Market Perspectives

Sentinel Trust Company, LBA
Investment Committee
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Spring Recap

Despite starting with the worst first day of the second quarter since the Great Depression, global equities ended the volatile month modestly higher.

The combination of plateauing overseas growth and higher Treasury rates contributed to dollar strength that boosted European equities, but not emerging markets. Overseas developed markets outperformed the US by nearly 2%, but emerging market equities finished modestly in the red. News flow over the month included increasing Russia sanctions, US labor costs, tariff threat uncertainty, as well as airstrikes in Syria and potential new Iran sanctions (which fueled a 6% rally in crude oil).

Economic Developments

Global growth continued to impress, with the International Monetary Fund (IMF) forecasting a robust 3.9% for 2018. A regional divergence has emerged, with growth rates declining overseas, but poised to pick up in the US. While remaining above trend, Eurozone growth has rolled over, with Germany lowering its 2018 forecast to 2.3%. European inflation also disappointed, remaining unchanged at 1% as goods prices were weighed down by the lagged effect of the stronger Euro. In response, European Central Bank (ECB) President Draghi followed with remarkably dovish guidance, still refusing to specify a target date for ending ECB bond buying. First quarter UK growth was only 0.1%, the weakest in five years, on weather-induced weak construction; that figure in combination with low inflation numbers pushed out the path of Bank of England rate hikes.

Japan's corporate spending and labor market remained strong, with the job-opening-to-applicant ratio hitting 1.6X. However, investor attention looked ahead to the September elections in assessing whether Prime Minister Abe's policies would continue.

While China's reported 6.8% growth (on strong retail sales) was reassuring, the large 100 basis point cut in the RRR (bank required reserve ratio) evidenced a shift in government efforts to offset macro credit tightening in the shadow lending market, as more stringent regulations were eliminated or delayed.

Market Action

US equities managed a modest gain despite the strong dollar without significant style or capitalization biases, although the energy sector gained 9% and staples fell 4%. International developed markets held up well despite trade and geopolitical tensions, with lower relative growth translating into a respite from local currency strength and more hawkish monetary guidance. European markets saw both UK and Eurozone issues gain 4% on dovish central bank guidance. Japan rose 1% in dollar terms net of the weaker Yen as cyclical issues did well; the "BoJ put" was much in evidence as central

bank equity purchases drove realized volatility from 33 to 6 in ten days.

Emerging and frontier markets were in the forefront, falling on both systematic and idiosyncratic news. Argentina, Eastern Europe, and Brazil were down 3-5%. The Turkish Lira fell 11%, as a popular carry trade inevitably unwound in front of upcoming elections after a long period of dollar borrowing and unorthodox monetary policy. Despite the 8% spike in Brent crude oil, Russian equities actually fell 8% (the most since December 2014), triggered by the Ruble's 10% fall as new sanctions targeted individuals such as metals mogul Oleg Deripaska (no obvious close ties to the Kremlin). Elsewhere, Indian stocks gained 4% despite currency weakness and higher oil prices on increasing confidence in the ongoing cyclic recovery. China stocks were little changed.

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Bonds and Interest Rates

After rallying early in the month on weaker than expected job growth and flat hourly earnings reports, Treasuries fell as rates increased 15-20 basis points across a broad range of maturities, on the Federal Reserve Board's (Fed) more constructive outlook, stronger retail sales, and rising employment costs and oil prices. March Fed Open Market Committee minutes showed little concern about sluggish first quarter growth, while at the same time bringing forward their forecast for hitting the 2% inflation target from 2020 to 2019. March retail sales beat consensus for the first time in four months, finally showing evidence of the effect of tax cuts. Wage pressures increased as private sector wages and salaries increased 2.9%, the largest since 2008. Finally, while first quarter growth slowed from the previous quarter, the mix augured well going forward as capital expenditures increased 6% (vs. 2% expected) and final retail sales increased 1.9% with little change in inventories. To be fair, weakness in core European bond markets contributed to the poor Treasury market.

Although weakening late-month (as 10-year Treasuries hit 3%), US high-yield bonds still managed a 0.7% gain. As has been the case throughout the period of rising rates, lower rated issues outperformed, with spreads tightening to post-crisis lows around strong earnings outlooks. CCC-rated issues gained 1.4%, versus 0.2% for higher rated BB bonds. Municipal bonds outperformed on reduced net issuance, with strength in the 10-year maturity range and in lower quality issues. Non-investment grade bonds in the Puerto Rico and tobacco sectors were up 1.5%. At the other extreme, emerging market bonds were hard hit by rising rates and weaker currencies, with dollar-denominated bonds falling 2% and local-currency bonds down 3.5%. The offshore Chinese high-yield market was weak on heavy issuance as local firms needed to refinance maturing on-shore shadow banking debt.

