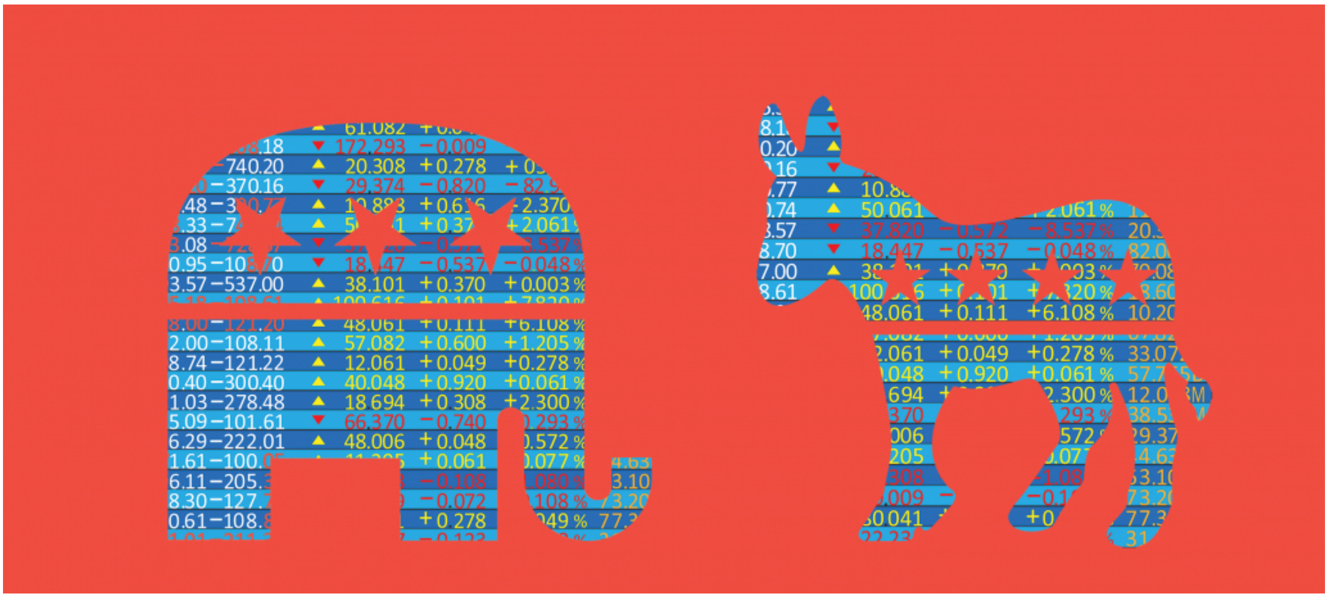
Problems Made in DC Can Be Fixed There



The Federal government has been moving markets of late.

Venezuela is the latest issue to watch. The U.S. is currently aligned with most of the world in seeking the overthrow of leader Nicolas Maduro. The sanctions look significant, with almost all Venezuela’s hard currency coming from oil exports, half of which go to the U.S. Finding new buyers won’t be easy, because even non-U.S. buyers will be wary of transacting through the U.S. financial system, potentially violating U.S. law.

In addition, Venezuela’s exceptionally heavy, viscous crude requires blending with condensate before it can be shipped. That condensate is imported from the U.S., so Venezuela will also need to find alternative supplies. So far, global oil markets have reacted calmly to the possible loss of Venezuelan crude, partly because years of inept management have reduced production to around 1 million barrels a day (MMB/D). Six years ago it was as high as 2.5 MMB/D. However events play out, it’s unlikely to be bad for the U.S. given our rapidly growing oil production.

Last year's corporate tax cuts propelled the S&P500 to a 22% return in 2017, as markets anticipated the jump in profits. Like the prior year's gains, the slump in December was also made in DC, resulting in a 4.4% loss for 2018. Tariffs (i.e. import taxes) imposed somewhat capriciously, and the unresolved trade negotiations with China led to a slowdown in Chinese GDP growth as well as downward revisions to corporate profits. This was followed by White House complaints about high interest rates, met with Fed chair Jay Powell's confusing comments suggesting rates may move much higher. Independence asserted, his comments were soon walked back, although equities responded sharply in the meantime.

Last week the federal government reopened, to widespread relief. Press reports described it as a loss for Trump, which naturally raises the likelihood he'll reject whatever negotiated compromise Congress presents on February 15th. Markets rallied on the agreement, and later weakened as tweets made clear the dispute over a border wall isn't yet resolved.

Predicting how each episode is resolved isn't easy, which makes a defensive posture attractive. The confusion over interest rate policy has sorted itself out, with the Fed likely on hold for now. However, the disagreement over the wall that shut the government for 35 days may burst open again.

But it turns out that the President isn't Emperor, and Congress has different powers that are intended to give it equal status. Although Trump will complain, Republicans are unlikely to have much stomach for a second federal government shutdown. This might leave the president turning to emergency powers to erect a physical barrier. That'll be held up by challenges from Congress, or in the courts, or both. For the equity investor, there's good reason to assume that this stand-off has lost its ability to move markets.

On trade, the negotiations with China drag on interminably.

But unlike the wall, there's no promised tangible objective. So the White House could at any time decide it wants some positive press and accept whatever China is offering, claiming victory.

This is the risk with not holding equities because of current uncertainties. The problems are all made in Washington, which means they're easily fixed there. Don't be surprised to see the budget stand-off and China both recede as concerns. With interest rates on hold and S&P500 2019 earnings growth of 6.5%, the market's P/E is 15.3. Equities remain a far better bet than bonds.

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