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"Sharpen Your Axe"

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There is a tale of an annual competition pitting two lumberjacks against one another to determine who could fell the most trees in a single day. From the start, it looked to be a lopsided contest. The first contestant was a strong and boastful young man while the second was a stoic, older lumberjack more than twice the age of the younger man and slight in stature. As the contest started, the younger lumberjack confidently raced into the forest. He began to systematically chop down trees, moving from one to the next in rapid succession. Meanwhile, the old lumberjack walked from tree to tree appearing to sit and rest after each felled tree. As the sun set, the young lumberjack, exhausted by his labors, returned to the camp seeing that the older lumberjack was already there. "Ha, the old man couldn't even finish out the day" the young axe man said to himself. Striding up the stage, he boasted to the judges that he had felled 10 trees that day. The judges quickly conferred, and the head judge stepped forward to announce the winner – the old lumberjack, who had felled 15 trees. As the crowd cheered, the young lumberjack turned in disbelief saying to the other "How can this be? You took breaks after every tree while I worked non-stop. How could you possibly have beaten me, I am younger, fitter and stronger than you." The older lumberjack smiled and said, "Son, I was not stopping to rest. I was stopping to sharpen my axe."

August days in financial markets tend to be quiet. Volumes contract as many investors take to the sidelines. This time offers a chance to spend time with families and friends, read a book, enjoy a beer; in short, it's a good time to sharpen our axes for the fall.

The first half of the year proved to be transitional. Abundant liquidity proved to be a little less liquid. Falling stock prices recovered. Long-term interest rates stopped going up and short-term interest rates moved gradually higher. The term structure of interest rates flattened dramatically. The dollar rebounded. Oil prices moved steadily higher. Growth outside the United States tended to disappoint while growth within the 50 states proved robust. Europe lost some of its earlier momentum while Asia stalled. China and most emerging markets slowed in response to a stronger dollar and increased trade friction.

Most economists see the Fed raising short-term interest rates twice more this year to at least 2.25%. These same seers predict term rates increasing to a cyclical high of approximately 3.0% over the next two years. They see continued economic strength in the U.S. relative to the rest of the world. In their view, the path of interest rates and the differential with its trading partners should support the dollar. A stronger dollar will put additional pressure on emerging economies that tend to need dollars to fund themselves.

Returning after Labor Day, investors are likely to confront a much different environment in our opinion. Liquidity conditions will continue to tighten as central bankers attempt to gradually restore “normal” monetary conditions. Later this year, Europe will begin to reduce asset purchases. Japan will reluctantly allow rates to rise modestly. The dollar is going to peak as economic momentum shifts away from the U.S. in favor of its trading partners. The U.S. faces rising inflation pressures and will attempt to push short rates higher. However, evidence of a moderation in U.S. growth in 2019 is going to slow or reverse the Fed’s policy of raising rates. The sugar high from tax cuts is going to run its course.

The consensus, like the confident lumberjack, relies too heavily on what they think they know. They should spend more time questioning what they don’t know. Economists are famous for extrapolating the trend. At some point, there is going to be a convergence in growth, inflation and interest rates which will normalize the relationships within currency markets. The success of the U.S. following the financial crisis has been remarkable. The additional fiscal stimulus at the beginning of this year turbo charged the relative economic growth of the U.S. to its trading partners. The reduced activity in autos and housing are early signs of a slowdown. The shape of the yield curve with the appropriate lead time is also indicative.

The gradual impact of tightening trade should be evident by fall. A protracted trade war would slow global growth. The escalation of tariffs will eventually lead to inflation as supply chains are disrupted, production costs are raised, and companies postpone or eliminate capital spending projects. Perhaps, Chinese growth will be impacted the most. A potential Chinese slowdown would be felt worldwide and would substantially raise the risk of another systemic crisis. Such a scenario could result in a dangerous rise in interest rates and fall in equity prices. A spike in interest rates this late in the cycle, given heightened debt levels, could usher in another deflationary episode similar to what we experienced in the Great Recession.

Alternatively, a relaxation of trade tensions would reverse the trends of the first half. Emerging markets, particularly China will begin to outperform, with Europe and Latin America right behind. Returns between the U.S. and the rest of the world would begin to converge. A weaker dollar will alleviate competitive pressures and restore valuations. The aging bull market would have the potential for another leg and interest rates could be normalized.

It is too early to discern the path that we are on. It would be premature to cut down a lot of trees in its wake without pausing to make critical assessments. Odds favor a restoration to normal valuations across global markets and a weaker dollar. It is widely anticipated that at its core the “art of the deal” is mostly a bluff. However, getting caught in a bluff can be a very costly miscalculation. We intend to sharpen our axe while we wait to see if the world can pivot away from trade disputes to the always elusive global synchronized growth.

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