Market Perspectives

Sentinel Trust Company, LBA
Investment Committee
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July Recap

Investors successfully compartmentalized favorable US economic and earnings reports from a seemingly growing list of macro-risks, while a thaw in European Union (EU)/US trade talks provided hope that trade wars would not go global, producing a modest bounce in international equities.

The big exception was China, where the continued escalation in the trade war piled on to an already weakening economy, causing the country and the region to underperform. Fixed income markets were mixed, with credit markets rebounding against a modestly weaker Treasury market. Commodities were volatile, as crude oil gave back much of last month's gains. The commodity index made a major (four deviation) move down to 2018 lows on the announcement of tariffs on an additional $200 billion of Chinese goods.

Domestic equities finished the month up 3.2% as value and particularly large-cap stocks outperformed, with mega-cap value up 4.6% and small-cap growth only 1.7%. Financials and healthcare gained nearly 6%, with real estate the only sector in the red. While gaining each week, the equity market shifted significantly mid-month as growth's lead over value was erased following Netflix's miss on subscriber growth and Faceplant's (Facebook) single biggest market-capitalization loss of any stock in one day. Despite the possible change in market internals, February's "volmageddon" seemed only a distant memory as volatility fell from 23 to 9 over just three months.

Foreign Markets

Foreign equities gained roughly 2.5%, as developed markets recovered most of, and emerging markets only a fraction of, second quarter declines. Eurozone stocks gained 4%, rallying on a strong German purchasing manager index report, Italian bad loan progress, and a temporary immigration deal. The gains occurred especially after Presidents Trump and Junker (EU) agreed to refrain from any automobile tariff talk while working to resolve the steel and aluminum tariff issue and to increase US agricultural exports. Despite rallying 2% on the EU/US agreement, Asian markets were weak, with Japan and Hong Kong little changed on trade and Chinese growth concerns.

China fell an additional 2.5%, with the A-share market down 25% in early July from January highs. These losses were sufficient to cost the country's ranking as the second largest equity market by capitalization (to Japan) for the first time since 2014. Authorities announced new tax cuts, injected record bank liquidity, and relaxed macro banking regulations—all in a calibrated attempt to offset some of negative effects of trade wars hitting just as the economy is slowing from a credit tightening that began in late 2016. Turkey was the other negative outlier, falling 7% (36% year-to-date), as investors questioned the country's governance after the central bank failed to raise rates as expected and the US sanctioned individual Turkish ministers. Brazil gained 12%, recovering one-third of second-quarter losses, as a market friendly candidate gained the support of centrists in front of the October elections. Falling oil prices supported India's 6.5% gain, while even oil-sensitive Russia gained 4%.

Economy and Inflation

US economic reports portrayed boom-like conditions, at least for now, with little headline evidence of increasing wage and inflation pressures or a drag from trade uncertainty. The June unemployment report set the tone for the month, with 600,000 people entering the workforce, 213,000 new jobs, and still subdued wage growth. The Job Openings and Labor Turnover Survey (JOLTS) pointed to an equal number of unemployed as there are job openings, with the voluntary quit rate rising to a 17-year high. The strength in the labor market is broad-based, with jobless claims hitting 50-year lows, the largest year-over-year change in manufacturing jobs since 1998, and a record low share of workers earning poverty-level income. Manufacturing capacity utilization spiked to 78%, up 3 percentage points from early 2017. The release of the second quarter gross domestic product (GDP) report closed the month out on an even stronger note, as while the 4.1% number fell short of optimistic forecasts, adjusted for inventories, real final sales were up 5.1%!

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Headline inflation numbers actually receded, although those of us with an axe to grind certainly found ample evidence of growing underlying pressures. Most importantly, the Federal Reserve Board's (Fed) preferred measure of inflation, "PCE Core," retreated to 1.96% (down from the 2.2% annualized first quarter index; the quarterly wage growth of 0.5% was also a bit light). At the same time, the core consumer price index (CPI) firmed to 2.3%, the fastest in six years. It would have been higher were it not for unexplained weakness in shelter, clothing, and airfares. Service sector monthly inflation came in at a warm 0.3%, reflective of growing labor and transport costs. Surveys show 24% of small businesses are planning price hikes, a 7-year high and up from only 4% in 2016. Finally, the New York Fed's measure of underlying inflation rose to 3.3%, the fastest since 2005.

