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Economic and Market Outlook

March 31, 2018

The Mistaken Gamble of Fiscal Policy

Section I. Making America's Deficits Great Again

We know of no economic theory that prescribes
adding to the fiscal deficit when
the economy is at full employment.
—RDQ Economics (Feb. 2018)
An Economic Consulting Firm

We are dealing with a fiscally unstable long-term
outlook in which inflation will take hold.
—Allen Greenspan (Feb. 2018), Former Fed Chairman

Under the guise of tax reform, late last year Trump signed legislation that will increase the federal budget deficit by $1.5 trillion over the next decade. And now the Congress, in its infinite wisdom, has upped the ante by another $300 billion in the latest deal to avert a government shutdown. Never mind that deficit spending makes no sense when the economy is nearing full employment: this sharp widening of the federal deficit is enough, by itself, to push the already-low net national saving rate toward zero.
—Stephen S. Roach (Feb. 2018), Yale School of Management

High and rising interest rates have important effects on the economy, especially on the prices of stocks and of homes. Because extremely low interest rates during the past decade caused equity prices to rise to unprecedentedly high levels, the shift to higher interest rates will slow and depress share prices. The level of real interest rates is particularly important for share prices, because higher inflation raises nominal profits in a way that offsets the inflation component of higher interest rates.
—Martin Feldstein (Feb. 2018), Harvard, National Bureau of Economic Research

Trade wars are good, and easy to win.
—President Donald Trump (March 2018)

Trade wars are never won.
Trade wars are lost by both sides.
—Senator Ben Sasse
Republican of Nebraska (March 2018)

The quotes above speak, or perhaps shout-out, that fundamental changes in fiscal, monetary, and trade policies are underway—and are likely to be adverse.

Moreover, the changes to each policy carry information concerning increasing risks to the economy and participants in the financial market.

We are not saying that either a recession or a bear market is imminent, but after nearly nine years of an expanding economy, the risk of a cyclical recession inside a longer-term Secular economic expansion has moved from below-average to above-average. We will discuss the reasons for this important change in the report that follows.

As we have in past periods of rising risks, we exercise heightened caution, while looking to our economic forecasting tools and the Nowcasting tools of the Federal Reserve Banks of Chicago and Philadelphia.

When we conclude that a recession is imminent, we will take all necessary steps to protect assets.

The market correction that took place during the first quarter of 2018, while expected, was not normal. It carried an alert that should not be disregarded.

Economic theory makes clear that making massive tax cuts and government spending increases at a time when the economy is near full employment is not only the wrong policy, but one that is dead wrong!

We fully concur with accepted economic theory. The dramatically expansionary fiscal policy is very likely to overheat the economy, driving inflation pressures higher.

One may ask, how can lowering taxes and increasing spending be a problem? The answer is that it becomes a problem when the economy is already operating at near full capacity.

Neil Irwin, writing for *The New York Times* (Feb. 7, 2018), in an article entitled, "The Stock Market Is Worried about Inflation. Should It Be?" explains the problem of inflation this way:

> It is a little like revving a car. Once a car is already at top speed, if you push the accelerator harder, you won't go any faster, but you may overheat the engine. Inflation, in this model of how the world works, is the evidence of overheating.

What does this all have to do with the stock market?

> The unemployment rate is already low, and the new tax cut may push economic growth even higher. Wall Street knows that if Fed officials think inflation is poised to exceed its 2 percent target, they will raise interest rates to try to stop that from happening.

John Maynard Keynes, one of the greatest economists in history (1893-to-1946), would have argued vehemently against using deficit spending and tax cuts to stimulate an economy at near full employment.

We argue that to use such stimulative action in our current environment will most likely result, as Keynes predicted, in the following:

1. Higher Inflation
2. Higher Fiscal Deficit
3. Higher Trade Deficit
4. Falling Dollar
5. Falling Bond Prices (i.e., Rising Yields)
6. Falling Stock Prices (i.e., a Bear Market)
7. Falling GDP (i.e., a Recession)

However, the reason that we believe that a recession is not imminent is directly related to the typically long lags between changes in perception and the onset of the effects of such changes on the financial market and economy.

In the short-run, we expect GDP gains of around 3% growth for much of 2018. Next year (2019) appears far more problematic. By mid-2019, all seven of the negative outcomes listed above are likely to be in play.

