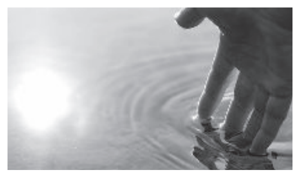
Christian Brothers Investment Services

MARKET PERSPECTIVE 2Q 2018

The Trade Deficit & Tariffs:

Is the Cure Worse Than the Disease?



CAPITAL MARKETS REVIEW

MARKET MUSINGS

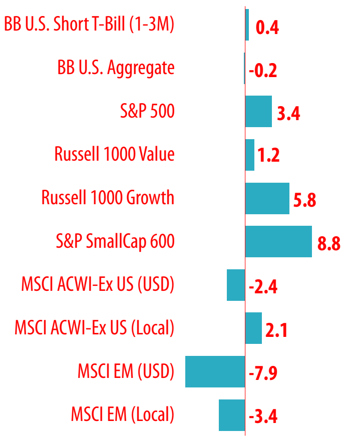
Has the U.S. trade deficit reached a point where it poses a greater risk to the economy than the imposition of tariffs?

Although most indicators signal that the U.S. economy remains on a positive trajectory, the debate over the trade deficit has become a focus of policy makers and may put a damper on continued growth. Has the U.S. trade deficit indeed reached a point where it poses a greater risk to the economy than the imposition of tariffs? Make no doubt about it—tariffs are a tax, and the cures being considered in Washington will have far-reaching economic impact.

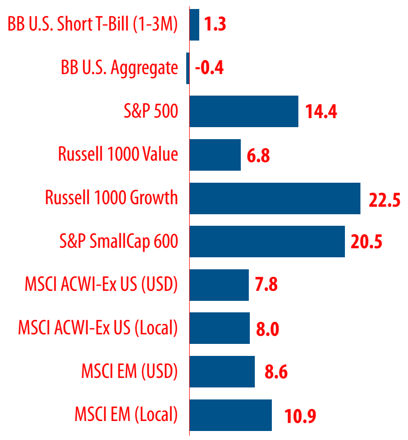
Capital Markets Review

GLOBAL OVERVIEW

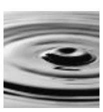
Market Performance: 3 Month



Market Performance: 12 Month

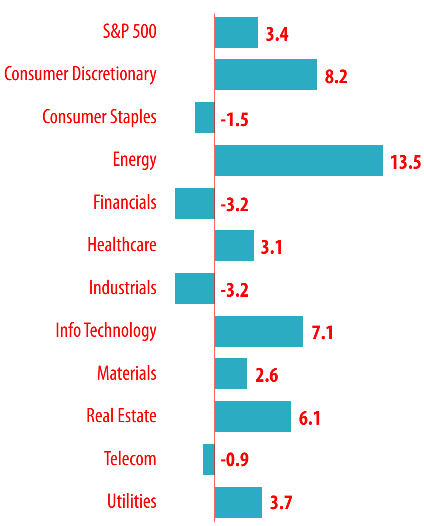


- U.S. equity markets remained resilient over the second quarter despite increased trade tensions and higher interest rates.
- The U.S. small cap sector outperformed as concerns of slower non-U.S. growth surfaced.
- Value stocks continued to underperform during the quarter.
- Non-U.S. equities were negatively impacted by the strength in the dollar.
- Over the last 12 months, U.S. large cap growth and small cap outperformed other sectors of the market.

