Insights: May 2019

Market Overview and Performance

Although it may seem like some time ago already, the month of April proved to be a very friendly one for investors. In short, economic data appeared solid, the feared "earnings recession" never materialized and negotiations regarding a trade deal between the US and China progressed to the point where many assumed that a positive agreement could have been reached by the end of the month. As we entered May, that narrative shifted meaningfully. While the fundamental trends remain strong, the trade talks have taken a notable turn for the worse, causing a justifiable increase in anxiety among invertors. As *The Economist* wrote in their recent special report, the nature of the dispute has devolved quickly. "Fighting over trade is not the half of it. The United States and China are contesting every domain, from semi-conductors to submarines and from blockbuster films to lunar exploration. The two superpowers used to seek a win-win world. Today winning seems to involve the other lot's defeat - a collapse that permanently subordinates China to the American order; or a humbled America that retreats from the Western Pacific. It is a new kind of cold war that could leave no winners at all." This is clearly the danger many including ourselves had always feared. While real consequences of these actions have already occurred, it is important to highlight the fact that matters can still be worked out. In fact, the market seems to whole-heartedly believe that this will be the ultimate outcome. When things began to unexpectedly unravel in early May, the reaction in US equity markets was a sell-off of just over -4 percent, hardly what one would characterize as panic selling. While this is reassuring, given the entrenched positions of both sides, a quick resolution still appears elusive. As always, thank you for reading our latest Insights.

	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	**4.05**	**18.25**
Russell 2000 Index	3.40	**18.48**
MSCI EAFE Index	2.81	13.07
MSCI Emerging Markets Index	2.11	12.23
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.03	2.97
Barclay's U.S. Aggregate Credit Index	0.61	**8.52**
Barclay's U.S. Aggregate Corporate High Yield Index	1.42	**8.78**
Barclay's Municipal Bond Index	0.38	3.28
Macro Measures		
Gold	-0.99	0.34
Crude Oil	**6.28**	**40.74**
CBOE Volatility Index	**-4.30**	**-48.39**
USD Dollar Index	0.21	1.36

Current Theme – Trade War Begins in Earnest – Both the US and China Ratchet Up the Rhetoric and Retaliatory Tariffs

While This Has Always Been the Market's Biggest Fear, Investors Seem to Refuse to Believe that Both Parties will Commit to Enacting Irrational Measures

With an April total return of over 4 percent, the S&P 500 has started off 2019 with four straight monthly gains. As a result, in just 120 calendar days, the Index has risen almost 25 percent off of the December low and completely recouped the almost -20 decline which occurred during a 95 day period in late 2018. It would be hard to argue that this rapid "V-shaped" recovery could have been any cleaner or more symmetrical.

S&P 500 Has Recouped the -20% Loss from Late 2018

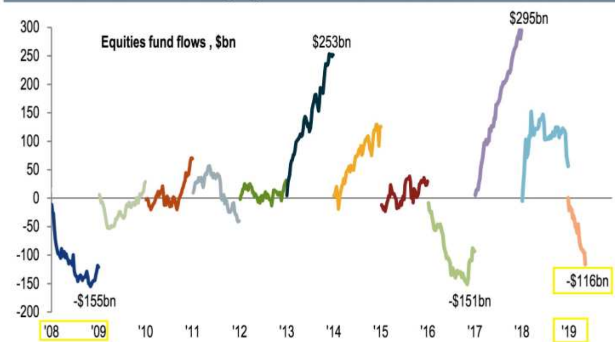
Source: Bespoke Investment Group

And, as we pointed put last month, the current path of the market is tracking right on top of previous non-recession -20 percent declines which occurred in 1994, 1998 and 2011. If one to were to take the chart below at face value, the average movement of the previous years would suggest that the S&P 500 could reach the 3100 level by the end of the summer. Incredibly, that would represent an almost +32 percent return off of the December low. However as the chart below highlights, rather than chase the market higher, investors have been taking money off of the table. As Morgan Stanly stated, the equity withdrawals thus far in 2019 have been the largest since the start of 2008. From a contrarian point of view, this is a positive sign since it suggests that there is little "over exuberance" present in the market despite the large gains achieved.

