BUSINESS INTELLIGENCE BRIEF

November 5, 2018

NATIONAL AND INTERNATIONAL NEWS AFFECTING LOCAL BUSINESS

Short Items of Interest – US Economy

- **Hiring is Up and so are Wages –** The latest jobs report showed some movement as far as wages are concerned and that has been long overdue. It is not the rocket speed that some had feared and there is still relatively little pressure on wage inflation but a least there are gains that can be considered near normal. The fact is that there are far more jobs available than there are people to take them. It is high time that politicians quite nattering on about creating jobs and spent more energy on creating people qualified to take the jobs that are on offer now. The problem is that addressing the lack of workers is far harder and more expensive than simply calling for business to create more jobs.

- **Diversifying Economics –** Janet Yellen has become the latest to call for different ways to do economic research. The trend over the last few decades has been for economics research to focus on issues that can be dealt with through mathematics. It has been the era of the econometrician and has focused on being a "hard" science as opposed to the fields like sociology and political science. This has meant that too few analysts focus on the issues of the day. Yellen pointed out that nearly all the modeling economists completely missed the financial sector meltdown as nobody was really studying it. There is need to spend more energy on case study analysis and on paying attention to anecdotal evidence that can lead to more real-world applications.

- **US Backs Off on Some Iranian Oil Sanctions –** The US had plans to impose sanctions on nations that buy Iranian oil but days before the policy was to come into effect the US has exempted several nations from these sanctions for six months. The list of those that have been exempted is more than a little peculiar. There are allies such as Japan, South Korea, Taiwan as well as important nations the US has some prickly relations with – India, Turkey and Greece. The big surprise is that China was granted an exemption as well. It seems the US is offering a little bit of a peace offering to China but this also benefits the Iranians as China is one of their biggest customers. At this point some 20 nations have already halted imports of oil from Iran but some may now be rethinking that stance.

Short Items of Interest – Global Economy

- **Iran Claims Sanctions Victory –** At the same time that several European states have received exemptions from the US sanctions on Iranian oil the government of Hassan Rouhani is touting the fact that Europe is fighting the US on the issue of these sanctions and the whole idea of the nuclear pact that the US backed out of. The machinations of all this has become murky. It is not all that clear what the US wants as far as Iran is concerned as the exemptions have taken a good bit of pressure off Iran for the time being. Most assert that the US may not be motivated by keeping oil prices south of $100 and this has introduced flexibility where there was not much before.

- **Agriculture Tariffs and the Vote** – It has been a tough and complicated dilemma for many in the rural communities. On the one hand this has been solidly Trump country for several years – areas that Trump won handily two years ago and where he has maintained popularity. That popularity has been challenged by pocketbook issues. The trade war with China has slammed the farmer very hard and sent many close to outright bankruptcy. The Trump team has been less than responsive and that has allowed disillusionment to set it. Unfortunately for the farmer there has not been much help offered by Democrats either.

- **France Hangs on to its Island Paradise –** Thus far the people of New Caledonia are unwilling to cut ties with their colonial power. The referendum that would have given the colony its independence from France failed and they will remain dutiful subjects.

Are the Rules Really Different Now?

"Nothing Lasts Forever", "what comes up must come down", "all business cycles have an end". Choose your aphorism or saying, there are many to choose from and they all essentially say the same thing. The economy of any given nation will have its ups and downs and the majority of the time one can see that cycle developing well in advance. That is want tends to anchor any kid of prognostication on the part of economic analysts. The current economic growth period is one of the longest on record and that longevity has given rise to all manner of interpretation and speculation. Some have asserted that it has lasted this long because it was anemic for so many years. Others assert that some fundamental rules are no longer in effect. One who has been asserting that it is now a whole new world is the Fed Chair – Jerome Powell. He is not alone and has some support from within the ranks of the Fed but there are skeptics as well. This opinion has implications as far as what the Fed plans to do with interest rates in the immediate future as well as in the longer term.

Analysis: There are many reasons the Fed will provide proof to justify any change in the Federal Funds Rate. Remember that this is the rate that banks essentially charge each other for those very short-term loans needed to conduct business. A change in the Fed rate does not automatically mean a change in all other rates although there has always been a close connection. The banks will usually determine their prime lending rate based on the rate set by the Fed but mortgage rates are not only affected by the Fed rate but by the rates on long term bonds. All the other rates are connected but not at the hip – car loans, credit card rates and all the others are certainly influenced by the Fed rate but there is always variability between issuers of that credit.

