Market Perspectives

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Investment Committee
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April Re-Cap

At one level, April developments are easily summarized: the combination of reassuring economic reports across leading economies, even more supportive central bank policies (a luxury made possible by quiescent inflation), and hopes for a finalization of a comprehensive U.S./China trade deal propelled risk assets to their fourth consecutive monthly gain. At another level, the market price action was not entirely internally consistent with the risk-on dynamic as:

- neither mainland-China shares nor industrial metals responded favorably to an apparent manufacturing stabilization in China,
- oil prices declined after the surprise lifting of sanction waivers,
- nearly 30% of world equity markets declined and
- investors priced in two Federal Reserve (Fed) rate cuts despite first quarter growth coming in at 3.2% (artificially boosted, but still 3.2%).

This self-evident lack of confidence suggests either that equity markets have a shaky underpinning or that bond investors are overly pessimistic (or that interest rates will stay at these low levels forever!).

World equities closed up 3.35% and approached the September, 2018 record high, with growth and quality factors winning at the expenses of momentum. U.S. shares gained 4.0% as first quarter earnings were not as bad as expected. Large-cap-growth stocks were up 4.5% versus 3.0% for small-cap growth. Value shares returned 3.6% across capitalizations. From a sector perspective, the economically sensitive financial sector was a standout performer (+9%) along with the trade-sensitive technology sector (+6%). Energy shares were unchanged despite crude gains. Healthcare shares fell 3% on Medicare-for-all campaign rhetoric. Utilities and real estate were little changed as defensive and rate sensitive sectors lagged. Complacency returned as implied volatility continued to fall and approached pre-October lows.

International equities gained 2.6%, with developed outpacing emerging market shares by nearly 1% and growth besting value by a similar margin. Despite the strong index gains, equities were more mixed than one might expect, with 28% of the markets in the red, albeit mostly in emerging markets. The Eurozone was a standout performer, being a natural beneficiary of positive growth reports in Europe and China as well as trade optimism. The more open, export-driven economies such as Germany, Austria and Sweden posted 6-7% gains. Greece gained 7% after the government proposed an early repayment of some official loans. Similar factors drove Japan's 4.5% gain, while Finland, New Zealand and Denmark posted losses. Trade optimism and economic stabilization did little for China itself (its A share index finished up only 1% after giving up 6.5% gains on profit taking). While Russia returned 4% on continued oil gains and decreasing post-Mueller sanction odds, outlier emerging market losses included Lebanon (-6%), Nigeria (-6%), Pakistan (-5%) and Argentina (-12% on increasing concerns over President Macri's reelection odds and subsequent default risks).

Economic Reports

As the month progressed, estimates of first-quarter growth steadily increased on reports that, while not as strong as the headline numbers might suggest, gave every indication that U.S. growth was declining (but not precipitously), global manufacturing was bottoming and the Eurozone was finally recovering. The International Monetary Fund (IMF), always a lagging indicator, further reduced its global growth estimate for 2019 from 3.5% in January to 3.3%, the lowest since the 2008 great financial crisis. First-quarter-U.S. growth was expected to be in the 1.5% range, a sharp fall from the 2.2% in the fourth quarter, on plunging consumption growth. Subsequent to that report, estimates increased as (1) the Institute for Supply Management (ISM) services index was consistent with 2% growth, (2) payroll growth approached 200,000, (3) manufacturing stopped contracting, (4) March core-retail sales spiked 1% month-over-month (more than double consensus) and(5) core capital goods orders increased 0.4% month-over-month. To cap off the month, first-quarter growth came in at a remarkable 3.2%. While inflated by a non-recurring surge in inventories (0.7%) and net exports (1.0%) that will detract from growth next quarter, the underlying momentum is intact with second-quarter consumption expected to grow at a 3% rate.

