Market Perspectives

Sentinel Trust Company, LBA
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October Re-Cap

The realization that the Fed was serious about maintaining its path of ongoing rate hikes amidst increasing concerns over growth that was peaking in the U.S. and slowing overseas proved deadly for both equities and Treasuries in October.

Global stocks fell 8% and "safe-haven" long-dated Treasuries lost 3%. While trade policy, the slowing Chinese economy and European uncertainties over Brexit and the Italian budget did not help, the bigger news was simply the market declines themselves. Selling begat more selling. The dollar gained 2% as remarkably strong U.S. growth further diverged from the rest of the world. Commodities were sharply lower as crude fell 11% on concerns over growing OPEC supply and a loosening of Iran sanctions.

Global equities marched in lock-step downward in October, falling 7-8% with little differentiation between U.S., foreign and emerging market shares, although with pronounced divergence within those categories. U.S. shares fell 7%, with value outperforming growth -5.5% to -9%. Smaller capitalization shares were down 11%. The defensive utility and consumer staples sectors remained in the black, while the more cyclical energy, materials and producer durables sectors experienced double-digit declines. Interestingly, technology shares were in-line performers despite the growth headwinds. After gains early in the month, with the Dow Jones average hitting an all-time high on October 3, declines ensued, with the month featuring the worst week for equities since 2011 and for the NASDAQ since 2008.

Foreign markets fell 8%, with value outperforming and growth and higher risk stocks lagging. Smaller stocks trailed, with emerging market small caps down more than 10%. Political developments produced two outliers:

- Italy was down 10% as the populist government's expansionary budget proposal collided with European rules.
- Brazil gained a whopping 19% as equity and currency investors responded to the landslide Presidential victory for Jair Bolsonaro, who promised to deliver "University of Chicago" economic orthodoxy to address Brazil's fiscal and pension imbalances.

Not surprisingly, emerging markets saw a shift in regional performance, with Latin America up 3.5%, Eastern Europe/Middle East down 4% and Asia down 11%. The latter was impacted by higher U.S. interest rates, slowing Chinese growth and escalating trade pressures.

"Despite the outsized growth, there was little evidence of an inflation pick-up"

While U.S. growth slowed from unsustainable second quarter levels, it contributed to market losses by being so remarkably strong as to achieve the difficult feat of eliciting hawkish Fed comments, while at the same time causing investors to worry about peak economic and earnings growth rates. To my surprise, despite the outsized growth, there was little evidence of an inflation pick-up, indeed inflation pressures seemed to recede. While September's hourly wages rose a strong 0.3%, the market-moving news was the Institute for Supply Management (ISM) composite activity measure spiking to its highest level in history, dating back to 1997. Similar

news flow continued throughout the month. The third quarter gross domestic product (GDP) of 3.5% beat the 3.3% expectation despite the drag from the interest sensitive housing sector, which fell for the third straight quarter at -4%, knocking 0.2% off overall growth. The reports ended on a strong note with U.S. payrolls gaining an impressive 250,000 jobs with strength across all sectors despite some hurricane headwinds. Amazingly, unemployment actually increased from 3.68% to 3.74% as people reentered the workforce. The much feared/hoped-for inflation surge was missing in action, as both the core Consumer Price Index and core Personal Consumption Expenditures (PCE) inflation metrics missed expectations while remaining below the 2% target level, with the Fed's favorite core PCE measure falling back to 1.6%.

Foreign Economies

While U.S. growth was exceptionally strong and surpassed expectations, overseas growth continued to trend lower with China's slowdown, escalating trade tensions and ongoing European political headwinds. Despite the boost from the U.S., the International Monetary Fund (IMF) downgraded global growth for both 2018 and 2019 from 3.9% and 3.7% on weaker trade growth. China numbers confirmed the continued slowdown, with manufacturing growth the lowest in more than two years.

Europe slowed significantly to 1.7% in the third quarter, down from 2.2% in second quarter. The U.K. Purchasing Managers Index (PMI) fell to its lowest since the aftermath of the 2016 Brexit vote. Swiss PMI fell and Eurozone October growth fell to 0.2%, the lowest since 2014. Italy showcased the nexus between economics and politics, with its 0% October growth rate no doubt reflective of ongoing governance concerns, as the European Union (EU) rejected the coalition government's budget and gave them three weeks to return with something better. Elsewhere, German Chancellor Angela Merkel announced plans to step down as party chairman, raising the odds of an early election. The U.K.'s Brexit path appeared likely to feature an extended transition period while remaining within the customs union. Japan was a relative bright spot, with manufacturing surprising to the upside. Overseas inflation remained low, but was on the increase, with Eurozone core inflation picking up from 0.9% to 1.1%, German inflation hitting 2.4% (the highest since 2012) and even Japan saw core inflation rise to 1%.