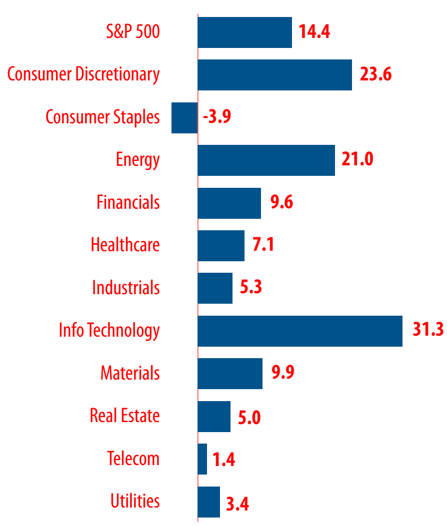


U.S. EQUITY MARKETS

Market Performance: 3 Month



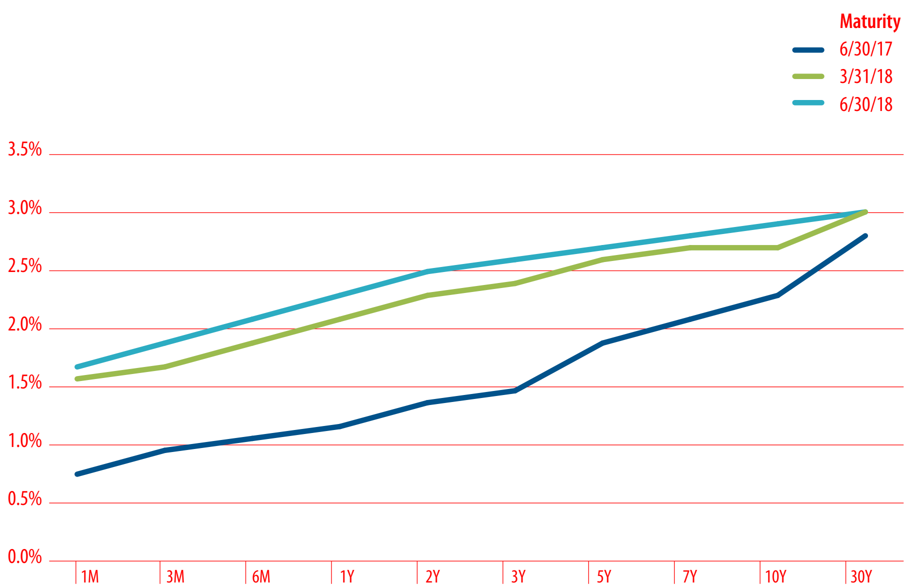
Market Performance: 12 Month



- Energy stocks rebounded during the quarter on higher oil prices.
- Financials and Industrials were notably weak on the quarter due to a global growth scare and trade tensions.
- The Information Technology and Consumer Discretionary sectors drove market performance over the last year, led by the FAANG stocks (Facebook, Apple, Amazon, Netflix, and Google).

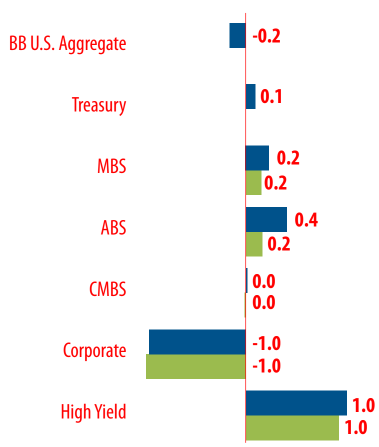
FIXED INCOME MARKETS

Treasury Yield Curve

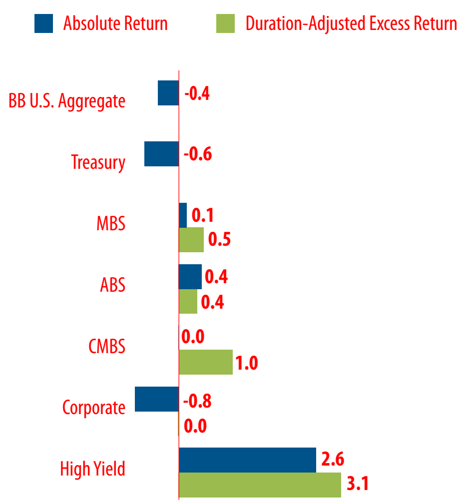


- The Federal Reserve increased the targeted Fed Funds rate by 25 basis points, as expected.
- The yield curve flattened, with the 30-year yield remaining unchanged.
- Over the last 12 months, the yield curve experienced significant flattening as the short end increased with little movement on the long end.

