



Basis Points July 10, 2018

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Above the Fold

President Trump's \$34 billion worth of tariffs came into effect on Friday, targeting industries central to Xi Jinping's "Made in China 2025" plan. As expected, China responded with tariffs of the same magnitude which target Trump's political base. The Chinese tariffs were delayed until immediately after the American tariffs came into effect, instead of at midnight Beijing time, to further emphasize that China is not instigating a trade war. Trump continues to cite unfair trade practices as the reason for the tariffs. In other White House news, the now-former head of the EPA Scott Pruitt was informed of his resignation on Friday following months of continual ethics controversies. This is contrary to Trump's claims that "it was very much up to" Pruitt. He is succeeded by his deputy Andrew Wheeler, so the EPA agenda is not expected to change. Over in Europe, the European Parliament voted on new, stricter copyright measures that would require digital content platforms

to filter out copyrighted content and pay other organizations like newspapers a fee to link to their articles. The vote rejected putting the measures on the fast track to passing into law. Further votes on the law are now delayed until September 10.

Three Things

- Emerging market stocks stumbled in the second quarter after a stronger dollar and higher U.S. interest rates led many investors to trade away from riskier investments in the emerging world. The Emerging Markets index fell 8.5 percent in the second quarter, the index's worst quarterly performance since the third quarter of 2015. Currencies in Argentina and Turkey, which heavily rely on outside capital to finance their budgets, declined most against the dollar. The currency decline raised fears that their dollar debt would be harder to pay off and more expensive to sell, increasing their deficits. Fears that the U.S. and China could escalate a trade war has become another worry, especially for countries that depend on trade like Russia, South Korea and Brazil. At the same time, higher oil prices are hurting countries that rely heavily on oil imports.
- Large Tech stocks are still doing most of the work when it comes to performance in the S&P 500 index through the first half of the year. In fact, more than 100 percent of the 3 percent gain in the index this year is due to only 10 large growth stocks. These 10 stocks include: Amazon, Microsoft, Apple, Netflix, Facebook, Google, Mastercard, Visa, Adobe and Nvidia.
- An annual report from Vanguard summarizes the statistics for the 401(k) plan that it administers, and the news is less than comforting for retirement savers in the U.S. In 2017, the average 401(k) account balance was \$103,900 and the median was \$26,300. Despite the recent uptick in balances from a strong stock market in 2017, balances are really not much higher than in 2007, and in terms of medians, 2017 is actually lower than 2007. This could be due to the fact that many participants in 401(k) plans are younger these days, due to the new auto-enroll features at large companies, so the average balances are lower. Looking at balances for those ages 55 to 64, a group approaching retirement, these balances are nearly twice as large as those for the 401(k) population as a whole. But even for this older group, 2017 median balances are lower than those in 2007. The one immediate policy implication suggested by these numbers is that auto-enrollment without auto-increase in the rate may well do more harm than good. If people are auto-enrolled at a 3 percent contribution rate, they are likely to stay with that rate. Some suggest that we make auto-enrollment and auto-escalation mandatory for all 401(k) plans, starting at a default contribution rate of 6 percent that rises gradually to 10 percent.

Did You Know

We have previously discussed the possible reasons why yields at the long-end of the yield curve remain stubbornly low, with the 30-year T-bond yielding just 2.95 percent, vs. the 2-year yield of 2.55 percent. This low yield relative to short rates is odd, as we are in a strong economic

environment with some investors anticipating a strong uptick in the inflation rate, so long-dated bond yields should be rising. One explanation could be that global economic growth is slowing, and foreign investors are taking safe-haven in U.S. government debt, which pushes our bond prices up, and yields down. But there could be another good reason, this one related to pension fund demand for bonds. Due to provisions in the tax reform bill passed last year, companies that make pension fund contributions get a big tax break for a limited time. The tax bill introduced a window for companies with underfunded plans to make additional contributions and get a tax benefit. Firms that contribute through mid-September of 2018 can receive deductions based on the old 35 percent corporate tax rate, rather than the new 21 percent rate. So a company that contributes \$1 million to an underfunded pension plan could have \$350,000 in tax savings before the deadline but would have savings of just \$210,000 after September. With a large amount of tax-advantaged contributions being added to pension plans this year, the demand for government bonds in those plans is up sharply as the pension fund managers put the money to work. This temporary uptick in demand may be contributing to lower yields on long-dated bonds.

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