October 23, 2018

# Trade Update! NAFTA 2.0 and the Global Trade Spat – Alex Petrovic III, CFP®

Since our last quarterly newsletter in July, there have been some positive trade developments, but the rhetoric with China has become more acrimonious. Let's start with the good news first.

Mexico, Canada and the U.S. agreed to revise NAFTA. NAFTA 2.0, or the USMCA (United States Mexico Canada Agreement), must still be approved by Congress and is mostly the same as the old agreement. The agreement should not have much of an impact on overall economic growth or inflation, but it is an important hurdle cleared. Letting NAFTA expire would have been very disruptive to manufacturing supply chains, especially in motor vehicle production. Plus, Mexico and Canada combined is our biggest trading partner.

The USMCA specifies that, to avoid a 2.5% tariff, 75% of the content of imported vehicles must be from North America (vs. 62.5% in NAFTA). In addition, 70% of the steel and aluminum must be produced in North America, and 40% of the vehicles must be made by workers earnings at least $16 per hour. Car makers may opt to avoid the added costs and hassle of complying with these rules and simply pay the 2.5% tariff.

The wage requirement should help level the labor-cost playing field among the three countries. The portion of an automobile that must be made in North America will likely be the result of less sourcing from overseas. However, we think the net impact is higher costs, much of which companies will likely pass-through to consumers. Finally, the agreement does not resolve the conflict surrounding U.S. tariffs on steel and aluminum (and the retaliation of Canada and Mexico to those tariffs).

With NAFTA 2.0 almost complete, we now expect the Trump administration to turn its focus to Europe and Japan, with the hope of wrapping up bilateral trade deals with them in the coming months, and then turning attention to China. President Trump and European Commission President Jean-Claude Juncker agreed at the White House on July 25 to avert a trade fight and work toward "zero tariffs, zero non-tariff barriers, and zero subsidies on non-auto industrial goods." U.S. Trade Representative Robert Lighthizer is meeting with EU trade officials at the end of November to try to avoid such an escalation.

Assuming the U.S. can resolve key trade issues with the EU and Japan, it is already coordinating a U.S.-EU-Japan trilateral approach versus China. A spokesperson for the U.S. Trade Representative said the trilateral group centers on concerns relating to China's "non-market-oriented policies and practices, industrial subsidies, and technology transfer policies and practices." (Source: WSJ.com, U.S., EU Trade Teams Seek Fast Results and Big Savings, 10/21/2018).

Now, moving onto the U.S. vs China. Ed Mills, Raymond James' Washington Policy expert recently wrote, "In recent days, we have been seeing a significant uptick in concern that we are in for a prolonged trade war with China that amounts to a U.S.-China cold war. The base-case now appears to be set for a prolonged negotiation and sustained tariffs." Indeed, a couple of weeks ago Vice President Mike Pence gave a blistering speech on U.S.-China relations, saying "the United States has adopted a new approach to China" with the message to China: "This president will not back down."

Toward the end of September, a new round of reciprocal tariffs between the United States and China kicked in. The United States imposed an additional $200 billion in tariffs on Chinese goods, prompting China to assess $60 billion worth of tariffs on U.S. products. This follows each country's initial volley of $50 billion in tariffs on their respective imports. President Trump imposed 10% tariffs on the additional $200 billion in Chinese goods effective September 24, which will rise to 25% on January 1, 2019. The initial 10% was meant to limit the impact during the holiday shopping season.

Tariffs and foreign retaliation have not yet had a big impact on overall economic growth. Total imports from China amount to less than 3% of U.S. gross domestic product. The direct impact of adding a 25% tax to those imports would therefore be noticeable, but not particularly large, especially when compared with the recent tax cuts and federal spending increases.

This latest action against China follows earlier U.S. tariff increases on imported steel, aluminum, solar panels, and washing machines. At this point, the White House has imposed trade restrictions on about 12% of all U.S. imports, while our trading partners have responded with increased tariffs on about 8% of all U.S. exports.

It's very difficult to gauge how long the tariffs will remain in place and how much they might affect the economy. From our readings, economists do not expect the trade spat alone to push the U.S. or the world into a recession. Most economists expect inflation to increase a bit, and for global and U.S. growth to take a small hit if the trade war continues well into 2019.

