DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter

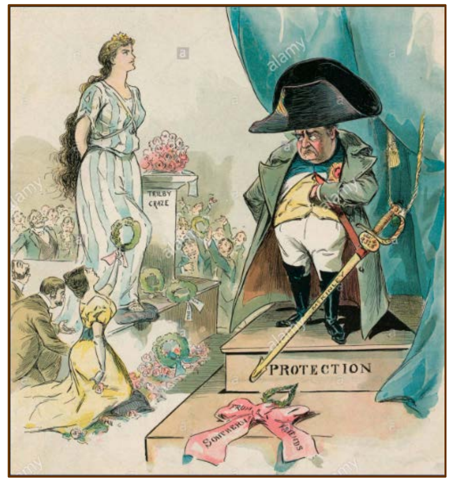
Q3 2019

July 2019

Tariff-ied

"Our past experience shows that great prosperity in this country has always come under a protective tariff."
-President Theodore Roosevelt, 1902 State of the Union Address

"Trade wars are good, and easy to win."
-President Donald Trump



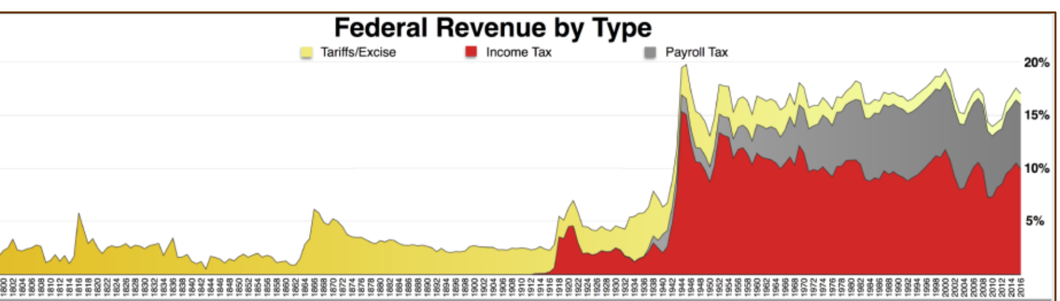
In January, 2018, the first bullets fired in the various trade wars between the U.S. and the rest of the world were in the form of tariffs on solar panels and washing machines. Shortly thereafter, in a tweet announcing additional tariffs on steel and aluminum, President Trump invoked the names of former President William McKinley and Tesla CEO, Elon Musk, to show both support and historical justification for his actions. Never were two more polar opposite personalities quoted in a single sentence, but the references were appropriate. The ink was barely dry on the Constitution when Alexander Hamilton began using protective tariffs to help foster the growth of 'infant industries' much like the technology companies of Musk today, and President McKinley was known in the 1890s by monikers such as the "Napoleon of Protectionism" and "Mr. Tariff."

Today, trade wars are much more nuanced than they were in the days of McKinley. Sanctions are used for political gain; countries manipulate their currencies to counterbalance the adverse economic impact of a tariff; and subsidies or special tax benefits are granted to protect many domestic industries. The mass use of these tactics is currently on full display, dampening world economic growth. Despite this headwind, domestic equities are hitting records thanks, in part, to a Fed that has assured the investing public that it stands ready and willing to lower interest rates to bolster a flagging ~~stock market~~ economy. But will the actions of a dovish Fed be able to counteract the headwinds created by trade tensions or should investors be tarriff-ied?

Tariffs Out, Income Taxes In?