Regardless of the actual timetable for all seven problems Keynes outlined as likely to occur, we will not predict the moment for defensive investment action, but will instead respond directly to the forecast of our tools, as stated earlier.

While highly unlikely, it is still possible that some combination of economic and political events may come to mitigate the level of our concerns.

Section II. The Hour of Inflation

In *Barron's* (March 3, 2018), Ben Levisohn wrote in his article entitled, "Dow Drops 3% for the Week—and It Isn't Just Tariffs":

> As frightening as protectionism—and the memories of the Great Depression that it rekindles—can be, any small change in Fed language could be just as frightening, at least in the short term. For years, the market could depend on the central bank stepping in to prop up the market, through good news and bad. Now, things are different. If the economy shows real signs of life, expect the Fed to pick up the pace of its rate hikes [our emphasis]. But even if the data disappoint, don't be surprised if the Fed keeps on tightening anyway. It's a world where bad news is bad news, and good news is bad news too.

> This is something the market hasn't experienced in a long time—real uncertainty: about the strength of the economy and the rate of monetary tightening; of the impact of trade policy on economic growth; on how quickly inflation will rise and how high yields will go with it [our emphasis]. And don't forget, at its peak on Jan. 26, the S&P 500 traded at 18.7 times forward earnings, well above average levels.
>
> That kind of valuation might make sense in a world where inflation is muted, interest rates are low, and the economy doesn't vary much from one quarter to the next, explains Evercore ISI strategist Dennis DeBusschere, but not when market volatility has increased and the path of the economy is more uncertain, resulting in what he calls the "violently slowing pace of stock returns."

Levisohn continued, "If the economy shows real signs of life. . . ." Well, it has! The Congressional Budget Office indicates, "The gap between the economy's actual output and its potential output, given available labor and productivity, has closed and … the economy is already expanding at a pace that exceeds potential [our emphasis]."

At or near the economy's potential means that the recent fiscal stimulus spells trouble. The following measures of price inflation reflect the degree.

Chart-1 (Average Hourly Earnings of All Employees: Total Private) illustrates that wage inflation is the highest in more than nine years.

Chart-2 (US – NY Fed Underlying Inflation Gauge and Core Inflation) forecasts the actual Core Inflation 16 months out. The NY-Fed's Gauge shows Core Inflation will reach 2.8% by 2019.

The strong upward trend seen in Chart-3 (Paying the Price) supports the Fed's forecast seen in Chart-2. Chart-3 tells us that surveys by the Institute for Supply Management indicate that a sharply rising percentage of business executives say they are paying higher prices for materials.

Another clue as to pressure on prices is to look at Producer Prices, which will in time feed into Consumer Prices paid. Chart-4 (Lagging the Leader) clearly shows the coming acceleration of the Consumer Price Index.

Perhaps the strongest evidence of all concerning the direction of inflation comes from the Massachusetts Institute of Technology (MIT). MIT has developed an inflation gauge called PriceStats, tracking prices of millions of items sold online. It is a Nowcasting tool that tells what inflation is doing to prices daily and across all segments of the economy. Chart-5 (Inflation Trend) not only shows the sharp upward movement as measured by PriceStats over the last year, but indicates that on the day of the Chart (Feb. 20, 2018) the U.S. inflation rate was 2.6%, not the Fed's 1.8%. Clearly, Nowdata suggest that the Federal Reserve is way behind the curve, meaning their goal of 2% has been breached and interest rates should be higher.

In an article from Dow Jones & Co., Inc. (Feb. 21, 2018), entitled, "Can't Wait a Month for Inflation Data?" the author, Eric Morath, quotes Michael Metcalfe, head of

Global Macro Strategy for State Street (Partner to PriceStats), who says, "We're not hitting the panic button just yet, but the trend in inflation is strong, and the question is 'How much stronger will it get?' [our emphasis]."

Metcalfe believes inflation is taking off: "If the inflation rate trend continues, you're probably looking for at least four [Fed interest rate] hikes this year [our emphasis]."

Section III. Main Causes of Inflation

Inflation is a sustained rise in the general price level whose source comes from the demand side (i.e., called *demand-pull inflation*) and/or from the supply side of the economy (i.e., called *cost-push inflation*).

Monetary Inflation is a part of the demand-pull category. It occurs when the money supply increases at a faster rate than output (i.e., "too much money chasing too few goods").

