POLARIS
WEALTH ADVISORY GROUP

The Polaris Perspective

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Renewed Fears

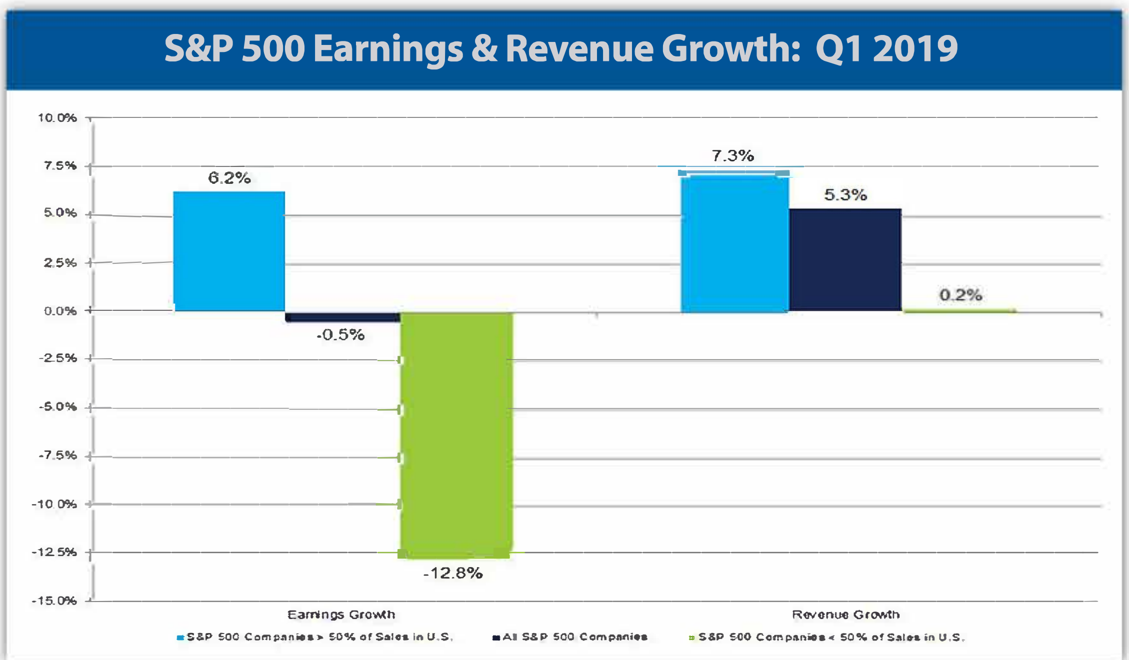
The first trading day after trade talks with China ended without any resolution saw the broader markets plummet, as fears rose that an escalating trade war could send the U.S. economy into a recession. May 13th ended with the S&P 500 down 2.4%, and the Nasdaq down 3.4%. This adds to the losses already experienced in May, with the S&P 500 down 4.6% and the Nasdaq down 5.5% month-to-date.

Polaris Wealth already took some action last week, trimming almost 20% equity exposure from our Rising Dividend Growth and Income strategy on Thursday and Friday, and approximately 10% from our Global Growth, Socially Responsible, and Rising Dividend Growth strategies. We shifted out of some of our "high beta" investments into lower risk stocks in our Focused and Concentrated strategies. We made these moves last week as it became more and more clear that the trade talks would not bear fruit. We chose to lower our exposure to areas of the market that we feared might suffer in light of China's inevitable retaliation to the United States' decision to increase tariffs. We lowered exposure in materials, industrials, and technology sectors. We will continue to lower our equity exposure to the markets if the sentiment remains negative. While sentiment is currently driving this market, there are still many very positive things going on that could make this current sell off very short lived.

Better Than Expected Earnings

Corporate earnings have come in stronger than expected. With 90% of the S&P 500 companies having already reported their first quarter earnings, it appears that this quarter's results will be stronger than expected. Analysts had expected corporate earnings to have declined by 4%. To date, earnings have come in with a blended decline of only -0.5%, with nine of the S&P's eleven sectors having stronger growth than expected.

