Weekly Market Flash

A Second Half of Contradictions

July 6, 2018

The financial news headlines on this, the first Friday of the second half of 2018, seem fitting. Appropriately contradictory, one might say, providing a taste for what may lie ahead in these next six months. First, we have news that Donald Trump's splendid little trade war is happening, for real now! Tariffs have been slapped on the first $34 billion worth of products imported from China. On the other side of the ledger, an American ship full of soya beans was steaming full-on to reach the Chinese port of Dalian in time to offload its supply before facing the retaliatory tariffs mandated from Beijing. Too bad, so sad, missed the deadline. Apparently the fate of the ship, the *Peak Pegasus*, was all the rage on Chinese social media. The trade war will be Twitterized.

The second headline today, of course, was another month of bang-up jobs numbers led by 213K worth of payroll gains (and upward revisions for prior months). Even the labor force participation rate, a more structural reading of labor market health, ticked up (more people coming back into the jobs pool is also why the headline unemployment rate nudged up a tad from 3.8 to 4.0 percent). Hourly wages, a closely followed metric as a sign of potential inflation, recorded another modest year-on-year gain of 2.7 percent.

So there it is: the economy continues to carry on in good health, much as before, but the trade war has moved from the theoretical periphery to the actual center. How is this going to play out in asset markets?

Manufacturers Feel the Pain

The products covered by this first round of $34 billion in tariffs are not the ones that tend to show up in Wal-Mart or Best Buy – so the practical impact of the trade war will not yet be fully felt on the US consumer. The products on this first list include mostly manufacturing components like industrial lathes, heating equipment, oil and gas drilling platform parts and harvester-thresher combines. If you look at that list and think "Hmm, I wonder how that affects companies like Caterpillar, John Deere and Boeing" – well, you can see for yourself by looking at the troubled performance of these companies' shares in the stock market. As of today those components will cost US manufacturers 25 percent more than they did yesterday. That's a lot of pressure on profit margins, not to mention the added expense of time and money in trying to figure out how to reconfigure supply chains and locate alternative vendor sources.

Consumers Up Next

The question – and probably one of the keys to whether this trade war inflicts real damage on risk asset portfolios – is whether the next slates of tariffs move from theoretical to actual. These are the lists that will affect you and me as consumers. In total, the US has drawn up lists amounting to $500 billion in tariffs for Chinese imports. In 2017 the US imported $505 billion from China – we're basically talking about the sum total of everything with a "Made in China" label on it. Consumers will feel the pain.

If it comes to pass. The collective wisdom of investors today has not yet bought into the inevitability of an all-out trade war. US stocks are on track to notch decent gains for this first week of the second half. The job numbers seem to be holding the upper hand in terms of investor sentiment. Sell-side equity analysts have not made meaningful downward revisions to their sunny outlook for corporate sales and earnings. Sales for S&P 500 companies are expected to grow at a rate of 7.3 percent this year. That reflects an improved assessment from the 6.5 percent those same analysts were projecting three months ago – before the trade war heated up. The good times, apparently, can continue to roll.

Since we haven't had a global trade war since the 1920s, we can't model out just how these tariffs, in part or in full, will impact the global economy. Maybe the positive headline macro numbers, along with healthy corporate sales and profits, can power through this. Perhaps the trade war will turn out to be little more than a tempest in a teapot. We may be about to find out.

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