The Economics Reference Library—Edexcel—provides the following explanations of causes for the two categories of inflation [with our underlining for emphasis]:

a) Demand-Pull Inflation causes include:
   1. **A depreciation of the exchange rate** increases the price of imports and reduces the foreign price of a country's exports. If consumers buy fewer imports, while exports grow, AD [Aggregate Demand] will rise—and there may be a multiplier effect on the level of demand and output.
   2. **Higher demand from a fiscal stimulus,** e.g. lower direct or indirect taxes or higher government spending. If direct taxes are reduced, consumers have more disposable income causing demand to rise. Higher government spending and increased borrowing create extra demand in the circular flow.
   3. **Monetary stimulus to the economy:** A fall in interest rates may stimulate too much demand—for example in raising demand for loans or in leading to house price inflation. Monetarist economists believe that inflation is caused by "too much money chasing too few goods" and that governments can lose control of inflation if they allow the financial system to expand the money supply too quickly.
   4. **Fast growth in other countries**—providing a boost to exports. Export sales provide an extra flow of income and spending into the economy.

b) Cost-Push Inflation causes include:
   1. **Component Costs,** e.g., an increase in the prices of raw materials and other components.
   2. **Rising Labor Costs** caused by wage increases, which are greater than improvements in productivity.

3. **Expectations of inflation** are important in shaping what actually happens to inflation. When people see prices are rising for everyday items, they get concerned about the effects of inflation on their real standard of living.
4. **Higher indirect taxes** where suppliers may choose to pass on the burden of the tax onto consumers [example—Tariff imposed on foreign goods].
5. **A fall in the exchange rate**—this can cause cost-push inflation because it leads to an increase in the prices of imported products such as essential raw materials, components and finished products (i.e., fall in the dollar relative to other currencies). [Note that this is also listed above as #1 in the causes of Demand-Pull inflation—creating a double-whammy.]
6. **Monopoly employers/profit-push inflation**—where dominant firms in a market use their market power [at whatever level of demand] to increase prices well above costs.

When we examine the specific causes of inflation, we find them awakening at every level, though—beside concerns over Tariffs on steel and aluminum of late, which we will discuss below—Labor Costs have been the most talked about.

In fact, *Barron's* devoted their recent cover article, "The Great Labor Crunch," by Avi Salzman (March 9, 2018), to the difficulty in finding good labor. But not even raising wages is solving the issue for employers. Salzman indicates how widespread the problem has become:

> Across the nation, in industries as varied as trucking, construction, retailing, fast food, oil drilling, technology, and manufacturing, it's becoming increasingly difficult to find good help. And with the economy in its ninth year of growth and another baby boomer retiring every nine seconds, the labor crunch is about to get much worse.

Salzman continues:

> The crunch threatens to stall America's economic engine: Oil and gas stay in the ground because there aren't enough workers to extract it; homes aren't built because builders can't find enough laborers. In Maine this winter, the state couldn't find enough people to drive snowplows.

As we showed earlier in this report, long before investors became concerned with wage inflation, as revealed by the jobs data for January, Producer Prices and the PriceStats (see again Charts-4 and -5) had been on a relentless move upward.

Moreover, the weakening dollar is one of the many additional sources of inflation that has come to life. This weakness has caused import prices to rise (see Chart-6 [Import Price Index]), which, in turn, has had a negative impact on the Trade Deficit—and through the increased Trade Deficit, the dollar's weakness has had a concomitant effect on the Fiscal Deficit--see Chart-7 (Federal Surplus or Deficit [-]).

In an article for Dow Jones & Co., Inc., entitled, "Dollar-Rate Breakdown Exposes Foreign-Exchange Mystery" (Feb. 25, 2018), Chelsey Delaney says:

> The U.S. currency has slumped 11% since late 2016 against its main trading partners, including a 2.7% decline this year in the WSJ Dollar Index. That is surprising many on Wall Street, where dollar strength has been anticipated as a series of Federal Reserve interest-rate increases has expanded the yield premium on U.S. Treasury notes over comparable securities such as German bunds.

