Financial Wanderings

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A masterful examination of the previous month's financial events, written by Brad Blackburn, CFP ®

(and made even awesomer by Andrea Dickerson)

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Although the commentary in this newsletter has been thoroughly researched, well-reasoned and contains many impressive multi-syllabled words, please enjoy it responsibly. There are many economic minds that are far smarter than mine—and even they can't agree on even the simplest economic questions. In other words, please enjoy this newsletter with the full understanding that it may be entirely wrong.

The last time the economy was this good

Congratulations to the American economy! Our GDP grew at 4.1% over the 2nd quarter, which is the best growth since the 3rd quarter of 2014, when our GDP reached 5%. Here's what I wrote back then:

In 2014, we've seen legitimate, broad improvement in the economy. If you want to deny that, I don't think you're honestly looking at the big picture. Our GDP grew 4.6% in the 2nd quarter and 5% in the 3rd quarter. While GDP isn't a perfect measurement, that's the best six-month period we've had since 2003. Imagine where we'd be if Europe, Japan and China were doing well. Imagine where we'd be if the Sequester hadn't happened (it may help us over the long-term, but it certainly hurts over the short-term). Imagine where we'd be if our government had done anything to help the economy in recent years rather than torpedo it? The world is actively conspiring to make life hard on our economy – and yet it's growing solidly.

Here's the problem. The party didn't continue.

Over the following 12 months, our GDP averaged a mere 2%. If history repeats itself, the markets won't be pleased. Thankfully, the economy does look resilient. As a bonus, Europe, Japan, and China are doing much better than they were in 2014. On the other hand, in today's world we have rising interest rates, an even more overvalued stock market, and we are four years closer to the next recession.

> *How did he turn a great GDP report into evidence of an upcoming recession?*

Almost no one expects the economy to continue this strongly. However, there are very few signs of any upcoming recession. If we can avoid falling back to 2% growth and settle around 3% for a few more years, that would be cause for celebration. Anything less than that would be cause for something different.

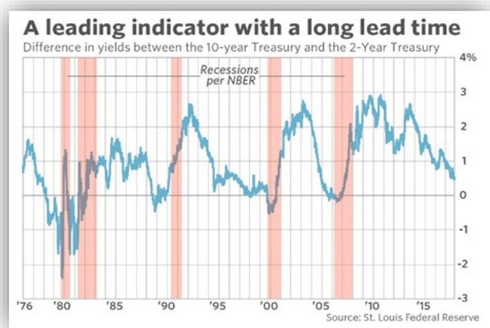
The “best” recession indicator

Over the last year or so, the financial world watched closely as one of the most reliable recession indicators moved closer and closer to predicting a recession. Before you get too nervous, it’s important to realize that the financial world really doesn’t have ***any*** reliable recession indicators.

However, relatively speaking, an “inverted yield curve” is as close to Nostradamus as you’re going to get. Here’s how to think about a yield curve: Typically, long-term interest rates are higher than short-term interest rates. For example, you’d expect a 5-year CD to pay a higher interest rate than a 1-year CD. That difference is the yield curve.

If long-term rates are a lot higher than short-term rates, that would be a “steep” yield curve (like the picture above). On the other hand, if long-term rates aren’t much higher than short-term rates, that’s a “flat” yield curve, which is where we are in today’s world.

The worry is that sometimes a yield curve gets so flat that it “inverts,” which means short-term rates are actually higher than long-term rates. That inverted yield curve has been the canary in the coal mine for upcoming recessions numerous times over the last 40 years.



The first thing to point out is that our yield curve isn’t inverted, it’s just flat. So, no recession “red flag” has been raised. However, the Fed is planning to raise rates two more times this year, which would push short-term rates 0.50% higher. If long-term rates stay flat, the yield curve will officially invert. If that happens, should you panic and immediately sell everything?

That probably wouldn’t be the best strategy. However, this is just one more sign that the economy is nearing the end of this economic cycle. At some point, a recession will happen. At some point, the stock market will fall. We’re getting closer to that moment every day. The more comfortable you are with that idea, the better you’ll react when it eventually happens.

