1919 INVESTMENT COUNSEL
Complexity to Clarity
100 YEARS

Weekly Market Insights

June 17, 2019

It was a great week for political junkies!

Last week a great economist and frequent public servant passed away. Marty Feldstein (1939-2019) served both Republican and Democratic administrations with honor and dedication to service. We need more Marty Feldsteins in this world.

The equity markets continued to advance last week. The Dow Industrials gained 0.41%, the S&P 500 was up 0.53%, while the NASDAQ gained 0.73%.

The U.S. economy showed some signs of a strengthening, but the primary reason remains the same: the tariff wars may end, but if they don't, the Fed will have to ease and with interest rates so low, income investors will fall back to feeling as though they have no choice but to buy equities.

That said, as we wrote in the title, political junkies had a field day. Trump threatens to implement more tariffs if President Xi doesn't meet with him at the G20. Trump has now put Xi in an awful position. If Xi meets with Trump, he looks to the world as if he is caving into Trump. If he doesn't, he risks escalating U.S. tariffs, something a leader of a country with a slowing economy doesn't want to risk. While pondering whether to take this economic risk, he faces a very difficult situation in Hong Kong. Adding to his problems, the RMB is falling against the U.S. dollar which could lead to one of China's great fears, currency flight.

Meanwhile, traveling to the Mideast, the United States-Iran dispute continues to create concerns, both because of possible hostilities and disruption of the energy markets. In addition, Russia and China continue trying to show their international strength by warning the United States about its military buildup in Poland. The reason we care so much about what is happening politically is that markets, financial and real, reflect societies' hopes and fears and this kind of political turmoil does nothing to relieve investors' concerns.

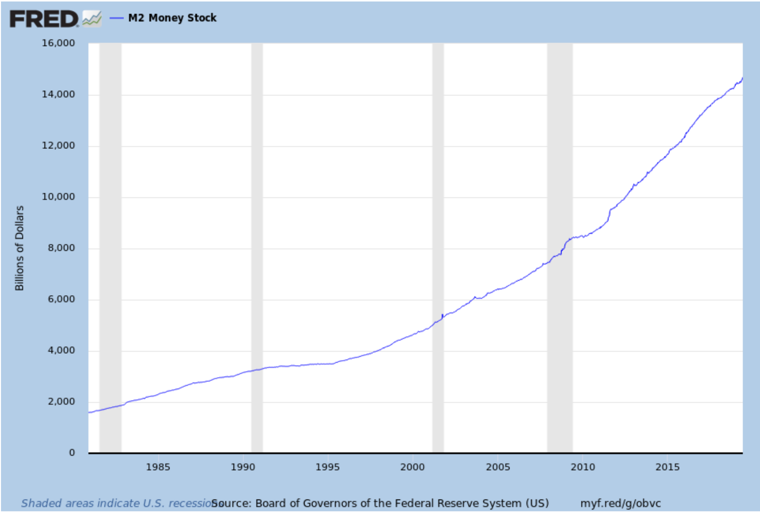
Parliament is no closer to solving the BREXIT problem than they were a year ago. Winston Churchill proves himself prescient again, "So they [the Government] go on in strange paradox, decided only to be undecided, resolved to be irresolute, adamant for drift, solid for fluidity, all-powerful to be impotent."

The Federal Reserve, of course, is always on investors' minds and it is a particularly difficult time for the Fed. It is under nearly unprecedented political pressure. It also has legitimate economic concerns. If the economy is slowing, is there a danger of the United States falling into recession? Should they risk cutting rates? There are many risks in cutting rates. The first, as we wrote of in the past, is appearing to cave into political demands. But more important is the economic risk. Some argue, particularly those who profess to adhere to Modern Monetary Theory, that there really isn't any risk at all. We addressed that argument a few weeks ago. Others who want the Fed to cut rates argue that the economy is far from its desired inflation rate, so there is no danger. Perhaps it would be helpful to pause and ask why most economists want to have inflation at all. Doesn't a country risk escalating inflation, so why not zero inflation? To many it appears counter intuitive to want inflation at all. The answer lies in a theory called The Money Illusion. It is a term coined by Lord Maynard Keynes. The basis is that most participants in an economy don't differentiate between nominal and inflation adjusted income or prices. Under those conditions, consumers and business people will confuse the inflation part of prices and incomes as real, which will keep them spending.

Weekly Market Insights (cont'd)

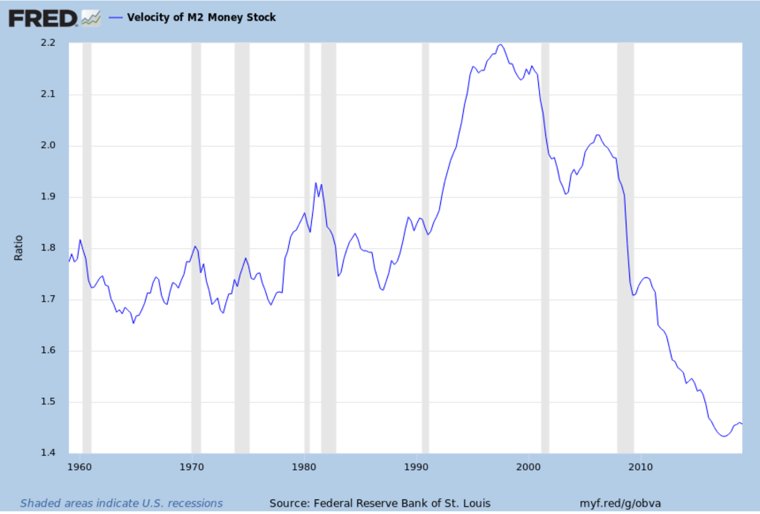
Another reason Chairman Powell and his colleagues may be hesitant to add liquidity to the monetary system is that there is a great deal of liquidity already in the system. In Chart A we show M2, which is a common

Chart A



measure of the amount of money in circulation and the exceptionally low velocity[1] which we show in Chart B. If the velocity of M2 should start to return to previous levels, the country would be in great danger of a very serious bout of inflation.

Chart B



Some analysts and investors believe the Fed will cut rates two or three times before the end of the year. We are highly skeptical of that view. It will take a more serious downturn or an all-out trade war to make the Fed so aggressive, even under dramatic conditions. One cut late in the year may be possible but it is far from a certainty.

I had the good fortune of meeting with three prominent political pollsters last week. All wisely reminded me that this is just the beginning. But pollsters being pollsters, they had to give qualified opinions. No one will unseat Donald Trump as the Republican candidate. At the moment, the most likely Democratic candidate will be Joe Biden. One reason is the Democrats will decide win ability is preferable to ideology. This makes sense. The most interesting observation came from a woman who runs a self-described Democratic, feminist polling firm. Both she and her firm are very highly regarded. The discussion turned to women and their views on Trump. It is highly reported that women don't favor Trump by a large percentage. She said that although many women in the Midwest don't like Trump, they gave this response to the question: would you vote for Trump? Here is a very interesting and understandable response. My husband and I lived through much of the great recession unemployed or severely underemployed. It was a terrible experience. Although Trump is not my favorite candidate, I won't risk the economy by making a change - yes I will vote for Trump.

To quote Upton Sinclair's pithy comment, "It is difficult to get a man to understand something, when his salary depends upon his not understanding it."

Stay tuned.

- Michael Olin Clark
moclark@1919ic.com

[1] The velocity of money is a measure of how fast money passes from one holder to the next. It is most commonly measured as the income velocity of money, which is the frequency at which the average unit of currency is used to purchase newly domestically-produced goods and services within a given time period.