Insights: August 2018

Market Overview and Performance

At first blush, July was a fairly encouraging month. Broadly speaking, both global equities and bonds managed gains and volatility declined. We even saw some rotation out the large technology names and a funneling of those gains into underperforming value sectors. But unfortunately, there are challenges in the system right now that are only getting worse. At the forefront, we have escalating trade wars and an unstable situation in Turkey. Fed Chairman Jerome Powell, summarized the current deteriorating trade environment, saying; “We hear from our extensive network of business contacts a rising chorus of concern. As you pointed out, lots and lots of individual companies have been harmed by this. We don’t see this in the aggregate numbers yet because it’s a $20 trillion economy, and these things take time to show up, but we hear many, many stories of companies that are concerned and are now beginning to make investment decisions, or not make them, because of this.” Even with no resolution to trade wars within sight, the market has now tuned its focus squarely to Turkey. There are many issues occurring with Turkey at the moment which we will discuss, but Russell Napier, Macro Strategist at research firm ERIC, provided some enlightening commentary on the importance of the situation. "Just to put it in context: the amount of money borrowed by Turkey is similar to the amount of money that was borrowed by Bear Stearns-it's about $400 billion. Lehman Brothers was $600 billion, so that puts it in context. This is a big number and it's lent from outside the system so it does have issues for financial stability, particularly in Europe and we need to make that clear."

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	**3.72**	6.47
Russell 2000 Index	1.74	**9.54**
MSCI EAFE Index	2.46	-0.36
MSCI Emerging Markets Index	2.20	**-4.61**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.02	-1.59
Barclay's U.S. Aggregate Credit Index	1.50	**-4.98**
Barclay's U.S. Aggregate Corporate High Yield Index	1.09	1.25
Barclay's Municipal Bond Index	0.24	-0.01
Macro Measures		
Gold	-1.03	**-5.44**
Crude Oil	-0.28	**18.29**
CBOE Volatility Index	**-25.41**	13.95
USD Dollar Index	-0.16	2.51

Current Theme – US Equity Markets Remain Near All-Time Highs, but Trade Wars and an Unstable Situation in Turkey Threaten the Status Quo

The Trade Tariff Stand-Off Intensified in July and Now Turkey Poses a Further Challenge to Global Growth

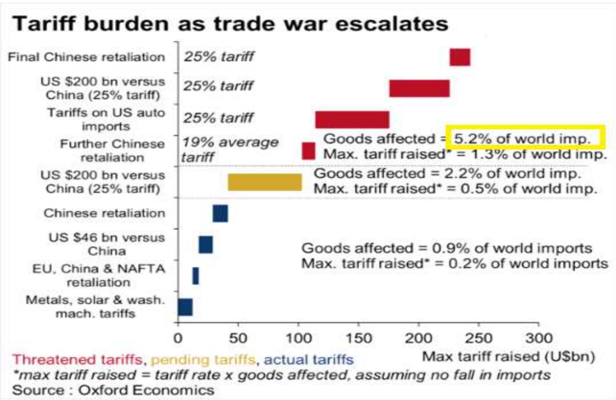
On a positive note, as of August 22nd, the current bull market will become the longest on record, surpassing the nine and a half year run-up in prices from October 1990 through March of 2000. As LPL Research, the author of the chart below says, it's just a number, but it reflects the resiliency of stocks through the tumultuous times following the Global Financial Crisis.

On August 22nd, This Will be the Longest Bull on Record

Source: LPL Research; Facset; CFRA

Unfortunately, as the chart below highlights, this Bull Run is being tested by an ever increasing game of retaliatory trade tariffs that now would impact over five percent of total world imports. And while some would have you believe that these measures are inconsequential at those levels, it's simply not true.

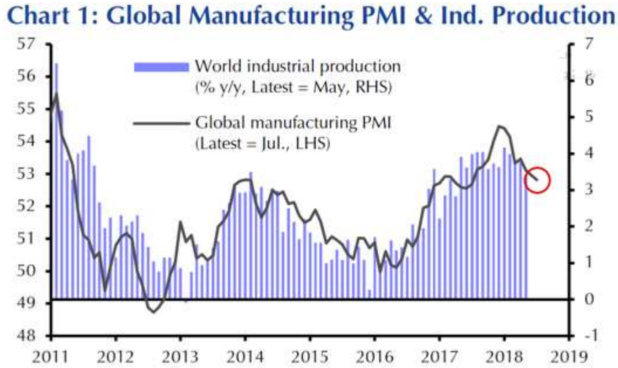
The Escalation of Trade Tariffs Has Progressed Rapidly



Source: Oxford Economics

As the chart below clearly shows, even though only a small proportion of the threatened tariffs have been implemented, global production and manufacturing is falling notably. This is because as Mr. Powell noted, behaviors are being altered as input costs, supply chain disruptions and market supply and demand dynamics are being artificially manipulated. The result is simply a reduction in global economic activity.

