Market Perspectives

Sentinel Trust Company, LBA
Investment Committee
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June Recap

June market action was very much a function of geography, with US markets little changed, but less benign results seen elsewhere depending on the proximity to increasing trade tensions.

China and other emerging markets were at the epicenter. While giving the appearance that the US is "winning" the trade war, the strength in the dollar and US asset prices was primarily due to exceptionally strong second quarter growth. Commodities were a real wild card, depending on the mix of double-digit West Texas Intermediate oil gains or trade-war-inflicted losses in grains and industrial metals. While central bank actions were not unimportant, they were overshadowed by geopolitical developments.

Global equities were remarkably resilient, falling only 0.55%, although the divergence among markets was revealing. The relatively insulated US equity market outperformed emerging markets by 500 basis points. Eurozone shares were little changed, aided by a recovery in the periphery. US equities gained 0.65%, with smaller capitalization and growth names outperforming. Mega-cap value shares were modestly negative. Sector results were bigger performance drivers, with a strong consumer sector (staples rebounded 4.7% and discretionary, including Amazon, up 3.6%), but technology gave up earlier gains to finish modestly lower on reports of export controls on sensitive goods sold to China. Despite the strong US economic news, industrial shares finished down 2.6%, hit by the combination of the strong dollar and tariffs.

International stocks fell 2%, with no pronounced style difference, but developed markets outperformed emerging shares by 300 basis points. European shares proved remarkably defensive overall, as the dovish European Central Bank (ECB) announcement supported a recovery in the periphery, with 2% gains in Spain offsetting similar losses in Germany (which was hit by immigration-related political infighting). Hong Kong lost 4.6%, suffering from trade fears and a slowing Chinese economy that impacted the region. Mainland Chinese shares fell another 5-8%, producing declines of over 20% since late January. Brazil fell 8% on election concerns and fears for global growth, bringing second quarter losses to 27%. Argentina won the race to the bottom, falling 20% for the month and 50% since late January, with blame equally assigned to local market moves and the currency collapse. While emerging market commodity importers suffered, the OPEC news helped Russia.

Trade Wars

The steady stream of protectionist trade talk and actions continued to weigh on markets, perhaps overshadowing a remarkably strong economic outlook in the US. While Europe's response to the steel and aluminum tariffs was quite measured, the larger concern centered around an escalating series of threats that included tariffs on $150 billion of Chinese goods, additional actions on $200 billion of goods if China retaliates and a spurious appeal to national security as justification for automobile tariffs.

A US-centric trade war might reduce global growth by 0.5% in 2019. However, investors also must weigh a likely spike in second quarter US growth to perhaps 4% and an improved relative outlook versus the rest of the world, especially China, where a growth slowdown is evident. After all, aggregate global growth remains stronger than the headlines might suggest, with growth having increased from 3.2% in 2016 to 3.7% in 2017 to 3.9% estimated for 2018. Although the International Monetary Fund's 3.9% forecast for 2019 is likely be marked down on protectionist concerns, its starting level is high. A key difference is that the growth driver has shifted to the US from Japan, Europe, and China. Growth has plateaued elsewhere, as the US is the only economy where leading economic indicators are still rising.

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Trade data exhibited strong momentum entering the month, albeit trending less positively. Global trade rebounded in April, with particular strength in Japan and emerging Asia. Similar data suggests that exports should be a big contributor to US second quarter growth, although likely to fade thereafter with the stronger dollar and protectionism. Air freight and sea container volumes are on a downward trend and Eurozone and Japanese export orders have recently fallen. However, global trade growth will slow but remain positive for the rest of the year.

Economies Gain

It would be hard to find any weakness in the US economy, as the recovery in manufacturing and energy has merged with continued strong service sector growth. Can you say boom? The May employment report hit the trifecta of a 223,000 gain in payrolls, a decline in unemployment to a dot-com era low of 3.8% and a 0.3% increase in hourly earnings. Even the broader (U6) measure of unemployment fell to 7.6%—a 17-year low. Retail sales were the strongest in six months despite higher gasoline prices, with May's consumption growth consistent with 4% second quarter gross domestic product (GDP) growth, as tax cuts and job gains take effect. On the manufacturing side, the Institute for Supply Management index matched its second highest reading since 2004 as freight shipments increased 12% year-over-year. In searching for faults, it is true that durable goods orders are running at much lower rates than late last year, but still close to 5%.

Europe presents a good example of what is happening elsewhere, where growth has fallen off from earlier levels, but still maintains a decent rate. Eurozone industrial production fell nearly 1% in April, although the underlying growth in capital expenditures was healthy. Similarly, the index of German business conditions fell but remained expansionary. A late month report suggested that Eurozone activity had indeed fallen from last year, but was consistent with growth of at least 2%, well above trend. Canada and Japan were similar in that some weakness was seen against a positive overall backdrop. Japanese manufacturing fell to the slowest pace of the year, although business confidence rose to a 4-year high, unemployment fell to 1992 lows and wage growth hit a 20-year high (admittedly only 1%!). While Canadian manufacturing expectedly fell, the jobless rate hit a 40-year low as wage growth has picked up from 1% to 4% over the past 2 years.

A previously highlighted risk is coming to pass, as China's growth is slowing much more than official figures would suggest. While the services Purchasing Managers' Index remained expansionary, May industrial production, retail sales, and fixed asset investment all disappointed, partly in response to a monetary tightening cycle that started at the end of 2016 to bring excessive credit growth more under (state) control. Authorities appear to have shifted towards greater monetary accommodation, with bank liquidity infusions and lower reserve requirements contributing towards the Yuan falling to six-month lows.