Current Path Still on Track of Past Post -20% Recoveries

Source: FMRCo; Bloomberg; Haver Analytics; Facset

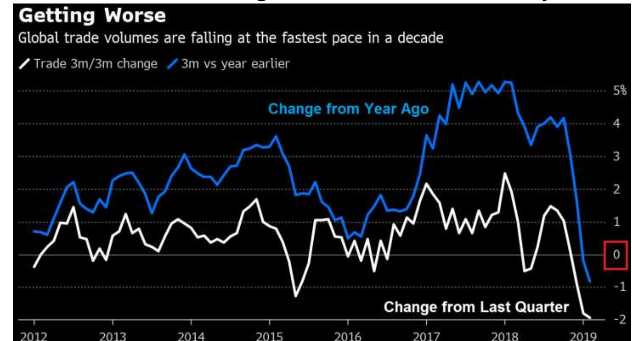
Early 2019 Has Seen Largest Equity Outflow Since 2008



Source: Morgan Stanley

From a more macro perspective, it is perhaps not surprising that funds are coming out of risk assets like US equities given the pace of the trends like the ones below. To be frank, global trade volumes are falling off a cliff. According to Bloomberg, on a quarter over quarter basis, trade has fallen by almost 2 percent and down 1 percent from one year ago.

Trade Volume Declining at Fastest Pace Since May 2009

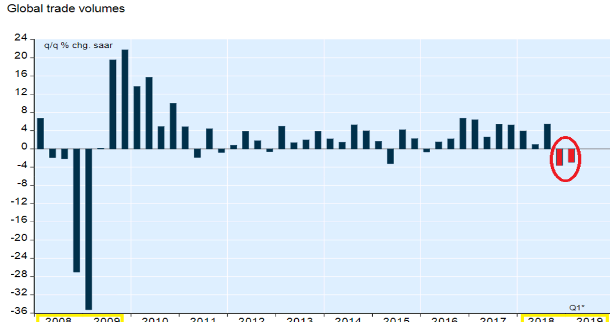


Source: CPB World Trade Monitor; Bloomberg

While those numbers themselves do not sound large, the sharp decline of the trend lines themselves tell the story of the rapid negative shift occurring.

One can get a better sense of the context here from the chart below – essentially, outside of recession, it is unusual to find quarterly declines in trade volume.

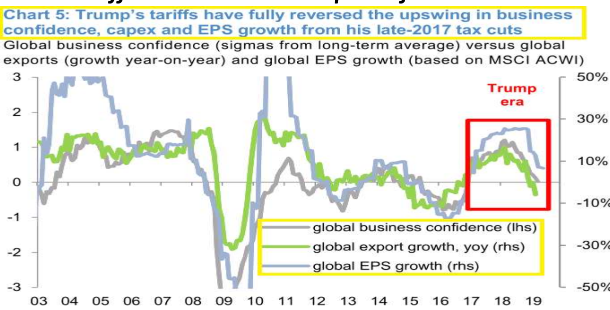
Current Declines in Trade Volumes Not Seen since 2008-9



Source: NBF Economics and Strategy

Unfortunately, as JP Morgan points out in the chart below, it is not just trade volumes that have slowed. According to their research, the current tariffs in place have almost completely reversed the globally positive impact on business confidence, capex spending and EPS growth that germinated out of the late 2017 corporate tax cuts in the United States.

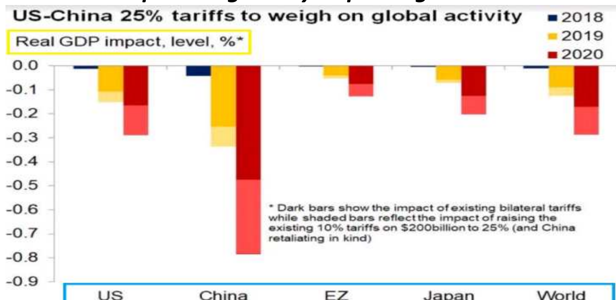
Trade Tariffs Have Reversed Impact of 2017 Tax Cut



Source: JP Morgan

The tariff impact is also starting to be felt in overall growth as GDP activity slows across the globe.

US-China Dispute Negatively Impacting Global Growth



Source: Oxford Economics

This is helpful in reinforcing the notion that the effects of trade tariffs are not isolated to the two nations directly involved in the negotiations. China plays a key role in what the OECD terms as a "Global Value Chain". Essentially, China imports a large amount of components from other nations, (most notably Japan, Taiwan and South Korea), and then compiles those inputs into finished goods. These products are then exported to other countries, namely the US.