The international backdrop was upgraded in both China and Europe as Chinese manufacturing stabilized and Eurozone domestic growth surprised to the upside. Given that global manufacturing should stabilize (with a lag from China), the question now is less one of further downgrades to growth and more whether it will inflect upwards or merely maintain its subdued level. The global manufacturing sector saw welcome signs of relief early month as China's Purchasing Managers Index (PMI) rebounded to an eight-month high, Germany's industrial production surprised to the upside and Eurozone industrial production fell much less than expected (with January revised upwards). China's reported first-quarter growth of 6.4% modestly beat expectations; more importantly, industrial production grew 8.4%, the most since July 2014. U.K. quarterly growth checked in at a respectable 0.3%, despite the continuing soap opera that is Brexit (its deadline was extended to October 31). The last day of the month brought a Eurozone surprise as growth increased to 0.4% quarter-over-quarter, up from 0.2% and well above trend levels. While forward-looking surveys cast doubt that this level can be sustained, unemployment fell to 7.7%, the lowest since 2008 and even Italy moved out of recession. Finally, with Chinese Vice Premier Liu He expected to return to Washington May 8 to finalize details such as the signing venue, investors' trade optimism seemed quite justified.

Interest Rates and Inflation

The release of the Federal Reserve Open Market Committee (FOMC) minutes highlighted that 2019 rate hikes are off the table despite forecasted continued above-trend growth and inflation close to the symmetric 2% target. After officially removing 50 basis points (bp) from its "2019 dot plot" and leaving only a single 25bp hike this rate cycle, the market swiftly priced in two rate cuts by the end of 2020. While the April growth numbers were encouraging, the Federal Reserve Board (Fed) is worried that its failure to increase inflation may become self-fulling, as decelerating inflation begets lower out-year inflationary expectations, undermining the Fed's credibility. While believing the concerns to be overdone, I am forced to admit that recent reports continue to support the Fed's perspective. Core inflation checked in at a 13-month low of 2.0%, with a month-over-month increase of only 0.1%, driven by increased sampling of internet pricing. Core inflation has annualized at only 0.7% the past three months. Perhaps even more surprising was that core consumer services were unchanged month-over-month as the productivity spike to 2.4% kept unit labor costs in check (offsetting wage growth).

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Foreign central banks, faced with not only an inflation shortfall but also growth concerns, not surprisingly tilted in a dovish direction. The European Central Bank (ECB) pushed back the timing of the first possible rate hike into 2020 saying that the recovery had been delayed but not derailed. President Draghi's further promise of an additional round of term lending to banks was met with internal resistance as being an incentive for Italian budget profligacy. The Bank of Japan, despite concerns over the bank credit transmission system, pledged to maintain both short and long rates at very low levels. It added that both growth and inflation risks were tilted towards the downside, noting that there were few signs of financial excess outside of the real estate sector. The Bank of Canada decided that future growth concerns trumped trailing wage and inflation pressures. It guided towards a continuation of accommodative rates given an unexpected slowdown in the employment and real estate sectors.

Despite dovish central bank guidance, safe haven bonds retreated as risk appetite returned, leaving benchmark global bond yields significantly higher as credit spreads continued to tighten. The combination resulted in Treasury returns of -0.3%, investment grade corporate returns of 0.5% (as spreads fell 9bp to 111bp) and global high-yield gains of 0.8%. Municipal bonds gained 0.4%, with noteworthy outperformance in the longer maturities. Higher yielding municipals gained 0.5%. The Treasury curve steepened with the three-month bill anchored as longer dated yields increased 10-12bp and fell 1.8%, giving back some of the March gain.

Global treasuries returned -0.6%, with benchmark 10-year yield increases of 19bp for U.K. gilts and 8bp for German bunds (now back in positive territory at 0.01%). Peripheral-country yields benefitted from the stronger Eurozone growth reports, with Portuguese and Spanish yield falling 10-15bp, although Italian yields increased 7bp on deficit concerns. High yield continued its strong run, with U.S. issues gaining 1.4%, led by the lower rated (CCC) segment at +2.3%. Emerging market debt was mixed, with the Global Diversified index gaining 0.2% despite modestly higher local yields and lower currencies.

Currencies

The dollar was little changed in maintaining its gains of the past two months, as the dovish Fed stance was offset by increasingly positive news in the retail sales and housing sectors. The safe-haven currency bid retreated, with the Swiss franc falling 2% to a two-year low. The Japanese yen's 0.5% fall was cushioned by encouraging China numbers and trade optimism. The British pound finished unchanged after a late-month rally spurred by rate-hike hopes. The Swedish krona, a remarkably undervalued currency and one predictably sensitive to global growth, unexpectedly fell 2% after the Riksbank (world's oldest central bank) guided towards an extended period of negative rates after the economy contracted 0.3% in the first quarter, the largest decline since the financial crisis. Similarly, the Korean won fell 2% as Asia's weakest currency approached a two-year low after negative first-quarter growth on falling exports and weak semiconductor demand.