In conclusion, we should be prepared that things are likely to get a bit worse before they get better. For now though, we recommend clients stay the course. The underlying fundamentals of the U.S. economy are fairly strong, and it should be able to withstand the impact of tariffs. The bigger issues in our opinion are future corporate earnings growth and impact of rising interest rates.

## This is too good to be true! Or, are we headed for a cliff?
## Sandi Weaver, CPA, CFP®, CFA®

What do you call an economy growing at 4%?
What do you call corporate earnings increasing by 20%?
What do you call a diminutive 3.7% unemployment rate?
What do you call cranking out 208,000 jobs a month?

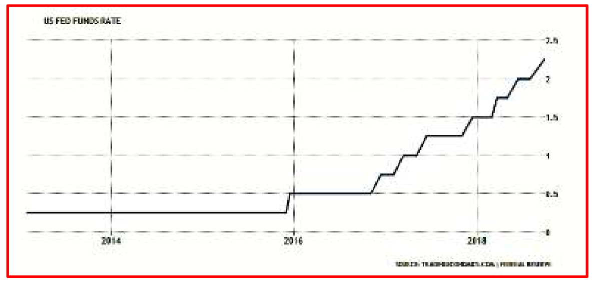
We have cut a deal with Mexico.
We've gone to the mat with Canada and won.
The European Union is close.
China is running scared and blustering. Look at their stock market.

We are rockin' in the sweet spot! Can life get better for this economy?

That was my opening salvo when I wrote the first draft.
But October is not known for the faint of heart.
S&P 500 stocks lost 6% in the second week, reverting to a 2% gain for the year.
The BarAgg Bond Index downshifted from a -1.6% return to a -2.1% loss.
Yet the markets are clawing their way back up as I write.
Is the party over? Or will our economy continue to hum?
Read on if you'd like a brief review of pertinent data points.
Or, skip to the CliffNotes summary for the nutshell!

**Gross Domestic Product (GDP)**. Our GDP grew at over 4% in the second quarter of this year. That's awesome. Estimates for third quarter expect even better growth. We had been stuck in a 2% growth rut but we've been exceeding that the last couple years. Averaging 3% growth may be attainable.

But naysayers claim that the unusual stimulus of low interest rates and Trump tax cuts are behind the 3% and 4% growth spurts. We and our grandchildren will pay the price down the road for our excessive spending now. National debt to GDP is high compared to other countries. That ratio was at 99% in late 2015. Now it's 108% a mere 3 years later.




We – the consumer, the government, our corporations - have been bathing in low interest rates since 2008. Now that interest rates are heading up – see the graph at the right - we'll be shocked at how high our interest expense payments will become.

Because of this booming economy, and their mandate to control inflation, the Federal Reserve Bank has promised us a gradual rise in interest rates. We've had 3 short hikes this year, with another likely in December. Short-term rates are at 2.25% now. That's cheap money compared to 5.7%, the average between 1971 and 2018. Yes, our interest expense will increase.

**Corporate Earnings** have been humming. Our large U.S. companies earned 12% more in 2017. Experts are projecting they'll grow at a 20% pace this year, and that's a solid estimate given we're done with 3rd quarter. Those experts also believe we'll grow earnings at a 10% pace in 2019.Although that's still above average, it's the delta, or change, in the rate that matters.

Headwinds are rising for companies. Their cost of money is increasing. Cost of raw materials is increasing for some companies due to tariffs. With our tight labor market, companies' cost of labor is just starting to increase.

The **Unemployment Rate**, at 3.7%, hasn't been this low for 49 years. Corporations are scrambling for workers. Although we haven't seen significant wage growth yet, pros expect it soon. There's a job opening for every unemployed person (see the chart at right) but firms cannot find the skills they need among the applicants. We haven't seen that since 2000, when we started tracking.


**Jobs Created** reflect the same hard-pumping economy, which is still creating a record-setting number of jobs – 208,000 versus 182,000 per month in 2017. Yet with a slowdown in immigration a la the Trump administration, and a record-low unemployed pool of workers, companies will automate even more and raise wages to compete for employees.

**CliffNotes Summary**

What's the upshot of competing for workers, a hot economy, tariffs on raw materials and on finished goods? Inflation. That leads us back to the Fed, and higher interest rates to temper the economy – eventually.

