Market Perspectives

Sentinel Trust Company, LBA
Investment Committee
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May Re-Cap

While the re-emergence of disappointing economic news suggested that global growth was decelerating, it was politics that spooked markets in May. It came in the form of an unexpected 9th inning breakdown in U.S./China trade talks and subsequent signs that President Trump might view bilateral tariff and company-specific threats as a core part of his expanded toolkit for "winning" (on both the employment and election fronts). Global shares did fall mid-single digits, but their investment-return pattern was orderly and consistent with fundamentals. In contrast, fear was more apparent elsewhere, particularly the government bond market, where intermediate Treasuries gained 3%. The Treasury volatility index increased 50% to a 2-year high as yield fell to September 2017 lows. Only wet weather and short-covering prevented double-digits declines in the commodity complex, where crude fell 15%. Only safe-haven-currency bids obscured widespread dollar strength.

As discussed in last month's letter, the first quarter represents interim "peak growth" for the U.S. and the developed world. With tight labor markets supporting strong consumption, the question revolved around one of timing as to when China's stimulus would cause the global manufacturing sector to finally inflect. Unfortunately, the May economic releases turned out to be more supportive of peaking growth than any near-term manufacturing upturn even before the trade war escalation, with an unexpected retracement in Chinese manufacturing an additional cause for concern.

While U.S. growth was always certain to slow from the inventory and net trade fueled 3.1% level, second quarter headline growth is now unlikely to pick up from the first quarter's underlying growth rate of 1.5%. This is disappointing as the expected pick-up in consumption growth to 3% appears to have been offset by negative late-month surprises elsewhere. Manufacturing weakness may be spreading to services as the combined purchasing managers index (PMI) plunged from 53 to 50.9, with the service index hitting a 3-year low. In addition, March core durable goods orders were revised from +0.2% to -0.7%, suggesting that capital spending was set to fall from the first quarter's 4% annualized to 0% in the second quarter. Nonetheless, the overall data was more mixed than soft as the University of Michigan consumer confidence survey (pre-tariff) surged to a 15-year high.

International Economic Developments

Overseas developed markets showed a similar pattern, as the Organization for Economic Cooperation and Development cut its 2019 growth estimate from 3.2% to 3.1% despite Eurozone quarterly growth doubling from the fourth quarter. Germany's above trend 0.4% growth occurred as a pick-up in auto sales and a mild-weather induced construction burst offset a still weak manufacturing sector (PMI of 44.4). An April retreat in the composite PMI warned of a return to trend levels. Japan grew nearly as much in the quarter (0.5%) as it does in a year (trend growth of 0.7%) as business spending unexpectedly maintained a rapid pace. The upside surprise makes it more likely that October's value-added tax increase from 8-10% will go forward, causing an adverse impact on consumption after some interim frontloading.

The U.K. reported record low unemployment, record high labor participation and first-quarter growth of 0.5%, a strong but unsustainable figure in that it was partially supported by Brexit fears (business and consumer stockpiling). Going forward, recent Brexit developments should suppress capital spending as the level and period of uncertainty has only increased following Prime Minister May's announcement on the 24th that she would be stepping down in June. The timing and confluence of a new and likely hard-Brexit hawkish Tory leader in July, the subsequent Parliament vacation into September and the imminent October 30th Brexit deadline increase the odds of another Brexit extension (or a Corbyn-led Labor government). Italy posted a positive first-quarter surprise in escaping recession with 0.2% growth despite a weak manufacturing sector. However, ongoing budget deficit concerns present upside interest-rate risks that could offset the fiscal stimulus.

Confidence in the critically important assumption that the Chinese economy, particularly the manufacturing sector, had already stabilized and was poised to accelerate was tested by May economic releases. Sentiment outside of the (overheated and overleveraged) property sector remained poor. Of particular concern was that the late month manufacturing PMI for state-owned enterprises fell below the breakeven 50 level, with new orders, import orders and output prices all slowing. That the government appeared to have already dialed back the stimulus effort was either a sign that they were confident an upswing was underway or one that the Trump tariff announcement was catching them at an inopportune time.

China Tariffs

While bilateral tariff battles have always fit the Trump mantra (when you have strength use it) and new tools are hard to give up (witness the Federal Reserve Board and quantitative easing), the bigger development is the apparent political calculation: broadening the attack on China is a winning election strategy considering the modest direct economic costs of a 0.3% hit to growth and a boost to inflation of up to 0.7%. These costs will mark a change from the effects of the prior tariff on China imports (25% on $50 billion and 10% on the next $200 billion) in that these will hit prices visible to the consumer (cellphones and electronics) and may not be offset by another double-digit renminbi depreciation.

