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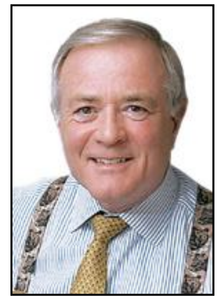

William Rutherford

Markets near new highs; rally could be running out of steam

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Continuing a long-term rally that started in July 2009, equity markets have powered upward. The Dow Jones, S&P and NASDAQ trade near all-time highs. The recovery has been slow, but showed strength in the face of adversity several times, in particular getting wind under its wings with the surprise victory of Donald Trump as president. During his campaign, Trump made many promises, among them repealing and replacing the Affordable Care Act, tax reform and reduction of taxes, less regulation and repatriation of money held overseas. The market liked what it heard and began a powerful addendum to the existing rally.

At the same time, the global economy was recovering, which further added to the strength of the U.S. rally. But then the failure of the Republicans to pass a health care bill caused some observers to question the ability of Republicans to pass their other legislative goals, and doubts about Trump's leadership skills set in. While optimism waned a bit, the economy powered on. The markets took strength from increasing corporate profits – 11 percent greater year over year through the second quarter of 2017.

The market worried that exogenous events might upset the trend. For instance, North Korea's frequent missile lofts were a worry. In a period of 24 hours, North Korea sent a missile over Japanese territory and a powerful hurricane struck Texas with untold damage. At the opening of the market on that day, the Dow was down 150 points, but settled the day up 50. So powerful has been the recovery that not even two calamities in one day could derail it.

The hurricane was a gift to President Trump; it provided the opportunity for him to divert attention from negative news. However, as headlines shifted back to tax reform, the markets again had to worry about deadline extensions and vague proposals. It began to look like the Republicans were running into the same problems they had with health care: too many proposals and not enough leadership. The Republican caucus was divided on what to do. The White House provided platitudes. Confidence in the Trump agenda began to erode. The markets stalled in August and entered September without enthusiasm.

The markets also had to contend with concerns about the impending federal debt ceiling, which must be raised by Congress to avoid a government shutdown at the end of December. The president commented that shutting down the government might be a good thing. The bond market did not agree.

As market enthusiasm started to flag, the dollar continued its decline and is now down about 20 percent since the Trump election – about as much as the market is up. The weak dollar looked to be a good thing for business, bolstering international sales and revenue. The dollar weakened even as the Federal Reserve contemplated interest rate increases. But if the economy needs bolstering after the powerful hurricane, raising interest rates would be counterproductive, and even a rate decrease might be indicated.

In the meantime, the president now contemplates a change of the Federal Reserve chairmanship. His preferred choice seems to be a former executive and investment banker from Goldman Sachs, Gary Cohn, which would further cement Goldman's influence on the U.S. monetary system. However, Cohn has been under a lot of pressure from colleagues and friends to quit advising Trump after the president issued incendiary comments about the Charleston riots. Cohn said he would not remove himself from consideration, but cautioned Trump about his comments.

Trump does not take lightly to criticism, so Cohn may no longer be the favorite candidate. All this turmoil only makes sense if you keep in mind that Cohn was a banker, and not an expert in monetary policy. The job of Federal Reserve chairman is primarily about monetary policy. As we have said previously, we cannot have a policy accident and Trump's approach might well lead to one.

As we go to press, North Korea says it has detonated a hydrogen bomb that it can deliver with an ICBM. The same day, President Trump announced that he wants to break off trade relations with our South Korean ally. To date, he has withdrawn from the Trans-Pacific Trade Partnership, ceding Southeast Asia trade to China, and threatened to leave NAFTA – our trade agreement with Canada and Mexico. Both Japan and Germany have said they will have to work around him. Congress is heading in that direction. We and Trump may soon find ourselves isolated from friends and trade. Yet the U.S. economy has shown resilience in the face of all this turmoil and we believe will continue to do so. Recent GDP numbers suggest strong growth. Stay invested and remain diversified.

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