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VIEWS FROM CAMELBACK MOUNTAIN

Two Weeks of Volatility

As of July 30th the S&P 500 was up 2.4% for the month and up more than 20% since year end. Conditions changed on July 31st, the date of the latest Federal Reserve Open Market Committee meeting. As you no doubt heard or read, the Fed cut interest rates by 0.25% for the first time in 10 years. We continue to think this was a mistake as the rate cut was unnecessary. The market promptly declined following the Fed's decision. We believe the decline was not caused by the 0.25% rate cut, but rather the disappointment that the Fed didn't cut 0.50% and telegraph further rate cuts later this year.

On Thursday August 1st another main issue that the markets care about came to the forefront. President Trump's economic negotiating team returned from China with the news that they had made little progress. The White House has come to believe that China is simply delaying to see if Trump loses the presidency in the next election. We believe this made Trump irate and caused him to lash out against China even though many of his key advisors warned him not to do so. This has ignited further hostile acts by both sides ranging from tariffs to currency manipulation to blacklisting companies and other unhelpful developments. This in turn has caused market weakness.

Interest rates here in the U.S. and abroad have plummeted as market participants now price in a 100% probability of another rate cut on September 18th and a high probability of yet another rate cut before year end. The two phenomena are now related in that the Fed indicated at their July 31st meeting that part of the reason for the rate cut was nervousness about international trade. Some are now speculating that Trump is fighting more with China so as to force the Fed to cut rates further. If this is true, it's pretty clear that this is a foolish way to manage monetary policy and world trade.

We continue to believe that the single most important issue for President Trump is winning the election next November. We also believe that if the economy weakens significantly, particularly due to a trade war with China (that he has caused at least in part) Trump will find it very tough to get re-elected. That leads us to believe that Trump is trying to deal with this now to get it out of the way. From China's perspective, the growth rate of their economy is clearly slowing and they have multiple challenges with high debt balances, many troubled companies, and nervousness among international investors that they are wooing to bring hard currency to their country. They also have protests in Hong Kong. We continue to believe that if China ends up in a full-blown trade war with the United States, their economy could tip into recession. If this happens, Xi Jinping could be facing a regime change. We're pretty sure he doesn't want that to happen so he has a big incentive to calm the trade war as well. Some analysts are questioning whether China's economy is strong enough to simply delay serious trade discussions until after our election next November. If President Xi continues on this path, he better be making the right call.

We have no illusions that China is a friend of the United States. We also don't believe that they intend to enforce the rule of law or intend to adhere to most components of trade negotiations that they will likely agree to. Among other concessions, we do think that China will eventually have to stop sending Fentanyl to the U.S. We continue to believe it is likely that the U.S. and China will come to enough of an agreement to tone down the hostilities and reduce the threat of tariffs and other unhelpful trade terms.

The Federal Reserve is now scared that the trade issues can further soften U.S. economic growth. They have precious few weapons to deal with an impending recession should it come in the next year or two because of the foolish policies that they and their predecessors have pursued for the past 10 years. They also have to contend with very foolish ongoing monetary policy actions in Europe and Japan where central banks have now driven approximately $15 trillion of sovereign debt issued by various countries to negative levels of interest. If you invest in a 10-year German government bond, your money is locked up for 10 years, you get no interest, and you will eventually get back only about 95% of your investment 10 years from now. We think that's a horrible investment. As you can imagine, this is driving some Germans (and other Europeans and Japanese) to take their funds, or to borrow funds in Europe or Japan, convert them into dollars and invest in 10-year U.S. treasuries yielding about 1.65%. Foreign demand has driven up the value of the dollar and caused dramatic declines in U.S. interest rates (pushed up prices have the effect of reducing yields). The Fed also has to deal with market expectations where unhappiness with their decisions could trigger further weakness. Janet Yellen is lucky she didn't get reappointed. We'll see how history treats her.

We think the 0.25% July rate cut and perhaps another 0.25% or 0.50% rate cut between now and the end of the year is fundamentally unimportant to the health of the U.S. economy and corporate earnings. The marketplace thinks otherwise as they are laser focused on the slightest hint of further Federal Reserve action or inaction. The market's focus on the Fed and any developments in trade negotiations is likely to lead to further day-to-day market volatility until better evidence is available about the likely outcomes.

We should learn a lot about these issues between now and year end. **We remain convinced that the U.S. economy and earnings at most U.S. companies are just fine. Markets don't go straight up forever; 5-10% short-term pull backs are common. We look for calmer markets and focus to return to fundamentals over the next several months.**

Please call any of us at L. Roy Papp & Associates if you would like to discuss this in further detail.

Best regards,

Harry Papp
Managing Partner
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