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MONTHLY UPDATE

AUGUST 2019

THE DOG DAYS OF SUMMER

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The end of summer brings so many changes. It's always been my favorite time of year. A new school year starts! Yes, I was a bit of nerd! Who am I kidding, I AM a nerd? My New Year's Eve is the day before school starts. I love the feel of a new notebook, colored-pencil shavings, the clicks of four-color pens … and, who doesn't love the motivating aroma of a new hi-liter when the cap first comes off? For me, August spelled challenge and opportunity. It was the beginning of a new adventure and I couldn't wait!

It's no different today and I'm still up for the fall challenge; although, it's a bit different. I'm challenged by weakening economic growth in Germany and China; global economic restructuring from trade agreements to supply chains; a Fed that can't seem to decide if it should raise or cut rates; an inverted yield curve; the modest threat of a recession in late 2020; and, a stock and bond market that can't decide if it should go up or down.

Why is all this a challenge? Simply put, these challenges stand between you and your goals; you and your peace of mind; you and your legacy; and you and your best self. So, let's break them down and examine their potential impact. Let's see if there's any economic or market reasons that might keep you from living your life on purpose for the reasons that are important to you.

GLOBAL ECONOMIC GROWTH

Global economic growth has taken a pause. We've had a pretty good 10-year run so we might expect growth to slow. Yet, economic growth doesn't die of old age. It dies because of policy decisions. It appears that recent policy decisions are having some impact. For me the question is whether the impact is real and lasting or imagined and temporary. For the record, I lean toward imagined and temporary and here's why.

Let's be honest. Domestic GDP growth isn't going to exceed 2.0% to 2.5% for a long time. This shouldn't be a surprise and it shouldn't weigh on the market. In fact, since the expansion began in the 3rd quarter of 2009, our average GDP growth has been 2.3%. Why? There are two key drivers of GDP growth: working age population growth and worker productivity growth. Both growth rates have been in decline for over a decade and added together equal 2.0%. I'm not aware of any catalyst in our near future that will change this. So, why the hype over 2.0% growth. It's exactly what it should be.

In Contrast, consider China, the second largest economy in the world. But, let's be honest, a country can only build so many empty buildings to boost it's GDP. Toss in the tariffs, and the Chinese economy, undoubtedly, becomes a little weaker. Now, consider Germany, the fourth largest economy in the world. Germany makes machines – really good machines. If the US and China are a little slow right now, demand for these machines slows. Over simplified, I know. However, that's what's happening. Machine exports from Germany fell by 1.8% in the second quarter and GDP contracted by 0.9%, although it is still positive.

What's all this mean? Right now, not much. Global economic growth has paused. But, inflation remains very low so there's not a lot of impact. Remember, we've had slow growth for a decade and during that same period, the S&P 500 grew 335%. I'm not convinced we should worry.

TRADE AGREEMENTS

Americans love binary decisions and direct causal effect. We seem to boil everything down to "if this, then that." This form of thinking makes for great talking points that we can spout with great conviction. That said, I think it should go without saying, but I'll say it anyway … the global economy is a little more complex than "if this, then that."

Tariffs are a tax and consumers pay the tax. Taxes take money out of our pockets. Tariffs are bad … If this, then that …

Yes, tariffs are a tax. The tax revenue goes to the treasury. Who pays it? It's easy to say the consumer because it's embedded in the price of goods. But, that's too simple. Sometimes, Chinese manufacturers hold their prices and eat the tariff. Sometimes, American manufactures eat part of it and the Chinese eat part of it. Then there's currency. China has devalued its currency – a whole different discussion on currency manipulation. In effect, a devalued Chinese currency eliminates the impact of a tariff driven price hike and consumer is not impacted. If this, then that just doesn't apply.

According to Wilbur Ross, US Commerce Secretary, all of the tariffs imposed by both the US and China add up to a whopping 0.1% of global trade. Exports from the US to China amount to about 1% of our $20 Trillion GDP. What am I saying? Economically speaking, the tariff furor is much ado about nothing.

THE FED AND THE YIELD CURVE

Let's face it. The Fed is in unchartered waters. It's trying to transition from quantitative easing and money printing to something that looks like normal. That's a bit difficult when the global economy isn't exactly normal. It's my opinion that the Fed should not have raised rates in the fall of 2018. Even though we're fully employed, there's no inflation. So, they've only fulfilled half of their mandate. They simply raised rates so that they could cut them if need be. That made no sense to me.

Well, absent a conversation with me, they've seen the error of their ways and recently cut rates, reversing their last 2018 decision. Their action seemed to confuse the world, implying there was more risk in the system than previously thought. So, a spooked world started selling stocks and started buying treasuries, big time! This caused the yield curve to invert. Demand drove up prices on the short end faster than it did on the long end. Generally, this is a sign, not a cause, that a recession is coming. However, the NY Fed puts the probability of 2020 recession at only 32%. Other forecasting tools have actually reduced their probability of 2020 recession. Why? It's simple. We're working. We're making more money. There are 6 million jobs without qualified workers. Domestic consumption, including housing, is about 71% of GDP and growing. Despite news reports to the contrary, the data shows that the consumer is doing pretty good.

THE MARKET

Yes, there's volatility. There's always been volatility, and it always comes and goes. Yes, we have corrections. There's always been corrections and the market recovers. No. We are not in, nor do I expect that we will be in a bear market very soon. Why? At least 1 of 4 conditions are present with every bear market: Recession; Extreme Stock Valuations; High commodity prices; or, an aggressive fed. Since we have none of these, it seems unlikely that we will have a bear market.

CONCLUSIONS

When I examine the fall challenges, I quickly realize that it's not so challenging. A deep breath and some critical thinking reveal that "If this, then that" simply does not apply to the global economy. The economy is more complex and is certainly better than the rhetoric and talking points make it seem.

Global growth has slowed, but growth is still positive. US economic growth is in line with expectations. "Trade Wars" have had little impact on GDP or the consumer because the dollars associated with the tariffs just aren't big enough. Temporary yield curve inversions currently demonstrate that investors perceive risk in the global economy. However, recession indicators, don't share that view. Domestic consumption is strong. Stock valuations are slightly higher than long term averages, but certainly not outsized. Commodities are cheap. We're not in a bear market and probably won't be in one for a while.

So, live your life on purpose for the reasons that are important to you. Be your best version of yourself knowing that the world isn't coming to an end. Buy a new hi-liter, open it, let the smell of opportunity waft up to you and smile.

All the best,
Paul

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