It is also important to understand why this kind of indirect influence matters. The Fed is not equipped to turn the economy on a dime, it takes many months for Fed policy to have an impact. To stimulate an economy the central bank needs the lending community to react to their lower rates and to start loaning more. The reality is that some will and some will wait. As the rates come down there will be more and more lenders willing to lend and the Fed seeks the trigger point by lowering the rates in small increments. By the same token the Fed needs time to control an overheating economy. It is not as if banks will suddenly stop loaning and companies will stop borrowing simply because rates went up by 25 basis points. To make the economy react to Fed decisions may take the better part of a year. This is why the Fed has to forecast and prognosticate. If the impact of their decisions will not be felt for the better part of a year, they will have to make assumptions about what the situation will be in a year.

This is why there has been so much interest in cycles and rules. There has been a lot of conversation regarding the efficacy of the Philips Curve and why it has failed to be the predictive tool it once was. It seemed logical enough and most importantly it actually worked as a predictor. It stated simply enough that when the rate of unemployment falls there will be a greater chance for inflation as wages will start to come up as employers have to pay more to get the people they want and need. This has not been the case this time and it has been pointed out that it was not the case a decade or so ago either. The assumption behind the assertion is that employers will pay the wages that are demanded by the workers but for the last ten to fifteen years that has not been automatic. The unqualified or undereducated worker has little leverage and is not going to command a higher wage. The sectors that used to be most sensitive to lack of labor have now discovered an alternative in technology and robots. The low-wage manufacturing jobs have been lost to automation and so have many of the low wage service jobs. The fast food place dumps counter help and replaces them with machines and consumers are made to do more and more of the work at a store as they check themselves out.

Right now, the Fed has not indicated that it will be changing its plan as far as hiking rates once more this year and again next year but there has also been no hint that it plans to speed things up either. The inflation motivation is not as strong as it once was but there are other reasons the Fed would hike rates. They want to make sure rates are high enough that they will have some ammunition when the next recession arrives (some assert that could be as soon as late 2019 or early 2020). There is also the desire to end some of the speculative borrowing that has been fueling the surge in the stock market.

Trade Gap Widens

The trade gap is wider than it as ever been and the US is running a higher deficit than it has in many years. This seems counterintuitive given all the energy that has been devoted to reducing the US dependence on China and other nations. The level of imported goods hit $218 billion in September and that is a record. The deficit climbed to $54 billion. The effort to address the trade imbalance has centered on imposing tariffs as opposed to getting China and other nations to buy more from the US and that kind of strategy often backfires – at least in the beginning.

Analysis: The most logical reaction from any given business is to reduce or escape taxes when possible and a tariff is a tax. The company that fears that something it needs will soon carry a higher tax will do what it can to obtain that product or service before the tax sets in. The importers in the US have been buying aggressively as they do not know what will be added to the list of products subject to a tariff. This sets up another issue down the road. That buying means a bigger inventory and if that s not sold soon it becomes a drag on the company. Most of what has been purchased will likely be consumed but not all and that inventory will hang over many companies into the coming year.

Expectations Dim for G-20 Breakthrough

There are messages flying around that will provide support for almost any position on the US-China trade dispute. The optimist can look at the comments by President Trump after his "very good" phone conversation with Xi Jinping but the pessimists can point to the fact that no similar declaration came from Xi and instead the Chinese leader raked the US over the coals with assertions that the US was employing the "laws of the jungle". The global markets had rallied last week on the assumption that President Trump was engaged in his usual "head fake" style of negotiating as he sounds hard line at the same time that he gives concessions. Now it is not clear what kind of concessions might be offered and whether any of them will be accepted by the Chinese. After months of bombast and blather the reality of the tariff and trade policy has started to manifest and many think that it has gone too far for the two nations to back away from.

Analysis: There are several facts that have emerged and they should have an impact on the course of the future conversation. The first is that China is in far worse shape economically than the US at this point. This has placed limits on the leverage the Chinese can enjoy. Their growth rate has sagged to just over 6.0% and in China that is tantamount to recession. The country has to grow fast enough to create at least 1.2 million jobs a month – just to keep pace with population growth - while the US has to create 250,000. The Chinese require growth of at least 6.0% to achieve this and the US can meet its goals with 2.7% growth. The bottom line is that China is not in a position to tolerate much more slowdown. The Chinese government has been engaged in a lot of stimulation of late but in the past this has led to higher rates of inflation as well as various financial bubbles and they remain wary of this developing again. The Chinese essentially have two choices when it comes to furthering growth at this stage. The first is that they will need to dramatically expand their own internal market so that Chinese consumers can support the Chinese economy. The other option is that Chinese companies will have to find other places to sell to. Neither of these options will be easy given the realities of a trade war with the US. If the Chinese are not exporting, they are not making money and that limits what the Chinese consumer can contribute and the fact is no place in the world consumes like the US does. The US will be hurt by these tariffs as well but it is likely to be a shorter-term issues as the US will be seeking other sources of supply – a much easier challenge than that facing China.

