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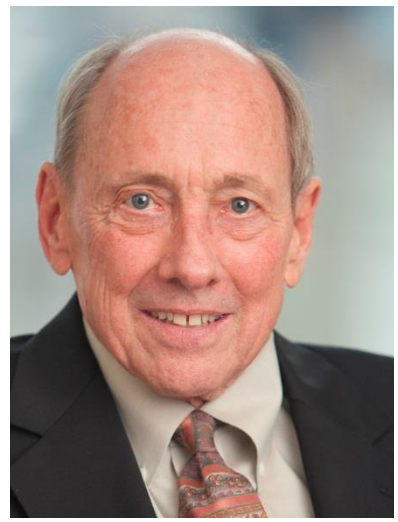

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The Trade War

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PMA clients – like much of America -- have their eyes on the markets, trying to read financial tea leaves against the backdrop of growing trade wars. We, too, pay close attention to the trade climate as we look to optimize client portfolios to both seize upside and soften downside. The trade environment is one of many elements we balance in our allocation process, and currently the squeakiest wheel!

Last March, President Donald Trump imposed tariffs of 25 percent on steel and 10 percent on aluminum. Canada, Mexico, Brazil, and the EU won temporary exemptions, though Mr. Trump later removed them. At the end of March, Mr. Trump reached an agreement with South Korea to exempt it, but with the provision that South Korea agree to a reduction of its exports of steel to the US by 30 percent—a quota.

Other countries quickly retaliated with new tariffs of their own. Not surprisingly, many of these tariffs were targeted to the Republican base—Midwest farmers. In response, the US has instituted or threatened further tariffs, again prompting other countries to respond in a tit-for-tat cycle.

Perhaps surprisingly, this war has not resulted in a major drop in the stock market. Year to date through August, the S&P 500 is up 9.9 percent. In the short-term, of course, the markets have reacted vigorously to announcements of actual or potential tariffs as they did on March 22 when fears of a trade war caused the Dow to plummet 724 points.

In aggregate, however, despite the potential for a destabilizing trade war, the US economy remains strong. GDP grew at 4.1 percent in the second quarter—a rate of growth not seen for nearly fifteen years. Unemployment is just 3.9 percent as new job creation remains strong. Both business and consumer confidence remain high. Corporate profits are strong (and only partially due to the corporate tax reduction).

With all this good news, we are left to wonder what might have been in the absence of a trade war. Clearly, the market has reacted positively to solid corporate earnings. But were we riding the trade war brake? And where will the trade war lead?

The topography of a trade war can change rapidly. On July 25, Mr. Trump met with European Commission President Jean-Claude Juncker at the White House and issued a joint statement that reads as if written by a free-trader.

While the EU communique clearly espouses free trade, the Korean agreement retains components of protectionism. Specifically, it calls for the reduction of some Korean restrictions on the imports of US cars (free trade), the elimination of tariffs on steel but with quotas (partially free trade), and the extension of the US tariff of 25 percent on Korean small trucks for 20 more years (protectionism).[i]

On August 27, Mr. Trump announced a deal with Mexico, which will still need ratification by Congress—far from certain especially if Canada is excluded from any “NAFTA replacement” as threatened by President. The Wall Street Journal reports that under the new deal with Mexico 75 percent of the content of an auto must be made in North America to be sold duty free, up from 62.5 percent (greater protectionism), and that 40 percent of the content must be made with workers making more than $16.00 an hour favoring US and Canadian production (new protectionism).

As indicated and importantly, Canada is not yet part of this agreement, but negotiations are underway. One of the main sticking points is the US insistence that Canada eliminate, or at least reduce, the protectionism that it gives to its vote-rich dairy farmers.

The above is based upon press reports. It will not be until the precise text of any agreement is made public that we shall know exactly what the agreements contain. To meet Mr. Trump’s ratification deadline, any agreements have to be made public by the end of September.

In addition, Mr. Trump is negotiating with China. The issues with China are not only economic but include issues of national security and internal domestic policies of China. However, our trade activities with China are small in comparison to those with our major trading partners, so that even if all trade with China collapsed, the effect on the US economy is not likely to be highly significant. Canada, Mexico, and the EU are primary.

All of this returns us to where we began and the question about how significantly to weight trade among all of the factors that drive global markets as we allocate portfolios? If history is a guide, while tariffs dominate the news, overall economic health indicators and corporate earnings ultimately move markets. The US economy is strong and corporate earnings are growing solidly. For these reasons, the PMA Investment Committee has decided to maintain its current equity allocations in its risk-controlled portfolios.

The dynamics of fixed income are different. In this booming economy, inflation pressures are likely to increase. The FED's response, as well as that of the market, may result in interest rate hikes, thereby increasing the risk of fixed income. In response, PMA has restructured the fixed income component of its portfolios to be less sensitive to increases in interest rates.

We will continue to monitor the squeaky wheel of trade, economic indicators, corporate profits and mid-term elections as we seek to optimize PMA portfolios. Watch this space for our most current analysis.

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[i] This agreement requires its ratification by the South Korean legislature. Mr. Trump has suggested the imposition of a tariff of 25 percent on automobile parts. Unless this threat is removed, the Wall Street Journal has suggested the South Korean legislature may balk at ratification.