Following China's retaliatory tariffs on $60 billion of U.S. goods, the Commerce Department's blacklisting of the Chinese communication firm Huawei (firms dealing with Huawei investigated) represented a significant escalation. Such actions and a similar non-tariff response from China (already targeting "unreliable" firms and people) have the potential to disrupt global supply chains and add to the economic costs. While Trump's escalation, the subsequent Chinese retaliation and apparent hardening of positions on both sides may all be simply posturing, the constraint from purely an economic and financial perspective may be less binding that I had expected. The surprise May 30th tariff tweet threat to Mexico evidenced Trump's comfort level with tariffs as a political weapon and that his 180-day delay on imposing tariffs on European auto tariffs was less of a pardon than a temporary reprieve pending a better deal.

The Federal Reserve Board (Fed) certainly is being given the opportunity to live up to its commitment to be data-dependent given the flow of market-moving news. Chairman Powell received much criticism for his early May (pre-tariff) statement that the pullback in inflation was transitory and that investors should not necessarily expect rate increases. While he could be faulted for not providing his rationale, to my mind, this investor "jawboning" was entirely appropriate given that (1) the market was pricing in rate cuts at a time when financial conditions had improved, (2) the Atlanta Fed's measure of "sticky" core inflation had stabilized at 2.4% and (3) the Fed five year/five-year forward inflation measure had increased from 1.7% at near-end to above 2.0%. Chairman Powell is no doubt grateful that the June G20 meeting falls just after (and not just before) the next Fed meeting, giving him time to collect his thoughts before the July meeting.

Equity Markets

As one might expect in a month where global equities fell nearly 6%, losses were widespread. Some 85% of the country markets tracked by Bloomberg finished in the red. At the same time, the market action was not reflexively risk-off, as positive fundamental news drove meaningful gains for a few outliers. U.S. shares underperformed, with the Russell 3000's 6.5% loss placing it in the bottom quartile of world markets. Being in line with the 7% emerging market loss, the NASDAQ did little better than the Shanghai composite. There was little distinction between growth and value, although small-caps lagged by 150 basis points (bp). The Russell 2000 was down almost 8% and small-cap value trailed mid-cap growth by 240bp. The 16% plunge in crude oil drove 11% energy sector losses. The rate-sensitive utility, master limited partnership and real estate sectors, supported by plunging Treasury yields, lost only 1%. The previously washed-out healthcare sector and the typically defensive consumer staples sectors outperformed. Technology shares fell nearly 9%.

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Despite the weak emerging-market-index performance, developed-market Sweden, Austria and Italy led global decliners in falling 10%, all being logical candidates given their respective sensitivities to the market for manufactured exports (as well as recession risks in the case of Italy). Politics also contributed to declines. Austria's Chancellor fell after the leader of his controversial far-right-coalition partner was discovered to have possible Russian ties. In Italy, the League Party's strong showing in the European elections was likely to embolden Salvini to escalate his conflicts with Brussels over budget deficit plans. Despite its heavy manufactured export exposure, Germany outperformed the 7% Eurozone index as first-quarter growth surprised to the upside. Japan's first-quarter growth was an upside surprise, but its market lost 7% due to the increased odds that a controversial sales tax hike would be enacted. South Africa also lost 7% despite hopes that President Ramaphosa's reform agenda would be enacted after his ANC party garnered nearly 60% of the vote and he subsequently reappointed strong finance and anti-corruption officials to his cabinet. Not surprisingly, China and its regional trade partners such as Korea and Singapore posted losses of 8-9%. Emerging Asia fell nearly 9%, while Latin America was down only 1-2%.

International positive outliers tended to have a political catalyst that outweighed the economic and commodity concerns. Argentina (technically a frontier market) gained 15% as the controversial former President Cristina Kirchner opted out of the running (although she would remain a Vice Presidential candidate). Greece gained 7% following a resounding pan-Europe election defeat that should see the ruling leftist Syriza replaced by a more market friendly New Democracy party. Nigeria gained 7% despite plunging crude prices as the economy grew more than expected and telecommunications shares gained. Similarly, Russia bucked both oil price and emerging market headwinds in gaining 3%, as Gazprom spiked 30% after doubling its dividend as part of the government's broader effort to boost the efficiency and distributions of state-controlled enterprises. Brazil overcame similar factors as well as continued growth disappointments in earning a moral victory with its 1% gain, as pro-reform protests reignited pension reform hopes. Australia managed to remain in the black despite its direct China linkages after a stunning defeat for the incumbent Labor party.