If there were to be a breakthrough at the G-20 meeting when Xi and Trump are supposed to be talking, what might it look like? Realistically it would either be a shift in Trump's position (which has happened many times before) or it would involve some kind of capitulation by the Chinese and that is not all that likely at this point. Analysts have asserted all along that something important has been missing from President Trump's set of tactics. His approach has been all stick and no carrot. If the US wants to close that deficit gap it has to sell more to China as opposed to simply trying to buy less. Importing less from China will not mean that US manufacturers will replace these goods – the US will simply import them from some other nation although the prices will likely be higher. The US should be urging greater engagement in the US economy and not less. That is a far more nuanced strategy than the blunt instrument of a tariff war and it is not something that President Trump has shown skill at developing.

Should Europe Embrace Trumpism?

There are many aspects of Trump policy that match well with the European right. The attitudes towards immigration are similar and there is the same frustration over the erosion of "national values" whatever that means from one country to another. The Italian government is a populist one now and similarly oriented groups have emerged in Germany, France, Sweden, Greece and so on. They are conservative parties but deviate significantly from traditional conservative positions when it comes to debts and deficits. Trump has presided over one of the largest boosts to the US debt and deficit in decades and at a time when many thought the US was in a good position to retire some of that.

Analysis: Now the populists in Italy (as well as others) are calling for that same kind if budget busting activity – sharply higher levels of spending along with sharp reductions in taxes. Italy's populist coalition is in deep trouble with the EU for their budget and they are now calling for the rest of Europe to emulate them with the argument that spending and reducing taxes will stimulate the economy to the point its success will mean more revenue for the government. The problem is that it never really works out that way as growth has not been high enough or sustained enough to provide that kind of boost. The conservative mantra was once rooted in fiscal conservatism but those days appear to be long gone.

What Else Can You Get from Armada?

As you peruse the Business Intelligence Brief you are no doubt wondering what else you might get from the authors of these reports. You are in luck as the BIB is not our sole publication. There is the Black Owl Report – published three times each week and aimed at the business executive. Keith Prather is the primary writer for the BOR and you can get a free one-month trial if you like. It is a subscription-based publication available for $84 a year. In addition to these regular reports we do longer in-depth studies, white papers and analysis of breaking economic and business stories. Beyond all that we like to be responsive to our readers and regularly answer questions posed by our readers – just e-mail chris.kuehl@armadaci.com for more details or to ask one of those questions.

What Comes Next?

The elections are nearly here and we can safely watch TV again. This has been a bitter year to say the least and there will be some very, very angry people regardless of the outcome. This has been a year when the center has all but vanished in a war between the "bases" – one extreme left and the other extreme right. Most of us remain in the center according to the majority of polls but we will end up picking a side if we want to cast a vote. For many this will be the end of it and life will supposedly return to some semblance of normal but in fact this should only be the start. After tomorrow we will have our latest collection of "representatives" and that should mean that we now start communicating with them.

We will have another shot at voting for most of them in another two to four to six years and if one assumes they want to remain in office, they will need to pay heed to those who would vote to either keep them or get rid of them. We now need to really get engaged with the system so that these politicians know what matters to us and why. They will certainly hear from plenty of lobbyists but will they hear from the rest of us? If the past is any indication they will not. We mostly abandon the process after the election and that is really not how it should be.

Big Changes Coming to the Business Intelligence Brief

The BIB has been published now for over a decade and through the years we have tried to adapt to the needs and interest of our readers. It is with this desire in mind that we are planning some changes to take place in the next week or so. I will be interested in what the readers have to say about these and welcome further suggestions on ways we can improve.

