What the U.S.-China Standoff Means for Investors and the Economy

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Please see important information at the end of this program. Recorded 5/24/2019

Hello this is Chris Hyzy, Chief Investment Officer, with the latest market update. With the increased volatility, investors are trying to figure out the central question which is "Where is the economy headed?" Recently, there a lot of unknowns that unknowns that are rising.

1. Uncertainty over global trade as the trade war between the US and China has escalated to its highest level. This particular unknown has elevated some additional questions that have not pierced the first couple of months of the year.
   I. The first one is "How long will the trade war last?"
   II. The second one is "What components will eventually be included in a deal, if there is one?"
   III. Three: "What are the ramifications for future growth?"
   IV. And fourth, given this – "How can one price this in within riskier asset classes such as equities and credit?"

2. And then going down on further unknowns, the second one that has also recently escalated is a Hard Brexit. A Hard Brexit was taken off the table in the past few months but now concerns are rising that it is back on which also weighs on global trade.
3. Number three, the confrontation with Iran has increased significantly in the past few weeks which raises geopolitical risk some more.
4. And fourth, how does all of this relate to the fundamentals of economic and profit growth in the U.S. and globally? And what is the latest move lower in yields and another inversion of the yield curve telling us about the probability for a recessionary environment in the short to intermediate term?

Now on the flip side there are also a bunch of knowns which are simply just not balancing out the unknowns.

1. The first one being the Fed is on hold for longer than many expect and next move is much more likely a cut than a hike.
2. Number two financial conditions broadly are attractive and potentially easier in the near future.
3. Number three the US Consumer and US job market still healthy and has momentum.
4. Four, investor sentiment is low (equity flows have been negative for 14 straight weeks) – so overall selling pressure is not high in our opinion.
5. And that relates to number five, equity valuation – even with little earnings growth, we do not see valuation as overvalued

So given all of this, we believe there are 4 scenarios to analyze and ones that could develop in the next 12 months:

I. Expansion – Global growth turns higher and heads above trend as a "surprise trade deal" develops which helps lift business confidence globally while Fed on hold and financial conditions stay easy
II. Moderation – Growth stays on trend in a tight range as geopolitical risk weighs on growth but financial conditions remain attractive, which balances out an aggressive slowdown (service economy still outweighs a hard manufacturing slowdown). In this scenario would likely include an agreement to meet and work on an eventual deal.
III. Contraction – Geopolitical concerns rise thereby pressuring global trade further and business confidence heads south creating a below trend growth environment. The Contraction scenario would include, in our view, a "no agreement to meet" and another round of tariffs on the remaining $325bln in goods.
IV. Recession – Falling business confidence leads to a major decline in Consumer confidence as evidence of job growth slowdown rises aggressively. In addition to a further major decline in trade, consumer spending drops and the Fed acts to slow to provide liquidity through lower rates. In the Recession scenario a "full blown trade war" that includes tariffs on all goods, further boycotts and blacklist items, and an escalation of national security interests which could also lead to a full blown "Tech War." This scenario would also include a Fed that stays on hold and does not cut rates, which lowers confidence further.

These scenarios are not difficult to lay out individually and many will try to assign probabilities to each individual event. However, we believe combinations of scenarios develop rather than any one in particular. The reason is simple: the concerns and events that surround them are fluid and evolve over time. Therefore, probability analysis on individual events may not be optimal. It is more important to assess combinations in our opinion.

So what do we expect? We ultimately expect a combination of scenario 1 (expansion) and 2 (moderation). As we believe both China and US need a rising "growth story" as US election cycle gets closer and China's domestic economy needs support. An ideal framework should support business and consumer confidence while financial conditions remain easy.

However, initially – in the next few months – the combination of scenarios 2 (Moderation) and 3 (Contraction) are more than likely to remain most visible. Here a delay to a Trade Deal and Brexit conclusion weigh on sentiment and business confidence. Ultimately, here in addition to the trade war that is unfolding is not just about economics – it is about technology dominance – according to our Global Research colleagues, which also has implications for capital investment, supply chain management, and a significant rise in on-shoring more likely in the years ahead.

Non-U.S. economies would struggle further in the next few months with the US economy (a trend growth) being powered by the consumer with an "easy" Fed. This leads to an environment that oscillates between moderation and contraction.

Within this context we expect eight main items to continue:

1. Pressure to remain on yields to the downside
2. Portfolio adjustments to be made by institutional investors that lower higher beta/higher growth areas and increase yield-oriented/more defensive positioning
3. The US dollar to remain with a stronger bias
4. Potential delays to capital investment plans as business confidence fades
5. Businesses in some areas start passing on the tariffs to goods prices, thereby placing a tax on consumers in specific areas
6. Capital investment plans get delayed, but not fully pulled back as businesses take a “wait and see” approach
7. Earnings and GDP growth forecasts are adjusted lower
8. The equity and credit markets price this in and we eventually head higher from there as expectations are re-set. Then with more clarity on the trade fronts, markets can climb the wall of worry discounting a more optimistic environment in our view.

We expect a buying opportunity to ensue in the equity markets between now and the end of summer for 5 Primary Reasons. Now this is even in the face of an escalating trade war that we expect.

1. A trade deal ultimately comes into focus the closer we get to the 2020 election cycle and through the G20 meeting in late June. The trade deal – even if it appears somewhat diluted from the original discussions – would remove a major short term uncertainty for both investors and businesses. In effect – the “operating rules” would be known in our view. Supply chain management and growth plans become much clearer.
2. Job growth in the US remains healthy as labor shortages continue and consumer confidence remains high.
3. We are closer to early/mid cycle than late cycle with productivity as the next major catalyst to support economic growth. This is just beginning due to wider automation and innovation. This gathers momentum with “on-shoring” and as more businesses protect margins and deal with rising wages, as well as a “skills gap.” In addition, demographic segmentation supports higher pent-up demand for the key drivers of the US economy (such as housing and overall services).
4. The Fed allows the economy to run above trend. This is likely to last for much longer than currently expected.
5. The sharp V-shape rally since the beginning of the year was powerful but the recent consolidations now places US equities back to virtually flat in the last 14-15 months in terms of price performance. The short term pull back has now placed equities at an attractive valuation again (below approximately 16X 2020 earnings – using only 3% growth on 2019’s earnings $168 for the S&P 500)

Finally, what should investors consider?

I. The consolidation in equity markets from the highs of early May was to be expected, particularly as the much anticipated trade deal was surprisingly pulled at the 11th hour.

Markets are likely to remain fragile as short term investors try to price in the evolving scenarios that we mentioned.

II. We would use weakness in the coming weeks as a buying opportunity for those that have equity allocations below their policy targets and have been waiting for more attractive entry points or have been waiting to re-balance portfolios in general. For investors that are fully allocated and have too much higher beta/higher growth exposure than their target allocations suggest – we would use this opportunity to diversify portfolios further to gain better balance as it will likely be difficult for trade talk to resume in earnest prior to the G20 in late June. The CIO portfolio strategies have diversified risk budgets across asset classes, therefore this latest pull-back has not warranted a large enough re-balancing. We are waiting out the "limbo period" until the combination of Expansion and Moderation scenarios ultimately evolve.

III. We still expect new high to develop in US equities in the next 6-12 months and believe 2900 to be fair value on the S&P 500, with the potential for 3000 to be reached as better prospects for 2020 become clear.

Thanks very much.

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