The Outlook: March 23, 2018

The meaning of "Global Trade War!" and jumpy nerves in the market.

It is the nature of the market to do screaming cliff-dives, now and then, and yesterday's 700-point drop was one of them. Almost always, the cliff-dives turn out to have sprung from false or distorted views of the real economic and business world, rather than clear and far-sighted views. But once in a great while—every third, fifth, or tenth year, or anything in between—a cliff-dive turns out to have "seen" something genuinely bad coming around the corner, in our real world. It's a little like a medical test for something frightening, like cancer, which produces 10 false positives for every real positive: the chance of one true reading in ten, or even one in twenty, is more than enough to scare us about the next test, when we consider the stakes.

If we reflected upon the history of the market's cliff-dives we would see that very many of them are triggered by something "new" enough, hence poorly understood enough, to be all the more frightening. Two years ago, the news of the Brexit vote was one of those. So was the unexpected plunge in China's yuan, three years ago, which the global speculating crowd instantly took as confirmation that China's economic and financial house of cards was collapsing. Those were hideously complicated subjects, and at first the market crowd, as a whole, hadn't the faintest idea what they really meant. So they were all the more alarming . . . until enough time had passed for reflection, plus more real-world facts to come down the road. Neither Britain, nor Europe, nor China has collapsed, and though determined doomsayers will always be with us, to most observers they don't look anywhere near collapse in the foreseeable future.

The cliff-diving crowd has no interest in its past mistakes, of course. It's only job is to stay alert for the next cliff-diving opportunity. It found one yesterday, labeled "Global Trade War!!!"

The power of "Global Trade War!!!" as a market nightmare is that it can completely ignore the whole picture, today, of the world's business and economic health. We might tell the cliff-divers "Look at the strength in the U.S. economy! Look at the financial strength of the giant consumer sector (where debt costs as a percent of disposable income are still near 40-year lows.) Look at the liquidity and earnings progress of the great majority of U.S. companies. All these things are being backed up, month after month, by almost every available measurement of the activity in the real world!" But the cliff-divers can shrug and say, "So what! Our "Global Trade War!!!" can wreck everything, no matter how strong it might be at the moment."

And there is really no answer to that, except to think it highly unlikely that the world's political leaders will actually shoot themselves in the foot, rather than merely threatening to do so, loudly, which is normal behavior for global politicians. The Smoot-Hawley tariffs certainly triggered a trade war, in the 1930's, which certainly helped the Depression plunge deeper and last longer. Of course, the cliff-diving crowd—and the economists and analysts who are shaken up by them, which is quite a few—would like us to feel, at this moment, that Smoot-Hawley was the wrecking ball which did most of the Depression's damage. At Outlook we doubt that extremely. The wrecking ball, in fact, was the appalling ignorance—among politicians and central bankers—which allowed national and global bank runs to succeed in destroying (in America) around one-third of the nation's banks, wrecking American's savings along with them. The next-biggest wrecking ball, in the U.S., was ten years of steep tax hikes and anti-business laws and regulations, which kept smothering recoveries before they could get on their feet.

Ten years ago, U.S. bureaucrats and political leaders made exactly the same mistake regarding bank runs—and the result was the worst Bear Market and deepest, fastest recession since the 1930's, perhaps. But they did see the mistake and control its effects within 6 months, rather than 10 years. Among the powerful, beneficial results of that terrible plunge are today's incomparable financial strength in U.S. (and a good many foreign) banks; and the same historic financial strength in the U.S. (and a good many foreign) consumer and business sectors. A repeat of Smoot-Hawley and the Depression's "global trade wars" would hurt plenty . . . but that pain would be borne by businesses, banks and consumers with infinitely more strength than their counterparts had, in 1930.

The final crucial part of "the whole picture" is always valuation: namely, is this unlikely nightmare showing up when the market is in one of its rare "Everything's wonderful!" moods, with most stocks priced for perfection? Or does the market's valuation, today, reflect an emphatic degree of caution and concern . . . hence far less risk that stock prices will both plunge deep, and stay there. Outlook's clients and friends won't be the least bit surprised when we say, "Not the first. The second." We'll close with a table prepared by Seeking Alpha analyst Brian Gilmartin—who always looks calmly at the facts-on-the-ground when the market is screaming and shouting:

Forward 4-quarter earnings estimates, S&P 500:	$158.32 vs. last week's $158.23.
P/E ratio:	***17.4x.***
S&P 500 earnings yield:	5.75% vs. last week's 5.69%.
Year-over-year growth rate of forward earnings estimate:	***+20.8%, the 17th consecutive week of sequential increases in S&P 500 forecasted earnings.***

As Outlook has noted a few times, the investment world argues all day, every day, about the "best" ways to measure valuation. But that Price/Earnings ratio of 17.4 is a very long way from "Everything's wonderful!" regardless of the fine-tuned debating points. (The market's 1999/2000 ratio—the very definition of "Everything's wonderful!"—was in the 30's, not the teens.)

Here's the Big Picture: short version.

- Remarkable business and consumer financial strength, especially in the U.S. but scattered around the world as well.
- A U.S. banking sector closer to "rock solid" than any time in the last century.
- Technological growth engines driving ahead: the "internet of things" is real, not imaginary, and touches every part of economic life.
- Oil and commodity markets in solid recovery from sharp bear markets ending in 2016.

And, finally:

- A U.S. President who is a risk-taker and a hardball negotiator. That is exceedingly rare, here or anywhere in the world, and it's made people nervous. But his actions (rather than words) of the past 12 months do not define a lunatic, nor a "loose cannon," no matter how loudly the political crowd says otherwise. He is sane, and so are the leaders in Europe and especially China. All those leaders are perfectly aware of the truth in U.S.

complaints about trade treaty violations, most emphatically by China. They are trying to figure out how to "make a deal" with the hardball negotiator without losing face at home. Threats and counterthreats of "Global Trade War!!!" are part of that process. That process is an absolute prescription for continuing jumpy nerves, in the market. But when companies are strong and growing, and valuations are anxious and concerned, "jumpy nerves in the market" means "Hold, and buy more," not "Sell, and run for the hills."

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