Delaney continues:

> Whatever the narrative, it is clear that investors expect the dollar rout to get worse. Hedge funds and other speculative investors are holding roughly $8 billion in bets against the dollar, according to Commodity Futures Trading Commission data, and $19 billion in bets that the euro will strengthen.
>
> "People are a bit unclear about why the dollar is not benefiting from U.S. yields that have been moving up so fast," said Sireen Harajli, a foreign-exchange strategist at Mizuho Bank. "I think that's because of concerns about the U.S. budget deficit [our emphasis]."
>
> Analysts at Capital Economics say the dollar's current slide "is reminiscent of the mid-2000s," when the currency fell significantly even as the Fed raised U.S. interest rates. The culprit then, and perhaps now: market expectations of increasing deficits in the U.S. government budget and the nation's trade account.
>
> Wider U.S. trade deficits have been a common thread in dollar bear markets. The dollar's sharp decline in the 1970s came as the U.S. moved from a trade surplus to a deepening trade deficit, along with the collapse of the gold standard and a decadelong battle with inflation.

So here we have, in the fact of a falling—not rising—dollar, one of the predictions from Keynes' work concerning the no-no of reducing taxes and increasing deficit spending in an economic expansion versus a contraction—see Chart-8 (What Doesn't Kill Me).

Keynes predicted twin deficit troubles for the economy from actions identical to those taken-up by the Trump administration and passed by Congress: a rise in the Trade Deficit and in the Fiscal, or Budget, Deficit.

Both Deficits are increasing, and both will impact inflation and interest rates.

In the investment blog called MarketWatch, Jeffry Bartash reports that the U.S. Trade Deficit in Trump's first year soared to a nine-year high of $566 billion. So much for President Trump's promise to slash the Trade Deficit.

Look again at Chart-7 where the Fiscal, or Budget, Deficit can be seen. Please note the return to an increasing Deficit during the past year (i.e., the line falls).

With a tax cut that is expected to be $1.5 trillion over the next 10 years, or approximately $150 billion per year, and with spending to increase $300 billion in the next 12 months, the Fiscal Deficit a year out will exceed $1.12 trillion—up from $665 billion in 2017 and $584 billion in 2016.

Since the annual Deficit must be financed by the Treasury's issuing (i.e., selling) enough to cover the Deficit, it means $1.12 trillion in new debt issues are on their way to the market.

In addition, the Federal Reserve plans to sell back part of their inventory of debt purchased during the economic crisis (i.e., $4.0 trillion held by the Fed). The so-called QE (Quantitative Easing) purchases that will unwind (i.e., be sold) will also weigh on the market. With the bond supply increasing and demand reduced by somewhat less-willing buyers—out of fear of the increasing presence of inflation—the supply will likely be met with a call for higher yields (i.e., lower bond prices).

Clearly, the expected rise in the twin Deficits (Trade and Fiscal), together with a falling dollar and rising inflation, spells trouble—as Keynes would predict.

The Trump administration, on the other hand, is betting that tax cuts and spending increases will boost the economy more than the downward pressure on the economy that we expect will come from an increasingly restrictive monetary policy.

We see, however, numerous problems within the economy that serve to block or blunt the positive effects of the fiscal stimulus.

To state the issue directly, there are supply-chain bottlenecks everywhere.

Please look at Chart-9 (Total Business: Inventories to Sales Ratio). Here we see what should be a positive (i.e., the downward slope of the ratio). The downward slope should suggest that Inventory rebuilding is coming and will add to reported GDP. We repeat, this *should* be a positive, but at this time the downward slope is, in fact, ironically very negative because it currently reflects the reality that component inventories are disappearing, and years of businesses having failed to expand productive capacity, let alone renew the depreciating usefulness of existing capacity, have created a true crisis (i.e., bottlenecks to production).

Now, some nine years from the end of the Great Recession, capital spending is finally underway. Unfortunately, nearly every industry reports major shortages of necessary equipment, labor, and component parts.

The result of the inventory crisis in the shorter-run (i.e., next one or two years) is upward pressure on prices. With the dramatic increase of funds from fiscal policy, we are presented with the classic definition of Monetary Inflation—*too much money chasing too few goods!*

Something so fundamental as component inventories is about to slow the growth of the economy.

Chart-10 (Real Gross Private Domestic Investment: Change in Private Inventories: Nonfarm) says it all. There has been a sharp drop in investments in

inventories since 2015. In fact, the trend is historically consistent with the onset of recession.

