When we last wrote, in early May, markets were "falling on news of at least a partial breakdown in the anticipated trade deal between the U.S. and China." We went on to suggest that "that could all reverse very abruptly". And in fact, it did. New trade talks were announced, and markets surged to new highs.

As we prepared over the past few days to again comment on developing conditions, we found ourselves in the midst of markets breaking down over trade concerns once again – but this time feels different.

First, an update on the economic backdrop …

The economy decelerated into 2nd Quarter, and our concerns about the intermediate term sustainability of the expansion became more significant than at any point in the past several years. But as we moved into the last part of July the data flow seemed to show the economy stabilizing again – at a slower pace, but, very importantly, with a renewed sense of energy.

With the employment data still relentlessly strong and the December government shutdown fading into the rearview mirror, the sluggishness of consumer demand had given way to a resurgence of confidence and willingness to spend. Similarly, official data showing a strong rebound in both business equipment production and core capital goods orders in June seemed to reflect renewed business confidence and an expansion in business investment.

Certainly, not everything looked so optimistic: Corporate earnings had essentially flatlined through the first two quarters after an exceptionally strong 2018; the now inverted U.S. Treasury yield curve had finally become a legitimate concern; and housing, which had developed an inconsistent but clear uptrend in the early months of the year, had lost all momentum.

But overall, things were suddenly looking more constructive again, particularly with the Federal Reserve changing the near-term direction of interest rates. The rationale for the rate cut announced on July 31 seemed rather muddled, but it did clearly signal that the Fed is not bent on pursuing a tightening cycle to the point of driving the economy into recession in the manner many had feared.

While it's true that the market stumbled sharply during the press conference by Fed Chair Jerome Powell following the rate cut announcement – whether in disappointment that the Fed was not committing to deeper cuts or simply at Powell's general sense of uncertainty – it regained its footing and had recouped nearly the entire decline by mid-day the next day, appearing poised to move to new highs...

...until an abrupt tweet out of Washington announcing new tariffs on $300 billion in Chinese goods turned the market instantly south, leading to cascading losses over the next 2 ½ days as the back and forth rhetoric and related repercussions escalated.

For a few brief moments in time, there had been an unexpected and largely overlooked case to be made that conditions were beginning to favor a meaningful extension of the economic expansion fueled by renewed consumer confidence, a rebound in business investment, and a supportive Fed.

Now, we'll have to see. The heightened potential for an acrimonious trade war creates a greater sense of uncertainty and foreboding than last time around. Many have made the case, accurately, that trade accounts for only a small part of the U.S. economy and should thus have only a minor impact on U.S. growth. But beyond the direct effects are the psychological effects – the business leaders who decide to postpone more aggressive investment in growth and development as they wait for a less uncertain environment, the consumers who hesitate to spend so confidently in concern over the stability of their incomes in a more unstable world. And both groups have shown sensitivity to heightened trade concerns.

For the equity markets, there remains a near-term path higher, for both fundamental and technical reasons, that cannot be ignored. Among other things, the U.S. remains the most attractive place to deploy capital, providing greater potential in the near term for our markets to recover and move higher. But the road becomes more challenging and more likely to lurch dramatically in either direction, as we have already seen.

So long as current conditions relating to trade persist, the risk to economic growth will be materially heightened, and the probability of markets successfully navigating a sustained path forward without more significant correction will be eroded. Yet for now, this market still seems to "want" to find reasons to move higher and has demonstrated over and over its capacity for doing so. Allocation strategy should proceed calmly and with recognition of the market's upside potential, but it should also be more attentive to the degree of uncertainty and the expanding risk that the economy could be dragged down by global trade issues and a related psychological undermining of the initiative that leads to growth.

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