Tariffs are probably the most visible risk we face. Yet talks on trade are progressing well, opening up markets for us. Alex's article this quarter can bring you up-to-date. But the implementation of yet more tariffs is underway. Remember September 17th's headlines on another $200 billion of Chinese goods? As Alex concludes in his writing, the impact is not expected to be significant for an economy our size, although it will lead to some higher consumer prices and some higher inflation.

Could something come at us out of left field? Oh absolutely. Try high levels of student debt or high corporate debt; try an all-out trade war with China, or an emerging market crisis may become contagious given a rising dollar; investors may shift quickly into bonds for yield; inflation might spike to unexpected levels – whether from tariffs or wage growth; try political high jinx with material economic impact.

The near-term economy looks reasonably solid. But it's time to be diversified with low-risk and high-risk investments when most of the investment quarterlies look too good to be true. They look pretty favorable this quarter.

## Market Recap – Jim Stoutenborough, CFP®

Let's do the numbers:

- In September the U.S. stock market returns wobbled and did not move in unison. After Labor Day, the S&P 500 was up 0.6% but the Russell 2000 was down with a (-2.4%) loss. International markets were up with a 0.8% gain and bonds were down (-0.6%)

- For the first 3 quarters of 2018 - Large U.S. companies, the S&P 500 Index, was up 10.6% and the Russell 2000 Index (small U.S. companies), despite the rough September, was still up 11.5% for the year. The international index, the MSCI World ex US, lagged, down (-1.5%). The Barclays U.S. Aggregate Bond Index (quality U.S. corporate and gov't bonds) was down (-1.6%).

| Asset Class | Index/Category | 2018 YTD | 2017 | 2016 |
|---|---|---|---|---|
| Cash and cash alternatives | Average 1-yr CD Rate | 0.7%** | 0.3%* | 0.3%** |
| U.S. Bonds | Barclays US Aggregate Bond Index | -2% | 4% | 3% |
| U.S. Large Companies | S&P 500 Index | 11% | 22% | 12% |
| U.S Small Companies | Russell 2000 Index | 12% | 15% | 21% |
| International Markets | MSCI EAFE NR USD | -2% | 24% | 1% |

*Numbers come from Morningstar.com, *FDIC.gov and **Bankrate.com*

## Our Meetings Can Be More Than Just Talking Numbers – Here's Why – Ann

We know that our meetings are probably not the most exciting event on your calendar. Listening to us talk about retirement or long-term care insurance may be intimidating or even downright scary. However, it is important that we meet with you on a regular basis for several reasons. Obviously, we can discuss your investment situation in detail to ensure we are meeting your investment needs and expectations and, if not, discuss ways we can change our strategy to be more in line with yours. We can discuss other financial planning related items that could become a critical event, if not timely addressed.

<u>Long-term care insurance</u>. No one wants to think about being in an assisted living facility. No one ESPECIALLY wants to think about the costs or seeing all of one's hard-earned assets turned over to a facility as payment for rendered care. We will discuss long-term care insurance options and help you choose a plan that is best suited for your anticipated needs.

<u>Current beneficiaries on accounts</u>. New child or grandchild? Divorce or Remarriage? It is important that beneficiaries be as current as possible on your accounts. We recently heard of an unfortunate experience involving a former client. An account had two beneficiaries assigned, but no contingent beneficiaries. After the account holder passed away, it was learned that one of the two beneficiaries had also passed away. Because there were no contingent beneficiaries assigned to the beneficiary who had passed away, THE ENTIRE ACCOUNT WENT TO PROBATE for the courts to decide how it should be distributed. This involved attorneys for the estate and the living beneficiary. Having contingent beneficiaries on an account could have very well avoided this scenario.

<u>Tax updates</u>. There have been recent tax law changes which can affect you. We can look at your past tax returns and point out how the current tax laws can be applied to your advantage. We are not tax advisors; however, we can provide you with beneficial tax information.

Change in investment risk tolerance. As one nears retirement, you might want to take less risk with stock and bond investments. One cannot weather the highs and lows over a short period of time, or one may be looking to different types of investments altogether.

Timely setting up education funds for children or grandchildren. Planning a child's education should start sooner versus later, and it just gets more expensive every day. We have several different educational account options to fit different savings patterns.