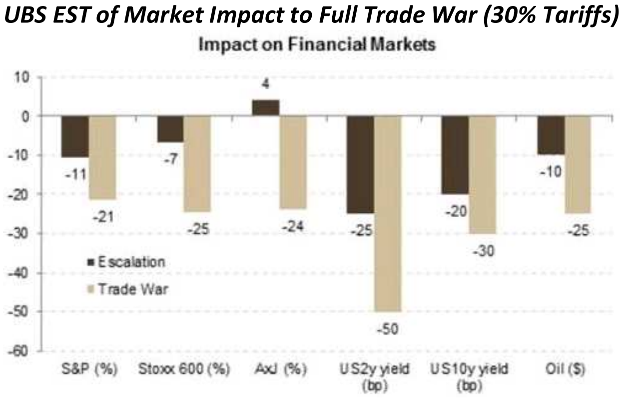
Global Economic Activity is Already Suffering from Tariffs



Source: Markit; Thomson Reuters; Wall Street Journal

We have written about how tariffs function as a tax on consumers and how they slow the gears of the global economy, but they can also spiral out into other areas and cause further economic damage. Consider the study from UBS below. By their estimates, the impact of a trade war escalated to 25 percent on goods would cause U.S. stocks to decline 11 percent and other asset classes to fare worse. A full out trade war, which they define as 30 percent tariffs, would result in U.S., European and Asian stocks all declining between 21 and 25 percent. US Treasury yields would also be impacted. Even if discounted by 50 percent, these projections imply a huge amount of value destruction.

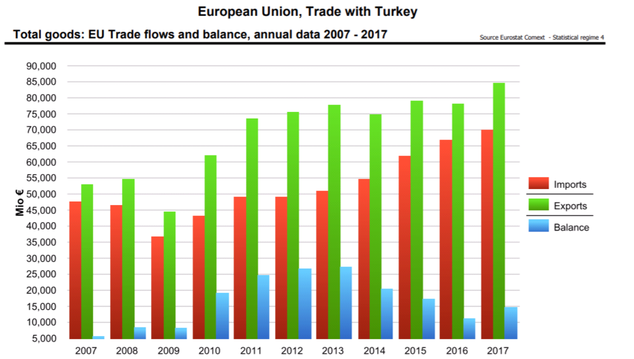
UBS EST of Market Impact to Full Trade War (30% Tariffs)



Source: Driehaus Capital; UBS

The odds are still in favor of new trade deals being worked out among various parties, so a full out trade war is certainly not being priced into markets. As of just a week ago, neither was a potential emerging markets crisis, however all eyes are now on Turkey.

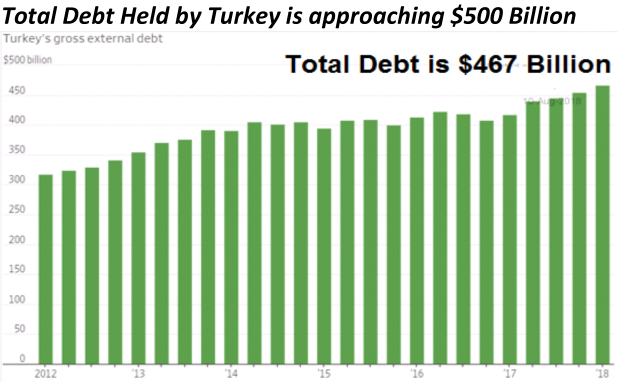
Overall Trade Between EU and Turkey is $180 Billion



Source: Marketwatch; European Commission

Structural problems have been in development for years in Turkey, but essentially, Turkey has survived off of its ability to attract foreign capital. They import most of their goods and natural resources and therefore need the foreign funds to offset their current account deficit. This system worked while President Erdogan promoted a pro-business secular economy which pushed the Lira higher, the deficit lower, and resulted in booming economic growth. As one can see from the chart above, trade with countries within the EU has been robust, growing to over $180 billion worth of goods as of the end of 2017. This makes them the fifth largest EU trading partner in the world, trailing only a few heavyweights like the U.S. and China. But there was a cost to pay for this booming growth – a huge mountain of ever growing debt.

