Market Perspectives

Sentinel Trust Company, LBA
Investment Committee
Bruce L. Swanson, PhD
APRIL 2018

March Re-Cap

Following February's market gyrations, which saw inflation fears exacerbated by the unwinding of ill-fated short-volatility strategies, March promised to be a month of rest and recovery as global growth was plateauing at a high level and the monthly employment report presented a remarkable combination of strong employment growth, higher workforce participation and little sign of wage pressures. In addition, North Korea tensions eased while NAFTA and South Korean trade talks advanced smartly.

However, despite the market-supportive backdrop, "event-risk" in the forms of social media data gathering and protection issues, combined with the Trump Administration's increasingly combative China trade policy, conspired to produce a volatile and mildly negative month for risk assets. Global equities fell 2% across the board. Treasury bonds rallied, quite strongly in the longer maturities, as investors became more convinced that the Federal Reserve Board (Fed) was acting proactively.

The headline 2% decline in US equities does not do justice to the intra-month movements, which saw the VIX (fear index) up 66% over a two-week period. During that period, the FANG stocks (Facebook, Amazon, Netflix and Google) fell 14%. Those four stocks accounted for 40% of market losses since the late January peak. After falling 2% on President Trump's March 1 steel and aluminum tariff announcement, equities subsequently rallied 4% on a remarkably benign employment report, only to fall 6% on data privacy issues at Facebook and an escalation of trade war fears, before recovering on hopes those fears were overdone.

Capitalization Bias

Within the market, there was a pronounced capitalization bias, perhaps reflective of the macro-drivers, as larger stocks were down 2-3%, mid-caps were little changed and small caps (growth and value) were up 1%. Despite the headlines and a 4% decline, the technology sector was not the worst performing group, as financial stocks were negatively impacted by both headline themes (benign inflation and tariff-induced growth fears). The rate sensitive and domestically oriented utility sector was a safe haven, gaining 4%. Value stocks outperformed growth stocks by nearly 1%.

International equities also lost 2% across both advanced and emerging markets, with a similar pattern: large caps and financial stocks were the worst performers, with utilities up on top. Australia was a notable outlier, falling 5% on the China trade tension and plunging metals prices. Japan was an in-line performer despite a real estate scandal involving the prime minister's family. Frontier markets remained in the black, taking year-to-date gains to 5%.

Economic Growth

The monthly employment report could not have been more supportive of markets and of Fed policy. The massive 313,000 net-job-creation figure did not cause the 4.1% unemployment rate to slip, as workforce participation increased from 62.7% to 63%. While 3-month annualized wage growth increased to 2.9%, the overall narrative allowed the Fed to "sell" a scarcely believable forecast: despite appropriately upgrading the economic outlook on growth and employment (its 3.4% 2019 unemployment forecast would be a 50-year low), its inflation forecast was little changed at 2.1% for both 2018 and 2019. The European Central Bank (ECB) removed its easing bias but remained remarkably dovish. It refused to specify a cut-off date for its bond buying program, despite having little high-quality paper left to buy, as the free-float of Eurozone AAA-rated bonds decreased to 8%.

Other domestic reports were also market friendly, suggesting that while growth remained above-trend, it was not accelerating. Even a few sub-2% first-quarter-growth estimates have appeared. Sentiment remained strong: CEO optimism was the highest since the survey started in 2002; US consumer confidence hit a 14-year high; and the number of people unemployed but wanting to work receded to pre-recession levels. The tariff proposals came at the same time as our trade deficit widened to a record level in absolute terms, with China accounting for 50% of the deficit. While retail sales disappointed for the third straight period, weekly jobless claims fell to 1973 levels and the fourth quarter gross domestic product was revised up significantly on stronger than expected consumer spending. That suggests consumers "borrowed" from the future in anticipation of their 2018 tax savings. The revision boosted full-year growth to 2.6%, which happened to be my longstanding outlier forecast, in contrast to consensus estimates which had fallen to 2.15% as recently as August.

