Market Perspectives

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August Re-Cap

August featured a more nuanced and collectivized Goldilocks story—investors judged the porridge on offer in emerging markets and Europe not to their liking, but not so distasteful as to go on a general hunger strike. Instead, as a group, they just ate more of their favorite brand.

More conventionally, while global equities finished the month modestly higher, US equities outperformed by more than 500 basis points (bp) as international concerns over:

- trade wars,
- Italian budget deficits,
- a disorderly Brexit,
- slowing China growth and
- emerging market contagion from plunges in Turkey and Argentina …

triggered sales of foreign assets, but not general risk aversion. Foreign proceeds were attracted into US assets as the US economy continued to impress. Not surprisingly, investors simply added to what had been working, namely US technology stocks, leaving the spread between growth and value styles and between US and international equities at near-record levels.

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Global equities gained 1%, led by the US at 3.5% as all major domestic indices hit new highs. There was a pronounced style bias as growth outperformed value by 400 bp across all capitalizations, with smaller stocks outperforming. Given Apple's 20% monthly gain (and 6% for the other "FANG" shares), it was no surprise that technology and consumer discretion (Amazon) were the top sectors (up 7% and 5% respectively); energy shares fell 3% despite higher oil prices; and financials and industrials were modestly positive but lagged over yield-curve flattening and trade-war concerns.

The domestic macro-backdrop became even more market supportive, at least for now, as economists upgraded their third-quarter growth estimates and, in his speech at an annual conference in Jackson Hole, Federal Reserve Board (Fed) Chairman Powell came out supportive of a continued reactive (dovish) Fed policy, noting that there was little sign of overheating and increasing inflation. While second-quarter growth was already known to be unsustainably high, third-quarter growth estimates were raised to 3% despite weaker auto and housing sales and a 7% gain in the dollar since April. Second-quarter growth was revised up to 4.2% and retail sales and business equipment spending surprised to the upside.

While investors took comfort in Fed Chairman Powell's reassuring gradualist orientation and could point to a rise in the unemployment rate from 3.8% to 3.9%, slowing employment growth, and tepid wage growth of 2.7%, most of the data suggests growing risks of overheating. The employment cost, core producer price, and core consumer price indices hit 10-year highs, with the latter spiking to an annualized rate of 2.9%. Survey data was equally strong as small business optimism approached an all-time high, job openings equaled the number of unemployed for the first time since the late 1960s and consumer confidence hit a 17-year high (even reversing two months of declines in the expectations component).

International growth slowed to still-reasonable levels, but suffered in a relative sense from an absence of the fiscal impetus present in the US Emerging market growth was downgraded, particularly in China as escalating trade-war fears pressured an economy already slowing from credit tightening. There was nothing in the second-quarter numbers to alter the outlook for advanced economies as United Kingdom (UK) growth rose to 0.4% and Japan surprised at 1.9%; while Eurozone growth disappointed at 0.35%, August manufacturing growth held firm and German business confidence surprised to the upside. While global trade appeared to have fallen off a cliff from as much as 5% at the peak of the first quarter to 0% in the second quarter, with June actually negative, there were more recent signs of stabilization and little evidence of tariff impacts.

Disorderly Brexit fears increased as it became acknowledged that UK/European Union (EU) negotiators will miss the key October deadline to hammer out their divorce agreement. The more immediate European concern was the upcoming game of chicken as the new Italian government's tax cut and welfare spending plans collide with the EU's deficit and debt reduction rules. China's actual growth had already fallen to perhaps 5%, with both manufacturing and credit growth slowing each month despite stabilization efforts. While the late-month-breakthrough compromise US/Mexico deal on auto components removed fears of a global trade war, every indication was that China would be in a different category, both because of popular support for redressing their trade policies and because of China's current vulnerability.

Markets punished Turkey and Argentina severely and equally despite the latter's embrace of a conventional International Monetary Fund (IMF)-led adjustment program and the former's rejection of all orthodox policies. Turkey checked every box in terms of an accident waiting to happen as its all-out go-for-growth approach left the economy dependent on foreign capital flows. Turkey's current account and fiscal deficits ballooned while inflation hit 16% (three times the target). The crisis hit when President Erdogan appointed his son-in-law as finance minister and then urged the central bank not to raise interest rates. The Argentina situation is more troubling in that, while the country needed to work its way out of an overvalued currency and twin deficits, debt levels were not excessive and President Macri had embarked a realistic adjustment plan before a loss of market confidence required him to request IMF help and raise interest rates to 60% in an effort to stabilize the currency.