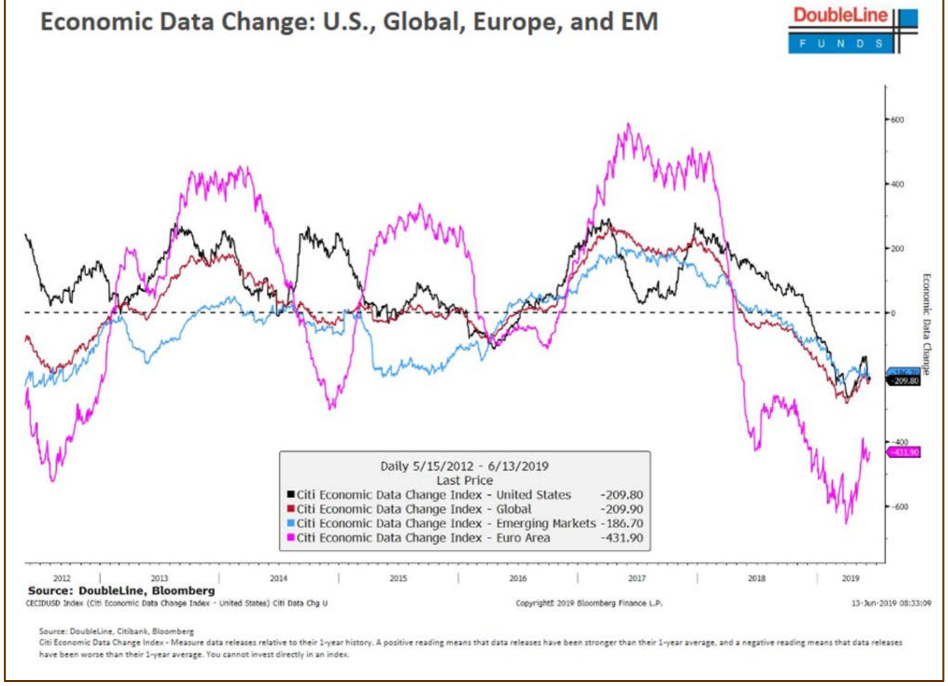
Political leaders in America, as far back as Washington, believed that political independence and national security were predicated upon economic independence. Tariffs were widely used as a tool to ensure the increase in domestic supplies of manufactured goods, including war materials. And it worked! An economic framework that included no estate or income tax, almost non-existent labor laws, a thrifty hard-working labor force, few societal barriers to entry, plenty of natural resources and, of course, inordinately high tariffs were the foundation for the U.S. economic miracle in the second half of the 19th century. In the late 1800s, the first 'Mr. Tariff,' William McKinley, was the poster child for American isolationism. In an ironic twist of fate, he gave the final speech of his life in 1901 calling for an *end* to the very tariffs he supported most of his political life. Twelve years later, the Federal Income Tax Law was passed and tariffs ceased being the main source of revenue for the Federal government (Chart 1)[1].

Chart 1



Synchronized Global… Slowdown

Chart 2



Supporters of America's isolationism past would be interested to know that tariffs are back in vogue. Over the past 18 months, trade tensions across the globe have become heightened. Coincidentally, during the same period, the world economy has gone from a state of 'synchronized global growth' to one with rapidly falling momentum. *The New York Times* believes that trade wars are "chilling business investment, confidence and trade flows across the world, a development that foreign leaders and business executives say is worsening a global economic slowdown that was already underway."[2] It is not far-fetched to assume that weakness in one country, driven by a fallout from the trade war, might spread to others as supply chain costs rise and business leaders delay decisions on capital expenditures and investment growth. Simply put, slowing economic activity is a common side effect of trade wars.

