DJC
THE DAILY JOURNAL OF COMMERCE, PORTLAND, OREGON


William Rutherford

Federal Reserve buys insurance; market drops anyway

Published August 9, 2019

With the broad stock market up 17 percent year to date, the U.S. would seem to be on strong economic footing. Job growth is robust, profit growth is good enough, unemployment is low and consumer confidence is strong. So what is so wrong that the Federal Reserve was prompted to cut interest rates? Interest rate cuts are usually reserved for a weak economy.

There are numerous reasons. The president mounted a campaign to get the Fed to cut rates, which worked. The Fed was intimidated into cutting rates, because the financial markets came to expect a cut and actually demanded it. How can a market demand anything, let alone a rate cut? Well, when the financial markets bet that interest rates will go down and rate cut expectations go up, the Fed is in the crosshairs. The president's demand clearly influenced the Fed.

Why did the president want a rate cut? The short answer is that it was good for his reelection prospects. The president has enjoyed the benefit of a strong economy, but with his favorability numbers still weak, he wanted some insurance.

Adding fuel to the fire, the president's tariff wars are taking their toll. He promised that trade wars are "easy to win," but they are proving to be anything but. Instead of working through existing trade agreements, the president opted to tear them up, bypass our trade allies and go head to head with China.

The president found the Chinese intransigent. That should not be a surprise to anyone with even the slightest knowledge of China. After all, China has a culture built over thousands of years as well as a long history of intimidation by western powers. The Chinese are quite proud of the progress they have made and their victory over their opponents in the great revolution. They have stated that they will not back down. It is a good idea to listen to one's negotiating rival.

Diplomacy might have worked, but we will never know now. It will take years to recover.

So, as the U.S. backs away, it looks to save face. The Chinese know they have the upper hand and have adopted a strategy of running out the clock. Our president knows this and ramps up the rhetoric.

So far, during this trade war, market values have dropped by more than a trillion dollars. According to Barron's the cost of the tariffs will outweigh any benefit from the tax cuts.

As the U.S. economy appears to continue growing, storm clouds gather. Economic growth in the U.S. is not what was promised, and global economic growth is slowing. Other nations have been forced to reduce interest rates to buoy up their economies. This effectively makes the dollar relatively strong and reduces our exports, hurting businesses and farmers. Trade conflicts have dampened growth throughout the world and are not helping at home either. We have the very odd circumstance of our Federal Reserve cutting rates to buoy up a very strong economy as our government's trade policies are threatening that economy. The Federal Reserve, recognizing that global and U.S. economies are weakening, is forced to backstop policies it does not agree with so things don't get worse. So the president bashes the chairman of the U.S. central bank to get his support for the trade war.

So how does this trade war end? We have ideologues in both the U.S. and China who are not prepared to give an inch. We could arrive at a point where the parties agree to disagree. But at this juncture, the Chinese are still ahead on points, and the U.S. probably will not want to give up on the game. Like a gambler that is behind, the U.S. may make riskier decisions. So we will probably end up with a long protracted period of meaningless negotiations until the clock runs out.

The U.S. thinks it has the upper hand, but it doesn't. China believes it is winning, so it won't quit either. The trade wars have now morphed into currency wars, in which there are no winners.

This will only end with the 2020 U.S. presidential election. It will provide a referendum, not on the China policy, but on the economy. Right now the president holds a winning hand.

According to the stock trader's almanac, in the years preceding presidential elections, since 1971, the span of July through October is the worst four months. The Dow Jones industrial average and the S&P index have tended to peak in July, bounce around for the next few months and then drop in October, ending in losses by Halloween.

But then, according to the same data, the Dow and S&P rally into year end.

What does one do as an investor? Invest long term in a diversified portfolio. One could try to avoid all China exposure, but that is very hard, and the whole issue could turn quickly. So, just stay focused on the long term. It will be volatile and it may take your breath away, but market timing doesn't work. What does work is a long-term strategy in a diversified portfolio. Get your asset allocation, stocks, bonds, cash, real estate and gold (if any) right, and about 70 percent of your returns will come from that decision.

William Rutherford is the founder and portfolio manager of Portland-based Rutherford Investment Mgmt. Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com. *Information herein is from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. Investment involves risk and may result in losses.*