The 2% gain in the popular dollar index understated its broader strength. The greenback gained 3.5% against emerging currencies, which were negatively impacted by country-specific developments as well as by China's threat to retaliate against possible US tariffs. With the strong oil move due to the likely US withdrawal from the Iran deal, lower inventories, and strong refined product demand, commodity index returns gained 3-5% depending on their constituent weights, with aluminum up 11% (Russia sanctions), Brent crude up 8%, and precious metals fractionally lower. Although foreign peers outperformed, US real estate investment trusts (REITs) overcame higher interest rates to finish in the black.

May Recap

Global equities again finished modestly higher. May was another volatile month that featured pronounced US outperformance as its 2-3% gains compared to 2-3% losses overseas. Strong US earnings and the favorable growth outlook positioned domestic stocks to maintain earlier gains in the face of trade tensions and Italian political turmoil that briefly threatened an existential Eurozone crisis. The latter development triggered a flight to quality in the forms of the largest one-day Treasury rally since the Brexit vote and a spike in the dollar (that piled systematic risk on to self-inflicted emerging economy woes across their currency, bond, and equity markets).

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May's geopolitical shocker came out of left (and right) field in Italy. The populist coalition's platform combined the supply-side, low flat-tax ideas of the (Northern) League with the welfare/guaranteed income of the Five Star Movement, partially financed with a 250 billion Euro sovereign debt write-down. Investors cast their own vote, triggering an eight-fold(!) blow-out in Italian-German two-year yield spreads in just a few days on fears that a possible new election might become a

referendum on Eurozone membership. Subsequently, the crisis was avoided as the coalition moved to plan B (by transferring their potential Eurosceptic finance minister to another department) and received formal approval to govern.

Equities

US equities gained 2.8%, led by growth, quality, and momentum factors. Technology stocks gained 7.5% as financials, staples, and utilities lagged, with the latter two posting negative returns. Growth stocks outperformed value stocks by 350 basis points, with smaller cap growthier issuers gaining 6% versus 0.6% gains for the large-cap value sector. REITs and master limited partnerships (MLPs) continued their recovery from earlier year lows with US REITs up 3% (rising for the third consecutive month), while MLPs gained 5%. On a year-to-date basis, the technology sector has outperformed the consumer staples sector by nearly 2500 basis points.

International developed equities fell 2%, with a similar style pattern, as growth stocks outperformed value stocks by more than 4%, no doubt reflective of weak financial sector performance in Europe (the Eurozone bank index fell double digits). While broader European equities were flat in local terms, the Eurostoxx index fell 6% in dollar terms as even the core markets of France and Germany fell 4%. Not surprisingly, Italian stocks fell 12% after the new populist coalition government nominated a long-time Eurozone skeptic as finance minister. Spain fell 9% on peripheral contagion and an unexpected change in leadership following a no-confidence vote. Developed market excitement was decidedly Euro-centric, with Canada, Australia, Japan, and the UK all finishing up about 1%.

Latin America was to emerging markets what the Eurozone was to its developed market peers. While the broader index fell only 3.4%, Latin American shares fell 14%. Brazil plunged 17% as the resolution to a massive trucking strike called into question optimism over future reforms and a market-friendly election outcome. While officially a frontier market, Argentina fell 22% as the central bank's loosening of inflation targets in the context of an overvalued currency precipitated a currency crisis that required IMF intervention. India fell 3.6%, as encouraging news on growth, tax collections, and weather (monsoon forecasts) contained the damage from an unexpected interest rate increase. China and Russia were relative safe-havens, gaining 1%, with the latter benefitting from some sanction easing. Uncertainty over trade tensions weighed on the space, as US/China appeared far apart and NAFTA talks missed an important milestone.

Economic Overview

While US growth appears to be accelerating, international releases continued to point to advanced-economy growth stepping down from 2017 levels but still remaining above trend. Growth estimates for US (2.8%), Europe (2.3%), Japan (1.5%), and UK (1.5%) are near the highest levels for the year. Even conservative estimates target at least 3% second-quarter US growth. First-quarter growth revisions saw a minimal inventory build and 11% annualized research and development growth. The US Institute for Supply Management report evidenced system-wide supply bottlenecks on the heels of rising transportation costs, with factory backlogs at their highest levels since 2004. Consumer confidence remained elevated despite higher oil prices. The unemployment rate fell to 3.8% (not lower since 1969), with even the broader U6 unemployment measure at a 17-year low.

Elsewhere, Eurozone quarterly growth fell from 0.7% to 0.4%, with more than bad weather to blame: the European manufacturing index fell to a 15-month low and inflation disappointed (although expectations picked up in sympathy with higher oil prices). Japan reported a negative 0.6% quarterly growth with falling inflation, although industrial shipments suggested a near-term bounce.