Market Performance: 3 Month



Market Performance: 12 Month



Corporate spreads widened during the second quarter, yet high yield managed a positive excess return due to the higher level of spreads.

- Excess returns for other sectors were modestly positive for the quarter.
- Over the last 12 months, high yield generated significant excess returns, followed by CMBS. Investment grade corporates were breakeven, while MBS and ABS posted modest excess returns.

STRENGTH OF THE DOLLAR

Trade Weighted U.S. Dollar

Major Currencies

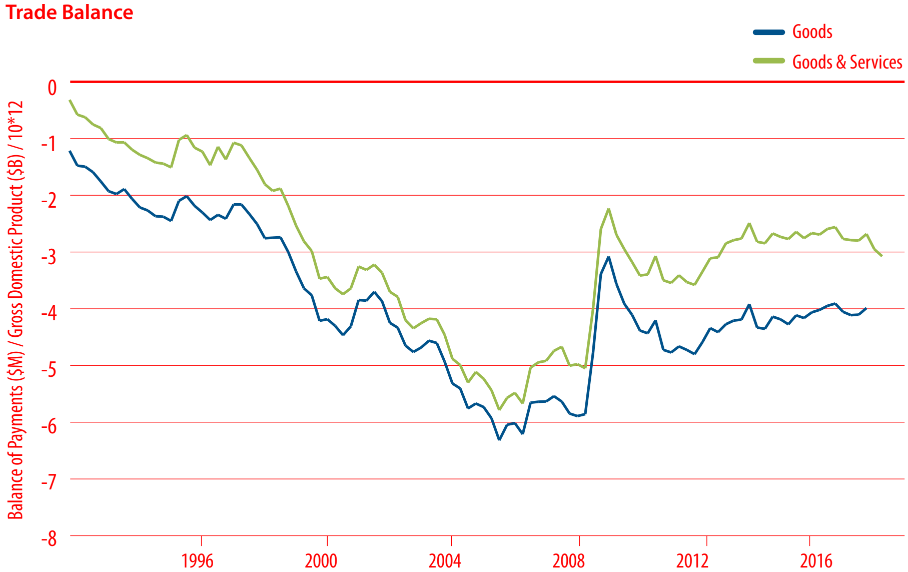
Source: Board of Governors of the Federal Reserve System via the Federal Reserve Bank of St. Louis as of 6/30/2018; https://fred.stlouisfed.org/series/DTWEXM

- Recent dollar strength needs to be viewed in a larger historical context.
- The dollar is below the average valuation of the last 45 years versus major trading partners.

Federal Reserve tightening and flight to quality leaves room for further dollar strength.

DOES THE TRADE DEFICIT POSE A THREAT?

Trade Balance



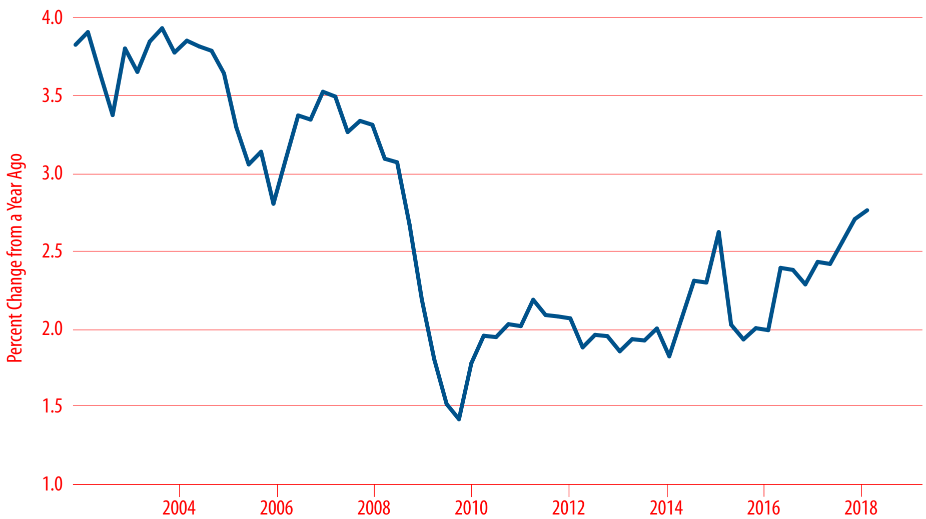
Source: U.S. Bureau of Economic Analysis via Federal Reserve Bank of St. Louis of 6/30/2018; https://fred.stlouisfed.org/graph/?g=fjy9 and https://fred.stlouisfed.org/graph/?g=fjyw