Emerging market currencies were mixed with gains for the Ukrainian Hryvnia (+4% on hopes that a reality television star would be elected President), the Russian Ruble (+2% on higher oil prices and reduced sanctions risks) and Mexican peso (2.5% on optimism with respect to trade and the new administration's macroeconomic orthodoxy). The Turkish lira fell 7% as the decision to challenge important local election results suggested that populist policies would continue.

Commodities

Depending on the sensitivity to oil prices, commodity indices lost 1% (Bloomberg) or gained 3% (GSCI), with the CRB index unchanged. Energy posted its best April year-to-date since 2009, with gains in crude (+7%) and gasoline (+9%) more than offsetting a weaker natural gas market (-4%) as OPEC shipments fell to a 33-year low and monthly output decreased for the fifteenth straight month. Despite the publicity, crude oil failed to respond to President Trump's surprise termination of the waivers on Iranian exports, perhaps suggesting that the announcement had been anticipated by the market and that the Iranian response is expected to be measured. More probably, the termination announcement simply offset a contemporaneous increase in U.S. inventory levels. Growth optimism drove gain 5% platinum gains, although gold and silver fell 1%. Agriculture and industrial metals both fell 3%, with hogs (+6%), cocoa (+5%), coffee (-4%), lead (-5%), soybeans (-5%), nickel (-6%) and aluminum (-6%) noteworthy movers.

May Positioning

While economic reports month-to-date have been mixed and Fed Chairman Powell argued that the hoped-for rate cuts would not be forthcoming, the market moving event has been President Trump's May 6 announcement that China had backpedaled on previously agreed terms and that the U.S. would raise tariffs on imports from China. As of mid-May, global equities markets had given up precisely 100% of April's gains, with performance varying as a direct function of their exposure to the unexpected setback (US -2%, developed international -3% and emerging markets -5.7%). Safe-haven assets have rallied once again, with the Japanese yen and Swiss franc up 1% and Treasuries (and especially municipal bonds) quite strong. Other risk assets are weaker, with emerging market currencies down 1% and high yield giving up much of last month's gains.

Despite the headline blowout April jobs number of 263,000 (versus 190,000 consensus) that saw the unemployment rate fall from 3.8% to 3.6%, economic reports were decidedly mixed. The unemployment rate fell only because a decline in the labor-force-participation rate. Manufacturing surveys suggested that stabilization will come with a lag as the U.S. survey saw new-orders growth fall below inventory growth and German manufacturing remained stuck at recent lows. Nonetheless, nothing seemed inconsistent with second-quarter growth in the 1.5%-2.0% range and monthly job growth of 150,000, more than enough to further tighten the labor market.

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The surprise May 6th tariff announcement threatens the macro-economic context, which was benign yet fragile, as the stabilization of global manufacturing was more a well-supported forecast than a reality. China's growth is more likely to stabilize than inflect and the Eurozone (and consequently, world financial markets) can scarcely afford increased recession risks given Italy's precarious position. I believe that a trade agreement will be reached. While it is true that the relationship is further complicated by the North Korean missile launch and by the surprise Iranian waiver move, the U.S. could give China the face-saving ability to implement an agreement through regulatory action (instead of law).

Since we had (prematurely) counseled selling into this year's rally after a rather strong call to purchase the most cyclic equities back in December, the pullback is not unwelcome. But it is not sufficient to merit aggressive buying given that indices are up 19% despite little improvement in forecasted earnings, leaving price-to-earnings ratios elevated at close to 19X.

From a short-term game theory perspective, it is hard to see that the Fed can lose by sitting tight. Should productivity gains continue to offset increasing wages, the Fed can claim to be extending the record long expansion. Should those gains prove ephemeral, allowing wage gains to translate into inflation gains, the Fed can say it was part of its plan to recession-proof the economy by allowing a period of above-target inflation. Should both the economy and productivity disappoint, the Fed can point to its foresight in halting the hiking cycle early.

What is the endgame of running perpetually accommodative monetary policy such that government-bond yields remain well below nominal growth rates? Where exactly are the signs of financial excess so often batted about? While inflation upticks and the consequent Fed response ultimately trigger most recessions, if inflation does not pick up, the tightening of the labor market to levels far below the natural rate of employment may itself plant the seed for the next recession.

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