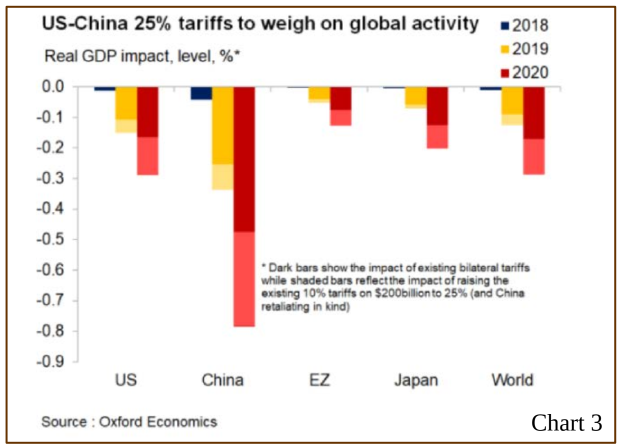
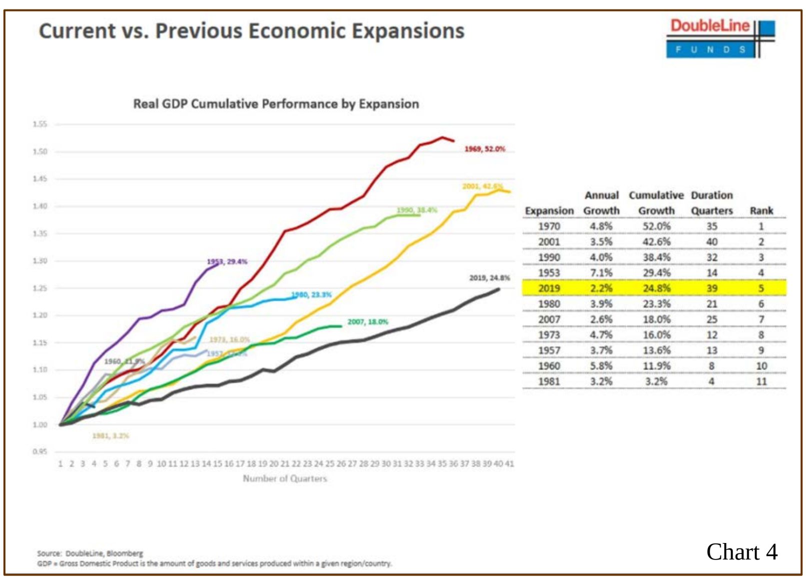


Chart 3

Battle of the Titans

While trade tensions are occurring across the globe, all eyes are focused primarily on the conflict between the world's two largest economies, US and China. According to Ben May of *Oxford Economics* the new tariffs only trimmed ".1 percentage points off his global GDP growth forecasts for this year and next to 2.7% and 2.8%," in part, due to the conciliatory tone struck by U.S. and Chinese policy makers at the G20 summit in Osaka, Japan at the end of June. However, if the U.S. escalates the trade war further from here and "levy 25% duties on the remaining $300 billion in Chinese imports not yet subject to a penalty" it is clear that the whole world will severely suffer, but "China will fare far worse than the U.S." according to the simulation from *Oxford Economics* simulation in Chart 3.



Expansion	Annual Growth	Cumulative Growth	Duration Quarters	Rank
1970	4.8%	52.0%	35	1
2001	3.5%	42.6%	40	2
1990	4.0%	38.4%	32	3
1953	7.1%	29.4%	14	4
2019	2.2%	24.8%	39	5
1980	3.9%	23.3%	21	6
2007	2.6%	18.0%	25	7
1973	4.7%	16.0%	12	8
1957	3.7%	13.6%	13	9
1960	5.8%	11.9%	8	10
1981	3.2%	3.2%	4	11

