Market Update

Some Reflections on “Capitalism and Freedom”

Dr. Milton Friedman, Nobel Laureate in Economics (1976)

What is a stake in the Mid-Term U.S. Elections?

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The Voice for Reason

Comments and Views for the Individual Investor

(July 31, 2018)- Perhaps the most influential economist of the 2nd half of the 20th Century, Milton Friedman, is quoted to have said, "**When government —in pursuit of good intentions— tries to re-arrange the economy, legislate morality, or help special interests, the cost comes in inefficiency, lack of motivation, and loss of freedom. Government should be a referee, not an active player."** Friedman penned the classic "Capitalism and Freedom (1962) and later won the Nobel Prize for Economic Sciences in 1976. He is historically remembered as member of the University of Chicago faculty but also held positions at other schools throughout his career and served as an economic advisor to both Ronald Reagan and Margaret Thatcher during his day. He was a strong proponent of monetary policy as a guiding force for conducting economic policy, views which were at odds with Keynesian economic theory.

As we approach the mid-term U.S. elections, the Friedman quotes about "re-arranging the economy", "special interests" and "legislating morality" seem particularly fitting as undercurrents leading up to the November election.
At stake for the Trump Administration will be perhaps its own survival. President Trump's approval rating is the lowest in modern American history for a U.S. president 18 months into the job and despite generally good U.S. economic indicators in terms of unemployment and GDP growth. The president suffers, quite possibly owing from his own doing, growing disaffection from within his own Republican Party over the Mueller special counsel investigation into potential collusion with a foreign power (Russia) and obstruction of justice dating to the 2016 election. He also has invited scathing criticism over his harsh rhetoric and erratic behavior toward traditional NATO allies, NAFTA partners, and traditional allies in Asia. Trump's "America First" policies, playing to a base of perhaps 30% of the US electorate, have viscerally appealed to some but brought about divisiveness across large cross-sections of the U.S. population————particularly among Americans of color, religious

minorities, and women voters. Many political analysts believe the election outcome will likely be decided by the vote of suburban women.

Trump, since taking office, has tried to "re-arrange the economy of free trade," He has sought to support "special interests" in certain heavy industries (steel and aluminum) located in certain strategically important political states (Michigan, Ohio, and Pennsylvania) against the advice of his own economic advisors. His intervention into "morality politics" has been among the most troubling of his presidency. He failed to denounce "alt-right" demonstrators at a political rally in Charlottesville, Virginia last year and he has sought to openly oppose immigration from Muslim and Hispanic countries————— via executive actions which have constitutionally been challenged and overturned by U.S. federal judges on numerous occasions.

Trump's support in U.S. Congress is hanging by a thread of four votes in the 100 member U.S. upper house (the Senate) and by about 23 votes in the 435 member lower house (the House of Representatives). Most pundits see Trump losing control in the U.S. Senate, but possibly hanging on to the U.S. House. Losing control of both houses to the Democratic Party will likely throw the U.S. into a constitutional crisis, the likes of which have not been seen since the Watergate hearings and the impeachment proceedings of 1974 which led to the resignation of President Richard Nixon.

What does the mid-year yardstick tell us about the momentum in performance of portfolio assets? Most analysts would agree that 2017 was a banner year for most investors who held significant equity exposure. However, mid-year 2018 has shown choppy results across several markets:

<u>Equity Indices (in local currency terms, 6/28/18))</u>

U.S. Dow Jones	down -2.2%
U.S. Nasdaq	up +8.7%
Euro Stoxx 50	down -2.2%
FTSE Euro 100	down -2.1%
German DAX	down -4.6%
HK Hang Seng	down -5.6%
Japan Nikkei 225	down -4.6%

China Shanghai Comp	down -16.6%
Australia All-Ord	up +1.7%
Emerging Mkts (MSCI)	down -1.0%

Global Bond indices

World Bonds (Citi)	down -0.9%
EMBI+ (JP Morgan)	down -5.7%

Alternative Investments indices

Hedge Funds (HFRX)	down -0.7%
Volatility, US (VIX)	up +11.0%
Gold spot	down -7.5%
Oil (WTI)	up +21.6%

Currency Index

US Dollar (DXY)	up +5.0%

Equity performance globally has been down about 2% since beginning of the year but with a lot of ups and downs————much driven by geo-political tensions and tough trade rhetoric spearheaded by President Trump's "America First" policies. Take note of the performance of the Alternative Investment Index, VIX, and its double digit increases. If you had invested in a volatility index fund (e.g. Blue Diamond Fund), it would have added positively to your return in first half of 2018! Exposure in some hi-tech names on NASDAQ or oil companies counters might have added alpha to your portfolio as well. Also non-dollar positions held in a US dollar base currency portfolio across the board have been subject to reduced returns as the harsh trade tariff rhetoric of the Trump administration has been largely bullish for the U.S. dollar (although this is by no means an assured long term trend!).

What are the prevailing themes in the 2nd half of 2018?

Clearly a significant prevailing theme will be that of the outcome of the U.S. mid-term elections as they will impact on the future of the Trump Administration policies.

Also watch the US dollar yield curve————that is the curve showing US Dollar short term interest rates extending out to 10 years and beyond. The yield curve is currently still slightly "ascending" which portends a positive economic outlook. However, lately the curve has been flattening out and, should it become "inverted," that would be a warning sign. When a yield curve becomes inverted, historically recessionary conditions are on average about 10 months away.

Sino-U.S. trade talks will have notable bearing on world economic growth. While they appear to have stalled mid-summer, new trade talks between Beijing and Washington are planned and we must be hopeful that the two largest economic powers will find areas of consensus that eclipse trade differences. The economies of the US and China combined account for almost half of global GDP activity. A trade war would be devastating for both economies and bearish for global economic growth as well.

Footnotes:

i) Mid-year economic statistics provided by The Economist (2018)

ii) An early 3rd quarter Gallup poll shows that President Trump's approval rating is at 39%. The previous 9 U.S. presidents dating back to 1954 all had approval ratings exceeding 40% in their second year of office with the average approval rating being 53%.

About the author:
Bruce VonCannon is a native of North Carolina USA and currently a Managing Director with Vanheel Management Ltd., a Hong Kong SFC and U.S. licensed independent asset management firm founded in 2002. His career spanning 27 years in international banking and wealth management has included assignments in New York, Taiwan, Hong Kong, Singapore and Geneva. He is a frequent speaker at financial seminars, universities, and business forums and author of "A Guidebook for Today's Asian Investor" (2017) published by Palgrave Macmillan.