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Politics or the Fed?

Global Markets and Regions

	3rd QTR	2018 YTD
US	7.04%	9.92%
Developed Europe	2.50%	-1.90%
Asia	1.80%	-2.70%
Emerging Markets	1.2%	-7.40%

US Markets

	3rd QTR	2018 YTD
Dow 30	9.90%	8.80%
Large Cap Cos.	7.91%	10.19%
Mid. Cap Cos.	4.95%	7.18%
Small Cap Cos.	5.07%	10.89%
Bonds	0.60%	-1.56%

Which is the greater threat to the markets? Recent market returns have been steadily positive. The current bull market is most extraordinary in its length, which is now the longest in history. The conventional evolution of a market cycle is generally one of rising equity prices as the economy expands. Gross Domestic Product (GDP) rises, business revenues rise, profits rise, wages rise and general confidence in the continuation of the cycle expands.

Stock prices reflect the results of this cyclical evolution. Falling equity prices are the result of the end of the economic cycle. All or many of the components that are the economy begin to reverse and stock prices reflect this fact. The heights and depths of the cycle are determined by the magnitude of the expansions and contractions. While this economic expansion has not been overly robust, the last contraction was the worst since the Great Depression. The lopsided nature of this last cycle has been unusual.

The Federal Reserve and other Central Banks are essentially directed to monitor and control the economic cycle by regulating interest rates and monetary conditions to prevent, or at least moderate, extremes at both ends of the cycle. They are tasked with controlling inflation, which can lead to economic distortions that can magnify the extremes of the economic cycle. Government fiscal and tax policies have their place in determining the health and direction of the economy. Government and fiscal policy in the mortgage arena certainly contributed to the extremes of the last contraction. But all contractions and market declines have the Bank's fingerprints, as they are blamed for tipping over the economy and markets when they finally go too far. With current conditions expanding and robust, they are well along the path of raising interest rates to monitor and control accelerating inflation.

External events, such as wars and rumors of wars can affect the economy and markets. They change the economic environment in ways that overwhelm all the other controlling factors. Politics has been described as the "continuation of war by other means." Most of our recent actual hot wars have been against foreign enemies; think WW2, Vietnam or the Middle East. Markets generally responded favorably once it became clear the US was going to win. Our current political climate has been described as a civil war; a cold war rather than a hot war, internal rather than external. Is this external event a threat to the economy and markets?

Civil wars erupt over irreconcilable differences. During the last Civil War, the economic impact was severe but particularly mixed. If you were in the North, the economy boomed. If you were in the South, the economic destruction was total and the negative consequences lasted well into the twentieth century. The war was neighbor versus neighbor. Sherman burned Atlanta and Sheridan burned the Shenandoah Valley. Are today's partisans going to start burning down their neighbors homes?

The real threat of wars, civil or otherwise, can affect the health of the economy as attention shifts from maintaining a healthy economy to somewhere else. Longer term macro-economic issues are not being addressed. The overhanging debt, budget deficit and pension problems are still trending in the wrong direction. The present strong economy is being attributed to tax cuts and reduced regulation, which have resulted in significantly higher corporate earnings. Trade deals such as the renegotiation of NAFTA and the resetting of trade terms with European and Asian countries have also been credited. China is still in negotiation, but the threat of politics is affecting the process. The divides and tenor of politics hang over these developments, rather than attention to the general welfare of the economy.

Trade deals are subject to Congressional approval. All of the recent deals can and probably will be altered by the next Congress. The politics of their oversight is important. We've gotten a confused sense of what the outcome of that oversight will be from current politics. Impeachment talk is being thrown around. Ongoing and open ended investigations are almost a certainty. Two modern presidents have been threatened with and subjected to the impeachment process. Nixon's experience came in the midst of a recession, so the negative overtones were exacerbated. Clinton's experience was in the middle of an expansion, so market disruption was significant but less pronounced. We can only guess what our next experience will be like if it comes to that.

Earnings and revenue growth are what ultimately drive and support stock prices. A strong and expanding economy is a necessary condition to that growth. Sound government fiscal, tax and regulatory policies support a strong and expanding economy. Anything that is perceived as a threat to those conditions, even a Federal Reserve doing what they always do, is a cause for concern. The current political climate has elevated itself to a level of concern that we've not seen for a while. We've always lived in uncertain times. The present times are nothing if not uncertain.