Market Perspectives

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Investment Committee
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March Re-Cap

The Federal Reserve Board (Fed) somehow managed to overshoot markets' already dovish expectations by unexpectedly moving guidance directly from a rate hike bias to one of rate cuts without stopping at "pause." This "miracle drug" not only drove a massive move downwards in global bond yields from already low levels, but anesthetized equity investors from concerns over fundamentals such as declining economic growth and corporate earnings. Despite the risk-off environment and the flood of money into bond funds, both the global equity and U.S. high-yield markets gained 1% thanks to central bank guidance and greater optimism that the tail-risks of a hard Brexit and an escalation in the U.S./China trade war would be avoided. For those who still care about such things, economic reports were encouraging enough to suggest that the Fed would have done better to stop at "pause," but the Fed could point to disappointingly low inflation levels as cover to do just about anything.

U.S. shares gained 1.5% as late-month trade optimism helped the market recover and approach Fed-induced intra-month highs. The month saw a pronounced bias in favor of larger and growthier shares, with growth more than 200 basis points (bp) ahead of value as the S&P500 gained 2% versus a 1% Russell 2500 loss. Large-cap growth stocks beat small-cap value by an amazing 570bp! Investors reached for interest-sensitive defensives and growthier shares still hitting their earnings numbers, as real estate investment trusts, technology and consumer staples sectors posted 4% gains and utilities outpaced energy shares despite the continued crude oil rally. Technical factors contributed to the market resilience, as the Fed's "all-clear" signal extended the year-to-date plunge in volatility and the resulting need for volatility-targeting funds to buy more equities.

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International Equities

International shares gained only 0.5% in a decidedly mixed month that saw little differentiation between emerging and developed countries. There was a 50/50 split between winners and losers amongst the 90+ markets tracked by Bloomberg. Mirroring the U.S., markets recovered late month. Growth names beat value by 2% and larger capitalization shares outperformed, with small-cap shares finishing in the red. Major developed market shares traded with a tight range, with Italy's 2% gain a noteworthy outperformer, being a direct beneficiary of the European Central Bank's (ECB's) dovish guidance and bank liquidity facility. The U.K. market gained 1% despite currency headwinds, as reduced hard-Brexit fears boosted exporters. Large caps outperformed by 2%. Japan finished in the black (up 0.6%), but was flat in local terms, as economic news was subdued but in line with expectations. Japan's labor market continued to tighten (unemployment rate declined 0.2% to 2.3%) and inflation continued to disappoint (up only 0.3% year-over-year). Foreign investors were net sellers and value shares once again underperformed, particularly in the second half of the month, on global growth concerns.

In contrast to developed market peers, the emerging market index gain (+0.85%) belied an unusually wide performance dispersion. India outperformed both Argentina and Turkey by more than 20%. India stocks rose 10% (despite the headwind of higher oil prices) as its new bankruptcy law passed a big test with the restructuring of a large steel company. Opinion polls, perhaps aided by recent tensions with Pakistan, showed it more likely that Prime Minister Modi would avoid the possibility of governing as part of a minority coalition government and foreign investor inflows hit two-year highs.

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At the other extreme:

- Turkey fell 15% on news that the country, highly dependent upon overseas portfolio inflows, had burned through 25% of its foreign reserves within a month in an effort to stabilize the currency in front of important local elections. Subsequent efforts to pressure currency short-sellers compounded the problem, as foreign investors sold bonds and equities.
- Argentina paced a broad downturn in Latin America as its market was caught in a vicious cycle - concerns over October elections increased as disappointingly high inflation and recession conditions triggered a spike in one-year Treasury yields from 40% to over 50%, further adding to election jitters.
- Brazil fell 4% as weaker economic news, the arrest of the former President and softening on anticipated entitlement cutbacks for the military raised fears that the broader pension reform agenda was in doubt.

Hong Kong and China shares gained on signs of economic stabilization and trade-truce hopes, with Shanghai Class A shares extending their rally by gaining 5%. Russia gained only 1%, despite the continued surge in oil prices on cautious positioning in front of the Mueller report release in the U.S.

World Economy

Economic reports went from bad to worse, with increasing evidence of the U.S. slowdown, providing real time support for the Fed's unexpectedly dovish about-face. Global gross domestic product growth has declined abruptly from 3.8% year-over-year in the fourth quarter of 2018 to 3.0% today, a level the International Monetary Fund defines as the "recessionary threshold." The slowdown has been most pronounced geographically in Europe and to lesser degree Asia (depending on your China-growth estimate), with particular weakness in manufacturing and global trade.

