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Investment Insights

Market Update: One Hand Washes the Other

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One hand gave Federal Reserve (Fed) rate cuts), while the other hand took away (new tariffs on Chinese goods), triggering down-side pressure and volatility across all asset classes last week. The trade truce between the U.S. and China came to an abrupt end with the August 1 communication from President Trump that the U.S. was planning a 10% tariff on some $300 billion of Chinese imports beginning September 1. The tariffs, if implemented, will target consumer goods for the first time, and has the possibility to open a whole new front on the U.S.-China trade war. One of China's policy responses was to allow the yuan to drop below CNY7.00 to the U.S. dollar for the first time in over a decade, a move that could precipitate more tit-for-tat currency devaluations and harden the negotiating positions of the two parties. The government has also ordered state-owned companies to suspend the importing of U.S. agricultural goods.

The near-term collateral damage from the spike in trade volatility could potentially include declining global sovereign yields; diminished inflation expectations; softening commodity prices; waning business confidence and investment levels; lower corporate guidance; and a general "risk-off" mentality among investors. Escalating U.S.-China trade tensions have been accompanied by sharp market selloffs in the past, followed by market resets/recoveries due to countercyclical forces (e.g., easy monetary policies) and a de-escalation of trade tensions as the negative effects become more apparent and painful to both parties. The more the market pain, the more the urgency to find an exit ramp—although each escalating round of trade tensions has seen eroding mutual trust and makes it more onerous to cobble together even a truce let alone a trade deal. Investors need to brace for episodic bouts of trade volatility but not lose sight of current favorable market fundamentals: better-than-expected U.S earnings; stronger-than-expected U.S. gross domestic product growth, led by the consumer; global central bank easing; productivity-led capital expenditures (capex) levels; and fairly priced U.S. equities

As we have discussed in the past year, short-term market direction is taking its cue from the on-again, off-again trade negotiations as investor sentiment remains nervous. However, more importantly, trade is secondary, in our view, versus what the yield curve in the U.S. is indicating. This line of thinking is squarely on the basis of how the strength of the economy and long term inflation expectations drive the level of growth over the medium and long term. We believe trade battles that may alter the current supply chain and add short term costs to multinationals can be balanced out in time. What is much more difficult is creating a monetary environment that stops deflationary forces in its tracks and helps support an expansion that pushes nominal growth (and therefore higher economic profits and cash flows) higher. In summary, the most important question, in our opinion, is not necessarily the end-game on trade rather it is now how aggressive is Fed policy likely to become in the coming months? The yield curve is telling the Fed that financial conditions are too tight.

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We expect equity markets to remain volatile in the short-term given seasonal patterns, the spate of corporate earnings news in the next month, and the fact that the next major Fed communication and action is more than 6 weeks away. We continue to believe that fair value on the S&P 500 for the remainder of 2019 is 2900 and fully valued at 3100. The next Fed meeting is on September 17 and 18. Therefore, technical factors in the markets are likely to pressure equity prices with the likelihood that the S&P 500 falls to the 200 day moving average of around 2800. This would equate to close to 7.5% pull-back from recent S&P 500 highs of 3025 at the end of July. We believe investors should step back and allow markets to settle down before adding to equity allocations at this time but be ready to increase risk, where appropriate, the closer we get to the next Fed meeting. It is our belief that the yield curve is suggesting that the Fed should consider getting more aggressive in order to right-size the curve (a much steeper curve is needed) and ultimately help move inflation expectations above their target rate. Each time that financial conditions tightened post credit-crisis risk assets corrected mainly due to a fall in nominal growth as inflation expectations peaked and eventually declined. In the most recent tightening of conditions (Fed policy normalization of 2017-2018) the rest of world (and more specifically manufacturing) came under significant pressure. This was first evident in early 2018 and before the trade battle ensued with China. Weakness gathered momentum as tariff and trade grappling picked up and rates in the U.S. were hiked further throughout 2018. The U.S consumer, however, led by the strength of the job market remained strong and continued to power the U.S. economy. This still remains at present time but the clock is ticking. The yield curve is telling us this and rates overseas, particularly in Germany and Switzerland which have their entire curves from 1 to 30 years in negative yielding territory, continue to suggest deflationary shocks are still gripping their economies. The Fed is likely to further recognize this in coming meetings. Our partners in BofA Merrill Lynch Global Research Economics continue to believe the Fed will cut a cumulative 75 basis points in this "mid-cycle correction", with the next cuts in September and October. But if the trade war escalates, they believe it won't be a mid-cycle correction and instead will be the start of a real easing cycle.

We will continue to watch trade developments and the level of China's currency depreciation as this places more pressure on the Fed. But more importantly, in our view, will be the U.S. Treasury yield curve. The more inverted the curve gets the higher the probability of an economic recession. We do not see this materializing any time soon given the underlying strength of the U.S. consumer, the lower than expected potential negative trade impact, and the Fed's potential more aggressive tone in the coming months (more aggressive communication and perhaps balance sheet expansion). We remain overweight equities and view this latest pull-back as a rebalancing of expectations, valuation, and a small reset back to more attractive levels. We prefer to let the dust settle for now but be prepared up ahead of the next Fed meeting to consider buying on weakness. We continue to prefer the U.S. versus the rest of the world and, specifically, large caps relative to small caps. We emphasize a balance of value and growth for style based investors and view a cross section of sectors that offer both an attractive level yield (2 percent and above) and earnings growth (double digit percentages) potential as areas that are likely to be in demand in this current low rates, complex global economic environment., these sectors namely include Technology, Industrials, Healthcare, and Financials. In fixed income, we view government bonds as a hedge on equity risk and prefer shorter dated yields given the shape of the yield curve. We are still emphasizing higher quality across the board and do not expect spreads to widen much into year-end – even in a risk off environment.

Index Definitions

S&P 500 is a stock market index that tracks the stocks of 500 large-cap U.S. companies. It represents the stock market's performance by reporting the risks and returns of the biggest companies.

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