Central Banks and Interest Rates

Central bankers stepped offstage to enjoy their summer vacations. The only surprise came from Japan, in what was variously viewed as either a technical tweak or an actual policy change. The International Monetary Fund's (IMF) updated forecast downgraded Europe, but reaffirmed 2018 global growth at 3.7%, unchanged from 2017, with only a small fall-off to 3.3% in 2019. Fed Chairman Powell unsurprisingly characterized the labor market as robust and the economy strong, suggesting with the usual provisos that five additional rate hikes by year-end 2019 remain on the table. As expected, the Bank of Canada raised rates to 1.5% in the face of NAFTA concerns and falling real estate prices, having little choice given full employment, 2% inflation, 4% wage growth, and a 3% neutral interest rate. The Bank of Japan surprised markets by adjusting its Yield Curve Control policy for the first time since 2016, widening the band around the 0% 10-year rate target from 10 basis points to 20 basis points, causing a brief spike in rates that was quickly suppressed. Whatever the longer-term implications, the proximal cause may have been to placate President Trump, whose same-day tweets complained about countries that lower their interest rates in order to weaken their currencies.

While Treasuries were little changed over the first three weeks, the Bank of Japan's unexpected policy tweak spooked the bond market, leaving yields up 10 basis points across the maturity spectrum and a -0.4% Treasury return. In contrast, credit markets were strong with spreads tightening 13 basis points in investment grade bonds, 25 basis points in high-yield bonds and 43 basis points in dollar-denominated emerging-market debt. Municipal bonds maintained their resiliency, outperforming intermediate Treasuries by almost 1%. German Bund (10 year) bonds fell to six-week lows on trade war concerns, only to finish 8 basis points higher on the month after the encouraging US/EU trade summit and the Bank of Japan move. While meaningful in percentage terms, Japan's bond yields moved the least over the month, up only 3 basis points after spiking up 7 basis points. Diverging from their equity and currency markets, China credit markets improved in July, with offshore high-yield bond yields falling 100 basis points as sovereign credit spreads tightened.

Commodities and Currencies

Commodities declined 2-4% over the month, depending on the index, with weakness across the board highlighted by a 2.8% plunge on July 11 after Trump retaliated to China's retaliation with a proposed tariff on $200 billion of additional Chinese goods. While the index cut its mid-month losses in half after the EU/US trade thaw, natural gas fell 5%, crude fell 7%, industrial metals fell 5%, and precious metals fell 3% to 7-month lows. Crude oil initially was mixed as Iran sanctions offset trade tension, but fell as trade wars escalated, Libyan ports re-opened, US supplies rose unexpectedly, and Trump floated the idea of drawing down the Strategic Petroleum Reserve. Grains finished higher, but not before soybeans fell to their lowest level in a decade on tariff concerns.

The dollar was mixed against developed markets, reflecting the cross-currents of 1) dovish European Central Bank guidance and continued Brexit uncertainty against 2) President Trump's efforts at jawboning the Fed to keep rates low. But the dollar gave back 1% against emerging market currencies: the Mexican Peso gained 7%, as incoming President Obrador (AMLO) signaled an orthodox macro policy; the Brazilian Real gained as a market-friendly candidate gained support; and the South African Rand rebounded 3% from depressed levels. The outlier was once again found in China, as the Yuan fell more than 2% to its lowest level since mid-2016 as foreigners sold equities.

August Developments and Positioning

A week into August finds global markets modestly higher, with US shares 200 basis points ahead of international equities, in both developed and emerging markets. The possible shift in US equity dynamics in the second half of July may have been a false step, at least for now, and lasted only until Apple reported, with growth names once again outperforming value stocks in August (by 200 basis points), technology shares up 4% and the energy sector down 2% on lower crude prices. European stocks were weaker. The British Pound was down 2% after its trade minister said that a "hard" Brexit was probable and Italy fell 3% after the new government team asked EU officials not to count Italian debt held in official accounts as real debt or government expenditures related to the funding of welfare and tax cuts as real spending—stay tuned!

The release of July's unemployment report saw a sizable miss in job creation at only 157,000 versus the 193,000 expectation. However, the economy's underlying strength was apparent in that:

- May and June figures were revised upwards,
- the Toys R Us shut-down took out 30,000 jobs,
- the broader measure of unemployment (U6) fell to dot-com era lows, and
- the estimate of slack in the labor force fell to 2006 levels.

Frustratingly, there was little evidence of increasing wage pressure. While US growth will not maintain its recent hot pace, the handoff from the second quarter looks secure despite some weakness in export orders, with inventories needing to be replenished and an upwardly revised savings rate suggesting that the consumption pick-up is sustainable. From the global perspective, purchasing manager index figures have fallen slightly, but still reflect above trend levels of industrial production in the Eurozone, US, and Japan, but with weakness in emerging markets, particularly in China.

