US Markets and Economy:

The trade war between America and China heated up in August. The US raised tariffs and accused the Chinese of manipulating their currency, and China retaliated with tariffs on some American exports. Even though each selloff in the month was followed by a spirited rally, the S&P 500 Index lost 1.8% for the month, the Dow Jones Industrials Industrial Average lost 1.7%, and the more volatile NASDAQ declined 2.6%.

Most economists agree that trade wars make all countries worse off overall, even though those domestic industries which get protection from imports can gain in the short run. Thus, each step up in the trade war tends to bring new selling to stocks, while any sign that the US and China will resolve their disputes leads to a stock rally. The situation is complicated by the US charge that China is a “currency manipulator.” What this means, in effect, is that the Chinese are pushing down the international value of the yuan to offset at least part of the US tariffs, since a cheaper yuan means that Chinese goods look less expensive to Americans. It is certainly true that in the past the Chinese have kept the yuan below its “free-market” price to drive its export-led economic growth. To make this happen, the Chinese had to buy up dollars on the foreign exchange market, paying for them with newly issued yuan. This explains how the Chinese have accumulated over $3 trillion in foreign exchange reserves, including over $1 trillion of US Treasury securities. Yet in recent months the Chinese have tried to keep the yuan from falling too much against the dollar. The danger here is that the Chinese will stop supporting the yuan and let it fall faster to offset recent tariffs. This could make the trade war spill over into a currency war, where all countries try to reduce the value of their currency to stimulate exports at the expense of their trading partners. Most economists believe that the disruptions caused by currency wars also make all countries worse off. Thus, stock traders and long-term investors are hoping that a settlement can be reached before more damage is done.

So far, in fact, the US economy has not been measurably affected by the trade and currency battles. Second quarter real GDP rose by a revised 2.0%, which is a respectable number, given that the economic expansion is more than 10 years old and the longest in US history. With unemployment at a very low 3.7%, it will be hard for the economy to grow much more than 2%
for 2019 and 2020. The Fed’s recent modest cut in short-term rates is designed to ensure that it will stay at 2% despite any headwinds from trade. If the economic growth rate does weaken, the Fed can be expected to cut short-term rates further to keep the expansion on track.

The US bond market, though, is much less sanguine about economic growth. The Treasury yield curve has mostly inverted, with short-term yield higher than long-term yields. These low yields have been a bonanza for long-term bond holders, who have gained 20% or more this year. But this inversion phenomenon has often preceded recessions in the past. In simple terms, the bond market is saying that short-term interest rates will be significantly lower in the next 6-12 months, which suggests some economic weakness ahead. Hedging activity by large fixed income investors has contributed to downward pressure on yields as they scramble to replace the income lost as homeowners refinance their mortgages at ever lower rates. The Fed will have to remain on guard, ready to ride to the rescue with monetary policy. Since inflation remains tame in the US, the Fed could cut rates without much fear of a pickup in inflation.

**World Markets and Economy:**

European blue-chip stocks fell around 1% for the month, as measured by the Eurostoxx 50 Index. European economic growth has been very slow, with the European locomotive German economy contracting for the last two quarters. German stocks fell about 2% for the month. If Germany is the locomotive, Britain is the runaway train, as it hurtles toward a no-deal Brexit in less than two months. Boris Johnson seems determined to crash out of the EU by keeping the Parliament out of session. British stocks not surprisingly led the way lower, with the FTSE 100 dropping over 5% for August, with the pound also weak. A no-deal Brexit would probably hurt Britain the most, but the shock waves could be felt around the world.

Japanese stocks, as measured by the Nikkei index, also had a bad month, falling 4%. Japan, which is still struggling to grow, will also lose if trade wars heat up. In addition, Japan and South Korea have also been squabbling with one another over trade and (still) World War II. Elsewhere in Asia, Hong Kong’s market has been crushed by the mass demonstrations for democracy, and Chinese threats of intervention. Stocks there are in a bear market and fell over 10% in August. Chinese stocks only fell about 1% for the month, even though the Chinese economy is slowing in response to the tariff battle with the US.

**OUTLOOK:**

US stocks remain in a bull market and are still well ahead for the year with the S&P 500 Index up over 18% through the end of August. Corporate profits grew 4.9% in the second quarter, down dramatically from the 20+% growth seen in 2018 but far better than initially feared, demonstrating companies’ ability to navigate a challenging environment. Valuations for equities hover around their long-term averages while high quality bonds are extremely expensive. Nonetheless, it appears that volatility has returned, which could make for a choppy few months until the trade battles are resolved.