Interest Rates and Fixed Income

Despite the carnage across all risk assets and becalmed inflation winds, the strong U.S. growth numbers reinforced the Federal Reserve Board's (Fed) guidance for gradual but continued rate hikes into 2020. That drove Treasuries lower with yields higher across the board. The first week of October set the tone for the weak Treasury market and planted the seeds for the subsequent equity plunge when Fed Chairman Powell characterized rates as "still accommodative and far from neutral." The Powell commentary and the outlier ISM report caused investors to double the amount of additional tightening priced in from only three weeks prior. Equally importantly, concerns over a flattening yield curve vanished as the 2-year/10-year spread doubled since August levels. While yields and Fed rate expectations retreated intra-month, the strong late-month ADP Research Institute report saw month-end yields higher across the board (up 15 basis points (bp) in the shortest maturities and 10-20 bp in longer term issues).

There was no place to hide in other parts of the fixed income markets as only cash generated positive returns. The broad U.S. aggregate bond market was a relative outperformer at -0.8% with corporate, high yield and emerging market debt losing 1.5%-2.0% as credit spreads widened across the board:

- 10 bp for corporate bonds,
- 14 bp for emerging local-currency bonds,
- 31 bp for emerging dollar bonds and
- 55 bp for high-yield bonds, where yields ended over 7%.

Overseas, strength in the safe-haven German bonds (2-year yields fell 10 bp to -0.6%) was offset by problems in Italy, where 10-year yields spiked 28 bp to 3.43% despite ratings agency updates coming in as expected. Real estate investment trusts held up well with a 3-4% loss despite the higher rates and wider spreads, although lower oil prices contributed to an 8% decline in the master limited partnership space.

Currencies

The dollar gained 2% on strong economic data and reiterated Fed guidance. Even the safe-haven Japanese yen gave back some of its strength late-month after the Bank of Japan pledged indefinite bond buying. Interesting, the Swiss franc actually fell 2.6%, as investors pushed back the timing for interest rate normalization in an economy with rising inflation and the world's lowest interest rate (at -0.75%). The Euro fell 2.5% on slowing growth and Italian budget concerns. Emerging market currencies proved resilient in declining only 1% as idiosyncratic events outweighed:

- a further 1.5% fall in the Chinese yuan to decade lows,
- the Brazilian election boosted the real by 9%,
- geopolitical developments triggered an 8%Turkish lira rally, and
- the Mexican peso fell 8% as the cancelation of a large airport project caused investors to question their benign assessment of President-elect Obrador's policy agenda.

Commodity indices fell between 2% and 6%, depending on divergent energy weights for the particular index. Natural gas gained 8% on decreased inventories in front of the heating season. Crude oil fell 11% on concerns over U.S. inventory growth, the highest OPEC production since 2016 and potential exemptions from the ban on Iranian crude imports for eight countries.

Precious metals were mixed, with safe-haven gold up 2% despite the stronger dollar while silver fell 3%, being more vulnerable to slowing global growth. China growth concerns pressured the metals complex, with 4-6% declines for aluminum, lead and copper; nickel fell 9%. A 9% surge in the Brazilian real boosted prices for their commodity exports, with coffee up 9% and sugar 18%.

November Portfolio Positioning

It is hard to argue that October's 8% plunge in equities, 2%-dollar rally and 55 bp blow-out in high-yield spreads support U.S. growth. However, I argue that October "de-risks" that growth by reducing the odds of a boom/bust cycle, particularly as I am downgrading my near-term inflation outlook. From a risk-adjusted-growth perspective, the market purge actually improved the domestic macro-backdrop going forward.

The most important domestic "de-risker" is that I now characterize the Fed's plans for gradual but ongoing rate hikes into 2020 as "appropriate," as opposed to "behind the curve." This is partly because the market has done some of the Fed's work for it, in that October's tightening of financial conditions was the equivalent of roughly an immediate 40 bp increase in Fed funds rates.

In addition, it seems appropriate to downgrade the risk of an inflation spike to 2.5% to 3.0%, at least near-term. The reason is that, while underlying service sector inflation pressures are steadily growing, this year's stronger dollar has suppressed goods prices and has caused both core CPI and CPE to retreat from 2% after previously rising to those target levels. While I still expect inflation to pick up to 2.5% by year-end 2019, the relatively benign near-term inflation outlook (particularly if energy prices do not bounce back), in combination with three rate hikes between now and mid-2019, will allow the Fed to catch up.

An additional "de-risker" is that equity valuations have improved and some of the speculative froth has been cleared out of the market, with smaller and/or growthier segments falling double digits. With the combination of outsized earnings growth and October's equity decline, large cap shares were only 20% overvalued. Our work also suggested that value stocks had reached equilibrium levels.

A final domestic risk-mitigator in handicapping the timing and depth of the next recession is that, aside from the unorthodox fiscal stimulus at a time of full capacity, it is hard to find obvious sector imbalances from a cyclical perspective. This means that while the contribution to growth from the fiscal impulse and manufacturing will inevitably slow from unsustainable levels, a gradual retreat towards 1.8%-2% trend growth is not the same as a 2019 recession. Current Fed funds rates and financial conditions are quite low relative to the boom economy and many of interest-sensitive sectors are far from elevated levels, particularly housing.

