

Your weekly market update

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Market Update

22 September 2017

In the past, presidential cycles have followed a very forecastable path. President Trump and his administration have been anything but traditional. An approach that entails disturbing and disrupting existing relations in order to “set something to shake loose” and report hollow victory. Administration wise, tax reforming is the real ‘make or break’. Small and medium sized enterprises are the back bone of economic job creation, not just for America but for all developed nations. America’s tax code has been just unnavigable for most business owners and citizens, unless you have an accounting firm dedicated to serving your tax needs. Simplification will not only increase transparency and fairness in the tax code, but will invigorate businesses to hire, invest and grow. President Trump knows this and must create a political climate to allow for such change which is why I believe the President has chosen to engage the Democrats as he has managed to polarize and not unite the GOP. Since the GOP controls both the House and the Senate polarization will cost him. Time is running out as much needed tax reform could be delayed deep into 2018 as bi-elections are coming. This risk not having enough Republican Senators and Congress people being re-elected. In other words, potential losing control of the House and or Senate. So December of this year has become the desired date to have a multitude of promise materialize such as replace and repeal, moving federal tax rate from 35% to 15%, DACA “dreamers” and raising the debt ceiling. Given the level of polarization in the GOP and the fact that December is not a conducive month for getting anything done, what will hold true is



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that the months ahead will see a Tsumani of politicking.

The other very dangerous events under foot by the Trump administration is the potential change in Fed chairwoman Janet Yellen, who is following in the steps of her predecessor Ben Bernanke. Mr. Bernanke had applied Keynesian economic theory to transition out of the global recession by bringing to bear heavy central bank intervention to induce economic recovery and bring about growth. As a pre election promise Trump made it clear his desire to replace chair Yellen. Why? All of Trump's economic advisors including Mr. Mnuchin favour supply side economic theory, which calls for the exact opposite approach by believing government and central banks have no business in economics. Supply side theory states that all that the government needs to do is lower federal taxes and decrease regulation. The core belief on supply side is markets are efficient and the economy should be let to run free. Chairwoman Yellen has introduced great transparency on how the central bank acts and communicates their intended action. A far cry from the days of Alan Greenspan and his cryptic speeches leaving economists scratching their heads looking for guidance. So why is Trump so confident he can have GDP hit 3%? Simply because he will remove all the governors and nannies that curb and ensure the economy does not over heat into a deep recession and the fire starter to this explosive growth is lowering taxes. Such a move represents an about face in economic policy.

Geopolitical tensions are amongst the highest in the world as North Korea prepares to launch a hydrogen bomb over the Pacific ocean. Additionally, the Russians issued a formal warning to America's military base in Qatar to stop attacking Russian soldier fighting hand in hand with the Assad military regime. America's fight in eradicating ISIS and the tyranny of the Assad has been continual and lasting. Russian soldiers (supporters of the Assad regime) in the regional has been under heavy attack along with heavy destruction of Russian military installations. Moscow's statement was simple: "We will retaliate by attacking American installations". Geopolitical tension always weigh on markets and promote a flight to safety of capital.

The Fed is being tasked unrealistically by Congress with seeking full employment. Policymakers do not wage all out war on

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joblessness. Instead, they seek how low can unemployment fall sustainably. Four times a year monetary policymakers write down where they think unemployment will settle over the long term, a number that they see as beyond their control. Where does the idea of a “natural” rate of unemployment come from? There are several reasons why unemployment cannot be eradicated fully. It takes time for people to move from one job to another. This causes “frictional” unemployment. If people cannot find jobs because they have outdated skills. Job seekers become “structurally” unemployed. Trade unions fight to keep wages too high to employ all workers in an industry. Equally, employers might use their buying power in the job market to keep wages low and jobs scarce. Monetary policy does not affect how efficiently workers can be matched to jobs, or the level of unionization. The only tool central bankers have to fight unemployment is to increase the level of spending in the economy, which can induce firms to expand and take on more workers. This is easy enough after a recession, when there are plenty of jobseekers around. However, in more normal times, when unemployment reflects frictional and structural factors, firms must pay higher wages to attract more staff which means charging higher prices too. If most firms raise prices, the ensuing inflation will erode the purchasing power of the pay rises that brought unemployment down to begin with. The natural rate of unemployment will eventually reassert itself. All that central bankers will have achieved is a nasty rise in inflation which, if it raises expectations of further inflation, might be tricky to undo.

How does the theory apply to today’s world? The only way economists can estimate the natural rate is by watching how inflation and unemployment move in reality. American unemployment is only 4.4%, yet inflation is strangely low. This has caused Fed policymakers to cut their estimates of the natural rate of unemployment in recent years. Some argue that the wrong data is being used because the unemployment rate excludes those who have stopped looking for work. Others say that inflation expectations are stuck too low. Sceptics have even begun to doubt the existence of the natural rate. But this requires a belief in one of two things: either central banks cannot influence the rate of unemployment, even in the short term, or they can peg unemployment as low as zero without sparking inflation.