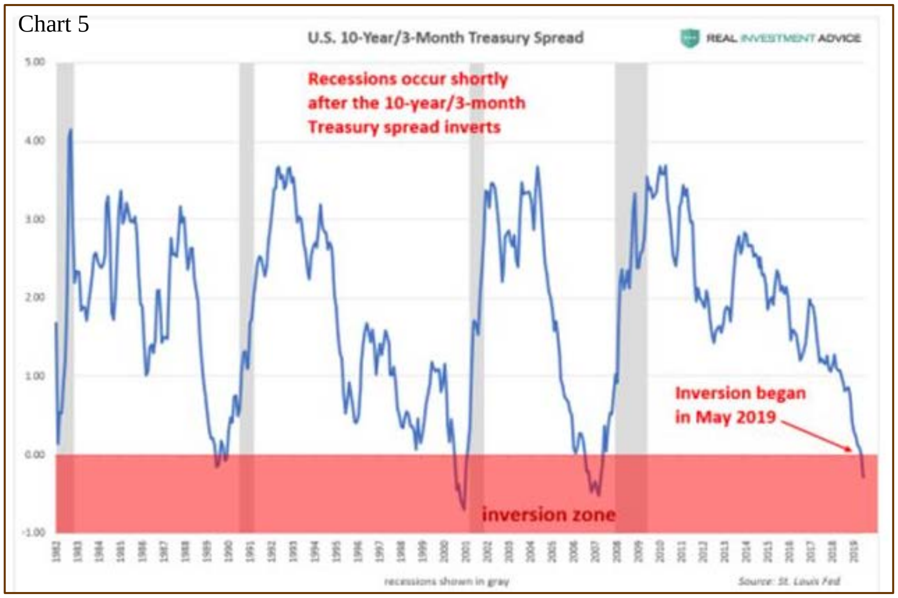
Chart 4

Record Economic Expansion

Despite trade wars and slowing economic growth, America is currently enjoying its longest economic expansion on record as evidenced by Chart 4. The U.S. is now in its 10th year of an economic expansion that began in 2009. "The streak now surpasses the 1991-2001 growth cycle to become the longest since 1854, which is as far back as economists have attempted to date business cycles." [3] What is notable about this particular cycle is it has not been as robust as past growth cycles. "The economy grew 3.6% per year during the 1990s" versus "an average rate of 2.3% per year since 2009."[3] Recent economic data clearly show positive momentum in the economy may be coming to an end. The rate of growth of many leading indicators is rapidly declining according to John Butters, Senior Economic Analyst at Factset. Similar data compelled J.P. Morgan to recently state "the probability of a recession in the U.S. beginning in the second half of 2019 has risen to 40% from 24% in early May" due to the escalation of trade tensions and an associated paralysis in corporate spending.[4]