China Reliant on Rest of Asia to Feed the Supply Chain

Source: MacroBond Financial; Markit Danske Bank; Daily Shot

What that means is if the US places a tariff on laptops coming from China, that also essentially increases the cost of business for South Korea who supplied the memory chips. Given this, it's not hard to envision how tariffs can quickly eat into trade growth across the globe. This not just a US/China problem in other words. Incidentally, the uptick in exports to China from other Asian countries is a welcome development. Unfortunately, the chart below illustrates that there are potentially more significant headwinds coming. As of now, roughly $400 billion in goods are being tariffed by either China or the US, however, another $400 billion worth of tariffs will be put into action shortly.

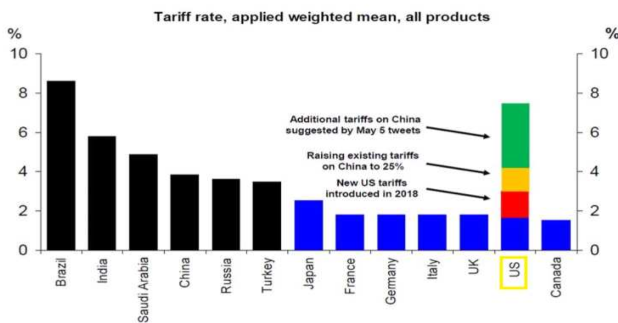
$400 Billion in Goods Now Tariffed Set to Hit $800B Soon

Source: Oxford Economics

According to Deutsche Bank, if the US chooses to follow through on its threat to tariff another $300 billion or so of goods, overall US tariffs levels – already well beyond most developed economies - would be among the highest in the world.

US Poised to Become One of the Most Protectionist Econ.

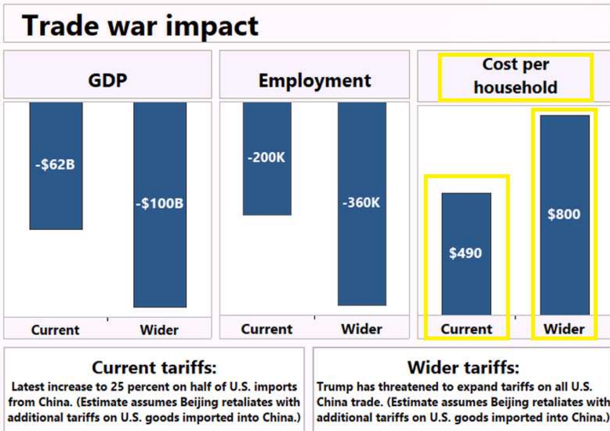
US tariff levels would move well above EM levels



Source: Deutsche Bank Research; World Bank

As we have stated in the past, tariffs are not paid by the exporting country, they are paid by the importer of the goods who must then find a way to deal with increased costs, usually by raising prices. This is a tax on the end consumer and its effects are real. Consider the chart below from Oxford Economics.

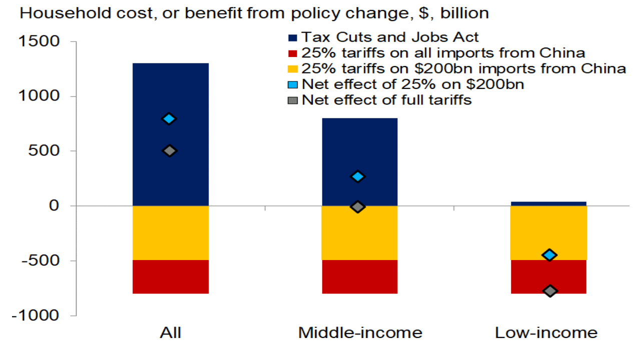
Tariffs Costing Avg Households Between $490 and $800



Source: Oxford Economics

In their analysis, the current tariffs in place have already cost the average American household $490 additional dollars this year. If the next round goes into effect, that cost will shoot up to $800. For context, the Federal Reserve has calculated that the average middle class family could not afford an unexpected $400 expense. One could argue that the recent tax cuts have muted this impact. Oxford Economics has looked at this data as well and found that the tariffs would totally wipe out the benefits of the tax cuts (blue bars) or worse for lower income households (grey diamonds).