Section IV. Examples of Inflation at Work

The following four examples illustrate inventory shortages constraining growth:

First—Housing Industry

The housing industry was the first to show real bottlenecks in production. Over the past two years in particular, as demand returned closer to normal levels, the increased demand could not be satisfied. The availability of both new and existing homes fell way short of demand.

Production plans by builders ran into shortages of both labor and materials. Instead of demand being met by increasing supply, prices moved higher.

Examine the following Charts:

Chart-11 (Housing Starts: Total New Privately Owned Housing Units Started) peaked back in 2013. For the last two years, starts have increased at a six percent rate, while inventories have collapsed—see Chart-12 (Housing Inventory: Vacant Housing Units for the United States).

Moreover, Chart-13 (Housing Inventory Estimates: Renter Occupied Housing Units for the United States) shows a near-zero growth rate year-over-year.

The housing industry reports that there are, in fact, 12% fewer homes available nationwide than one year ago.

What did change was the price of homes. The price of homes increased 6.3% during 2017. Note Chart-14 (S&P/Case-Shiller U.S. National Home Price Index). During this past year, the Home Price Index surpassed the prior peak in 2007. Inflation in the housing industry is everywhere from inputs to final sales.

Second—Labor Sources—All Industries

All 12 Federal Reserve districts reported economic gains that were modest to moderate at the January 2018 meeting.

However, every district reported ongoing labor shortages described as constraining growth.

Finding qualified labor for unfilled jobs is more than just a little difficult.

The qualified labor shortage is such an important shortage because it impacts inflation from two directions:

1. Labor shortages pressure wage costs higher.
2. Labor shortages increase the severity of bottlenecks in the entire supply chain, creating the need for priority demand decisions and higher prices from components to finished goods.

The latest Labor Dept. report declares that there are 6.2 million unfilled job vacancies in the U.S. At the same time, they report 6.7 million unemployed. Why? Lack of skill-sets ranks at the top.

Bloomberg's article (Feb. 15, 2018) entitled, "Inflation's Real Threat to the Economy," reports:

> One of the biggest contributing factors to depleted inventories and the resultant increased prices is a lack of transportation. The shortage of truckers has become an acute problem for suppliers and poses a material threat to the economy.
>
> The number of truckers, who move 70 percent of the nation's freight by volume, has flat-lined over the past three years. Technological advances present several disincentives: Tracking truckers' hours electronically inhibits their ability to work longer hours than laws permit, and constant news of self-driving vehicles discourages long-term career prospects.
>
> The upshot is a stunting of economic growth prospects as prohibitively high transportation costs force manufacturers to raise prices and shelf potential expansion plans. [Our emphasis.]

The article concludes with the warning: "Pay close attention to inventories. . . . Lagging inventories reflect widespread shortages."

The Bureau of Labor Statistics report is presented in Chart-15 (Job Openings, Hires, and Quits). The report is known as JOLTS (i.e., Job Openings and Labor Turnover Survey). Chart-15 is the result of the Survey through December 31, 2017.

The two main points of the Survey's Chart are quoted as follows [with our emphasis]:

- For most of JOLTS history, the number of hires (measured throughout the month) has exceeded the number of job openings (measured only on the last business day of the month). Since January 2015, however, this relationship has reversed with job openings outnumbering hires in most months.
- At the end of the most recent recession in June 2009, there were 1.2 million more hires throughout the month than there were job openings on the last business day of the month. In December 2017, there were 323,000 fewer hires than job openings.

Third—Energy Industry

As far back as October 2017, the SeekingAlpha blog reported that there were major shortages of infrastructure components, which would constrain output and put upward pressure on inflation during 2018.

Shortages constraining output or production include such items as the following:

1. Labor shortages
2. Pressure pumping equipment
3. Drilling Equipment

4. Re-built and new fracking equipment
5. Overbooked service providers
6. Refining capacity upgraded and new
7. U.S. crude exports draining domestic Inventories

Halliburton's CEO, in the SeekingAlpha blog cited above, stated, "The day when supply and demand come into balance is further out than people think due to equipment needing replacement."

SeekingAlpha's contributing analyst, Adam Mancini, said, "The Bottom Line—In addition to equipment restraints, access to labor is an even more complex issue, with critical, chronic labor shortages being reported across the sector. Labor that is hired is inexperienced and inefficient, leading to reduced drilling and completion efficiency."