Tale of Two Asset Classes

Chart 5

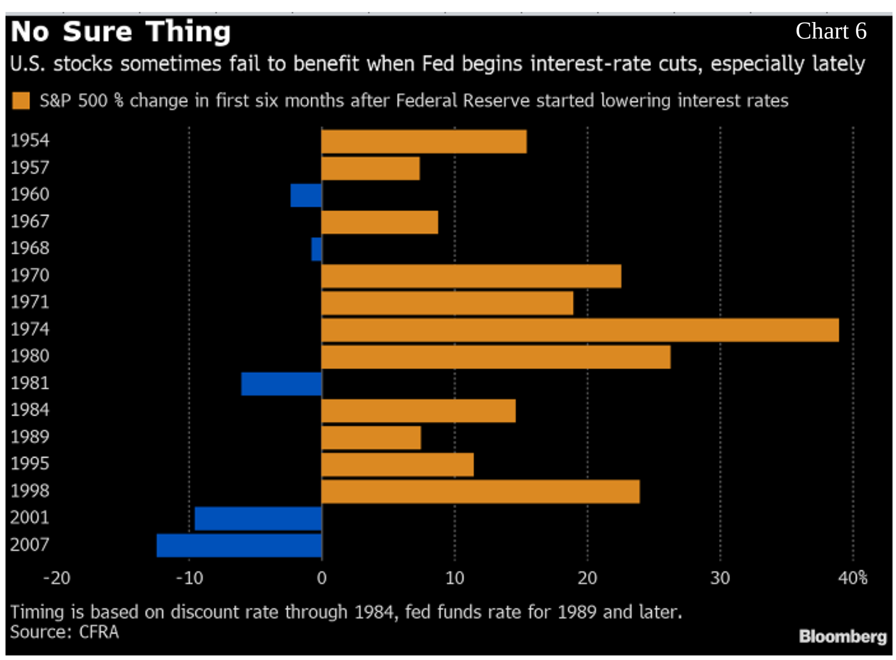


The performance of stocks in the first half of 2019 would seem to contradict recent economic data. While S&P 500 earnings were flat in the first quarter, and are expected to decline 2.6% in Q2, the Index was up over 18% for the first half of the year. Meanwhile, in stark opposition, economic trouble ahead is clearly rearing its ugly head in the bond market. The yield on the 10-year Treasury has dropped from 3.25% last October to 1.95% at the beginning of July or a 40% decline in yield. Perhaps even more alarming are the warning signs the multiple inversions on the Treasury yield curve are attempting to convey. A yield inversion occurs when bonds with short-term maturities yield more than bonds with longer maturities. Historically, this augers a period of slowing economic activity in the future. But there is one inversion which has been a better predictor of future economic activity than others. Since the 1950s, when the 3-month bill and the 10-year Treasury invert, the U.S. economy has gone into a recession within the next 311 days from the initial day of inversion, on average. The most recent example of this phenomenon occurred for the 9th time in May, 2019 (see chart 5). Will this time prove to be the charm or is history destined to repeat itself?

Fed to the Rescue?

The general consensus is that the Federal Reserve will attempt to ameliorate the various inversions of the yield curve by lowering short-term interest rates when they meet again later this month. According to Bloomberg, the odds that the Federal Reserve will *cut* interest rates at their July 30th meeting is now 100%. Potential rate cuts have stock investors cheering as all major stock indexes have recently hit historical highs. However, history suggests the bullish advantages of interest rate cuts for the markets may already be baked into current stock prices. Data compiled by Bloomberg show the S&P 500 Index fell 12.4% in the first six months after interest rate cuts started in 2007 (Chart 6). The drop broke a post-World War II record of 9.5% set in 2001, when the central bank's previous series of reductions got under way. Declines in the S&P 500 also followed moves toward lower rates that began in 1960, 1968 and 1981. Stay tuned to see if the next round of rate cuts will catalyze growth and raise markets to yet higher levels.

Chart 6



Conclusion

Recent global economic data have been disappointing, “nevertheless, talking heads, strategists and commentators rationalize higher stocks in the belief that more ‘cowbell’ by the Federal Reserve will spur new investment, hiring and economic growth.”[5] While the stock market may find renewed vigor from a 25 or 50 basis point cut in interest rates, the global economy will not be able to move forward in any meaningful way until certainty returns. The Fed is being asked to do too much. Even negative interest rates in Europe and Japan have provided little relief for those economies. “We are at a unique point in financial, economic and political history in which there have never been so many possible outcomes (many of them adverse).[5] We now “face heightened technical and fundamental risks, similar to (but not as extreme as) the previous market tops in early 2000 and in late 2007.”[5] As a result, we vehemently believe there needs to be a ‘margin of safety’ imbedded within our portfolios and we will continue to err on the side of caution as trade wars continue to negatively impact leading economic indicators. In the meantime, we will watch from the sidelines to see if Chinese General Secretary Xi Jinping and U.S. President Donald Trump have a change of heart and ease trade tensions and work to re-stimulate world economies much like President McKinley did in the early 20th century. The Fed will step in to help, but it is doubtful the markets can stay ebullient if trade with China is not resolved and investors become tarriff-ied.

Sincerely,

Chris L. Doucet, CEO

Footnotes

1 *U.S. Federal Individual Income Tax Rates History, 1913–2011". Tax Foundation. September 9, 2011*

2 *NYT, June 18, 2019, Jeanna Smialek et al*

2 *Bloomberg Businessweek, June 6, U.S. Economy Celebrates 10 Years of Growth, But No One’s Partying*

3 *PBS News Hour, “Can the longest economic expansion in U.S. history last?, July 1, 2019, Gretchen Frazen*

4 *Bloomberg Businessweek, June 10, 2019, PeterCoy,pp.4-6*

5 *Doug Kass, “In the Land of the Blind”*

Admin Notes

- Form ADV: Please contact our office at (205) 414-9788 if you would like to receive a current copy of our Form ADV II or the Schedule H Brochure.

  Proxy Solicitations: If you receive calls regarding proxy voting, we suggest that you inform the caller that you have delegated Doucet Asset Management full authority to vote the proxy on your behalf. Please note that we are not able to prevent these calls from being placed to you directly.

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