# ECONOMIC COMMENTARY

July 2018

## The Geo-Political Winds of Change are Blowing

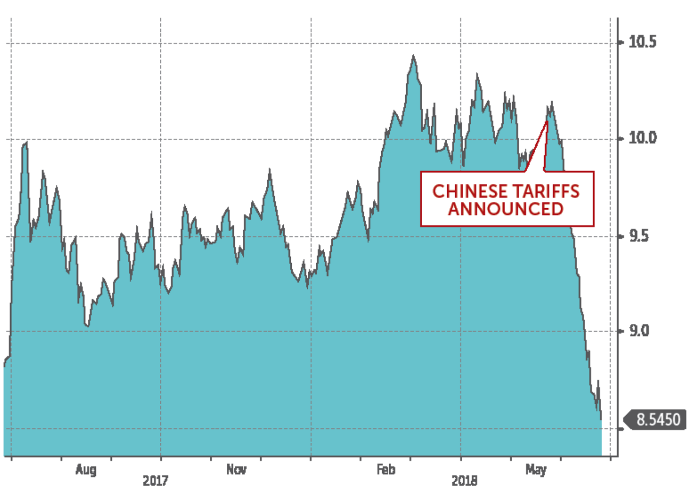
By Mel Miller, CFA® | Chief Economist

In my first quarter Economic Commentary, I stated, "The actions taken the first quarter by the President pose the greatest long-term risk to the economy of any decisions in my lifetime." Specifically, I shared my concern about the newly enacted tax reform bill, which will add $1.5 trillion to the national debt and the imposition of 25% tariffs on imported steel and 10% on aluminum ran the risk of a full-blown trade war.

The identified trade war risk intensified during the second quarter as the Chinese government retaliated by announcing $50 billion on specific imported American goods because of President Trump's imposition of $50 billion tariffs on imported Chinese goods. If no additional tariffs resulted, the macro impact on the U.S. economy would be less than 0.5% reduction in Gross Domestic Product (GDP). While the overall economic impact is small, specifically targeted products will suffer.

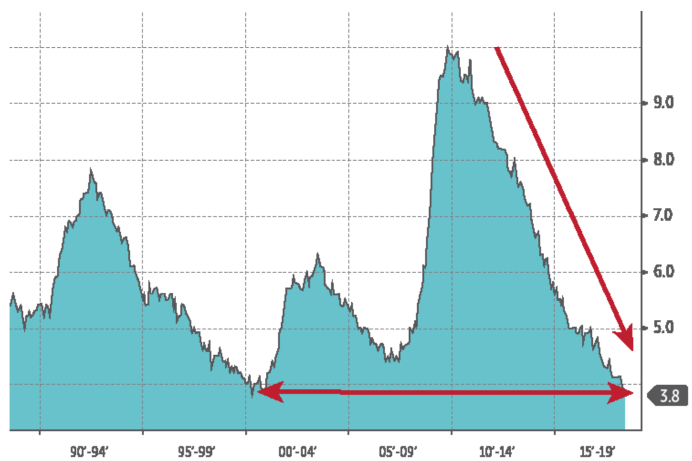
China, for example, retaliated by imposing a 25% tariff on soybean imports, the estimated cost to Iowa farmers is $624 million. The price chart of soybeans for the last year highlights the risk to U.S. farmers of a soybean trade war.

### Soybean Price per Bushel



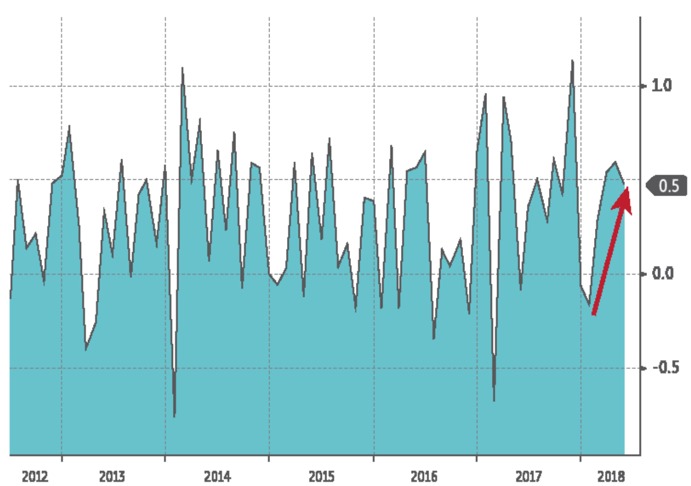

In addition to Chinese retaliation, the European Commission has proposed setting 25 percent duties on U.S. goods, such as orange juice, bourbon, jeans, and motorcycles in response to perceived illegal U.S. action. The U.S. motorcycle company Harley-Davidson recently announced plans to shift some of their production to Europe to avoid the tariffs. Not what President Trump wanted. Canada and Mexico did not sit idly by and accept the new tariffs on their exports to the U.S. by initiating tariffs on specific U.S. exports to their countries.

### Unemployment Rate




While I am still not forecasting a full-blown worldwide trade war, I cannot rule out the possibility. The current administration has a way of surprising conventional thinking, so anything is possible. The imposed tariffs to date, while having a minimal impact on GDP, are never the less inflationary, and will place additional pressure on the Federal Reserve's anti-inflationary techniques.