1) **We will be going to a three day a week publishing schedule – Monday, Wednesday and Friday. My travel schedule has become more and more packed and I end up missing more issues that I care to. The thinking is I can accommodate a more regular schedule and still deal with the travel requirements.**
2) **Each issue will have new content for you to peruse. There will be the "graph of the day" – some interesting chart or graph that pertains to some element of the economy and some explanation of what it means and where it comes from. People seek to be better informed with facts and statistics these days and this will be our contribution.**
3) **The BIB will expand to a 5-page publication to accommodate the "graph of the day" and that page will also feature articles that focus on the issues involved in running a business. This will include everything from HR pieces to management tip and hints and many other topics that will appeal to business people at every level.**
4) **Down the road we are developing a weekly version of the BIB that will capture several of the smaller pieces that appear through the course of the week – this will be published on Fridays as an opportunity to catch up with what might have been missed that week. We are also developing a podcast version of the publication that will summarize the news in each issue in a brief presentation.**
5) **Speaking of presentations, we will be running a list of places where the Armada guys will be speaking. This allows you to come and make your comments personally. Not all of these engagements will be open to the general public but we will let you know when you can arrange to come hear Chris Kuehl and Keith Prather live!**

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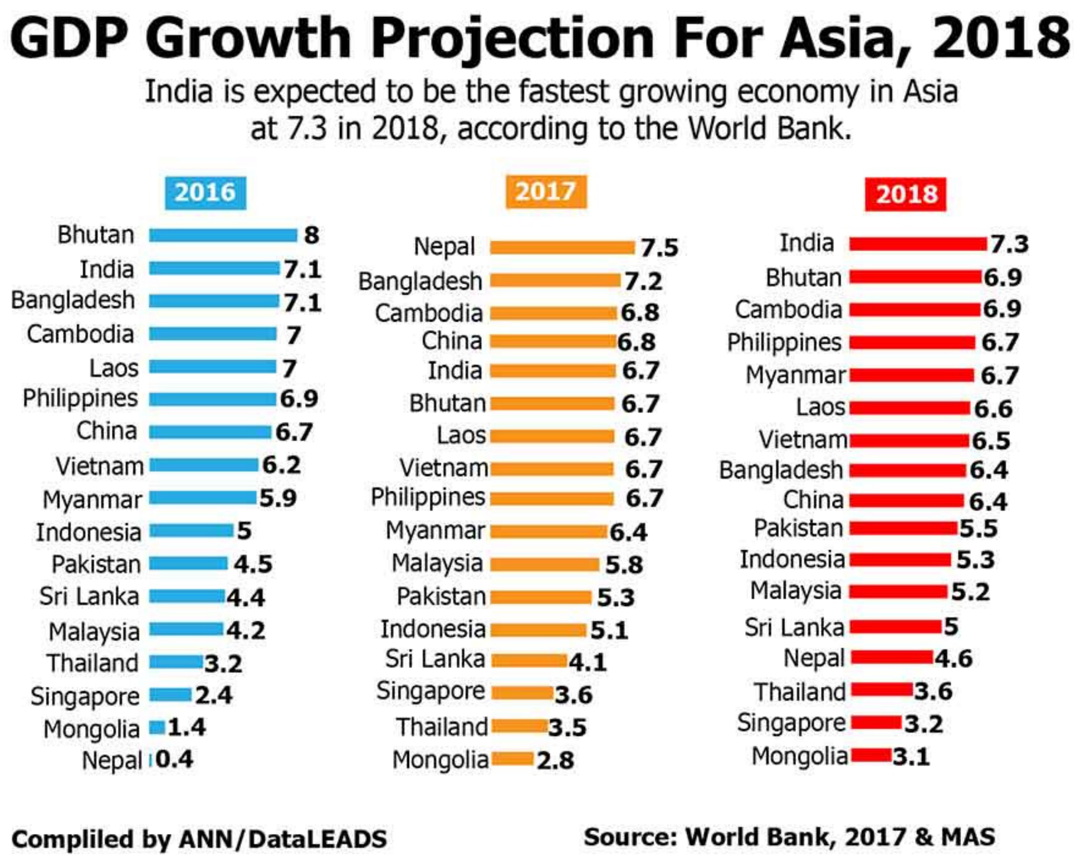

This will be a new feature for the Business Intelligence Brief – each issue will contain a chart or graph of some other visual interpretation of the economy. Sometimes it is easier to look at this kind of data to get a sense of what is happening in the world – it certainly can make comparisons easier. Along with the visual we will offer some commentary regarding what this all means.

The chart above shows the growth of a variety of Asian nations and several things stand out. The first and perhaps most important is that growth for the whole region has slowed over the last three years. This is interesting as it has taken place at the same time that growth in the US and some of the European nations has improved. Given that most of these Asian states rely extensively on exporting to nations like the US there is deepening concern that trends are not turning in their favor. They are seeing more and more competition from South America and Africa and there have been efforts underway to reduce the amount of importing the US does.

One factor that may well favor these states in the not-so-distant future is that the US will have to seek alternative sources for the goods that have been purchased from China in the past. The largest beneficiary of that shift will be India but several of these nations will see additional business coming their way.

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