WELLS TRECASO
FINANCIAL GROUP

Portfolio Talk
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"Prayer of the Modern American:

Dear God, I pray for patience and I want it right now!"

–Oren Arnold

I want a trade agreement with China and I want it right now! Kind of makes me a modern American right? However, as President Theodore Roosevelt said, "Nothing in the world is worth having or worth doing unless it means effort, pain and difficulty." And that is where we are now with our negotiation with China. Intuitively, we all know that China has taken advantage of the rest of the world by stealing intellectual properties, forcing joint ownership of businesses that are established there, forced tariffs causing import products to be priced unfairly, and these are just a few of the unfair practices identified. What's worse is that this has been known and going on for decades, starting in 1978 when China introduced far-reaching economic and social change.[i] So why is it so important to take a stand? Several reasons why, but the most glaring are:

- China's autocratic society poses a potential threat to the region.
- China's footprint on the global economic stage is a force.
- China's admitted plan to become the largest economy in the world by 2050![ii]

Quite scary at how far they've advanced in such a short period of time. But why is this such a concern? Most believe the concern is centered on point #1. When an economy is not free and is controlled by the government, power has one objective, to stay in power. Trade and government policies become one and the same. An example of this was when Russian invaded Ukraine. Russia needed a seaport so it could occupy the Black Sea with a fleet of ships. Russia, being a pseudo capitalist country, was supplying natural gas to Ukraine under an agreement established when Russia broke apart. When Ukraine decided to form a union with other nations to receive natural gas from the European Union, Russia warned them that this act would violate their agreement and Russia responded by invading Ukraine with soldiers baring no insignias on their uniforms and denying their act of war. Eventually Russia was not able to cover their act and occupy the Ukraine to this day. Autocratic regimes can act in ways that are not free market oriented or democratically motivated. If steps are not taken now to slow the aggressive and threatening advances made by China, what actions could we face if they felt a neighboring country was acting against their best interests? Could this lead to a potential WWIII? Most wars are started because of greed; commodities (oil), land, gold, etc. Better to put our stake in the ground now.

Now comes the pain and difficulty.

Pain: Look for some slowing in corporate growth, especially in products that contain metal, electronics, and building supplies. These are the larger imports from China and have a 10% tariff growing to 25% the beginning of 2019. Also, another potential concern would be if China enacted the "nuclear event". This would happen if China chooses to stop buying US Government debt along with dumping the more than $1.15 trillion they own. This act would cause rates to increase and possibly push our economy into recession!

Difficulty: Patience is needed now that the ball is in play and hopefully we can find a resolution sooner than later. Negotiating with China is and will be different and more difficult than the agreements we've secured with our neighbors to the north and south. However, China's economy is more dependent on ours than ours is on theirs. How much? In 2017 China's trade with the U.S. was $505.5 billion vs. U.S. trade to China was $129.9 billion. What's more relevant is the trade deficit is $375.6 billion ($505.5 billion-$129.9 billion).[iii] These deficit dollars can be used to buy U.S. investments on the "cheap" and avoiding currency exchange risks. What assets: China's been accumulating real estate, companies, equities & U.S. Treasuries. Not a real concern unless the percent of ownership gives them too much leverage on our economy, then refer to point #1 mentioned above.

Economy

So where do we go from here? Markets have been a little more volatile the beginning of October, something we haven't seen since February. We believe there are two factors at work:

- Interest rates spiked after comments from Jerome Powell, chairman of the Federal Reserve, referenced the possibility of 4-5 more Fed Fund Rate hikes. He also mentioned increasing fed fund rates to as much as 50 basis points beyond normal! Fear rippled through the markets, fear that this kind of rapid rise could cause our economy to slip into recession.
- Tougher trade talk from China on reaching an agreement causing some $200 billion of Tariffs to take effect.

Are these valid concerns: Partially, but only if the extremes happen. Take increasing fed funds, the Federal Open Market Committee (FOMC) who determines the direction of rates relies on economic data issued regularly to influence their decisions. I find it hard to believe that these voting members of the Federal Reserve would increase rates if the economy started to slow! That is exactly the opposite of the policy they're implementing. The reason for the increases so far are to normalize rates so "if" the economy softens they can turn around and lower rates to stimulate growth.

The China trade talks are kind of different given the "Save Face" attitude of the Chinese. We believe an agreement will have to have the appearance that

China won some concessions and definitely didn't lose. Will this happen, we believe so.

But going back to the real motivator of equity markets, earnings are continuing to improve. So far with companies that have reported, 82% have beat estimates with revenue up 8% and earnings up 25%! S&P 500 earnings are projected to top $159.00 per share in 2018 and $170.00 in 2019 according to Jill Carey, strategist at Bank of America Merrill Lynch. With the S&P 500 trading at approximately $2,785 today, the Price/Earnings Ratio is 17.5X for 2018 and 16.4X 2019. Both are not expensive! Average since 1926 is 16.8X and markets rarely trade at average, they're either above average (positive economic outlook) or below average (negative economic outlook). The U.S. GDP grew at 4.2% annualized in the third quarter and is projected to be close to the same in the 4th quarter, unemployment at 3.7% last month is the lowest in decades and business sentiment is at decade highs…I believe these are positive indicators providing a greater than average P/E multiple pathway!

[i] "China's four-decade route to the world's No 1 economy" by Peter Wong 4/2/2018.
[ii] "China's four-decade route to the world's No 1 economy" by Peter Wong 4/2/2018.
[iii] The People's Republic of China – Office of the US Trade Representatives dated 10/15/2018.

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