### Retail Sales Less Food and Autos

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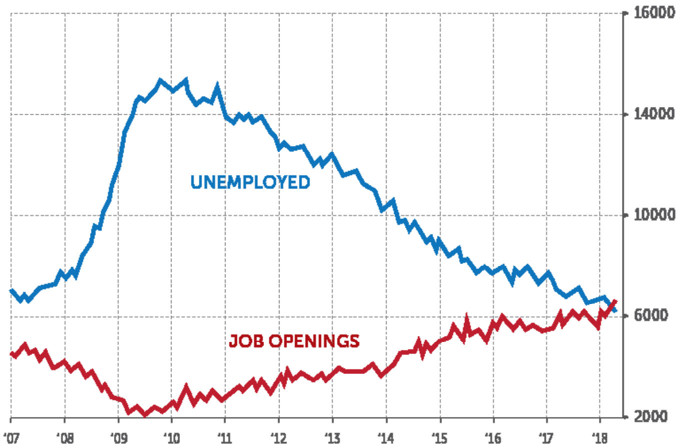
The labor market continued to strengthen during the quarter. The unemployment rate continued to fall reaching the lowest level since April 2000. The last time the unemployment rate has been this low was the 1960s. In fact, the number of unemployed workers is less than the current job openings. Look for upward pressure on wages as employers are "paying up" to attract candidates for open positions.

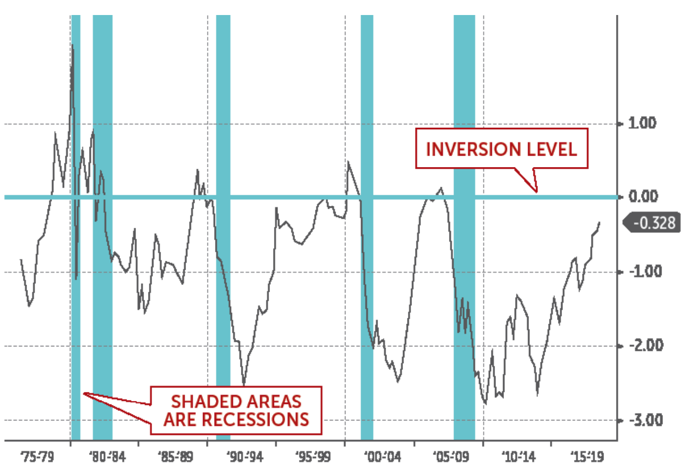
## Unemployment vs. Job Openings




Consumer spending, the lifeblood of the U.S. economy, continues to grow as evidenced by the rebound in retail sales less food and autos. Year over year personal consumption has outpaced income growth slightly, which has resulted in a decline in personal savings. Given the strong labor market, retail sales growth should continue.

Is the nearly 10-year economic expansion approaching the end of the cycle? Is the nearly flat treasury yield curve predicting a recession shortly? These questions currently dominate the financial press, so I feel it is appropriate that I share my thoughts.

## 10 Year - 2 Year Treasury Yield




The current expansion is the second longest in history, but that does not necessarily mean it is nearing the end. Business cycles follow a pattern and the economy is still not showing the typical late-cycle characteristics, such as high inflation and high interest rates. Baring a black swan event, my five-factor recession predictor model is not flashing recession warnings. In fact, only one of the five factors exhibits cause for concern. The treasury yield curve is at risk of inverting–meaning the yield on the two-year exceeds that of the ten-year. As of this writing, the difference is only 32 bps.

The FED has raised short-term rates seven times since 2015 pushing the FED Funds rate from 25 bps to the current 2% to slow the economy and exert downward pressure on inflation. Chairman Powell and the other officials are well aware of the "dangers" of an inverted yield curve, yet they have more ammunition today than ever before. The FED's balance sheet is a new factor. During the 2008 Financial Crisis, the FED bought $4.477 trillion treasury, corporate, and mortgage-backed bonds to stimulate the economy by lowering longer-term interest rates. Starting last fall, they started to unwind their holdings and have reduced the position to "only" $4.319 trillion. I look for the FED to increase the pace of the sales. The strategy would help to put upward pressure on longer-term rates and reduce the risk of an inverted yield curve. The negative side of this strategy is it will also likely raise the value of the dollar which in turn will hurt U.S. exports. Everything comes at a price!

The GDP grew 2% in the first quarter of 2018, but second-quarter economic data suggests the pace accelerated. I am projecting second-quarter GDP growth of approximately 3.5% and would not be surprised if it reaches 4%.

Preliminary June data is not as strong as April-May. The stimulative impact of the Tax Reform Act might have run its course, and the FED's strategy of increasing interest rates is beginning to slow the economy.

I hate to be the bearer of negative news. At this time I do not see a recession on the horizon, but with the current geopolitical situation and rising interest rates, I predict second-quarter growth will mark the highest quarterly growth rate for the next couple of years.

*Mel Miller, CFA® is Chief Economist and a member of the First Affirmative Investment Committee. He monitors economic conditions and market movements, and keeps the firm and its network advisors current on economic issues.*

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*Source of graphic data: Bloomberg*

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