Fourth—Component Shortages in Electronics Industries

In an article entitled, "Component Shortage to Last Longer than Expected," by Barbara Jorgensen, of BBG Enterprises, a publication focused on the needs of component buyers, sellers, and suppliers—she wrote (Oct. 19, 2017), "Electronics manufacturers are scrambling for components."

Tight supplies of capacitors, thick-and-thin film chip resistors, inductors, etc., used by manufacturers representing many industries—including automotive, broader industrial, and military aerospace—are experiencing 20-to-52-week lead times along with sharp increases in prices.

An article entitled, "Causes of Electronics Component Shortages," written for American Computer Development, Inc. (Jan. 22, 2018), the author states:

> This past year has seen an exponential increase in demand for electronic components resulting in the largest epidemic of component shortages across supply chains since 2010 [our emphasis]. Some industry experts are concerned this year's imbalance of demand and supply could be the most severe of the century. Currently, lead-times for supplies are stretching to more than 30 weeks. There's no short-term relief ahead for electronics manufacturers who are scrambling for components given this deficiency is now projected to last through 2018—longer than industry experts expected. The result is that in some cases component deliveries won't be available until well into 2019.

EBN, The Online Community for Global Supply Chain Professionals, reported the following in November of 2017:

> Due to the boom of the ever-growing Internet of Things (IoT), a heavy usage of consumer electronics, and the move towards more complex safety and infotainment systems in automobiles, demand for resistors is on the rise. Automotive, mobile device, and factory automation applications are all fueling demands. Because of this, manufacturers in these industries are paying extra

> premiums for a commodity that has traditionally remained steady at less than a penny per part.
>
> OEMs are scrambling to find new sources of supply for these usually easy to find parts. Fusion Worldwide, a large independent electronic components distributor, reported a significant increase in resistor Request For Quotes (RFQs) over the last two months, with the months of June and July producing 20 times the amount of inquiries as compared to any other instance over the past year. What's more, the electronics distributor has seen a 200% uptick in capacitor demand in the last month, driven by mobile phone component needs.

The bottom-line concern for nearly every industry is just how unprepared they are for sudden increases in demand.

Years of neglect to the corporate infrastructure has augmented the risk of general inflation increases. See again Chart-10 (Real Gross Private Domestic Investment: Change in Private Inventories: Nonfarm).

One last remark on inflation at work: Chart-16 (NFIB Small Business Optimism Index) is higher than at any time, other than a single month in 2005.

Barbara Jorgensen, quoted earlier, said about widespread component shortages, "When supplies are tight, big and strategic customers move to the front of the line [our emphasis]."

We may well be looking at the peak of Small Business Optimism, if crowding-out of small businesses begins.

Section V. Tariffs—You Have Got to Be Kidding!

Dominic Rushe, Pulitzer-Prize-winning business editor for the U.S. edition of *The Guardian*, begins his lengthy rejection of "Trade wars are good," by saying:

> As America inches towards a potential trade war over steel prices can Donald Trump hear whispering voices? Alone in the Oval Office in the wee dark hours, illuminated by the glow of his Twitter app, does he feel the sudden chill flowing from those freshly hung gold drapes? It is the shades of Smoot and Hawley.
>
> Willis Hawley and Reed Smoot have haunted Congress since the 1930s when they were the architects of the Smoot-Hawley tariff bill, among the most decried pieces of legislation in US history and a bill blamed by some for not only triggering the Great Depression but also contributing to the start of the second world war.

Rushe continues:

> It is not his first protectionist move. In his first days in office the President has vetoed the Trans-Pacific Partnership (TPP), the biggest trade deal in a generation, said he will review the North American Free Trade Agreement

> (NAFTA), a deal he has called "the worst in history," and had his visit with Mexico's President cancelled over his plans to make them pay for a border wall.

Quoting Dartmouth professor and trade expert, Douglas Irwin, Rushe writes:

> "The main lesson is that you have to worry about what other countries do. Countries will retaliate," said Irwin. "When Congress was considering Smoot-Hawley in the 1930s they didn't consider what other countries might do in reaction. They thought other countries would remain passive. But other countries don't remain passive."
>
> The consequences of a trade war today are far worse than in the 1930s. Exports of goods and services account for about 13% of US gross domestic product (GDP)—the broadest measure of an economy. It was roughly 5% back in 1920.
>
> "The US is much more engaged in trade, it's much more a part of the fabric of the country, than it was in the 1920s and 1930s. That means the ripple effects are widespread. Many more industries will be hit by it, and the scope for foreign retaliation, which in the case of Smoot-Hawley was quite limited, is going to be much more widespread if a trade war was to start," said Irwin.
>
> When you start talking about withdrawing from trade agreements or imposing tariffs of 25%, if you are doing that as a protectionist measure, that would be blowing up the system."
>
> That the promise of "blowing up the system" got Trump elected may be why the ghosts of Smoot and Hawley are once again walking the halls of Congress.