Interest Rates and Bonds

Treasury market volatility increased 20% from the start of the month as 2-year and 10-year yields rose to 10-year and 7-year highs, only to fall sharply in response to Eurozone geopolitical turmoil, before recovering on the strong late-month jobs report. The Barclays bond index gained 0.7%, as longer dated Treasury yields fell more than 10 basis points; investment-grade corporate bonds gained 0.5% despite modestly wider spreads. US high-yield bonds failed to participate, being little changed, but lower rated issues continued to outperform with CCC-rated issues up nearly 1%. Municipal bonds outperformed across the entire credit spectrum, even on a pre-tax basis, as 5-year municipals gained 1% and lower quality issues gained as much as 2%. Despite the Treasury market gains, developed-market non-dollar bonds lost more than 2%, with non-dollar high-yield bonds losing more than 3%. Emerging market bonds continued to be weak across the board as problems in Turkey and Argentina led to contagion elsewhere that intensified after the Italian induced Euro weakness/dollar strength. Emerging market dollar-denominated debt fell 2%, while currency weakness drove 5% losses in local debt.

Absent the Italian theatrics, Treasuries might have been little changed in May as both Fed commentary and inflation reports were inconclusive. While the Fed left rates unchanged as expected, individual members who previously were labeled as dovish

have come out in support of the need for ongoing gradual rate hikes. At the same time, May meeting minutes pointed to a collective comfort in letting inflation run above target. Inflation developments were similarly mixed, with core inflation showing no signs of acceleration (falling short of expectations in remaining at 2.1% year-over-year). The Fed's core personal consumption expenditures (PCE) inflation indicator was revised downwards from 2.5% to 2.3%. On the other hand, hourly wages rose by a warmer than expected 0.3%.

Currencies and Commodities

A flight to quality and wider rate differentials, both of the "interest" and "growth" varieties, contributed to continued dollar strength. The dollar was up 2% against major currencies, particularly against the Euro, which traded as low as $1.16 and fell more than 3%. The Australian dollar, Swiss Franc, and Japanese yen maintained their value. Emerging market currencies plunged once again, falling 3.5%, with 6% losses in the Mexican peso and Brazilian real.

Commodity indices gained 1% despite modest declines in crude oil and gold as natural gas spiked 7%. Brent crude hit a 4-year high of $80 against a backdrop of potential Iranian sanctions before falling sharply on reports that Russia and OPEC would loosen production cutbacks.

Current Thinking

The drafting of this letter was delayed pending this week's ECB meeting where President Draghi continued to surprise (me) with remarkably dovish monetary guidance. One can see that others thought the same because, in post-announcement currency trading, for the sixth straight time the Euro traded down after Draghi's meeting announcement. While the year-end curtailment of central bank bond buying was expected, the guidance that the earliest actual rate hike would not occur until after the summer of 2019 at the earliest was not.

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For all of the talk about a hawkish Fed, policy remains accommodative, particularly for this stage of the economic cycle where:

- growth is well above trend and accelerating,
- unemployment is already 0.7% below the Fed's own estimate of full employment,
- manufacturing is facing supply bottlenecks, and
- private sector wage growth is picking up.

Furthermore, the Fed has already communicated that a period of above-target inflation will be met with relief, not resistance. Even if the Fed wanted to act more proactively, the prospect of at least 15 more months of negative rates in the Eurozone ties its hands as unexpected tightening might prompt a spike in the dollar. Finally, the Bank of Japan recently reiterated the need to maintain its asset-purchase program as inflation shows little signs of picking up.

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Financial Conditions

We had previously noted a remarkable statistic that as of late January, US financial conditions (as measured by Goldman Sachs) were even more accommodative than during the 2000 dot-com era. While conditions have tightened overall as the dollar has rallied 5% against major currencies, intermediate Treasury yields are 35 basis points higher and investment grade credit spreads are 35 basis points wider. We are only returned to December 2017 levels and have probably moved little more than 33% of where we need to be. It is worth noting that high-yield bond spreads are only 25 basis points wider, US growth is accelerating, implied equity, and bond

market volatility is unchanged (despite the elevated realized volatility) and regulators have given a nod and a wink to highly leveraged bank lending.

The recent tariff actions and risks of its further escalation can be placed within this "financial conditions" framework. However, before doing so, as a trained economist I am disconsolate that the US is no longer the champion of free trade, a theory whose implementation has lifted so many out of poverty across the world. Sentiment aside, from a game-theory perspective, the US is in a position to extract some "wins," however mis-defined, as our economy is growing faster and is less open in terms of trade (can better absorb any adverse effect) and we have lower existing tariff levels (easier argument). From a quantitative perspective, the most recent 25% tariff on $34 billion of Chinese goods amounts to only 1% of total US imports, so while there may be increased market volatility and very modest price pressures and output losses, the real fear should be one of escalating risks. In that regard, one hopes that this negotiating approach yields some form of resolution before our economy slows and populist pressures rise.

