over the last year and a half and thus short-term interest rates have been rising. At the same time, long-term interest rates in the U.S. have not changed very much. Financial market commentary has been addressing this phenomenon, often referred to as a flattening yield curve. As can be seen in the graph above, the U.S. yield curve spread between the 10-year and 2-year Treasuries has fallen to 29 basis points. This is the tightest spread since August 2007.

To be sure, yield curve information is not infallible and inversion could be driven by other factors unrelated to future macroeconomic performance. Interestingly, global real interest rates are low, so U.S. rates could be capped in part due to this phenomenon. For instance, comparable 10-year yields on German, United Kingdom and Spanish bonds are currently at 0.34%, 1.26% and 1.24%, respectively. Regardless of the reasoning behind the flattening yield curve, FOMC policymakers need to take the possibility of an inverted yield curve seriously.

The Federal Reserve raised the fed funds rate for the second time this year on June 12th. This marked the seventh such increase this cycle and brings the fed funds rate to a range of 1.75% to 2%. So far, long-term yields have not increased in lockstep with the Fed's rate increases. U.S. long-term yields could certainly move higher, but the evidence currently seems to suggest that inflationary expectations remain subdued going forward. This suggests the risks of yield curve inversion are best avoided by the FOMC's caution in raising the fed funds rate during the balance of the year despite telegraphing two more moves in 2018.

During his post-meeting testimony, Fed Chairman Powell suggested that economic growth was being influenced, at least in the short term, by tax cuts and government spending increases signed into law by President Trump last year. Interestingly, he dismissed, for now, concerns that President Trump's trade policies, including tariffs on steel and aluminum imports, were hurting growth, saying the Fed had yet to see any data indicating an impact.

In closing, ongoing concerns regarding rising interest rates, a flattening yield curve and the impact of impending tariffs on international trade caused stocks to sell off in February and March this year. Since then, the U.S. stock market has rallied year to date. Stocks have been buoyed by a robust first quarter earnings season with more of the same expected for the second quarter earnings season underway currently. The strong economic backdrop is certainly helpful, with 2Q GDP estimates as high as 4% (compared to 1Q's 2%) and the national unemployment rate dropping below 4% during the quarter for the first time since 2000. S&P 500-member companies reported a roughly 24% increase in 1Q earnings from the same period last year, aided in part by lower tax rates. Analysts expect this pace of earnings growth to persist throughout 2018 with 2019 seeing some moderation in this pace of growth to about 10%. Let's hope that cooler heads prevail as it relates to trade policies and the Federal Reserve moves in a cautionary fashion as it contemplates further rate hikes this year.