Last, but not least, meetings give us the chance to ensure we have your most current contact information. And best of all – they give us a chance to see you face-to-face and catch up on your lives.

## Changes to RJ Investor Access You Should Know About – Ann

On October 20, Raymond James will make changes to Investor Access in an effort to provide a more modern, streamlined client experience. Foremost, it will change the name from "Investor Access" to "Client Access" as it will be more focused on client services. Fonts will be changed and the site redesigned in an effort to become more mobile device friendly. Clients can view documents through an app, and the site will have an improved login help page. An updated market information screen for more convenient at-a-glance information with simpler access will be added.

Clients can more easily receive reports through the RJ vault and view linked external accounts. Clients will have the option of adding an extra security layer when logging in using two factor authentication.

Along with these changes, client email notifications that previously came from notifyinvestor@raymondjames.com will be sent by notifyclient@raymond james.com. Clients should add this email to their list of approved emails to continue receiving important notifications from Raymond James.

Clients may view the planned updates by visiting raymond james.com/investoraccessupdates. The Investor Access summary page will also display a banner with information and links.

## Inside & Outside of PWFS

**Alex Petrovic III –** Happy (almost) Halloween! I can't believe we are in the final stretch of 2018. Time flies by, and the past three months have been no exception.

Amid home renovations, with the intent to move next year, we travelled to Yalta, Russia for about two weeks to visit my wife Dasha's parents in early September. As you may remember, I met my wife in Yalta, Ukraine back in 2003 while I was serving in the U.S. Peace Corps in Ukraine. Yalta and Crimea were a part of Ukraine until Putin and his "little green men (soldiers)" annexed it in early 2014. Since then the international sanctions on Crimea and Russia have made it much more difficult to travel to and from Crimea, as well as renewing her parents' U.S. visas and something as basic as sending a letter or package to them.

It took 4 airplanes, one hotel stay, and about 2.5 days of stressful travel to get there, but once we arrived, we settled into a relaxed routine. Her parents found us an apartment in their building to rent for our stay. They also found us a gentleman to drive us around when needed. Most days we slept in, enjoyed home cooked Russian meals, and hung out at her parents' home. Benny enjoyed the Russian playgrounds, the numerous fountains around the city, and trying to understand Russian cartoons. Her parents had not seen Benny in the flesh, only over video chat, so they relished the opportunity to hug, kiss and teach him a bit of Russian. They also experienced his occasionally picky eating habits and the typical toddler tantrums.

Yalta is a beautiful coastal resort town on the Southern edge of Crimea surrounded by green mountains, vineyards, and the former palaces of the tsars. The World War II Yalta Conference, attended by FDR, Churchill and Stalin, was held at Livadia Palace, which is about 10 minutes from her parents' apartment.

While in Yalta, we enjoyed visiting two of the nearby palaces and their extensive gardens. The Nikita Botanical Garden was always a favorite of ours, and we toured it with a long-time friend of Dasha's. Dasha was also able to arrange a few meetups with other friends of hers that she hadn't seen in many years. During our visit, we did have a moment or two of "Russian stress". Our first taxi ride in Yalta reminded us that we were 'not in Kansas anymore.' Seat belts typically go unused, speed limits are often ignored, and the side streets of Yalta are exceedingly narrow and winding. All of this, along with an aggressive taxi driver, led us to wonder if we would also see a Russian hospital during our stay. We made it safely back to our apartment, but our pale white knuckles and faces stuck with us for a couple of hours!

All in all, the trip went very well. It was wonderful to see her parents after so many years. They were thrilled to finally squeeze and kiss little Benny, and the city and Black Sea served as a beautiful backdrop. Hopefully we will make it back again sooner rather than later since the sanctions have made it more difficult for her parents to ever visit Kansas City again.

**Sandi Weaver –** I hiked Mt. Rainier National Park in Washington this last quarter. It was an awesome trip, lovely wildflowers. We spent a bit of time on the Pacific Crest Trail, which winds through the park. We learned a great deal about the eruption on St. Helena, which we hiked one day. The park also wins the award for the most despicable outhouse I've ever seen, even worse than the bottomless pit outhouse in Croatia we poor hikers were forced to use there!

**Jim Stoutenborough** – Not much has been happening on the home front except I have been trying to watch less TV and read more. I am about to finish "The Martian" which is just as good as the Matt Damon movie but with more science geekiness.

