DM portfolio commentary

1st QUARTER 2018

After many months of virtually unprecedented tranquility in equity markets, the serene backdrop that investors had been enjoying came to a jarring halt in the opening quarter of 2018. Though attempting to assign specific causes to interim market moves is ordinarily a dubious endeavour, in this case the catalysts for flux were fairly identifiable.

The quarter's first significant stock price decline began at the start of February, when 10-year Treasury yields in the US made their way up toward 3% and investors began to consider the bond/equity tradeoff for the first time in many months. Though a 3% annual return for a decade commitment may still not be that enticing in its own right, the rise in rates probably cast thoughts forward to a point when bonds might represent a more competitive alternative to stocks than they do presently and when investor capital might be reallocated away from equities at the margin.

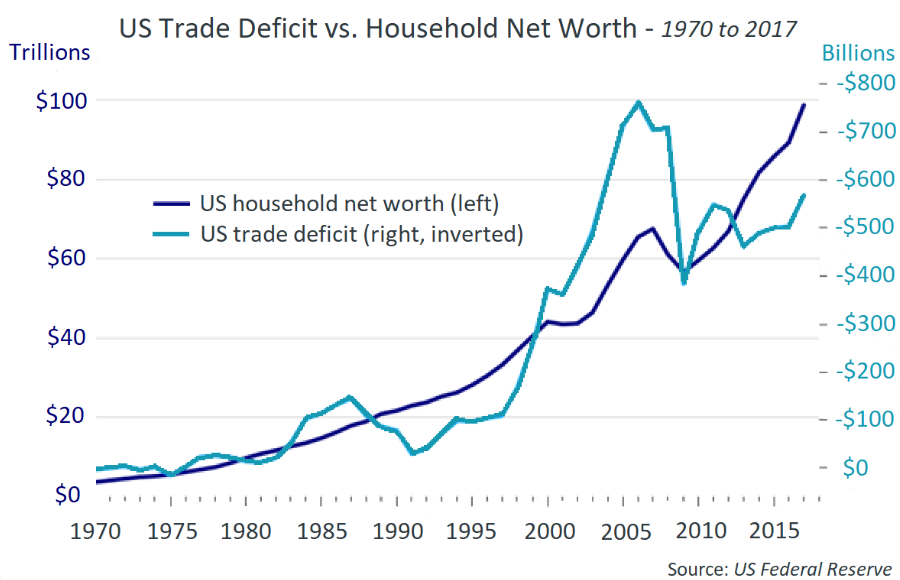
Following the resultant "correction" in index levels (loosely defined as a 10% drop), cooler heads seemed to prevail and major markets recaptured the bulk of their losses within days. Though rising rates can undermine stock prices and commercial activity at extremes, usually toward the end of a business cycle, we're still a long way from such a circumstance and, while policy makers have been nudging the cost of money higher, they are also undoubtedly mindful not to let monetary prudence tilt too far toward economic suppression. At the same time, sharply higher reported earnings reminded investors that rates are climbing for the right reasons: because major economies are in a synchronized uptick, employment conditions and consumer sentiment are strong, and businesses are doing very well. In such an environment, it can be difficult to stay out of stocks for an extended period and so the February dip quickly became a buying opportunity.

Whereas the relative tug of war between equities and interest-bearing vehicles is part of the normal ebb and flow of investment markets, the catalyst for Q1's second bout of weakness was far less typical. The Trump administration's decision to open battle lines across the terrain of global commerce – first targeting steel and aluminum with steep tariffs, then broadening its assault to hit China across several industries – evoked bad memories of past trade wars and their very negative implications for economic activity and equity market performance. Because this variable seems to be driven almost entirely by the prevailing moods of a small group of players and the propensity of each side in the skirmish to either escalate matters or acquiesce, it is unfortunately difficult to analyze and incorpor-ate into investment strategy (doubly so, given the current administration's demonstrated habit of shifting policy direction abruptly and departing from initial courses with little forewarning or even ideological consistency). Despite the troubling nature of developments so far, we are none-theless heartened by the following considerations:

- First and most significantly, the value of America's proposed actions against China is small relative to the size of both economies and the volume of trade conducted between them. Economists estimate that, if fully implemented, the impact of the Trump tariffs would amount to as little as 0.1% of China's GDP, while the cost to the US of China's trade response thus far would still be dwarfed by the stimulative benefits of congress's recently passed tax bill and the repatriation of offshore corporate cash expected throughout the year.
- Second, while Mr. Trump's moves have earned him few friends internationally, some of the most potent resistance to his proposed trade impediments has come from within the US itself. Metal users howled in protest against the steel and aluminum tariffs, helping Canada and Mexico to secure exemptions from the restrictions, and in mid-March, 45 trade groups representing many of the country's largest companies sent a letter to the White House urging it not to follow through with its proposed actions against China, claiming that these measures would harm consumers, imperil thousands of American jobs, and potentially undermine the strong growth track on which the US economy currently finds itself.
- Third, with the Republican party already polling poorly ahead of upcoming mid-term elections, the White House may find itself under elevated pressure to find a way to climb down from the largely unpopular position it has assumed (especially given that China's rejoinder has focused on goods predominantly exported from "red" states).
- And, finally, if there's one thing that the past year or so has revealed it's the greater weight that the President seems to place on immediate signals of affirmation above any conviction for travelling difficult roads toward the fulfillment of long term policy goals. Trump perhaps opened a dangerous box when he tweeted frequently that the stock market's appreciation through 2017 should be viewed as validation of the strength of his economic leadership; if that's true, the market has spoken clearly in the negative each time the government has elevated its trade embargo rhetoric.

Without scurrying too far down the rabbit hole of economics, it's also worthwhile to address the contention of certain members of the US government that America is "losing" in the game of international trade. First, a country's trade balance is not analogous to a household income statement, where inflows are "good" and outflows are "bad". For example, deficits in the global exchange of goods with meagre profitability and declining industrial importance (like steel or aluminum) may be compensated for by surplus flows in more dynamic areas, like engineering consulting or aircraft manufacture, which pay better wages, require a highly skilled workforce, and undeniably do more for a nation’s global position.

Instead of being viewed in isolation, a country’s balance of trade should be regarded as just one variable contributing to its economic profile and, with the US economy having grown to the world’s largest since the Second World War, its stock market the most valuable, and its citizens the richest on the planet, it stretches plausibility to call the country a “loser” within the modern framework of global commerce. As the accompanying chart suggests, the average American family has certainly not been imperiled by the expansion of its nation’s trade deficit over the past half century.



Though the executive office of the US government may appear to be willfully blind to the considerations outlined above, some are suggesting that its initial hardline stance may turn out to be a bargaining ploy, with the end goal being revisions to China’s treatment of intellectual property and its habit of requiring transfers of proprietary technology from firms wishing to do business there. Because of the economic stakes at play and the demonstrated ineffectiveness of past forays into trade restriction, we are hopeful that current events will move in such a constructive direction. In fact, the President’s chief economic advisor recently said that the government’s announcements should be thought of as “first proposals” and that it is entirely possible that proposed tariffs will never actually be enacted.

Of course, we will be watching developments closely in the weeks ahead, but for now we believe that the market’s recent wobble will eventually be regarded as an unremarkable detour within the secular bull we’ve described in past commentaries. All the same, if you’d like to discuss these issues further, or review your portfolio’s asset mix and risk profile, please don’t hesitate to contact us.