A blinkered view of only the global manufacturing sector and selected hard data might well conclude that an intensifying international recession has already arrived on U.S. shores. Examples include:

- China export growth crashed to -20% annualized after seeing 20% growth as recently as October.
- February credit growth came in at half the expected number.
- Overseas manufacturing continued to deteriorate, with disappointing late-month Eurozone numbers the proximal cause for the Treasury yield curve inversion. Purchasing Manager Index (PMI) readings fell below 45, having been at 65 in January 2018. New German orders plunged to August 2012 lows.
- U.S. manufacturing may be finally succumbing, as February industrial production would have been negative absent a cold-weather-induced spike in utility output.
- Despite a strong January, retail sales (reflective of a supposedly strong consumer sector) went negative on a trailing quarterly basis for the first time since 2013. A collapse in auto durable sales offset the strong month, leaving real consumption virtually unchanged in January.
- A surprisingly low 20,000 gain in job growth fell well short of the 170,000 consensus and represented a precipitous fall-off from 311,000 the prior month.

As discussed at length in last month's letter, a broader and more forward-looking view of the economy would suggest that the Fed has made a mistake, or perhaps has deemphasized sustainable growth and financial stability in its concerns over quiescent inflation. While we had anticipated an inflection in China growth around mid-year, stabilization has already occurred as manufacturing PMI remained above the threshold level of 50. Taiwan and Korea saw similar improvements. The first post-Lunar New Year reports saw a modest pick-up in fixed asset investment, led by a 12% increase in the property sector.

While Eurozone manufacturing gets all the attention, the blended PMI which includes services advanced to a three-month high. Similarly, the blended U.S. number was consistent with far-above-trend growth. The headline U.S. February job number may have disappointed, but in retrospect was mostly a payback for warm weather earlier in the year which caused the spike in January's construction and leisure sectors. The labor market has no remaining slack as the broader U6 measure of unemployment fell from 8.1% to 7.3%, the lowest since 2000 and wage growth moved to a decade high 3.4%.

Inflation and Interest Rates

Inflation has moved even further away from the Fed's 2% target and has shown no signs of reaccelerating. Lower year-over-year gasoline prices drove the low headline 1.5% consumer price index (CPI) number. The more important core CPI edged down from 2.2% to 2.1%, a 4- month low. The late-month core personal consumption expenditures (PCE) report potentially vindicated the Fed's attack on deflation risks by delivering more benign inflation news, as the Fed's key metric rose only 1.8% year-over-year and 0.1% month-over-month.

Abrupt central bank U-turns towards max dovishness, surprisingly so with the Fed and perhaps inevitably with the ECB, drove yield declines that were breathtaking in view of the already low starting points. Ten-year Treasury yields plunged 30bp to 2.4%. The late-month inversion of the yield curve spooked the markets with the 3-month/10-year spread ominously inverting for the first time since 2007. German yields fell 19bp, while moving to a negative yield for the first time since 2016. The rally was widespread, with Italian and U.K. yields falling 25-30bp.

The Treasury index gained 1.9%, with particular strength in the longest 20+year maturities which returned 5%. U.S. investment grade bonds benefitted from the Treasury rally in gaining 2.4%, purely on duration exposure (as opposed to tightening credit spreads) as evidenced by the 3.3% return for the highest rated issues. The U.S. high-yield market extended its strongest first quarter rally since 1992 with a 1% gain. Depending on the maturity, municipal bond performance ranged from decent to exceptional, as while intermediate bonds gained nearly 1%, long-dated issues returned 4.5% despite the call option headwinds, as they rallied on a relative basis from 96% to 93% of Treasuries. Dollar-denominated emerging market debt gained 1.1%, but currency weakness left local emerging bonds with a 1.3% loss despite a 9bp fall in local yields.

Currencies and Commodities

The dollar was moderately stronger against both developed and emerging market currencies despite the unexpectedly dovish Fed guidance. That illustrates the truism that currency moves are changes in relative prices and that risk aversion matters, as the safe haven Swiss franc and Japanese yen posted modest gains. The Canadian dollar fell 1.3% after the central bank guided to below neutral rates following much weaker than expected business investment and household spending. The British pound fell 1.7%, giving up early month gains, as while hard Brexit risks were reduced, uncertainty increased over what comes next. The Euro fell 1.4% on the ECB guidance and subsequent discouraging economic reports.