Overseas reports were similar as the OECD (Organization for Economic Co-operation and Development) raised 2018-2019 growth rates, global manufacturing held near a 7-year high and Eurozone unemployment fell to 8.6%, below equilibrium levels, and well down from 12% in 2013. Japanese machine orders, a proxy for the manufacturing sector, grew at the fastest rate in three years.

"Sentiment remained strong: CEO optimism was the highest since the survey started in 2002; US consumer confidence hit a 14-year high; and the number of people unemployed but wanting to work receded to pre-recession levels."

China continues to manage a soft-landing from the double-digit levels of only five years ago as its tries to reduce its budget deficit for the first time since 2012. While reiterating a 6.5% 2018 growth target, China did not pledge to exceed it. Evidence of the growth slowdown continues, with the manufacturing outlook falling the most five years. The service sector also disappointed. Perhaps relatedly, China relaxed rules on bad bank loans, lowering mandatory coverage ratios in an effort to support lending. Such actions and the targeted reduction of excess real estate inventory and of heavy industry capacity have insulated global markets from the rationalization of the old economy.

Interest Rates

The combination of a benign wage report, moderating growth and trade concerns led some investors to worry that the Fed's tightening plan was too aggressive, causing the Treasury yield curve to flatten significantly. The spread between 2- and 10-year yields was crushed by 13 basis points, while finishing the month at 47 basis points, the tightest since August, 2007. Longer maturities outperformed, with 20-year maturities gaining 3%. Credit markets saw a reversal of recent performance in that higher rated issues outperformed as credit spreads widened. Investment grade corporate bonds were up 1%, but US high-yield bonds returned -0.6% (longer-dated high yield bonds -1.6%. Floating rate leveraged loans continued their rally, benefiting from pressures in the short-term dollar-funding market. Eurozone bonds rallied after the ECB commented that inflation was sluggish and its recovery would be shallow. The 10-year German bond yields fell below 50 basis points for the first time since January. Real estate investment trusts recovered 3%. However, master limited partnerships fell 7%, resulting in double digit year-to-date losses despite a 5% gain in oil prices as new rate-setting regulations spooked investors.

The dollar fell as much as 2%, often driven by specific trade and geopolitical developments. The British pound gained 2% after perhaps no more than optical progress on Brexit negotiations. The Mexican peso gained nearly 4% on hopes that a NAFTA agreement would be concluded before their July elections. The Won gained 2% after South Korea reached a new US trade agreement and Kim Jong Un promised to attend a US summit meeting in late April. The Chinese Yuan reached its highest levels since 2015. While commodity indices gained 2% on the back of oil and natural gas prices, tariff concerns caused weakness in the metals sector, with iron ore falling 18% over the month.

"The combination of a benign wage report, moderating growth and trade concerns led some investors to worry that the Fed's tightening plan was too aggressive, causing the Treasury yield curve to flatten significantly.

April Positioning and Thoughts

After continuing to be cautiously positioned entering April, our inclination is to (modestly) increase equity exposure. The recent market decline, economic and tax-assisted earnings growth, and passage of time have made US equities less unattractive, moving from 30-35% to "only" 20-25% overvalued. As valuation sensitive investors, we should respond to this change, at least incrementally, as errors of omission in not

“Two specific upcoming data releases might well be market-moving. The first is the April 11 release of March inflation. Even hitting the consensus estimate of 2.1% might come as an unwelcome reminder to investors that US inflation pressures are growing. The second is the mid-month release of the US Treasury’s semi-annual currency report with the possibility that China could officially be labelled a “currency manipulator.” While I hope and believe that an escalation of trade tensions can be avoided, the report may be an indicator of President Trump’s intensions.”

buying when valuation levels improve offset some of the potential advantages from active investing. Our work continues to suggest that energy and financial sectors are the most attractively valued, with the industrial sector having the least appeal.