- While the absolute trade deficit has increased, relative to the size of the economy, the goods deficit is manageable.
- Including services, which account for a large percentage of U.S. GDP, the trade deficit does not pose an economic issue.
- The deficit "per se" is a cloak to wage war on unfair trade practices, IP protection, and technology transfers.
- Tariffs, however, are a very blunt instrument, and there will be negative repercussions from reduced global trade volumes.

WAGES FINALLY INCREASING

Employment Cost Index

Total Compensation, All Civilian



Source: U.S. Bureau of Labor Statistics via Federal Reserve Bank of St. Louis as of 6/30/2018; https://fred.stlouisfed.org/series/ECIALLCIV

- Wages continue to recover.
- Anecdotal evidence suggests workers are beginning to change jobs given the improved wage picture; will this impact earnings?
- With unemployment at low levels, we may see upside risks to inflation.

INFLATION MOVING TOWARD FED TARGET

Personal Consumption Expenditures

Chain-Type Price Index

Source: U.S. Bureau of Economic Analysis via Federal Reserve Bank of St. Louis as of 6/30/2018; https://fred.stlouisfed.org/series/PCEPI

Personal Consumption Expenditures, the Fed's preferred measure of inflation, is normalizing toward the Fed target (2%).

- Interest rates need to normalize as well.
- There is potential upside risk to inflation given the employment and fiscal stimulus situations.

LOW FINANCIAL STRESS

St. Louis Fed Financial Stress Index

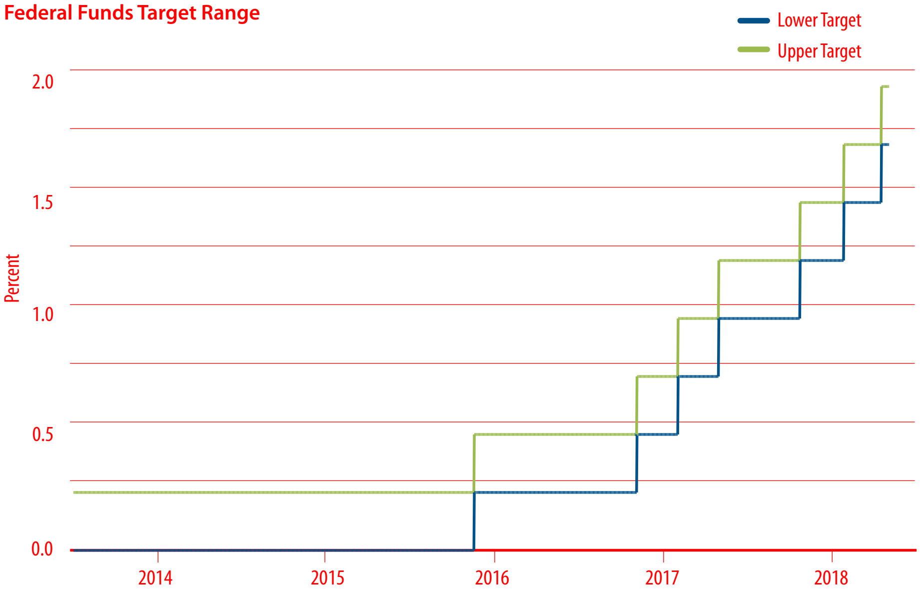
Source: Federal Reserve Bank of St. Louis as of 6/30/2018; https://fred.stlouisfed.org/series/STLFSI

- Fear of consumer retrenchment or recession is premature given this indicator.