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Emerging market currencies fell nearly 2%, giving back much of their year-to-date gains. The flight to quality, global growth concerns and idiosyncratic factors more than offset the plunge in U.S. interest rates. Latin America was particularly weak, with Argentine peso down 6% as the central bank was forced to tighten on disappointing inflation/growth news. Brazil, Colombia and Chile experienced 3-4% currency declines. The Turkish lira recovered to finish down only 4% as government policies triggered short covering. The South African rand fell 3% on ongoing power grid reliability issues. The Indian rupee was the outlier, gaining 2% on election optimism.

Commodities were mixed but ended up 1% (+/- 1% depending on the energy weight) despite the stronger dollar and increasing global growth concerns. Crude continued its rally gaining 2%, reaching November's $60 level and enjoying its best quarter since 2009 on Saudi Arabian and Russian production cuts and a surprise decline in U.S. inventories. The energy complex was otherwise mixed, with natural gas falling 4% on warmer weather while gasoline spiked 5% on refinery shutdowns and Venezuelan supply concerns. Precious metals were weaker, with gold and silver down 2-3%. Other metals were mixed, with zinc up 6% and lead down 6%, somewhat depending on the sensitivity to a U.S./China trade resolution. Elsewhere, hogs gained 18% on China swine flu developments, while corn (supply surprise) and coffee (Brazilian real weakness) fell 3-4%.

April Positioning

As of late April, economic and political developments have been sufficiently encouraging as to blunt the risk-off bid, with safe-haven currencies and global bonds moderately weaker. While the market still expects a rate cut and assigns zero probability of a 2019 rate hike, the Treasury curve is no longer inverted. The 2-year/10- year spread increased from 12bp late March to 21bp. Risk assets are once again on the move, with global equities up nearly 3% and high yield tacking on another 1%. Qualitatively, the market action is a reprise of March, with little distinction between emerging and developed markets and continued large cap and growth stocks outperformance. One difference is that interest-sensitive assets have retreated, with long-dated Treasuries -3% and real estate -2%; health care stocks fell 5% in reaction to 2020 election posturing. Crude oil has gained an additional 5% on tighter Iranian export sanctions, bring the year-to-date increase to more than 40%

Economic releases suggest that international growth has indeed stabilized, but the degree to which growth will inflect upwards remains unknown. U.S. growth reports were mixed, but gave no reason to alter my view that the labor market will continue to tighten throughout the year, wage growth will resume an upwards path and that core inflation will once again surpass 2% by year-end, absent continued productivity gains.

The Q1 growth report of 3.2%, far surpassing even the most optimistic estimates, may complicate the Fed's communication challenges, but does little to change our outlook or market positioning. The Fed will need to defend against charges that its abrupt move to a rate cut bias was an overreaction as nominal growth has continued to exceed 5% at a time of an overheated labor market and 10-year Treasury yields of only 2.5%. Furthermore, overall financial conditions are hardly restrictive, having eased to only being in line with the trailing five-year average. The outlier number is of less importance than one might think as my view on near-term recession risks was merely confirmed. The positive surprises were in components that were either non-recurring or mean reverting factors (spikes in road construction, net exports and inventories) and contained no information that would alter the late 2019 outlook.

While the growth number may be reassuring, my focus for some time has been less about the immediate future and more about conditions in the fourth quarter. My judgment has been that the U.S. growth will still be at or above the 1.7% trend level, thus continuing to generate the 100,000 jobs/month needed to further tighten the labor market. The overheating in the U.S. would be within an international context where growth in China and Europe has already stabilized with at least some degree of recovery now expected going forward and the ECB will have new head, almost certainly to be more hawkish.

At this point, the Fed appears to have placed a bet that productivity growth will continue to prevent increasing wage growth from translating into increasing inflation and that financial stability risks are manageable. Should inflation perk back above 2% later in the year, the Fed will be faced with either letting inflation run hot (and risking an even steeper yield curve) or completely reversing its latest reversal with an unexpected rate hike. Alternatively, while continued benign inflation would avoid a potential mini boom/bust cycle for the economy and markets, financial stability risks are growing and will ultimately need to be addressed. The argument made by some potential candidates and even some economists that there are no limits to government borrowing when interest costs are so far below nominal growth being only one troubling indicator.

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