As one would expect, companies with more than 50% of their sales coming from domestic sources have faired much better than those with larger international sales. You can see from the chart to the right how skewed these numbers are this quarter.



Source: FactSet

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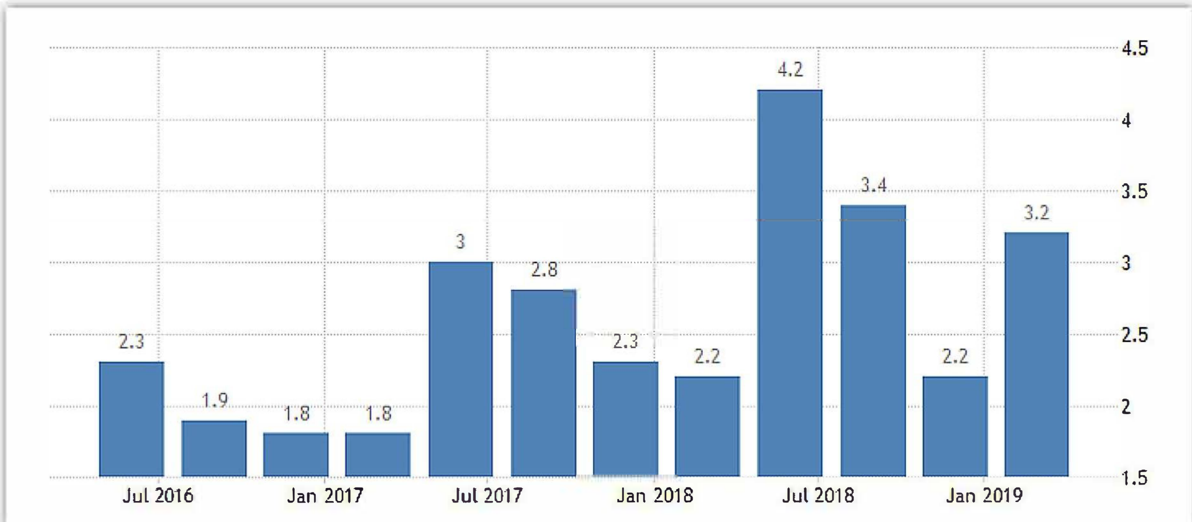
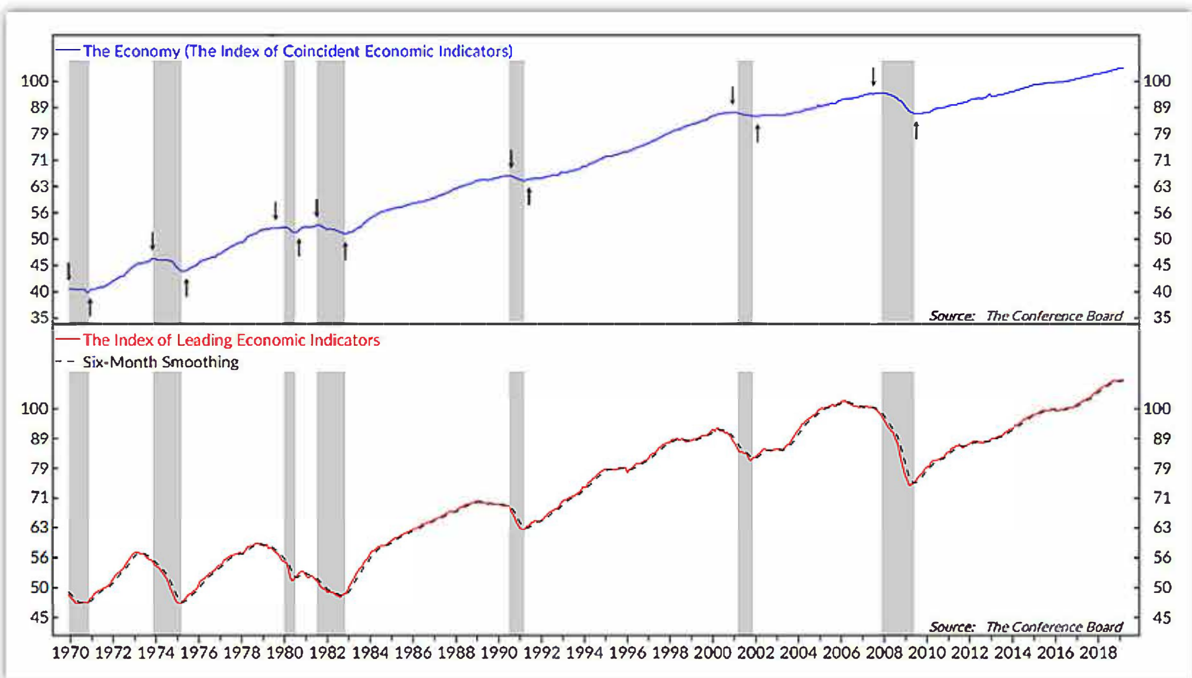
Our Economy Remains Strong