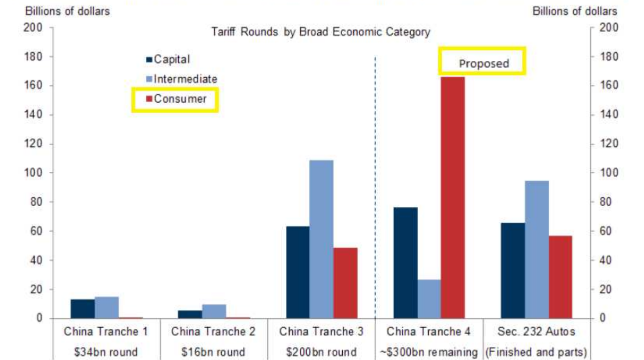
Trade Tariffs Could Potetially Wipe Out Tax Cut Benefits



Source: Oxford Economics

There is also another factor at play here which is, "What are the actual goods that have tariffed so far?" In large part, they have been intermediate goods, or those used in the manufacturing of other finished goods. With the escalation of the US tariff policy to include an additional $300+ billion worth of items, consumer goods, or basically the everyday items commonly bought by households, will now be priced significantly higher. As the chart below from Goldman Sachs illustrates, up to this point, these consumer goods have intentionally been largely left out of the implemented actions.

Consumer Goods Set to Become Large Portion of Tariffs

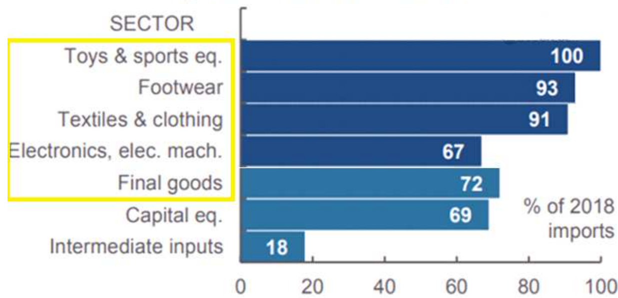


Source: Goldman Sachs Invetement Research

So the estimated cost of $490-$800 already paid by families this year is likely to go much higher.

To give an idea about what kind of goods we are talking about, look at the chart below from Scotiabank. As they point out, roughly 70 to 100 percent of things like shoes, clothes and electronics are imported and set to be included in the list of tariffed Chinese items.

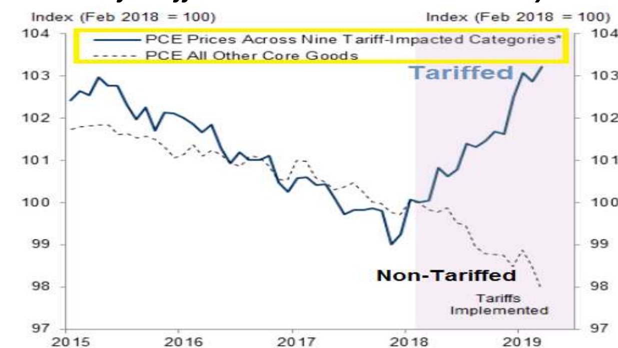
Next Round of Tariffs Will Shift to More Consumer Goods



Source: Scotiabank Economics; PIIE.

Another key issue is the actual tariff level itself. For example, on the roughly $200 billion of tariffed goods, the rate has been set at 10 percent. The US buyer of the item could in theory negotiate a 3 percent price cut from his Chinese manufacturer, eat 3 percent of his profit, and pass on a 3 percent price hike to customers. The chart below from Goldman Sachs suggests that this type of counter-tariff shift in price curves has been occurring. The prices of tariffed goods are up by a little over 3 percent while the prices of non-tariffed goods have actually declined since 2018. The main problem is that a US company simply has no way to absorb the impact of their tariff bill going from 10 percent to 25 percent.

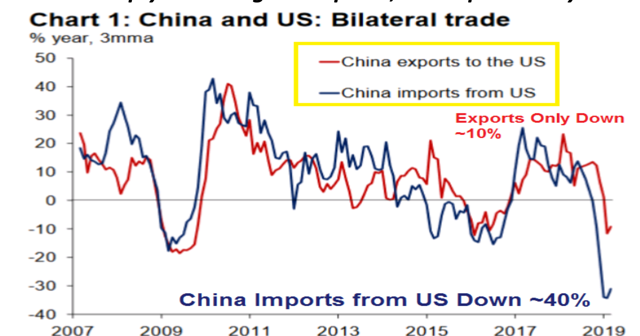
The Cost of Tariffed Goods Has Risen Dramatically



Source: Goldman Sachs Investment Research

While we are sympathetic to the argument that China will feel the impact of decreased demand for their now pricier goods, as we have stated in the past, Americans still want to purchase a lot of what China makes. Conversely, China does hold some leverage regarding what they import from the US as well. As the chart below highlights, China imports from the US are down by roughly -40 percent over the past year while China exports to the US are only down -10 percent over the same time period.