Who will win the trade war?

In our growing trade war with China, America has a big advantage: We buy five times as much stuff from China than they do from us, which means we have five times as many targets to hit with tariffs than they do. If they match our tariffs dollar for dollar (as they’ve promised to do), they’ll run out of ammunition quickly. However, that doesn’t mean China is helpless. Beyond tariffs, there are many other ways China can fight a trade war.

An obvious one is by leveraging North Korea. Trump tweeted about this recently, saying China

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might be *"exerting negative pressure on a North Korea deal"* because of the trade war. In that way, China might force Trump to choose between winning the trade war – or solving the North Korea problem.

China could also fight the trade war by making life hard on American businesses in China. For example, Starbucks might suddenly find it much more difficult to get permits for new locations. China can also use its control of the media and powers of propaganda to encourage boycotts of US businesses. In other words, even if Starbucks could get permits for a new store, a lot less Chinese people might end up buying coffee there. China has a history of using "boycott diplomacy." In recent years, they've boycotted fruit from the Philippines, salmon from Norway, cars from Japan, and all kinds of stuff from South Korea.

Another advantage China could exploit is the $1.2 trillion dollars of US government bonds they own.

If they chose to sell all those bonds, it could do significant damage. Essentially, China could force interest rates to rise quickly here in America, which could really hurt our economy.

However, in this globalized economy, any damage to the US economy will hurt the Chinese economy too. China would prefer a strong American economy that keeps buying a bunch of stuff from them. In this intertwined global economy, everyone benefits when the US economy is strong.

That's the problem with trade wars. There are few good strategies for fighting them. The tariffs we are putting on China hurt us just as much as them. Their strategies for fighting back hurt them as much as it hurts us.

Ultimately, the stock market seems to think it will all get worked out, and I agree. The most likely scenario is for something like our "deal" with North Korea: An almost meaningless agreement, both sides will declare victory, and we'll forget about it for a while. If that's how it works out, the markets will be very pleased.

A tax compromise

As we move towards the midterm elections, and the likelihood of a divided, gridlocked government, I want to use my tiny little soapbox to make an important point: Compromise is good, and absolutely vital in our system.

With that in mind, here's my idea for a grand compromise on taxes. As you're reading it from wherever you stand politically, I'd like you to ask yourself: Would you take this deal?

I'm going to start with my big offer to Conservatives: A corporate tax rate of… ZERO.

Before my Liberal friends get too upset, remember that the corporate tax only makes up 9% of our total tax receipts. However, abolishing the corporate tax could give American businesses a meaningful competitive advantage (at least until other countries copied us). It's not only the actual savings from not paying taxes. Think of all the time, money and energy that corporations spend attempting to pay as little tax as possible. What if they could focus that energy on more productive things? Perhaps the best part of this idea is that it

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would encourage businesses to invest right here in America to maximize their tax-free profits. Conservatives, are you happy?

My offer to Liberals is a little more complicated. In exchange for a corporate tax rate of zero, what if we taxed all income the same way? I've never understood why capital gains, stock dividends, and other forms of income are often taxed at a lower rate than income from a hard day's work. For example, a long-term capital gain or a dividend from a stock will generally be taxed at only 15%. However, earned income from an actual job can be taxed anywhere from 10% to 37%. That feels un-American to me.

The idea behind giving capital gains and dividend income extra-special treatment is that they result from taking an investment risk – which is vital for a thriving economy. However, isn't actual work vital to a thriving economy too? If an investment is only good because of a super-special tax rate, then maybe it's not such a great investment. Let's get the government out of the business of picking what kinds of income are better than other kinds – and tax all income at the same level as earned income.

So that's my proposal: A corporate tax rate of zero, but once all those profits trickle down to workers, investors, and owners – every bit of income is taxed at your normal tax rate.

So… who says no to that deal?

Probably Everyone

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