Mixed International Markets

The headline 2% loss for international equities does little justice to the violence of the damage in individual markets, with currency weakness accounting for half of the 1.8% loss in developed markets and more of the 2.6% loss in emerging markets; growth outperformed value by more than 300 bp. Japan gained 2% despite the trade tensions, benefitting from both a safe-haven bid for the yen as well as surprisingly strong 1.9% second quarter growth, a sharp reversal of -0.9% in the first quarter. European shares were quite weak as the UK fell 4.5% on intensifying Brexit concerns and outsized exposure to the mining sector. Eurozone shares fell a similar amount despite easing trade tensions, as the unfolding Italian budget drama spooked the banking sector in contributing to a nearly 10% monthly loss.

While emerging markets fell only 2.6%, the return dispersion crushed the 12% Japan-Italy spread as the investors targeted the most vulnerable markets. Turkey and Argentina were each down 30% despite employing radically different crisis-fighting tactics. Brazil fell 11% in front of a wide-open October election and South Africa fell 9% on recession and land reform concerns. Despite strong macro fundamentals, Russia fell 7% on sanction risks. At the other extreme, higher-rated emerging markets proved resilient, with the Asian emerging market index down less than 1%, despite a 5% loss in China.

Interest Rates

High-grade fixed income markets were little changed on a global basis, but with regional divergence a function of currency moves and risk aversion. US Treasuries were a primary beneficiary on both accounts in gaining 0.8%, as 10-year yields briefly breached 3% early in the month, fell as low as 2.8% mid-month, and ended at 2.86% as risk-aversion eased and core personal consumption expenditures inflation hit 2%. The Treasury curve flattened, with 10-year yields falling 7 bp more than two-year yields. Municipal bonds lagged in giving up some of their outperformance, with returns in the three-to-five-year maturities modestly negative. Non-dollar sovereign bonds fell 0.8%, with a flight to quality much in evidence as German and Swiss bond yields fell 10 bp to 0.33% and -0.1% respectively! In a related development, Italian bond yields spiked 50 bp to 3.24% on fiscal spending concerns.

Developed-market credits remained resilient, with US high-yield spreads trading in its tightest year-to-date range ever. There was little change in monthly spreads in the US and only modest widening in Europe; emerging markets, not so much. US high-yield and leveraged-loan returns of 0.7% and 0.4% were in line with their underlying Treasury benchmarks; European high-yield losses of 1% were driven more by currency than the 10 bp spread widening. Dollar-denominated-emerging-market debt fell 1.7%, as spreads increased 43 bp to June-end levels. Local-market bonds plunged 6%, a loss entirely currency related as yields rose only 10 bp.

Currencies and Commodities

The dollar's modest 0.8% headline monthly gain belies the volatility within the month, particularly against emerging markets (which fell 6%), as plunges in the Turkish lira and Argentine peso threatened other vulnerable markets. A flight to safety lifted the dollar to one-year highs mid-month as the lira fell 30% (with President Erdogan's response being a call for an "economic war") and the peso fell 22% (as currency stabilization proved challenging despite a credible International Monetary Fund back-stop and 60% local interest rates). While the dollar subsequently declined as trade tensions eased, emerging-market currency losses were widespread, with Brazil and Russia down 7% and South Africa down nearly 10%. Developed-market currency patterns also reflected a flight to quality, with the Australian New Zealand dollars down 3% and the Japanese yen and Swiss franc up 1-2%. The Euro fell less than 1% despite the concerns reflected in the Italian bond market.

Depending on the index, commodities gained 1% or lost 2%. Demand concerns over global growth and trade put pressure on prices, with the exception being a 1.5% gain in crude oil driven by supply risks. West Texas Intermediate crude oil fell more than 5% to two-month lows on a US inventory build, only to bounce back on Iranian production shortfalls and anticipation of the sanctions taking effect in November. Industrial metals were particularly weak on China concerns, with zinc and nickel down 6-9%. Precious metals were no safe haven, with silver down 6% and gold falling to its lowest level since January 2017.

September Positioning

The first week or so of September has seen continued movement in the "equity gap" race. Value shares outperformed by more than 1% on technology sector weakness and the US extended its lead over foreign peers by more than 2%. Tellingly, even US technology shares have done no worse than international advanced and emerging markets, each down nearly 3%, with China/Hong Kong shares down 4%. The dollar has gained an additional 1% against emerging market currencies, with the South African rand down 3%, but is mixed against developed currencies. Treasuries were weaker, with longer maturities down 1% or more as the market priced in additional Fed rate hikes.

Two important macro developments on September 7th underpinned these month-to-date moves: new tough Trump tariff talk and the release of the August employment report. As expected, on the first day after the expiration of the public comment period, President Trump called for the imposition of tariffs on $200 billion of Chinese goods "very soon." The monthly jobs report was at least equally important. Although the upside new-jobs number was offset by previous month revisions, the spike in the monthly wage gain to 0.4% took the annual rate to 2.9%, a nine-year high.