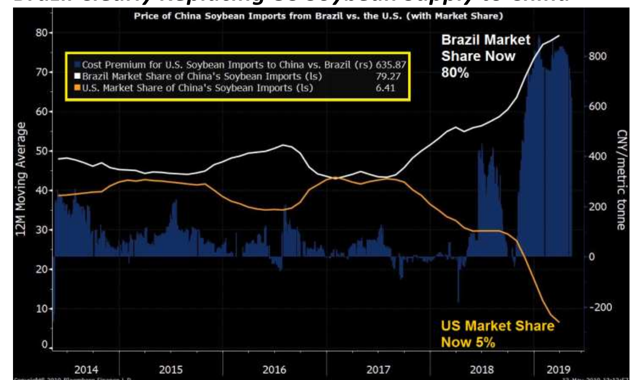
China Sharply Reducing US Imports; US Exports Only -10%



Source: Deutsche Bank; Haver Analytics

Granted, this has a lot to do with the nature of what China buys from the US – namely agricultural products. However, this also highlights an area where they are able to push on a pressure point. Consider the chart below from Bloomberg. At the end of 2017, the US and Brazil were each providing China with roughly half of their required soybean demand. Since that time, the US share of the market has fallen to just 5 percent while Brazil now provides over 80 percent. Additionally, Brazil now has a cost advantage of roughly 800 Chinese Yuan per ton over the US. This is exactly the type of unintended consequences of a trade war which can permanently alter global supply chains – often to the detriment of incumbents (US).

Brazil Clearly Replacing US Soybean Supply to China



Source: Bloomberg; 361 Research

Going Forward

As we have discussed over the recent months, the sentiment driven market sell-off at the end of 2018 did not alter the fundamental dynamics of the global economy which remain generally positive. However, there is strong reason to believe that the remainder of 2019 may prove more challenging as the global supply chain and consequent growth, is threatened by the total disruption resulting from escalating tariffs. Developments, either positive or negative, do not occur overnight, so this risk is well appreciated by market participants. For the time being, the consensus view is that both sides remain motivated to find common ground, particularly with the US election coming in 2020. As such, we are constructive on the near-term outlook for risk assets, but would anticipate some largely sideways price movement over the summer months as negotiations evolve. A resolution of trade disputes could clearly lead to a more bullish shift for the end of the year and into 2020.

With that outlook in mind, we would emphasize the technology, financial and industrials sectors as we look out toward the remainder of the year. We view the 4th quarter declines as a benefit to the technology sector in 2019 as valuations and earnings expectations were both notably reduced. Technology names, viewed as vulnerable to trade, have also been disproportionately hurt in the recent downtrend. Financial names are very reasonably priced after substantially underperforming the S&P 500 Index for much of 2018 and trailing thus far in 2019. We feel that this is overdone, and with many valuation metrics reaching multiyear lows, several quality large cap names are attractive in our view. The industrial sector stands to benefit from a likely positive outcome to the trade disputes which have handicapped global growth. In fact, despite the threat of disruption to the global supply chain, the sector is still up almost 20 percent year to date.

After sharp declines at the end of last year, small and mid-cap stocks remain attractive in our view despite outperforming their large cap counterparts since the decline in late 2018. These companies are generally less impacted by trade tariffs, making them a good counterbalance to companies exposed to the global supply chain. As of the end of April, both the Russell 2000 Small Cap Index and the Russell Midcap Index were up more than 18 percent for the year to date period, and both ahead of the return S&P 500 over the same time frame.

With the recent weakness in the US, equity markets outside of the US are even more compelling in our view. Non-US markets remain much more accommodative in their monetary policy endeavors. Importantly, valuations are substantially lower than the US – at multi-decade lows in some cases. This, combined with the fact that growth rates outside of the US are expected to outpace those anticipated domestically, make non-US markets attractive. We have favored emerging markets equites for quite some time. The asset class suffered in 2018 from both a strong US dollar and trade tensions. However, their valuation and growth levels are compelling, and PMIs (a reflection of economic health) across emerging markets as a group are now expected to exceed developed markets for the first time in many years.

The flattening yield curve is far and away the largest source of unease for many fixed income investors. With a re-visiting of a yield curve inversion in early May, concerns over a dramatic slowdown in growth and even a recession sometime in the near future are still top of mind for many. We have written about these concerns in the past and are also wary to a certain degree, however, at this time, we do not see the eminent worries as valid. The data simply does not support that scenario just yet. For our fixed income exposure, we continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We also favor municipal bonds and short-term corporate bonds based on the belief that the opportunity in these segments provides a better relative value.

Small allocations to gold and non-precious metal commodities continue to serve us well as a diversifier in portfolios during equity market fluctuations.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.

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