# Boenning Morning Comment

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Stocks fell yesterday reversing Friday's gains. There is a very high profile World Economic Forum going on in Davos, Switzerland this week. CNBC is giving it non-stop coverage. Last year, just as the tax cuts were going into effect, almost everyone was optimistic. Stocks followed a decent fourth quarter run with a spectacular January. Of course, we all know what followed, a sharp correction in February featuring two sessions where the Dow dropped by more than 1000 points.

This year seems quite different. There are many fewer economic tailwinds. The tax cut is now a year old and will no longer provide a year-over-year bump to earnings. Brexit is less than 90 days away without a solution. Workers in yellow vests are creating havoc in France and echo effects throughout Europe. The ECB has slowed quantitative easing while the Fed is raising interest rates here. China's growth is declining. Tariffs are now in place and Mr. Trump threatens to raise them further should China not support better protection for intellectual property. Sovereign debt levels are exploding as nations around the world try to stimulate growth to extend the economic upcycle.

Many leading voices from the investment world from Seth Klarman to Ray Dalio (Google these names if you don't know who they are) are voicing concerns and rightfully so. No one, including the two names just mentioned, can tell us when they will start to spoil the party. Inflation and interest rates remain very low and earnings continue to grow. The decline in stock prices in 2018 has moved valuations back to levels one can call fair. Valuation per se is no longer an issue.

I have often said that recessions occur as a result of economic imbalances. At this very moment, I don't see any. It is unlikely they will occur this year. The yield curve still hasn't inverted although it is hovering between 15 and 20 basis points from being dead flat. Low inflation is keeping cost in check. GDP growth is slowing around the world but is still expected to be over 3%. However, with that said, there is an obvious air of concern, not only in Davos, but all over the world.

I will cite four areas of concern that bear watching:

1. The amount of sovereign debt outstanding.
2. The economic future of China
3. The rise of populism
4. President Trump.

**Sovereign Debt** – What is happening in this country is also happening worldwide. Debt-to-GDP ratios are exploding. While low interest rates make the cost to service debt tolerable, the burden increases as rates slowly rise from near zero and entitlements, contracted by law, expand at an accelerated base now that many baby boomers have reached 65. For a decade low interest rates plus declines in defense spending, have offset the burden of rising debt. But now defense spending is up, entitlement costs are accelerating, and deficits are exploding under a leader, Mr. Trump, who has never feared the use of debt or high leverage. The problem of too much leverage is never apparent until it is too late. Simple math suggests one percentage point of increase interest cost on $20 trillion in debt is $200 billion of additional expense per year. Either that gets added to a deficit already over $1 trillion per year or it must be offset by cost cuts elsewhere. The only elsewhere is entitlement costs.

**China** – For decades, China has growth at 7-10% per year as it emerged from the Mao era. But now the laws of large numbers are catching up. China's government is doing all it can to stimulate growth including tax cuts and easy money. But all that is doing is borrowing from tomorrow to sustain growth today. It is a losing battle. China wants to accelerate the transition from a manufacturing and infrastructure economy to one built upon the consumer, like the U.S. But growth is still slowing and will likely continue to slow in future years.

**Populism** – There is a long history of what happens to economies after income inequality reaches extremes. In France, a business-friendly pragmatist replaced an unpopular socialist who promised good things but got swallowed by France's bureaucracy. But his tax policies, favoring business and the wealthy, have backfired and led to a storm of protests. France's democracy today is built on our model. It was our greatest ally in the Revolutionary war. There are a lot of people who treat the gilets jaune movement as a precursor of what to expect around the world. Maybe it won't erupt here in the same way. But we have already seen contagion from Europe in other ways. After the migration from the Middle East and Africa swamped Europe two years ago and the election of Donald Trump, with his base of populist support, we have reacted here with a big fight over a wall separating Mexico from the U.S. While some still see immigration as an American ideal, many see it as a threat to our safety. The normal left-right immigration fight is the threat of migrants stealing our jobs versus the land of opportunity. Not so today. With unemployment close below 4%, this time the argument is a combination of safety and preserving the existing American heritage versus those who view America as a land of opportunity for all. As the current government shutdown shows, this is a battle likely to escalate before any solution can be reached.

**President Trump** – Without getting into politics, the economic concern about Trump centers on the impulsive nature of his decision making process. The most recent example, although not economically significant, was his decision to pull all 2,000 American troops out of Syria ASAP. The decision was apparently made without input from the military, his security team, or the Defense Department. For weeks now, others have had to backtrack from that decision. The current concern is about tariffs. These are taxes. Despite Mr. Trump's assertion that China is paying us billions, the entire burden is being paid by U.S. importers. It is hard to plan without some confidence of ongoing business rules of the road. As a result, investment spending is under pressure.

All of these concerns are real. None overwhelm us today. All could become major factors tomorrow. Perhaps all the concerns are overblown and none will create a storm. With all that said, in the short run, earnings reports and forecasts for 2019 will dominate. Early results have been good and managements are cautiously confident. Short term, that should rule and we continue to believe 2019 can be a good year for stocks. But the concerns of Davos are not about to fade. The end cycle euphoria that sometimes occurs isn't likely to evidence itself this time around. Perhaps that is healthy. Moral: watch to numbers; earnings and interest rates are the driver of stock prices. But don't lose sight of the four issues described above. Some may fade but others will get more worrisome. They matter.

Today Mariska Hargitay is 55. Airline pilot Chelsey "Sully" Sullenberger is 67.

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