"a gradual retreat towards 1.8%-2% trend growth is not the same as a 2019 recession "

It is both a cyclic and secular positive that residential investment has not only never recovered from pre-2007 mortgage bubble highs of 6.5% of GDP, but has now plateaued (and even declined modestly) at 3.4% of GDP. Mortgage rates are up 140 bp since September and interest and property tax deductions have been capped. With housing unlikely to make its usual contribution to a cyclic downturn, the secular implications are positive for growth in that savings previously funding the housing sector will be redirected towards more productive investments. In the end, the most likely imbalance remains the labor market (last month's combination of $250,000 job growth and rising unemployment might argue otherwise).

Murky International Backdrop

Despite a less volatile domestic outlook, U.S. equities remain overvalued in aggregate. Investors have only priced in barely two rate hikes in 2019-2020. In contrast; the Fed has guided at least four hikes. The recent market plunge is unlikely cause the Fed to pause as it did in February, 2016 and the international backdrop is best characterized as murky, given the importance and inherent uncertainty in assessing China's current conditions and future prospects as well as the political uncertainties in Europe. The European Central Bank (ECB), having waited so long to begin monetary normalization, finds itself in the unenviable position of starting the tightening cycle (end net bond buying at year-end, with the first rate hike likely in September) at a time when inflation and employment have surprised to the upside, but growth has been steadily falling from 2.4% at the end of 2017 to 1.6% today.

While Italy is on an unsustainable debt trajectory and the new coalition government's budget plan to expand the deficit is a clear violation of EU rules, there is no comparison between 2018 Italy and Greece in 2008-9 whether measured by budget deficit (2% versus 15%), current account deficit (surplus of 3% versus deficit of 12%), net international investment position (-7% versus -87%) or percent of debt held by foreigners (33% versus 67%). In addition, while Italian banks remain fragile (being under-reserved with a low total capital ratio), progress has been made, with tier 1 capital up from 7% in 2008 to 14% in 2017, Italian government bond holdings of only 4 years duration and a reduced wholesale funding dependence at only 21% (better than the Eurozone average).

Italy does pose an existential risk to the Eurozone at some point. The gap between the demands of the populist collation and the rules of the EU seems difficult to bridge. However, it seems

equally easy to imagine that an immediate crisis could be avoided with a face-saving agreement that delays the day of reckoning. While the overall agreement is likely to incorporate some of the Italian demands on immigration, one possible stop-gap on the economic front is for the ECB to provide additional low-cost liquidity to Italian banks. That would allow Italian banks to buy additional government debt that the ECB cannot, while at the same time creating a more virtuous funding circle (avoiding deposit runs). In theory, this could allow the ECB to start (and hopefully accelerate) a tightening cycle that is much needed for Europe overall, while still providing support to an economy that is struggling, partly as a result of this unresolved conflict. From a Pan-European perspective, with the Brexit divorce process likely to include an extended transition period where the UK remains in the customs union, the path of European rate increases may be faster than expected despite the slowing growth and political uncertainties.

China Slowdown

We had called for a China slowdown to be a possible unappreciated risk for financial markets since early 2017 (along with unexpectedly higher Treasury rates and a less than optimal Brexit outcome). While difficult to determine how much growth has slowed, it is worth asking when growth will inflect and how big subsequent growth rates might be. Our qualitative assessment is that growth levels have continued to deteriorate on a monthly basis. The negative effects from the trade war will only add to the pre-existing downdraft. Government policy measures will cushion, but not offset, the declines. So, it appears that the upwards growth inflection is a mid-2019 event. While bearish near-term, the government is making the best policy response possible in trying to facilitate a transition from an unsustainable credit- and investment-led economy to a slower growing, but more balanced one.

Since 2017, President Xi has prioritized structural reform over headline growth in recognizing the need to reduce the debt-fueled investment share of the economy from its lower, but still very high level of 45%. Determined to regain control of the level and allocation of credit in the economy, the government has clamped down on the "shadow-banking" sector by reducing its growth from 17% in 2017 to 3% today. The determination to rein in credit despite the slowing economy is reflected in aggregate credit growth, which is actually negative on a year-over-year basis. The government has wisely elected to cushion the negative credit impulse by encouraging consumption (cut taxes on autos) and helping traditional credit providers (lower required reserves and interbank rates).

A recent China central bank press release hinted that lower interest rates (and inevitably, a weaker currency) may be forthcoming given deteriorating conditions. While my mid-year upward-inflection-point forecast is low conviction, the more important question is that of China's intermediate-term outlook, as forecasts range from a V-shaped recovery to a credit crisis contagion that spreads globally. My expectation lies somewhere in the middle, with widespread bad debt being ultimately absorbed by the government that results in multiple years of sub-par growth, but little contagion, partly because the debt is all locally owned and partly because the savings rate is so high.

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