The US economy grew by an annualized 3.2% in the first quarter of 2019, easily beating expectations of 2%.



Source: tradingeconomics.com, U.S. Bureau of Economic Analysis

And there are no signs that the economy is slowing down. All leading economic indicators point towards continued economic growth.



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China Will Eventually Come to The Table

The United States and China were nearing a trade deal that would have lifted all tariffs, allow American companies to operate in China and strengthen China's intellectual property protections. Discussions fell apart when China called for considerable changes to the negotiating text that both countries had been using as a blueprint for a substantial new trade pact.

Some say that China miscalculated the rhetoric coming out of the White House as weakness, as Trump complained that had the Fed not raised rates our economy would be growing as fast as China's. Regardless, President Trump was angered by what he considered an act of defiance. He escalated the trade war with China by raising tariffs on $200 billion of Chinese goods. China has retaliated by increasing tariffs on $60 billion of American goods, a list of more than 5,000 goods.

This trade war is not good for either side, but it impacts China significantly more than it impacts the United States. The United States imported over $557 billion in goods from China in 2018. The United State exported only $179 billion in goods to China last year. If you want to play the game of tariffs, United States can hurt China more than they can hurt us.

China does hold one last chip, selling or not buying U S Treasury bonds. They currently own $1.13 trillion in Treasuries. While it may be a bargaining chip, it puts the Chinese in real danger (and could even help the United States).

If China decided to sell its U.S. Treasuries, it would force the price of Treasuries down, considerably impacting their own $1.13 trillion investment. Even if they did sell 100% of their investment, where would they put the money? U.S. bonds are among the highest yielding in the world when incorporating their relatively low risk. China would make less on their future investment. In addition, a sell off of any magnitude could lower the value of the dollar. This would then make U.S. products and services sold abroad less expensive, and thus more attractive to foreigners to buy. This would be a stimulus to the U.S. economy.

In the end, the United State and China will negotiate a trade deal. It does not benefit either side to have a prolonged trade war. Unfortunately, volatility may still remain because the trade deal will need to be enforced (especially when dealing with intellectual property). In the meantime, expect the markets to be very choppy.

Selling Is Only Half of the Equation

We took our first steps to get defensive in your portfolios. If the market continues to show weakness, we will continue our counter measures by lowering your equity exposure in the strategies that allow for it or shifting from higher risk stocks into lower risk stocks in those strategies which must always remain 100% invested in stocks. That said, getting defensive is only half of the equation.

We must remain vigilant in our decision of when to reenter the market. This is referred to as "risk on" investing (vs. "risk off" when getting defensive). When the trade war ends, our markets will rally, and we'll position ourselves accordingly to take advantage of it as best as possible.

As always, I welcome your questions and comments.

Sincerely,

Jeffrey J. Powell
Managing Partner & Chief Investment Officer