GREENLEAF TRUST

# Perspectives

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## Economic Commentary

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Happy New Year! It is my hope that you had a wonderful 2018 and that 2019 will once again present many fabulous opportunities for you and your families. December proved to be a challenging month for investors, as all of the gains made earlier in 2018 were stripped during the 14% reduction in nearly all of the popular equity averages. What seemed to be on the minds of investors as volatility grew and sellers ruled the day for most of December? The most recent meeting minutes of the Federal Open Market Committee (FOMC) left those most concerned about a recession in the near term with two conclusions. First, the new rate hike was unwarranted and would have an impact on consumption large enough to turn GDP negative. Secondly, the meeting minutes as well as the comments of Fed Chair Powell suggested the economy was slowing and that the Fed was revising their September estimate of 2019 GDP growth to 2.3% from the original 2.5%. By themselves neither of these perceptions should have created a 14% repricing of equities, but piling on to the Fed's comments was the release of China's manufacturing activity, which declined at a rate much greater than expected. Finally, there began to be whisper numbers surrounding a revision downward for Apple's revenue forecast for 2019, which many have come to see as a proxy of the US economy.

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For many years, you may have read that the equity markets are a leading indicator of the future economic cycle, and therefore, those that subscribe to this theory are more prone to sell into market declines — especially in the face of what they believe to be deteriorating economic news. The relationship between market declines and GDP reversals is not perfect, though significantly higher than that of economists' forecasts. At Greenleaf Trust, we prefer to focus on the most relevant ten leading indicators, of which market performance is only one. As previously mentioned in several columns by myself, Nick Juhle our Director of Research, and Chris Burns our Investment Strategist and Senior Fixed Income Analyst: 1) the inversion of the yield curve, 2) retail sales and 3) employment are fairly reliable in forecasting economic downturns — though no one indicator is sufficient to call the trend or direction. Should all three deteriorate in symmetry, our concern would indeed be heightened.

Currently, the inversion of the yield curve has received the most attention by institutional investors as it tends to be a reflection on the perception of the future as seen through the eyes and minds of the bond market. Normally, in times of GDP growth, the yield curve is neither flat nor inverted. Flat would be a condition that exists when the short end of the market (Fed Funds Rate) is not significantly lower than the five, ten and thirty-year Treasury. Currently, the ten-year Treasury rate is near par with the Fed Funds rate. In a normal fixed income market, investors should be paid more to take on rate and maturity risk. This condition only exists if the supply and demand side of the market allows it to exist. Traditionally, bond buyers keep their investments short in duration when they don't trust the future of economic growth and believe that the Fed will reverse course to once again increase money supply to stimulate a stalled economy.

China's economy is important to our GDP, but by no stretch is it important enough for the market volatility that was created by the release of the Chinese manufacturing activity data. China has been in a long term reduction phase in its GDP rate of growth. The peak of GDP growth was reached in China nine years ago at 11%. The current expectation of GDP growth for China in 2019 is 6.3% which will be down from the estimated 6.6% in 2018. While it isn't possible to precisely measure the GDP impact on net exports for the US, given a small decrease in the Chinese GDP forecasts for 2018, most analysts see this number as a 1/10th of one present increase in net exports, which translates to far less than that in actual US GDP.

On January 7, our Greenleaf Trust research team will present a series of seminars for clients and friends of Greenleaf Trust. This seminar series is conducted annually to review what occurred in 2018 and also present our forecast on what we expect to happen in 2019. We will offer summaries of that seminar in our printed materials, newsletters and website postings. During that seminar, we will revisit the context of our GDP make up and I think it is relevant for this discussion as well. We estimate that the 2018 US total economy will be $20.7 trillion when all is said and done. For many years, while the aggregate has changed, the percentage of each major component has remained consistent: consumer spending, 70%, business investment, 18%, government, 17%, and net exports -5%. GDP calculation has always been calculated as Consumption + Investment + Government + Net Exports (Imports-exports).

The movement required in any of these categories to change the aggregate growth rate substantially in either direction must be significant. Clearly, the category that has the largest potential of impact is consumption. As we have stated many times before, the consumer is employed, has received real wage increases for the first time in a decade, has not decreased savings as a consequence of spending and in all measures on major consumer confidence surveys remains optimistic about their economic circumstances. Unless and until this condition changes, the $14.5 trillion that was spent on consumption in 2018 and the $14.9 trillion forecasted to be spent on consumption in 2019 will drive whatever GDP growth we experience.

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A small increase in net exports (more imports than exports) will not change our condition nor will any increase or decrease in business fixed investment. One could, and I certainly have for some time, argue that government spending should decline or government revenue should increase to make progress on closing the budget deficit increases occurring annually.

Attorneys like to argue around a common set of facts. The deficit common set of facts are quite simple. Our government will spend, as a portion of GDP, $3.8 trillion. Our government will receive $3.2 trillion in revenue. The difference will be added to our national debt, for which we will pay interest. The economic impact of government spending reductions and/or increased revenue (tax) is that both are, in the short term, negative inputs for the economy — and therefore, take significant political courage and will. Republicans have traditionally been deficit hawks, but since their party now controls the executive and senate branches of government they have lost all appetite for spending reductions or fiscal control. Democrats who have sought more revenue through increased taxation will know that they have earned the control of the House, seek legislation for tax increases that will pay for what they believe is a renewed healthcare mandate. The legislative vote total numbers work for neither party as both must seek allies across the aisle to achieve their desired legislative goals. With that reality in mind, it seems certain that 2019 GDP is not likely to be impacted by either government spending or tax increases.

Trade policy is important, but in reality changes gross GDP impact only around the margins. We are a mature economy and so are the majority of our trading partners. Trade policy must be fair and equally benefit all partners, as we are a mature economy needing them as they need us.

Tariffs are a fool's folly when not a structural part of agreed and negotiated fairness. A tariff-free world benefits size and scope economies, but will always be lobbied against by many special interests in every country, and thus, we are likely never to be without them. One only needs to look at the net export component of our aggregate GDP to realize that even significant tariffs on industry specific product will not move the GDP needle. The discussion is clearly about the nationalistic movement increasingly present in the US and industrialized Europe, but serves no comprehensive economic benefit in either the near or far term, and thus, while tariffs may appeal to a political base, they have a very small input to GDP.