From the desk of the CIO
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This month's focus:

1. Currency and geopolitics
2. Interest rates and tariffs

Currencies - It's On!

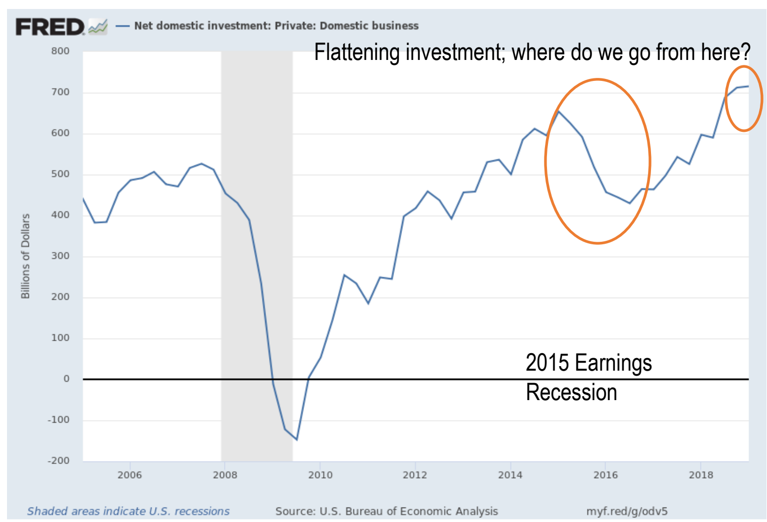
What's on? The global battle for world supremacy, that's what's on. The players are the United States, China, and the Eurozone, and to a lesser degree, Russia. If you're investing in financial assets, this battle is already impacting you.

The two big dogs fighting it out at the moment are the United States and China. Their respective currencies; the *US Dollar* and the *Renminbi*. This all goes back to the 2008 Financial Crisis that was triggered right here in the USA. Pre-2008, the dollar was ***it*** for global trade. China collected dollars by selling their exports to us, then used those dollars to fund their trade with other countries. This made China, and by extension their other trading partners, dependent on the dollar to conduct financial transactions. The Financial Crisis of 2008 greatly hindered transactions, teaching the Chinese that relying on the dollar is potentially a volatile proposition at times.

The other observation the Chinese seem to have latched on to is how the U.S. leverages the use of the dollar in foreign policy. If the U.S. uses economic sanctions in geopolitical pursuits, the U.S. government can enforce these sanctions, in part, by using the United States Treasury Department's authority over transactions that involve the U.S. dollar globally. The result of this dynamic is that the Chinese have worked to internationalize their currency through opening their bond markets to the rest of the world. In starting to look a little more like the U.S., China has indicated the currency battle **Is On!**

Remember also, that up until recently all global trade in oil was priced in dollars. In 2018, China's Shanghai exchange started trading oil futures contracts in Renminbi, which now represents around 12% of all oil futures contracts. In addition, China has been stockpiling energy for the last few years. They have been increasing their imports of oil during a time when their economy has been slowing. Why? Because, free of shorter-term energy dependence, they can attempt to disrupt energy markets by tanking the price of oil markets to the detriment of U.S. shale producers. Another trade bargaining tool.

After decades of globalization, it seems the three major global empires, the United States, China and the Eurozone, have swung back to more of a nationalistic approach. Managers of publicly traded companies take note of such dynamics and it causes them to put a hold on business investment. In the chart below of net domestic private investment, you can see that in 2015 business investment dropped significantly. This resulted in poor corporate profits and stock market performance. We are watching the flattening of this line now to see if it begins to turn downward as it did in 2015.



Interest Rates

Interrelated to currency values is the issue of interest rates. The Federal Open Market Committee (FOMC) met last week and left short-term interest rates unchanged. However, they seem to have opened the door to possible rate reductions later this year due to a recent slowdown in economic growth, which is partially due to the trade tariff situation with China. So far, a rate decrease has been interpreted as a somewhat positive development for stocks. This is the old "bad news is good news" dynamic. Two things happen with lower interest rates; stocks appear more attractive when guaranteed rates are low, and low rates eventually spur economic growth which is good for stock prices as investors tend to look forward.

It's been a while since investors have experienced decreasing interest rates, although rates are still low by historic comparisons. There is an inverse relationship between interest rates and bond prices. Bond prices rise as yields fall. There is also a relationship between short-term and long-term interest rates. The chart below shows the 10-Year U.S. Treasury yield moving up slightly in recent days in anticipation of a potential rate cut in the near future. This may be in anticipation of increased economic growth resulting from short-term interest rate reductions.

Slightly upward movement in 10-Year U.S. Treasury Bond yields.

If short-term interest rates do indeed trend downward, it will cause us to re-think some of our fixed income exposure in our portfolio models. One possibility is reducing floating rate debt which is a better bet when interest rates are rising. Another move may be to add more high yield corporate bonds that benefit from increased economic growth which will eventually result from lower short-term interest rates. See below for a discussion of corporate debt.

Corporations have borrowed money at record levels with rates so low for so long. Because of the high levels of borrowing, there have been many articles written in reputable publications, such as Forbes, regarding the looming corporate debt crisis. One of the assumptions of this theory is that interest rates were going higher and as corporate debt matures and needs to be refinanced it would be at higher rates, increasing interest payments for companies and reducing net profits. Or worse, causing corporate credit defaults. At the moment, with rates trending lower, the corporate bond debacle seems to have been kicked down the road.

Summary:

- Geopolitical tensions and a reversion to a more nationalistic posture by the world's largest economies could cause tumult in the stock market over the longer term, and volatility in the near term. Despite President Trump's positive tweet on trade talks with China this week, a deal will be difficult for both countries.
- Fed talk is now centered around interest rate cuts. This might be good for stocks in the short term but also may signal a weaker economic back drop in the longer term.
- Lower rates are historically a positive for stocks and bonds.