I also finished a couple of business related books – "Predators Ball" about the rise and fall of Michael Milken and the 1980's junk bond market along with "A First Class Catastrophe" about the 1987 stock market crash. I just started re-reading "Blood on the Streets" about the 2000-2002 bear market.

Maybe the next investment history book I read needs to be a little more upbeat – after these three books no wonder Alex and Sandi found me hiding under my desk the other day.

**Bryson Slater** – I am welcoming in this fall season with open arms because it means my schedule is finally starting to slow down a bit. I have been bouncing around the state over the past couple months, attending weddings and other events, essentially every weekend… a good, yet exhausting, problem to have! I am in the homestretch of my CFP course with the test coming up in mid-November. That means all my "free time" from here on out will be allocated directly to my studies! I am looking forward to the rapidly approaching holidays to kick my feet up and relax with friends and family after a very busy past six months.

**Marsy Gordon –** The last few months brought several family celebrations. It also brought a visit from our four-year-old grandson while his parents took a brief vacation. While he was here, we checked out the model trains at Union Station with his cousins. We also were able to stand on the pedestrian bridge over the real train tracks outside, while we watched two long trains going in opposite directions pass beneath our feet. That is a fun experience with little kids!

May you and those who are dear to you have a wonderful holiday season.

**Ann Kloster –** Earlier this month, I went for a long weekend in New York with my six sisters-in-law (yes, I wrote that correctly – six). Too much food and laughter, not enough sleep, and loads of fun.

It was raining when we left KC, and it rained every day in NY. On the way home, we were chatting with our fellow travelers and learned that it had apparently rained that weekend over a great portion of the country. Coming from Arizona? Drizzle and rain. Nebraska? Stormed. Ohio? It just poured! So, Kansas Citians, it was evidently raining over a large part of country, not just on us.

**Marilyn Brohm -** My best friend (since 8th grade) and I took a road trip to Taos, New Mexico last month. We stayed in a 300-year-old casita near the Taos plaza, so we were able to walk to restaurants, shops and the many, many art galleries.

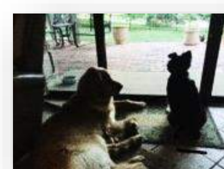
We made a day trip to Santa Fe enjoying the gorgeous scenery along the way, walked the plaza and took in the Georgia O'Keeffe museum. She was quite a woman, way ahead of her time in independence, creating a style completely her own.

My one indulgence was art prints (can't afford the originals). So now all I need to do is frame them. I plan to bring in a few to decorate our office space – so beautiful and colorful – just like Taos itself.

**LaDonna Parker -** The last six months of my life were spent at home, in the hospital, and in rehab. My social life consisted of home health care professionals and friends, neighbors and family who visited me at home and in rehab.

April 16th I suddenly experienced intense back pain. After numerous trips to the emergency room, a mis-diagnosis, and MRIs, the radiologist discovered that my pelvis was broken in three different places. I could not walk and there was nothing that could be done.

Just as I was really beginning to feel better and able to walk unaided by walkers, I fell on my steps at home and broke my right wrist in numerous places. I had surgery and my wrist now has a plate and seven pins in it. Will that set off metal detectors?



I had to give my dog to my sister to care for and neighbors had to come over and open bottles for me. My poor little dog was so confused. Why did he have to keep going to Aunt Connie's house? Where was mamma? Why was Mom lying on the steps yelling "HELP!"? When Bailey came home, he stuck to me like glue.

I went back to work. One day shortly thereafter, I accidentally stabbed my left hand with a sharp kitchen knife. For my efforts there was blood all over my kitchen and I had to have four stitches. Now I had two hands that did not work well.

I have heard that bad things happen in threes. If that is so, I am finished!

**Jeannine Shaffer –** Our annual neighborhood block party and homes association meeting took place in early September. To entice residents to attend, an ice cream truck, family friendly food, facing painting and elaborate balloon creations to entertain the children were provided. The tremendous regreening in our neighborhood was evident by all the young families with strollers, kids riding bikes or scooters, and chasing one another. The families we had so much in common with have moved away, and we know fewer people and less about our new neighbors, since we lack the common bond of play dates, carpooling, school and sporting events.

After 30 years in the neighborhood, we have become the older people next door.

Sandi Weaver

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