Industry Perspectives - Q2 2019

Trade Deals and Central Bank Rate Policies Continue to Influence the Bull Market Run

Overview

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The world's central banks have been extremely reluctant to increase short-term interest rates given persistently sluggish global growth.

For years, nations have used tariffs and regulations to protect internal businesses.

The Fed's challenge in achieving its stated mandate is complicated by the uncertainty surrounding the trade dispute with China and other countries.

Clay Brethour, CFA
President, Buffalo Funds

The S&P 500 Index posted its best 1st half of a calendar year since 1997, rising 18.54% from January 1 to June 30. During the most recent quarter, the Index was in negative territory for the first two months (April and May) then rose 7.05% in the final month, marking the best June since 1955, and finished with a return of 4.30% for the quarter. As we have discussed previously, two main underlying forces – central banks and trade policies – continued to drive financial markets during the period and will likely continue to do so going forward.

Overall, the world's central banks have been extremely reluctant to increase short-term interest rates given persistently sluggish global growth. For the past two years, the U. S. Federal Reserve Bank (the "Fed") has been an outlier in this area, conducting a series of rate increases. However, in a recent reversal, it now appears positioned to begin decreasing rates. This newsletter will be published before Fed Chairman Jerome Powell delivers his semi-annual monetary policy report in mid-July to the House and Senate committees, and while it is impossible to know exactly what he will communicate prior to his presentation, it's highly likely he will reiterate that the Fed's overarching goal is to sustain economic expansion with a strong job market and stable inflation environment. While this is a noble goal and one that, if met, is positive for prolonging the bull market, there are factors influencing those objectives that are beyond the Fed's control.

The Fed's main tool for attempting to meet its goals is managing monetary policy – the setting of short-term interest rates. Although the Fed kept interest rates unchanged at its June meeting, by observing signals in the Treasury yield curve, it is anticipated rates will be coming down in the near future. With the Fed's current short-term benchmark rate target of 2.25-2.50%, it doesn't leave much cushion to reduce rates to stimulate the economy in the event of a recession. However, the market is forecasting that the Fed will cut short-term rates by 1% (100 basis points) through the end of 2020 to a level of 1.25-1.50%.

Historically, the Fed has cut rates by about 5 percentage points (500 basis points) in order to revive the economy during a recession. From the current Fed Funds Rate target of 2.25-2.50%, it would only get about halfway there before hitting zero and potentially needing to launch another round of bond-buying and/or applying other unconventional monetary policies to stimulate the economy. While we do not believe the economy is heading into a contraction as experienced in 2008-09, we are seeing the Fed revise their assessment of a "neutral" policy rate to a lower absolute level when compared to historical standards. The persistent lack of inflation is one of the reasons leading to this recalibration of traditional monetary policy. The ability to reduce short-term rates to stimulate the economy is a luxury the U.S. possesses, compared to other countries' economies that are already in, or near to, negative yield territory.

While monetary policy is very important to economic growth, there is another underlying factor of which the central banks have no control – trade policies between nations. Trade policies will continue to be the wildcard that will gyrate the financial markets back and forth, depending on the tweets and media stories of the day. Nonetheless, tariffs need to be viewed within the proper perspective, based upon their impact to the U.S. compared to other nations.

The U.S. accounts for nearly 25% of the world's Gross Domestic Product (GDP) and is the largest export destination for China, India, and Germany, and the second-largest export destination for Japan. These 4 major economies are heavily dependent on exports – nearly half of Germany's GDP comes from exports. Therefore, a global decline in demand has the potential to affect their financial systems, employment rates, and even internal political dynamics.

The U.S., by comparison, is fairly insulated from the global economy. Only about 13% of our GDP comes from exports, and nearly half of those goods and services go to our neighbors Canada and Mexico. All three North American countries are in the process of ratifying a new trade deal that was negotiated and signed last year.

Therefore, tariff uncertainty is having more of an impact on countries outside North America. Mario Draghi, the President of the European Central Bank, recently told the European Union that additional monetary stimulus and more expansionary fiscal policies may be needed to overcome persistent economic weakness, largely because of pervasive uncertainty in global trade. Meanwhile, China's economy is also struggling as its population base isn't wealthy enough to offset lost exports through increased domestic consumption. While we don't want to minimize the impact of tariffs on the U.S. economy, through our discussions with company management teams, we understand that there is a negative impact to company margins. Our point is that, on a relative basis, the overall economic impact is more acute to foreign exporting nations.

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For years, nations have used tariffs and regulations to protect internal businesses. It isn't necessarily a new idea that governments have developed in the Age of Nationalism.

As the 2nd quarter came to a close, the U.S. and China reached a tentative "cease-fire" agreement in the trade war. The U.S. agreed to delay potential new tariffs on at least $300 billion in Chinese goods, and in turn, China will back off its threat to restrict exports of rare-earth elements to the United States. Trade negotiations are expected to reopen after U.S. President Donald Trump and Chinese President Xi Jinping met at the G-20 Summit in Japan.

As stated in our March newsletter, we continue to believe that a trade deal with China will be forth coming within months, but "ending" the trade war will mean something quite different to each side. China would prefer that all tariffs be lifted immediately. However, with China's history of backsliding on negotiated deals, the U.S. will likely demand that the current tariffs remain and the lifting of tariffs occur incrementally as evidence of compliance to the agreement is substantiated.

Trade deals are difficult to monitor and enforce, so Washington needs to hold on to at least some leverage to ensure that the Chinese follow through. President Trump announced at the end of June that if negotiations once again stall and the U.S. moves forward with new tariffs, they may only be 10% and not 25% as previously threatened.

This reduction in tariffs ostensibly would still help nudge Beijing toward more painful concessions, while lowering the risk of inadvertently tipping the U.S. economy into recession or sparking political backlash. This option potentially allows the U.S. to keep pressure on China long enough to deny Beijing the strategy of simply trying to wait out the U.S.

It makes sense for the U.S. to hold its fire at this stage. The self-inflicted economic costs of tariffs on Chinese exports could be material, as evidenced by the multitude of companies filing protests at the recent Commerce Department's hearings on potential new tariffs. A cease-fire, moreover, is hardly the same thing as a trade deal, so the possibility that the U.S. may eventually make good on its threat will still be hanging over Beijing's head, giving Beijing reason to make greater concessions to U.S. demands whenever negotiations resume in earnest. From a tactical perspective, what the U.S. wants most is leverage, and it arguably gets more by threatening tariffs than it gets by imposing them, considering the political and economic damage that could occur.

The Fed's challenge in achieving its stated mandate is complicated by the uncertainty surrounding the trade dispute with China and other countries. Any changes in interest rates will likely have minimal impact to the overall economy, compared to any sudden change in the outcomes of the current trade disputes. While equity investors should enjoy the sizable total returns year-to-date, the past several months have produced increased market volatility. This volatility might be amplified going forward as companies provide financial guidance on the impact of higher costs that tariffs are having on their businesses. Regardless, we recommend investors stay the course, as we believe that stocks will continue to have a runway for growth into 2020.

Clay Brethour, CFA, is the President of the Buffalo Funds and has been an investment professional since 1992. He joined KCM in 2000. At the Buffalo Funds, Clay works with equity portfolios and his focus areas include healthcare, industrial and material sciences, energy technology, and consumer discretionary sectors.

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For questions or to speak with a relationship manager about adding any of the 10 Buffalo Funds to your portfolio, contact:

Christopher Crawford
ccrawford@buffalofunds.com
(913) 647-2321

Scott Johnson
sjohnson@buffalofunds.com
(913) 754-1537

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