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While a devastating global trade war seems unlikely with the thaw in the US/Mexico auto dispute and Canada's likelihood of joining Mexico in signing an updated North American Free Trade Agreement deal, trade tensions with China have only increased. President Trump appears determined to escalate. He appears to calculate that the political and economic window could not be better as:

- mid-term elections are approaching,
- bi-partisan support exists,
- the US is in a cyclic boom, and
- China is on a downward slope even before the trade threats intensified.

Having been bearish on Treasuries for a number of years, in early January I said that the Fed was behind the curve. I forecasted that the strong US economy and rising inflation would push 30-year Treasury yields from 2.88% to 3.2% by October and that the Fed would raise short-term rates four times in 2019. These looked like increasingly unlikely outcomes as of late August (bond yields had moved up to 2.96% and the market had priced in only one rate hike in 2019, with the prevailing narrative being that the Fed was already making a mistake in tightening in the face of a rapidly flattening yield curve). Since the August lows, 30-year yields have increased to 3.13%, the market is pricing in 1.7% rate hikes and the curve has (very modestly) steepened.

While a crowded trade to judge from record short futures positions, I expect the Treasury yield curve to move upwards. The market still prices in a remarkably accommodative Fed policy given what appears to be an overheated economy—all measures of inflation are at or above target and increasing, unemployment is well below the Fed's definition of full employment—at a time when third-quarter growth should hit 3%, a number far above trend. In fact, far from tightening, the Goldman Sachs financial conditions index actually loosened appreciably between late June and late August.

In addition to this list of usual suspects, two additional factors bias interest-rate risks to the upside: the tail risk of higher oil prices from a Middle East supply shock and the possibility of a positive surprise in Europe. The oil market is more vulnerable to supply shocks than in recent years since excess production capacity has shrunk to 1.5%, as much as 50% less than typical levels. A plausible 1.3 million barrels per day in supply declines from Venezuela and Iran and continued shale bottlenecks combined with 1.4 million barrels per day in 2019 demand growth would further tighten the market and expose it to any other adverse development in the Middle East. Gold would likely be one of the few asset classes to prosper, as the Fed would inevitably look through the resulting inflation spike.

More constructively, the European surprise could well take the form of either an October Brexit divorce agreement that avoids a worst-case outcome (as the EU appears more motivated to cut a deal) or a more immediate positive catalyst in the form of an Italian budget less profligate than feared (as Italy's fiscal starting point is actually better than much of Europe, having a 2.8% current account surplus and structural budget deficit of only 1.3% and declining). While the debt trajectory ultimately needs to be addressed, I would expect an EU compromise that tolerates some additional Italian fiscal spending. This would allow investors to move past Italy and notice that Germany and the core countries have reached full employment, Spain is in its fourth year of 3%+ growth, and the Eurozone's big 3.5% current account surplus is suggestive of an undervalued Euro. Either surprise would result in higher long-term rates and European currencies.

Positive European news would drive Treasury bond yields higher, both directly as European rates increase and indirectly as the stronger Euro/weaker dollar would further loosen US financial conditions. This highlights why the normalization of currently distorted interest rates in the developed world is such a challenge as even good fundamental news may be viewed as bad for financial markets if it hastens rate increases. Despite higher rates, such developments would be welcome news for emerging markets as the dollar would likely weaken globally.

It has been well documented that the decade-long outperformance of growth stocks has tried value investors' patience—annualized growth returns have beaten value by 350 bp since early 2007. The gap has widened further more recently, with the spread increasing to 1600 bp since last November. A similar "gap" has opened up in that US stocks have outperformed foreign shares by more than 7% per year since late 2007 and more than 9% since late 2016. A recent JP Morgan quantitative strategy report puts the recent US outperformance into perspective in concluding that this divergence in price momentum has rarely happened even when breaking the world into regions, and is unlikely to persist.

I do not see this unsustainable gap being closed with an international equity boom. While foreign currency valuations are attractive, equity valuations are only modestly so in an absolute sense. In addition, interest rate normalization has only begun and is unlikely to be deterred by emerging market developments (partly because emerging market contagion should be limited and partly because the US is already overheating). This implies that the gap will be closed from US underperformance, particularly in the frothier momentum-driven parts of the growth segment. Evidence for the detachment of valuation from fundamentals can be seen as the companies most shorted by hedge funds are up more than 20% this year; a similar "losers" index of firms with poor balance sheets and profitability has gained even more. Not surprisingly, while remaining underweight global equities, we have modestly increased our exposure with an outsized relative weighting towards foreign stocks. Finally, emerging market currency and short-duration local instruments are preferred emerging market debt options, especially after last month's weakness, as there is still insufficient reward for reaching out in duration or into corporate credit, particularly when expecting many more Fed rate hikes.

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