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Interest Rates and Fixed Income

The serial Trump tariff tweets that seemingly attacked the weakest part of the global economy (tradable manufactured goods) at a time when central bankers were already agonizing over inflation shortfalls predictably led bond investors (a/k/a deflation vigilantes) to front-run the Fed in pricing-in three rate cuts over the next year. Towards the other end of the maturity spectrum, yields fell 35bp, leading to gains of 1.5% for intermediate and 6.5% for longer-dated issues. While the embedded rate-cut forecasts caused the 3-month/10-year spread to dramatically invert over the month (from +8bp to -23bp), the flattening was much less pronounced across other maturity pairs. The Treasury market development was such a shock that the MOVE index (of expected bond market volatility) spiked to a level nearly 50% above its 12-month average.

With the 2.35% monthly Treasury gain as a reference, U.S. credit market performance was unsurprising, as returns directly related to credit risk, duration and liquidity. The U.S. investment-grade bond return of 1.5% was little short of the 1.8% for the Barclay's Aggregate as spreads widened only 18bp, with AAA-rated issuers actually outpacing Treasuries. Conversely, the U.S. high-yield market fell 1%, with the lowest rated (CCC) issues losing nearly 3%. Investment-grade municipal bonds somewhat lagged in returning 1.4%. Lower rated municipal bonds continued their rally by gaining 1.5-2.0%. Emerging market bonds gained nearly 1%, while local market issues were little changed as currency losses offset yield declines of 16bp.

Currencies and Commodities

While the most popular dollar index (DXY Index) was only 0.3% higher, currency markets reflected broad-based underlying dollar strength (outside of safe-havens) as emerging market currencies fell 1.5%. That only the safe-haven Japanese yen (+2.9%) and Swiss franc (+1.9%) were the only monthly gainers among the sixteen major currencies evidenced dollar's strong breadth. The British pound was down 3% as post-May hard-Brexit fears scuttled rate-hike hopes. The Mexican peso was down 3.4% after falling 2% within 10 minutes after Trump's tweet on May 30th. The Euro fell only 0.4% as generally favorable European Parliament election results and the temporary reprieve from potential U.S. auto tariffs cushioned losses. The Chinese renminbi fell only 2.5%.

Only acts of God in the forms of torrential rain and tornados prevented double-digit losses for the commodity complex. The GSCI index declined 9% versus a 4% fall for the (grain-heavy and energy-lite) Bloomberg index. Base metal prices responded to growth concerns related to trade-war-escalation fears, falling 6-9%. Precious metals were mixed. Gold gained 2%, silver fell 2% and platinum plunged 10% after hitting a yearly high on supply concerns and slowing auto sales (particularly in China). The energy sector was quite volatile, with crude oil little changed through May 20, only to fall 15% late month with both trade tensions and high U.S. inventory levels sparking its worst plunge in 7 years.

June Positioning

June month-to-date shows a sharp

V-shaped recovery in risk assets, but one (once again) unaccompanied by a pullback in safe-haven Treasuries, which are little changed. Through June 11, global equities have gained 4%, with the U.S. up 5% and emerging markets up 2%. The dollar has given back some of last month's gains, falling 1.4% against the Euro and 1.2% against emerging market currencies. The dollar weakness boosted overseas bond returns, with the non-dollar bond aggregate gaining 1.5%. High-yield bonds fully recouped May losses with a 1.5% gain, while emerging market debt gained 1.7%. Commodities were little changed despite the dollar give-back, although gold tacked on another 1.5% on dollar weakness and dovish Fed talk.

Equites have bounced back thus far in June, supported by indications that Fed Chairman Powell was open to rate cuts and evidence that the that U.S.-Mexico trade/immigration skirmish would be quickly resolved. Headline economic releases fed the interest-rate-cut narrative:

- the much-anticipated May jobs report saw a gain of only 75,000 (half the consensus number), with downward revisions to the prior two months;
- core inflation was quiescent in remaining at only 0.1% month-over-month for the fourth consecutive month;
- trailing wage growth declined to 3.1%; and
- ISM manufacturing retreated to a 3.5-year low, confounding expectations of a slight increase.

The equity market is correct in viewing the direct impact of President Trump's tariffs as relatively minor; however, the potential implications and indirect costs are not. While the Mexican tariff proposal was always going to be resolved quickly (since there is no U.S. support for such a measure and Mexico has no real leverage, given that close to 40% of its economy is tied to the U.S.), this apparent weaponization of tariffs for political purposes raises the odds of tail-risk outcomes for current outstanding trade disputes with Europe over autos and Airbus subsidies. More importantly, the use of non-tariff economic weapons, targeting the technology sector, represents a direct challenge to China's strategic vision (Belt Road Initiative and Made in China 2025) over which compromise would not seem possible.

