THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – MARCH

US Markets and Economy:

US stocks finished the first quarter on a sour note. All major indexes fell in March, with declines ranging from just under 3% (S+P 500, NASDAQ) to almost 4% (Dow Jones). The proximate causes were the same as the previous month: new signs of a potential trade war, and the reality of rising interest rates. President Trump announced plans to hit China with tariffs on $60 billion worth of imports to the US. While this plan, which could always be revised, is partly in retaliation for well-documented Chinese intellectual property (IP) theft, it also is a bargaining chip to force the Chinese to reduce their trade surplus with the US. Most economists doubt that bilateral deficits and surpluses can be meaningfully altered by trade restrictions, much as pressing on a balloon will only force it to expand elsewhere. Of course, the real danger which Wall Street senses is not these tariffs, or the steel and aluminum tariffs (which have been mostly suspended for our trading partners), but the possibility that other countries will retaliate against the US, leading to further restrictions on trade. Most such trade "wars" do not have any winners. However, the March declines were moderated by the belief that the US "bark" is worse than its "bite," and that cooler heads and compromise will prevail. But the upcoming months may lead to further trade surprises, which could keep Wall Street jumpy.

The FOMC's mid-March increase in the Fed Funds rate by ¼% was no surprise, and Wall Street is fully prepared for two more such increases during 2018, and perhaps three more in 2019. In this scenario, the bull market can continue, as many have when interest rates rise gradually from very low levels. In fact, the latest increase in the Fed Funds rate just brings it up to about zero in real terms (after subtracting inflation). This is still accommodative monetary policy. What would unsettle Wall Street (as in February) is any sign that wage inflation was growing substantially, or that price inflation was picking up to levels above the Fed's 2% inflation target. Such an event could force the Fed to increase interest rates more quickly. Although there are no concrete signs of such an acceleration of inflation, Wall Street may also be unusually jumpy around every release of new data on economic growth and inflation, and every release of new details about FOMC deliberations.

The economy itself remains in excellent shape, with GDP growth picking up nicely to 3%, employment growing robustly, while unemployment stays very low, and price and wage inflation remaining "subdued," to use one of the Fed's favorite words. At the same time, corporate profits

are growing smartly, pushed forward in part by the recently enacted large business tax cuts. There is no real disconnect between this smooth economic growth and a volatile stock market: traders are always looking ahead and reacting (often overreacting) to potential dangers lurking in the future.

Thus, on balance, the path of least resistance for US stocks remains upward, but long-term investors are likely to be buffeted by even more volatility this year. In the long run, however, investors are richly compensated for hanging tough when the going gets tough.

World Markets and Economy:

Canadian and Mexican stocks also fell for the month, as the future of NAFTA remains in doubt. Canadian stocks have not been hit as hard as Mexican stocks, since the White House seems more interested in punishing our neighbors to the south. Yet NAFTA has been a net gainer for all three countries, according to most economists. Business supply chains in the Americas are more integrated than ever, and it would be expensive if these supply chains were disrupted. Once again, traders in Mexico and Canada are hoping that US threats are merely bargaining chips, but both Canadian and Mexican stocks will be hostage to trade developments this year.

European blue-chip stocks, as measured by the EUROSTOXX 50 Index, also fell for the month, although the decline was smaller than in the US. While Europe does not relish a trade war with the US (interested readers can google “chicken tax” to see what has transpired in the past), European stocks have been buoyed by more signs of economic growth, which should be good for corporate profits. Even Italian stocks remained fairly firm in March, as the prospects for a new government improved. This optimism has not spread to Britain, which is in the throes of a messy Brexit. British stocks, as measured by the FTSE Index, are now down 8% for the year.

Japanese stocks also fell in March. Japan is the only major exporter of steel to the US not to be exempted at least temporarily from the new tariffs. Additionally, Prime Minister Abe is still fighting corruption allegations, which may reduce the effectiveness of his economic policies, which have clearly turned the Japanese economy around after decades of stagnation. Over the last twelve months, the Nikkei average, not counting dividends, is up about 11.9%, which is better than the US S+P 500 (up about 11.7%).

OUTLOOK:

The long-term path for US stocks is still up, as a strong economy delivers higher corporate profits. However, the return of volatility, and the possibility of more surprises on trade and interest rates, suggests, as Bette Davis memorably said, we are in for “a bumpy ride.” Long-term investors must have the patience and discipline to ride out these short-term gyrations.