We would add that, given the rise of nationalism in recent years, and given leaders with a shaky understanding of either economics or history, the chance of a trade war is uncomfortably high.

Let us trust that Senator Ben Sasse of Nebraska (see opening quotes) is heard: "Trade wars are lost by both sides."

In June of 1930, Henry Ford reportedly told President Hoover that the Smoot-Hawley Tariff bill was "an economic stupidity." Few listened!

Chart-17 (Dow Jones Industrial [1929-1933]) draws a picture of stupidity not foreseen. In October of 1929, as the Senate debated the tariff bill, the stock market crashed. In June of 1930, Hoover signed it into law, declaring the economic decline that began in August of 1929 was over.

The word *Depression* came into "economic language" well after the decline was over. The decline was so powerful that economists needed a new word for the decline. Today, the word *Depression* has been replaced by *Recession.*

For history buffs—the 1929-32 Crash took 25 years to recover from (i.e., passing the old high on November 23, 1954). The Crash itself lasted a little over 33 months and the stock market fell 89%.

Section VI. State of the Economy

The current state of the economy is one of expansion. That conclusion is based on the current status of the seven economic indicators that have served us well.

Our conclusion is further supported by the Nowcasting Indexes of the Federal Reserve Banks of Chicago and Philadelphia.

The status of each indicator appears in the Summary Table below.

Summary Table of Charts 18-24

Indicator No.	Chart	Indicator Name	Status
(1)	Chart-18	Civilian Unemployment Rate (Current vs. 12 Months Moving Average)	Positive
(2)	Chart-19	Real Retail and Food Service Sales (Percentage Change from Year Ago)	Positive
(3)	Chart-20	Industrial Production (Percentage Change from Year Ago)	Positive
(4)	Chart-21	Real Personal Income Excluding Transfer Payments (Percentage Change from Year Ago)	Positive
(5)	Chart-22	All Employees: Total Nonfarm Payments/Civilian Labor Force (Percentage Change from Year Ago)	Positive
(6)	Chart-23	10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity	Positive
(7)	Chart-24	Smoothed U.S. Recession Probabilities (Percent)	Positive (low prob.)

Concerning the indicators listed in the Table above (see Charts-18-24), it is important that any decision to reduce the allocation to stocks due to an expected Recession depends on sell signals from a majority of the seven indicators.

In effect, four of the seven must be negative and, at the same time, the market direction must be negative (i.e., the 40-Week Moving Average of the S&P 500 Index must be greater than the current week).

It is clear from the Table above that we are nowhere near meeting the required forecast for a Recession and, by derivation—a Bear Market (see Chart-25 [Bear Markets Rarely Occur Unless There Is a Recession]).

Chart-26 (Chicago Fed National Activity Index) is clearly above the -.70 line which declares a recession exists.

Chart-27 (Aruoba-Diebold-Scotti Business Conditions Index) is also well above the -.80 line that declares a recession exists.

Therefore, both Nowcasting tools strongly support the conclusion of our seven economic forecasting tools—the economy is currently in expansion.

Section VII. Concluding Remarks

The issue before us has been the shape of the next-year-to-two-years as it pertains to the economy as well as to the financial markets.

We have concluded that, while there is no imminent threat to the economy's growth rate, there is a threat posed by expected increases in the rate of inflation and our interest rates.

The threat is above average, which means the probability of a cyclical recession and bear market for stocks could become an imminent forecast as we enter 2019. As for the bond market, inflation will force longer bond yields (i.e., particularly beyond 10-years) to move sharply higher (i.e., bond prices lower). The bond market has already begun a bear market (i.e., in prices) in recognition that the Fed has begun raising rates.

As we said earlier in this report, should we conclude that a recession and bear market have become imminent as a result of adverse changes to the outlook projected by our forecasting tools and analysis, we will take all necessary steps to protect assets.

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