The impact on financial markets will exceed the pure economic effect from the modest U.S./China overlap. First, S&P 500 exports to China are 5% of revenue, much more than the economy overall, even more for U.S. multinationals. In addition, the U.S. is targeting the technology sector through blacklisting Huawei and firms that conduct business with it; more generally, technology exports to China will be subjected to greater scrutiny as potential strategic security risks. Such developments and the potential need to reorganize global supply chains should pressure tech productivity and profits. This could impact the economy overall, as the U.S. Bureau of Economic Analysis has estimated growth in technology activity has accounted for 30% of total growth in averaging 8% since the great financial crisis. Finally, there may be an impact on overall U.S. productivity if the conventional wisdom that technology capital expenditures have a disproportionate effect turns out to be true.

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The Fed, being somewhat a political animal, will pay close attention to the optics of the last-minute trade breakdown. However, it no doubt will defer any action at its June 19th meeting since it falls immediately before the G20 meeting in Osaka (although the market is pricing in 20% odds of an actual cut). The deflation vigilantes have put significant pressure on the Fed to act given the significant market -implied rate-cut odds and an expected year-end 2020 rate of only 1.44%. The late July meeting presents a 76% chance of a cut, including a 14% chance of a 50bp move. Mid-September rate cut odds are over 90%, with a (cumulative) 100bp cut being as likely as rates remaining at current levels!

I am forced to change my outlook and will concede that the Fed will cut rates this year, tentatively expecting a 25bp move in September. Given the downside risks created by (1) the trade war escalation and the manner in which it has been conducted, (2) the optics of an abrupt fall off in growth, (3) a decline in out-year inflation expectations of 20bp since April 30 at a time when current inflation had seemingly already peaked, (4) disappointing new employment numbers and (5) the knowledge that the Fed may switch to a more dovish inflation-targeting strategy late next year, the Fed would risk a meaningful post-hoc judgment should it ignore what the bond market is saying and growth subsequently surprised to the downside.

At the same time, the bond market has massively over-reacted to the most likely economic impact of the trade war escalation. While my forecast that the U.S. would maintain at least trend growth in the fourth quarter is at risk, recession risks have not materially increased for several reasons:

- While President Trump calculated that a no-deal was better politically than a weak deal, he does not need to implement his tariff threat to its fullest level (or with immediate effect) to deliver his desired message of being tough on China. The market realization of a more nuanced approach will remove some downside tail risk outcomes for the economy and Fed policy.
- Since China was already stimulating the economy to the tune of 1.3% of

gross domestic product and the Fed had already made its dovish pivot, no immediate policy reversal is required. That is an important risk mitigator given the usual lags on economic impact. China will allow the renminbi to further depreciate as a policy stimulus, breaching the headline 7.0 level, but avoiding a run on the currency. China's recent unexpected manufacturing slowdown obscures broad-based strength at smaller firms, which are more representative of the private sector.

- The magnitude of the rate cuts priced in the market would normally only be seen at a time of recession, geopolitical event or market riot. Vice Chairman Clarida recently noted that the Fed is closer to achieving its dual mandate than at any time in the past 20 years. So, it is hard to make the case for the Fed to make such aggressive cuts as simply a prophylactic against potential risks. There are few signs of excess across the economy. Furthermore, inflation is unlikely to decline further given the growing weight of administered prices in the basket (healthcare now 24%), particularly after the warm May PPI services inflation report.

With the market hope for massive near-term rate cuts likely to be extinguished, and the term premium for 10-year Treasuries at a record low, defensive rate positioning in the forms of reduced exposure, duration and excess cash seems appropriate. It is also tempting to remove a small-curve steepening trade put on last September as the 5-year/30-year spread has nearly tripled. However, it remains somewhat attractive as a hedge against either outright recession or a potential dovish tweak to the Fed mandate. If the bond market is overestimating downside risks, the equity market appears to be pricing in all of the benefits of lower interest rates with none of the potential negatives that have driven rates lower.

After being right for the wrong reason to advise buying the May equity dip with the expectation that good economics would triumph over good politics in the trade war calculus, it makes sense to completely unwind that incremental purchase. With the 5% month-to-date gain, U.S. equities are back to selling at a 16.1 forward price-to-earnings ratio with the assumption of 7% fourth-quarter-earnings growth seemingly vulnerable to a downgrade. High-quality defensive shares should be sold as they are priced (small-cap defensive shares are selling at a 75% premium to their history) such that they share the downside risk of a possible upward retracement in bond yields, but without the equity market upside.

Judging cash to be a better risk/reward than defensive equity positions, I am reducing not only U.S. but international equity exposure, while maintaining an unchanged relative overweight to international shares on valuation grounds. This will take total listed equity exposure back down to levels last seen after the January 2018 market spike. While confident that international issues will significantly outperform over time, I am also confident that equity markets will be more volatile than investors expect. This volatility and the expected vulnerability of U.S. shares means that we are likely to get future opportunities to rebuild international exposure, particularly should the overvalued dollar once again rally as a safe haven.

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