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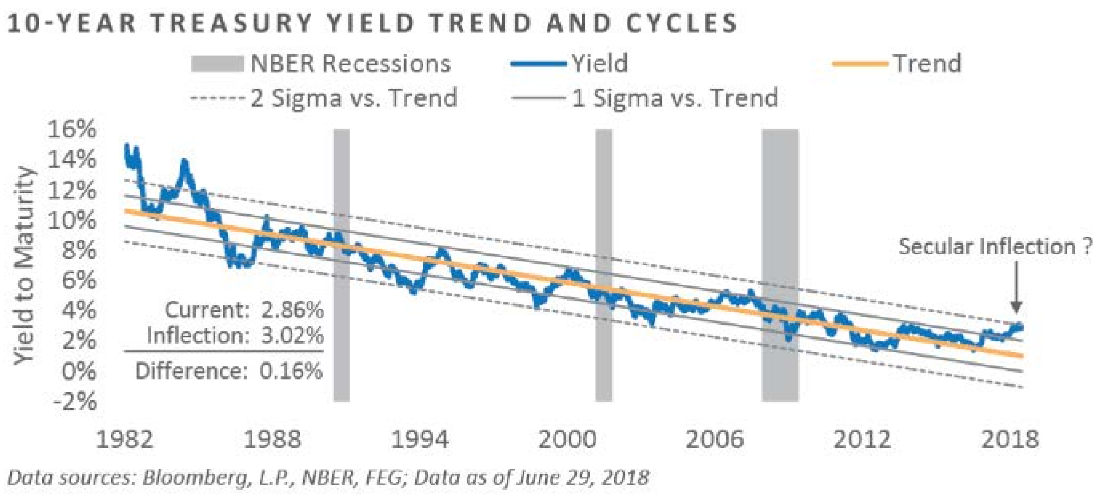
2Q 2018 and Beyond

Tariffs, taxes, and Trump – choose your own adventure

After a roller coaster Q1 that saw volatility return to the global marketplace, headline reactions signified Q2. It seemed that each day read either "Stocks rise as investors shrug off trade war concerns," or "Stocks retreat on renewed tariff fears." On balance, U.S. stocks fared better than international counterparts across growth, core, and value segments. Domestic small-cap indices outperformed large-cap indices, which fits the current administration's "America First" policies since small firms typically earn most or all of their revenues within U.S. borders, whereas about 40% of S&P 500 companies' revenues come from abroad (we also observed this same pattern in Q4 2016 when President Trump unexpectedly won the White House). Furthermore, emerging markets took a beating with tariffs disrupting trade and the strengthening dollar making crucial U.S. imports more expensive.

A reversal of fortune?



The yield on the 10-year Treasury, regarded by some as the most important number in finance, peaked at over 3% in May, fell back to close the quarter at 2.851%, and has held near 2.9% into mid-summer.

While this chart looks busy, the key takeaway is that the 10-year yield has trended downward since the early 1980s. Meanwhile, it is no coincidence that the total debt to GDP ratio for the United States in 1980 was 150%, while in 2018 it stands at 370%.[1] Moreover, consumer spending usually accounts for about two-thirds of U.S. GDP.

The price of bonds and yields have an inverse relationship (for those seeking to better understand the nuances of the relationship between price and yield, please refer to our 1Q2018 Market Commentary that discusses the mechanics in finer detail). Here's why it matters: in reversing its quantitative easing program, instead of buying bonds – which pushed the price of bonds upward and yields downward – the Fed is now allowing bond holdings to mature without replacing them, and this reduction of its balance sheet is ensuing at a historically unprecedented pace: in October 2017, the Fed began reducing the bonds on its balance sheet by $10 billion per month; $20 billion per month starting in January, $30b in April, $40b beginning July; and this unwinding is expected to step up to $50b per month in October 2018. Observe the trend of the 10-year yield since this unwinding began last October:

Trailing 10-year US Treasury Yield as of July 23, 2018

Source: https://www.bloomberg.com/quote/USGG10YR:IND

Clearly, the general uptrend in yield has mirrored the Fed's unwinding schedule. While we can reasonably project that rates may continue to rise, the degree to which the 10-year rate may rise is unknown. This scale of bond sales is historically unprecedented. Moreover, the 10-year yield is a value that the Fed typically cannot directly control as it does with the federal funds rate. The reason the 10-year yield is so significant is because it's a benchmark value upon which many other interest rates crucial to economic growth are set, including mortgages, corporate and muni debt, etc. By extension of this benchmark 10-year figure treading into uncharted waters, it could impact the affordability of housing, for example, should this rate continue to rise. Put simply, cheapening credit has helped fuel growth in the U.S. economy for the past 30+ years. The real questions investors need to consider are, what happens to the market – and your portfolio – in a scenario where mortgage rates increase and consumers have less to spend, or if increasing rates discourage firms from expanding?

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Can the tax cuts stimulate economic growth?

One potential salve may be the Tax Cuts and Jobs Act, a broad-based tax reduction under President Trump, with the thought being that more income saved from tax breaks could spur growth and help offset rising credit costs. Under the Act, the maximum corporate tax rate permanently drops from 35% to 21%, which is certainly healthy for corporations given that the U.S. has long had one of the highest tax rates in the global economy. However, it gets a bit murkier when examining the impact on individuals. According to analyses by the Tax Foundation and the Tax Policy Center, individuals earning in the 80th to 99th percentile would receive a 2.9% increase in after-tax income, while those below the 80th percentile would see an increase of 1.7% (those in the 20th percentile and below would see their income increase by just 0.4%).[2] A key distinction is that the highest-income, upper class Americans have a high propensity to save tend to put excess capital to work through investing, while middle-class Americans have a higher propensity to consume. So while the tax reduction may continue to benefit corporations and their investors, the net effect on their customers, who may be facing higher borrowing costs, is less clear.

Actionable intelligence

While the U.S. is enjoying the ninth year of the present bull market, led by growth stocks in the tech sector, we must remember that momentum investing works until it doesn't. Inflection points are easy to identify in hindsight, but now may very well be the time to take out some value insurance. It is difficult to know when this insurance policy will pay out, but that is the very nature of insurance: protection from a future event that we cannot know in advance if or when it will happen. It is crucial to note that having a strategic asset allocation is what matters. Asset allocation has been found to explain over 90% of a portfolio's variability in returns, with security selection and market timing combining for less than 10%.[3] So while the pulse of markets may jump or fall day to day in reaction to sensational headlines, yours should not. Rather, your time and attention would be best served to looking at longer-term trends and ensuring that your portfolio allocations are best aligned to suit your individual goals and objectives.

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[1] Source: The Investor's Podcast #173
[2] Source: https://www.thebalance.com/trump-s-tax-plan-how-it-affects-you-4113968
[3] Source: https://www.cfapubs.org/doi/pdf/10.2469/faj.v51.n1.1869