Having said that, two specific upcoming data releases might well be market-moving. The first is the April 11 release of March inflation. Even hitting the consensus estimate of 2.1% might come as an unwelcome reminder to investors that US inflation pressures are growing. The second is the mid-month release of the US Treasury’s semi-annual currency report with the possibility that China could officially be labeled a “currency manipulator.” While I hope and believe that an escalation of trade tensions can be avoided, the report may be an indicator of President Trump’s intensions.

Interest Rates

To judge from the flattening of the Treasury curve in March, investors may be overreacting to last month’s benign wage and inflation reports in front of what appear to be “baked in” inflation gains over the second quarter (as some one-off 2017 reports roll-off the trailing 12-month calculations). While one might assume that market pricing already reflects this mechanical pick up in inflation, it is hard to reconcile the retracement in the 10-year Treasury yield down to 2.73% (and only a 30% chance of four 2018 rate hikes) with what may well be a 50-basis point pick-up in inflation. It is likely that the Fed’s core personal consumption expenditures (PCE) inflation measure will hit its 2% target by quarter-end. Since much of the pick-up would be seen in the April report, this is a much-awaited data release.

This may surprise investors more than the Fed, which is likely to reiterate its gradualist approach to rate normalization, emphasizing that the 2% target is symmetric, while remaining silent on the likelihood that they are behind the inflation curve. The market may boost the odds of four rate hikes, but the curve is unlikely to flatten. The dollar is likely to be mixed, with pressure from lower real yields and dovish Fed guidance somewhat offset by an increased possibility of four rate hikes in 2018 (and a dollar that is much less overvalued after its 14% decline since year-end 2016).

Trade Tensions

Global equity markets are little changed after the first few trading days of April, however realized (10-day) volatility has further increased. This reflects concerns over growing trade tensions with China, as China’s proposed 25% tariff on $50 billion of imports from the US represents a significant escalation in both speed and proportionality from their earlier response to President Trump’s initial call for steel and aluminum tariffs. While NAFTA negotiations are proceeding better than expected following Trump’s apparent compromise on US content for automobiles, the risk is that China will be treated as a different case. Some form of redress was a specific campaign promise and has broad bipartisan support in Congress. Support extends to the International Monetary Fund, which interjected that it shares similar concerns and that China is aware it needs to make changes. It is a close call whether the Treasury report declares China a currency manipulator. (Certainly it was in the past, but China’s currency has appreciated 10% since year-end 2016 and is not substantially undervalued now). If it happens, investors may have a difficult time determining whether this is a step towards effecting changes to China’s intellectual property and ownership issues or is simply a misguided effort to reduce our trade deficit.

Investment Opportunities

Two investment areas appear attractive after recent market weakness. The first, the purchase of shorter-term high-quality corporate bonds might even act as a modest hedge against the other, the purchase of financial sector stocks. For example, one-year AA-rated corporate debt is a reasonable place to park excess cash, as spreads versus similar quality (AAA-rated) municipal bonds have spiked from 20 basis points to 95 basis points over the past year. In fact, the spread for 1-year maturities has risen to levels in line with the 20-year maturity benchmarks. The entry point would be attractive as investment-grade corporate debt was (by far) the worst performing segment in fixed income last quarter, losing more than 3%. It has continued to underperform in April. In addition, spread widening was most pronounced at the front of the curve, with spreads widening 20 basis points since February lows, more than twice that of longer-maturity corporates. It is also an indirect play on some technical forces at work in the short-term funding markets that have caused effective borrowing costs to become quite elevated versus official rates (pressuring the short-end of the credit market).

Financial sector equities also are appealing "buy-low" candidates after being the worst performing sector last month (-4.3%), while losing all of their relative outperformance for 2018 despite a 35-basis point increase in intermediate Treasury yields. While March's benign inflation reports and related rate curve steepening were negatives, the sell-off was across the board, including not only banks, but life insurance companies and credit card lenders. The sell-off speaks to fears of a recession and a pick-up in credit losses, something not on the horizon at least for 2018. While not a trade based upon an interest rate forecast, warmer inflation would rekindle interest in the group.

*Together, families prosper*SM