While markets breathed a sigh of relief at the apparent EU/US "peace accord" and even the incoming leftist Mexican president would like to sign a new NAFTA agreement (before moving on to his domestic agenda), the prospects for a near-term trade deal with China have not improved. First, while President Trump might well have wanted to call it quits after garnering some small but tangible trade "win" before the mid-year elections, Congress seems even more hawkish, particularly with respect to technology transfer and intellectual property protection. This points to the more strategic nature of the economic problem within the larger context of a geopolitical rivalry. As opposed to a simple bilateral tariff negotiation, China talks will be intertwined with the World Trade Organization (WTO), from whom even the EU has joined the US in seeking remedies for intellectual property violations. Finally, China does not seem to be backing down despite a slowing economy, as the direct cost of proposed tariffs is a somewhat manageable 0.5% of GDP and the recent burst of monetary accommodation might be as much driven by a need to prepare for a long siege on the trade front than to simply support the economy.

We have an expectation of higher volatility given:

- our increasing concern about the gap that has opened between renewed investor complacency and speculative valuations in parts of the US equity market,
- greatly reduced depth in even the most liquid markets such as S&P futures,
- uncertainties brought about by global central bank rate normalization,
- building inflation pressures,
- China-related issues, and
- the intermediate-term consequences of the US structural budget deficit.

Despite enjoying the modest bounce in emerging market debt from our recent purchases, I would look to reduce dollar-denominated exposure on further spread tightening given their duration and my fears of higher long-term interest rates.

The confluence of 10 consecutive years of equity gains (with outsized performance of growthier segments) coupled with a rational rotation towards smaller capitalization shares (seemingly less exposed to trade wars and the strong dollar) has pushed the midcap software and internet segment towards bubble-like valuation levels.

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Even before the August rally, so-called FAANG stocks had beaten the S&P 500 27% to 5% for the year and 181% to 40% for the past 5 years. As correlations between large-cap FAANG members have broken down this year, the smaller-cap Russell 2000 software index is up over 30%, with the SaaS (software as a service) group up 50%. A telling metric of market speculation is that the most heavily-shorted small/mid cap stocks rose 15% in the second quarter, pushing their forward price-to-earnings multiple up four points. All of this within the context of an equity market expecting double-digit earnings growth as far out as 2020, by which time recession risks, with its negative 20%+ earnings growth, will be increasing.

Fed officials are well aware that monetary policy will need to bear the burden of supporting the economy in the next recession. Fiscal policy will already be tapped out as a consequence of today's large structural budget deficit and lack of voter appetite and consequent political leadership for entitlement reform. Given the current 4% budget deficit during an economic and financial market boom, a deficit as large as 8% during a next recession is quite plausible. Bond investors know this as well. By combining the consensus timeframe for the next recession (82% chance in 2020/2021) and the degree of renewed quantitative easing (bond purchases in the longer maturities), they seem to actually estimate a prospective bond return to the next recession. This holds down long-term bond yields and, potentially, interim dollar strength.

As we have often discussed, the flat yield curve tells us little about US economic prospects and recession risks due to the distortions caused by unorthodox central bank policies, both past and present. Tellingly, the last few times the Treasury curve was this flat, real short-term interest rates were already positive 3-4% (as opposed to negative 1% today). In addition, separate and distinct from forecasting near-term central bank moves in the US, Eurozone and Japan, the preceding paragraph shows that our yield-curve analysis needs to reflect investors' anticipation of future unorthodox policies during the next downturn. Finally, an additional quantitative-easing-related complication relates to whether the Fed will upsize its targeted terminal balance sheet, thereby reducing the size of its bond purchases while potentially needing to rely more on additional short-term rates increases.

Given the distortions in the Treasury market and the relatively calm conditions prevailing in US financial markets at present (as realized equity and bond volatility equity has fallen toward year-to-date lows with still benign levels of inflation), this seems an opportune time to fund a long option strategy on the Treasury curve—one that that would benefit from any event that would shake up the Treasury market's forward pricing that rates will be 3% across the curve forever. Possible events that are much more likely than the market expects include higher inflation, a realization that the Bank of Japan's recent tweak was actually an important policy change, hawkish ECB policy immediately after President Draghi's retirement (or conversely an inability to act due to growing Italian concerns), or the Fed's self-preservation fear of an inverted yield curve, whether distorted or not. The position would be structured to lose money should conditions remain little changed or if the entire curve shifted downward, but would pay off in a boom/bust scenario.

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