Not just America but many developed nations and their central banks are finding that igniting inflation may prove much more difficult than anyone thought.

Jean Claude Juncker, President of the European Commission announced that, “the eurozone is growing faster than the United States” during his annual state of the union speech. Europe’s booming economy was near the top of his list. Ten years since the crisis struck, “Europe’s economy is finally bouncing back,” The EU has now found unity after Brexit and Juncker declared, “the wind is back in Europe’s sails”. In fact, growth in the 19-country eurozone has quietly outshone America for the last two years. The latest annualized growth numbers show the single currency bloc growing at 2.3%, compared with 2.2% for the world’s largest economy. Eurozone unemployment has fallen to the lowest levels since 2009. Factories are humming again, with production up 3.2% on the last year.

The Eurozone might be doing better, however the crisis has left deep scars and many wounds, that are far from healed. In France, the economy is expanding at an annualized rate of 1.7%, fuelled by confidence in French president Emmanuel Macron and his reform agenda. France’s economic growth continues to lag the Eurozone average. Germany’s economy remains solid, but German citizens are becoming increasingly worried about inequality and low wage jobs. Spain has bounced back from the crisis, but inequality is rising and unemployment remains painfully high at 17%, second only to Greece. Italy’s economy is doing better, but worries remain over heavy bank indebtedness. Despite the rapid pace of job creation, Eurozone unemployment remains high (9.1%), worse than the EU average (7.7%) and the US (4.3%). EU economies would need to be expanding faster to generate steeper falls in unemployment. The outlook for the Euro area has improved a lot, although the economic growth is still closer to 2% than 3%.

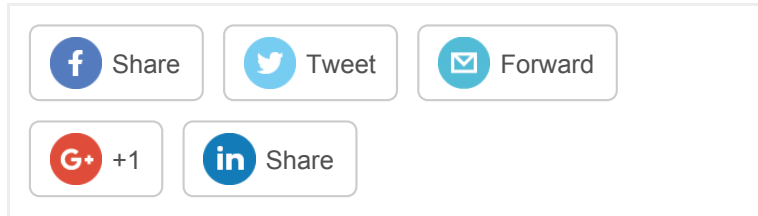
Britain struggles to negotiate any kind of resemblance of exit talks with the EU. Prime Minister Theresa May’s latest speech had an air of desperation and frustration regarding the lack of progress being made in moving talks forward. This spells more headwinds for the United Kingdom.

WTI (West Texas Intermediate Crude) hit a nearly four month high at \$50.81 on Thursday, despite three straight weeks of rising stockpiles in the aftermath of Hurricane Harvey, which shut a quarter of America's refining capacity. American refineries are processing about a million barrels a day less oil than at this time last year due to impacts from Harvey. However, the difference between crude oil and refined product prices remain wide, which gives refiners a strong reason to keep processing crude at a time when they're normally winding down operations to perform maintenance on their facilities. Refiners may put off some maintenance and keep plants running so they can continue to take advantage of fat profit margins, sustaining demand for feedstock crude oil. Hurricane Harvey has done more to reduce the glut in oil and the actions of OPEC. All expectations are that American oil producers will rush in and ramp up to regain market share in crude and refined oil products.

Canada is leaving out some very rosy economic past performance numbers. The question going forward is will this last? Canadian retail sales volumes declined in July, pointing to a slower pace of growth at the start of the third quarter, though a pick up in inflation in August still left the central bank with room to raise interest rates again. A moderation in growth heading into the third quarter is expected after a strong first half of the year made Canada a G7 leader. Solid performance prompted the Bank of Canada to raise interest rates twice so far in 2017. Economists are trying to gauge whether the central bank will raise rates once more by the end of the year or wait until 2018 to tighten. Data released on Friday showed overall retail sales rose 0.4%. While that topped expectations, economists focused on a 0.2% decline in volumes, which suggested economic growth was likely flat in July. Friday's mixed economic data was not definitive either way and suggested the BoC could take its time raising rates, but another rate rise is highly likely.

China's attempts to reduce risks from its rapid buildup in debt are not working as quickly as expected and credit growth is still too fast. Standard and Poors (S&P) in June stated that a cut in China's credit rating may be in the cards. China's "de-risking" drive that started early this year was having less of an impact on credit

growth than initially expected. The fact that leadership has shown greater resolve to implement the deleveraging policy is a big step, however that did not stop S&P from down grading China from A+ to AA-. China's finance ministry said the downgrade was "a wrong decision" that ignored the economic fundamentals and development potential of the world's second largest economy. In short, China's economic growth has been fuelled by limitless lending by the Peoples Bank of China to Chinese banks which have lent money out as if it is going out of style. An over leveraged and over built economy does only one thing: collapse.



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