However, the widening of corporate bond spreads cannot be overlooked.

PATH TOWARD NORMALIZATION

Federal Funds Target Range



Source: Board of Governors of the Federal Reserve System via the Federal Reserve Bank of St. Louis as of 6/30/2018; https://fred.stlouisfed.org/series/DFEDTARL

- If inflation settles around the Fed's target, expect Fed Funds to normalize around 3% - 3.5%.

Market Musings

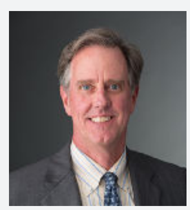
Last quarter, I highlighted the risk from the increasing rhetoric around trade protectionism and the potential economic toll of tariffs. Make no mistake, tariffs are a tax and—if imposed—will offset some of the benefits from the recent U.S tax cuts. I wholeheartedly believe in free markets and the benefits from comparative advantage and trade. However, with all the attention on trade and tariffs, I thought I would review whether the U.S. trade deficit has indeed reached a point where it poses a greater risk to the economy than the imposition of tariffs.

The St. Louis Federal Reserve published a blog post earlier this year which succinctly puts the trade deficit into perspective. The absolute value of the trade balance of goods has worsened—the deficit is 10 times larger than it was 25 years ago. However, when adjusted for the size of our economy and price changes, the trade deficit for goods has improved since 2005. And when one includes not only goods but services, where the U.S. enjoys a surplus, the total trade deficit doesn't look onerous at about 3% of GDP[1].

To add more uncertainty to the trade story, one must recognize that measuring the trade balance is imprecise, and there are inconsistencies in the reporting values of countries' imports and exports. According to figures reported by the World Trade Organization in 2016, the value of all countries' imports was $350 billion more than the goods they exported[2]. One country's imports are another country's exports, so this number should net out—but there are obvious distortions in the calculation of trade. A working paper from the Bureau of Economic Analysis examines this distortion. The iPhone is a perfect example: It is designed by Apple in California, assembled in China, but sold in Europe by an Apple subsidiary in a low-tax nation. Is the iPhone an import or an export? And what is the value? The study concludes that U.S. exports were undercounted and imports overstated by a combined $280 billion in 2012. With these adjustments to the data, the U.S. trade deficit is closer to $257 billion (about 1.6% of GDP) rather than the reported number of $537 billion[3].

When one includes not only goods but services, where the U.S. enjoys a surplus, the total trade deficit doesn't look onerous at about 3% of GDP.

My conclusion from these analyses is that the trade deficit is not the cause of American workers' woes, and the cures being considered in Washington may be much worse than the disease. However, the adage "It is hard to fight City Hall" rings true. If significant tariffs are imposed, companies with a low exposure to import costs and a higher domestic revenue stream should prove to be defensive investments—for example, healthcare, financials, and small cap stocks.



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1. "Three Views of the U.S. Trade Deficit." The FRED Blog, 16 Oct 2017, https://fredblog.stlouisfed.org/2017/10/three-views-of-the-u-s-trade-deficit/.
2. "World Trade Report 2016: Levelling the Playing Field for SMEs." The World Trade Organization, 27 Sep 2016, https://www.wto.org/english/res_e/booksp_e/world_trade_report16_e.pdf.
3. Guvenen, Fatih, Raymond J. Mataloni Jr., Dylan G. Rassier, Kim J. Ruhl. "Offshore Profit Shifting and Domestic Productivity Measurement." Bureau of Economic Analysis, 6 Apr 2018, https://www.bea.gov/papers/pdf/GMRR-2017.pdf.