Left to themselves, the US economy and stock market are healthy and gaining strength. But they're not being left to themselves, as Trump bulls his way into the china shop, creating serious potential headwinds for the US economy.

THE GOOD NEWS

The year began with a return of volatility to the stock market. Shares were up sharply in January, down sharply in February, and closed out the first quarter down a fraction of a percent. During the second quarter, both the economic news and the stock market took on a more constructive tone.

The US unemployment rate fell to 3.8% in May, its lowest reading since 2000. Consumer spending, housing starts, and capital spending all picked up nicely, as the broad economy built momentum. Confidence surveys of businesses small and large were buoyant and consumers had a rosy view of the future.

Stocks also perked up, rising 5.5% from the end of the first quarter into the second week of June as corporate tax cuts passed by Congress last December worked their way into corporate spending plans, whether for capital investment, new hires, or share buybacks.

Abetting this improving economy is a Federal Reserve under the leadership of the new Chairman, Jerome Powell. A Trump appointee, Powell is moving the Fed to a more "dovish" or accommodating policy posture, where inflation is not always so ardently resisted. Frankly, we think this is a good thing. The Fed has two official mandates: promoting full employment and fighting inflation. The latter has tended to take precedence to the detriment of the former. We think promoting full employment deserves more policy deference, particularly given how contained inflation remains.

For stock investors, of course, a more lenient Fed is a boon, as it's the Fed that kills bull markets by raising interest rates to quell inflation.

So, on the positive side of the ledger, the second quarter saw a reinvigorated economy and a Fed inclined to let it run. That's a very attractive scenario for investors. Unfortunately, countervailing forces came into play and stocks gave back some of their earlier gains. The market closed the quarter up 3.4%, putting the market's first half gain at 2.7%.

AND THE BAD

Just as the picture for the US economy and stock market was brightening, President Trump decided to pick a fight over trade with virtually all of our nation's major trading partners: Mexico, Canada, Europe, and particularly China. His preferred tool in trade disputes appears to be tariffs—both levied and threatened—on imports to the US.

Trump apparently believes, mistakenly, that a US trade deficit is necessarily a bad thing and indicative of our country having struck "bad deals" with our trading partners. His goal, it seems, is to reduce the US trade deficit by bullying our trading partners with tariffs on their exports to the US. Tariffs make those exports costlier and so less competitive with US goods, the idea being that US consumers will shift their preferences to US goods and thereby reduce the trade deficit.

Trump's strategy is quite simple: We import more from most of our trading partners than they import from us. For example, the US imports about four times as much from China as China imports from the US. Therefore, in a trade war, we can inflict more pain on them in the form of tariffs than they can inflict on us. It's like we have more chips to bet in the card game and so can simply out-bid them into folding.

UNINTENDED CONSEQUENCES

Unfortunately, Trump isn't engaged in a card game where all bets play out on a single table. For example, Trump's moves have already produced a significant rise in the US dollar relative to other currencies. This reflects both a) an anticipated reduction in US imports (fewer dollars buying foreign goods and thereby foreign

currencies) and b) global investors' flight to safety given the heightened risks posed by the prospect of a global trade war. The problem here is that a stronger dollar makes foreign goods cheaper for US consumers and so MORE attractive, offsetting the effects Trump seeks through tariffs.

Similarly, Trump seems largely unaware of the global supply chain that supports virtually all of US manufacturing. In June, the time it takes suppliers to deliver components to manufacturers rose to its highest level in decades. While some increased delay in delivery is a result of strong demand for components, the disruptive effects of trade tensions also played a major role. Indeed, General Motors warned just last week that Trump's tariffs on steel and car parts could be so disruptive they would cause "less investment, fewer jobs and lower wages" for GM employees.

Suffice it to say that, as in most matters, President Trump is shooting from the hip in his global trade policies. The result has been heightened uncertainty globally, which means a heightened sense of risk. This caused the US stock market to pull back from its highs in the second half of June while sending China's stock market into a tailspin.

UNFORCED ERRORS

We find ourselves in a situation where, left to itself, the US economy is gaining vigor, which was reflected in a strengthening US stock market. But it's not being left to itself as Trump has bulled his way into the china shop (pun intended), creating serious potential headwinds for the US economy.

As we've remarked for some time, assigning probabilities to Trump's actions is a fraught exercise. The markets have been betting that Trump's bluster on trade is a negotiating tactic rather than a blueprint for action. Our concern is that Trump is more serious than investors think he is. And trade is one area where a US president has very wide latitude.

One of our favorite economists estimates that if Trump levied all the tariffs he has threatened, it would effectively cancel out the fiscal stimulus injected to the economy by last December's tax cuts, both corporate and individual. This would leave the stock market in the latter innings of the ball game, as it were, with less encouraging prospects than we had entertained.

IN SUM

In our view, the primary risk to the US economy and stock market is policy error, specifically trade policy errors. Were Trump to dial back his aggressive tone on trade, the US economy and stock market could have quite a ways to run.

We should note here that the tax legislation passed by Congress last December *could be* very positive for the US economy over the next several years. By lowering the corporate tax rate and incentivizing capital investment, Congress created conditions that could spur not only an increase in corporate profits but, more importantly, an increase in US productivity, employment, and non-inflationary wage growth. This could, indeed, be a rising tide that lifts many boats.

That said, we have vigorous criticisms of the overall Republican legislative agenda. The tax cuts enacted last December will explode the US budget deficit, a problem the Republicans created and which they will endeavor to "fix" by slashing social programs—Medicare, Medicaid, Social Security, etc. This is a time-worn strategy: intentionally blow up the federal budget deficit and then use it as an excuse to cut social spending.

So, the Republicans' generosity to corporations is to be underwritten by the neediest among us. But it doesn't have to be. A more pro-growth corporate tax policy could better be financed by those most able to afford it: the wealthy. That would be us. And that's how we think it should be.

Farnum Brown, Chief Strategist

*The opinions expressed herein are those of Arjuna Capital, LLC ("Arjuna Capital") and are subject to change without notice. This material is not financial advice or an offer to sell any product. Arjuna Capital reserves the right to modify its current investment strategies and techniques based on changing market dynamics or client needs. This is not a recommendation to buy or sell a particular security. The **S&P 500® Index** is the Standard & Poor's Composite Index of 500 stocks and is a widely recognized, unmanaged index of common stock prices. Arjuna Capital is an independent investment adviser registered under the Investment Advisers Act of 1940, as amended. Registration does not imply a certain level of skill or training. More information about Arjuna Capital including our investment strategies, fees and objectives can be found in our ADV Part 2, which is available upon request. AJC-18-19*