Central Bank Actions

As everyone expected, the Federal Reserve Board (Fed) increased its benchmark rate in June and, as most expected, suggested two additional rate hikes for 2018. The updated Fed "dot plot" implies three subsequent hikes in 2019. The Fed also was forced to update its not terribly believable prior forecasts, boosting its inflation and employment numbers, but not its estimates for equilibrium levels of inflation and unemployment. This reinforces either the Fed's utterances that it is happy to let the economy run hot or my suspicion that it knows that it is behind the curve but are unable to catch up too rapidly.

The bigger central bank news came out of the ECB, which pushed out any hope/fear of a long overdue rate increase until at least September 2019. Rates were also left unchanged in Japan and Switzerland. In the UK, the Bank of England was slightly more hawkish than expected—although there was no rate increase following a period of tepid growth, the vote was closer than expected and the threshold for reducing its balance sheet was lowered.

Inflation

Inflation data were in line with expectations, with US reports consistent with gradually increasing temperatures, but no real spike in inflation fever. An early-month report portended pricing pressures from the manufacturing side with elevated readings for prices paid, supplier delivery times and backlog. The core consumer price index hit a 15-month high of 2.2%, despite a surprising drag from used-car prices and airlines fares, suggesting continued increases should those factors reverse. Separately, the Fed's preferred inflation metric (core PCE) rose more than expected to 2.0%, thus hitting the Fed's target for the first time since 2012. There were few surprises elsewhere, with the UK at 2.4%, Japan unchanged at 0.7% and the Eurozone at 1.0% (actually a slight decline).

The dollar gained 0.5%—posting its first positive quarter since 2016—although the headline number understated significant widespread gains. The Euro was an outlier, recovering from an ECB-induced one-year low following a strong late-month economic report. Significant losses were seen in both developed and emerging market currencies, in the 3-4% range for Korea, New Zealand, China, and Brazil. Australia, Japan, and Taiwan lost around 2%. Trade wars, slowing growth and loosening monetary policy caused the largest Chinese currency fall since 1994, when its foreign exchange market was first established. The South African Rand lost 7.5% on funds outflows and the Argentine Peso fell 14% after striking a deal with the International Monetary Fund.

Bonds and Interest Rates

After initially moving up towards 3% early in the month in anticipation of potentially more hawkish guidance from the ECB, Treasury yields fell sharply to one-month lows on trade war concerns before recovering on the strong late-month report. Altogether, the rate curve flattened with the Fed's rate hike and continued tightening bias raising 2-year yields by 12 basis points, with 30-year yields actually down 2 basis points, leaving 2/10 spreads at a post-crisis low and Treasury returns flat for the month. While high-yield debt was also little changed, corporate bonds lost 0.3% on heavy supply as spreads widened to 2-year highs. In contrast, positive net funds flows drove a +0.2% municipal bond performance, with shorter maturities outperforming.

Overseas bond markets saw bigger moves in both directions, with peripheral European bonds bouncing back from last month's Italian political scare after dovish ECB guidance. Emerging market debt was particularly weak on the stronger dollar and slowing Chinese growth. Greek bond yields fell 60 basis points after a long-awaited restructuring of some official European debt. Yields in Portugal and Spain fell 20 basis points, but Italian spreads tightened only half as much. Emerging market hard-currency debt fell 1% as spreads widened 23 basis points, with local-currency debt hard hit by a 3% average fall versus the dollar.

Commodities

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The various index returns diverged significantly, from +1.4% for the GSCI total-return index to -3.7% for the Bloomberg index. Indices with the higher energy weight were stronger, as West Texas Intermediate (WTI) crude oil gained 11% (despite the stronger dollar) after the OPEC/Russia revised-production deal was more bullish than anticipated on top of production shortfalls in Libya and Canada. The headline agreement called for a one million barrel/day increase starting in July to offset the unexpected sharp declines in Venezuelan production. However, it is only a partial offset since some OPEC members are already at capacity and those production declines are continuing. Brent oil was only up 3%, with its premium to WTI halved.

Other commodity sectors were on the receiving end of trade wars, weaker overseas growth and the stronger dollar. Trade tensions drove grain losses, with corn and soybeans down 11-15%; other "softs" such as wheat, sugar and coffee fell 6-8%. China growth fears hit industrial metals, with zinc and aluminum down 7%. Despite the higher oil prices, precious metals fell, with gold down 3.5%, falling to a six-month low.

Early July Action

July has seen a continuation of two themes from May: US equity outperformance and a Treasury market little changed from a return perspective, but one characterized by a pronounced flattening of the yield curve. A seemingly benign employment report more than offset continuing trade-war fears while boosting investor confidence that the biggest threat to the ongoing expansion is excessive Fed tightening, particularly given the risk of tariffs.

July month-to-date (through the 12th) has seen domestic equities outpace international shares by 260 basis points, virtually the same as June. While Treasury returns have matched June (up 0.1% or less), curve steepening has been quite noticeable given the short time period.

Goldilocks herself could not have penned a more favorable June employment report. The headlines included an outsized 213,000 gain in non-farm payrolls (which followed an even stronger May number) and an increase in the labor force of 600,000 —a remarkable increase this late in the economic cycle. Of equal importance was that wage pressures remain modest, with the growth in annual earnings unchanged at 2.7%.

The big increase in the labor force surprised many, but was an unalloyed positive for the economy. Much of the increase came from the less-educated cohort, including some out on disability. However, note that the mix of workers biased reported wage gains lower. A more indicative measure of the state of the labor market is wage gains for those leaving an existing job. That figure has risen to close to 4%.

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