Near-Term Backdrop

The near-term macro backdrop seems remarkably supportive, despite the trade war risks, to the extent to which my biggest risk is that of a boom/bust cycle. This might result partly from years of excessive monetary accommodation and partly from fiscal stimulus at such a late stage in the business cycle. Importantly, this would be occurring at a time when inflation is rising and the Fed will be unable to pressure the brakes any harder. One could argue that trade uncertainty might dampen growth through higher market volatility and economic and political uncertainty. It might also trigger an unsustainable spike in the dollar, as US/international growth differentials might diverge further (trade makes up 43% of the European Union economy, 28% of the broader Organization for Economic Co-operation and Development – OECD - economies, but only 13% of the US).

The US macro-backdrop is supportive for now, but intermediate-term risks are rising and valuations are high. Accordingly, while desirous of adding to risk exposures where fundamental value appears, we will continue to maintain a defensive posture, selling into strength as appropriate. As outlined in our last letter, we became incrementally more constructive on US equities, feeling that, with weak post-January performance, the passage of time, corporate tax cuts, and a positive growth outlook, valuations had improved, particularly in the energy and financial sectors. Since that time, the market has rallied 6%, the dollar is up 5% against major currencies, and the energy sector has gained 13%, even more than technology. Surprisingly, the financial sector is little changed despite higher interest rates. Given these results, we sold into recent market strength, while lowering our target energy weight over the period from 14% to 10% and our technology weight from 14% to 12%. The financial sector was maintained as a large overweight. Incremental funds were allocated to consumer staples and healthcare areas, including large-cap biotech, on relative weakness.

International Preference

We are maintaining our preference for international equities and remain constructive on European peripheral banks, despite the angst in Italy and the prospect of yet another year of negative rates punishing net interest margins. At the same time, the unusually accommodative policy and associated weaker Euro will continue to support the ongoing economic expansion and to mitigate the downside from trade risks, thus supporting the recovery in real estate values and other forms of bank collateral. While Italy is not Spain (highly competitive, booming economy) and proposals to roll back retirement reforms and hand out "guaranteed income" threaten long-term fiscal solvency, 2/3rds of Italians support the European Union, government-debt-service coverage will improve due to the lagged effect of lower interest rates and the banking system has raised capital levels while making good progress rationalizing bank loans.

The obvious place to search for fundamental value is in emerging markets (EM), given the double-digit declines since late February. Whether, when, how, and where to buy are questions with less obvious answers, as there is a fascinating debate between Harvard's Dr. Carmen Reinhardt who has predicted a true crash and various emerging market apologists, often at sponsor firms.

I find myself somewhere in the middle. It is true that many EM countries have gorged themselves on low-cost debt (particularly in the corporate sector) and that rising US interest rates and a stronger dollar might contribute to a downward spiral of (1) higher local interest rates (particularly for oil importers), (2) a stressed corporate sector, and (3) an economic slowdown. QT (quantitative tightening) in the US will only magnify the challenges with the cost and availability of dollars. Finally, policy mistakes have been widespread and upcoming election outcomes in Mexico and Brazil are viewed with less optimism.

At the same time, I am sympathetic to the view that emerging market fundamentals are better now than in past crises and that valuations compares favorably to its own history and to that of the developed world. While EM government debt has increased from 36% to 48% of gross domestic product since the financial crisis, advanced economy debt has increased from 84% to 104%. While 50% of EM debt in the benchmark is dollar-based, 85% of the broader EM debt market is in local currencies. Furthermore, outside of a few benchmark countries, most local EM debt is held locally; for example, in Brazil, the foreign share is only 12%. Importantly, the recent downdraft has

improved EM currency valuations from modestly overvalued to somewhat cheap, suggesting that much of the needed adjustment has already been made. Finally, the size of growth of China (and its debt) complicates any aggregate analysis; while some sort of bad debt implosion is quite possible, the aftermath might be similar to Japan, given that the debt is internally funded from the high savings rate.

While we will step up our exploration of additional EM public and private strategies, my immediate focus will be in the public debt area, emphasizing local currency instruments as valuations are attractive, high yielding non-dollar alternatives are non-existent, and the relative downside risk is modest if our timing is premature. Such investments would be an attractive diversifier in our fixed income portfolios. From a risk-management perspective, EM debt markets must first stabilize before EM equities can rally, an important consideration should market conditions continue to deteriorate.

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