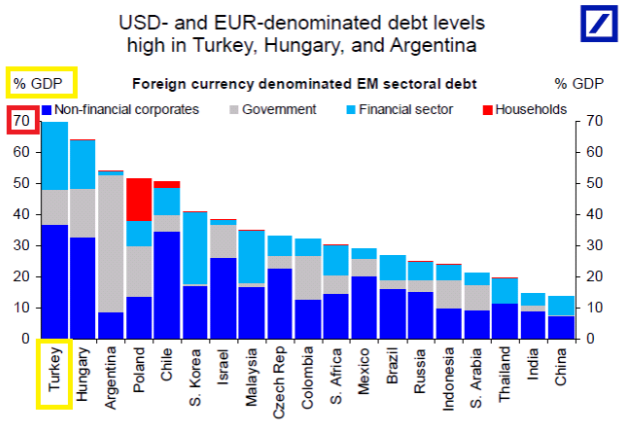
Total Debt Held by Turkey is approaching $500 Billion



Source: Wall Street Journal; Turkish Treasury

And Turkey has plenty of it, close to $500 billion as the previous chart shows. Now to be clear, $500 billion is a big number. But perhaps more important is the measure of how that absolute debt number compares to the size of the overall economy. As you can see below, Turkey's debt as a percentage of GDP is 70 percent, well beyond most other significant emerging markets.

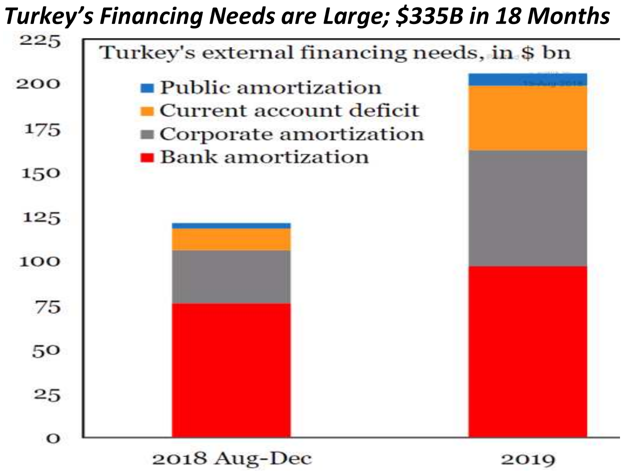
Turkey's Debt to GDP at 70% - Higher than Other EM's



Source: Deutsche Bank; IIF

Importantly, most their debt is held by corporate entities, so unlike Argentina where most of the debt is held by the government, Turkey faces more complex challenges should they need help in handling their debt burden. And right now, they need a lot of help. The chart below succinctly illustrates the problem – over the next 18 months or so Turkey needs to finance $335 billion dollars in maturing debt obligations.

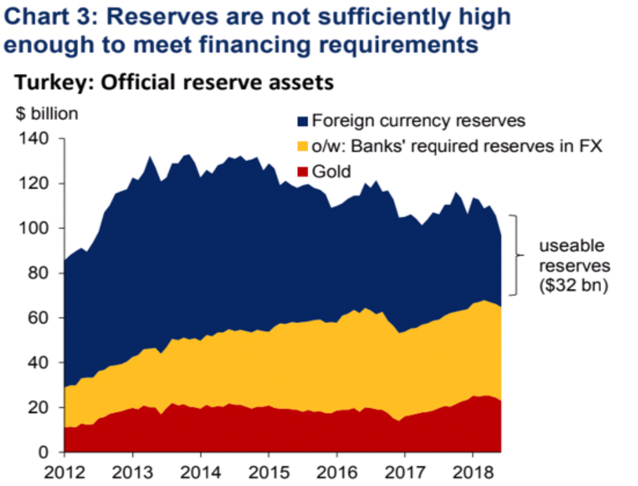
Turkey's Financing Needs are Large; $335B in 18 Months



Source: Guardian; Haver Analytics; IIF

Again this is an astoundingly high number, but more importantly, the debt is "foreign-currency denominated" based which means it is U.S. dollar based. The problem here, and for other emerging market countries, is that when the U.S. dollar surges, as it has, and their local currency declines, which it has, the financing becomes ever more expensive. And in fact, Turkey does not hold anywhere close to the amount of useable reserves required to meet their needs.

Reserves Too Low to Meet Financing Needs - Only $32B



Source: Oxford Economics; Haver Analytics

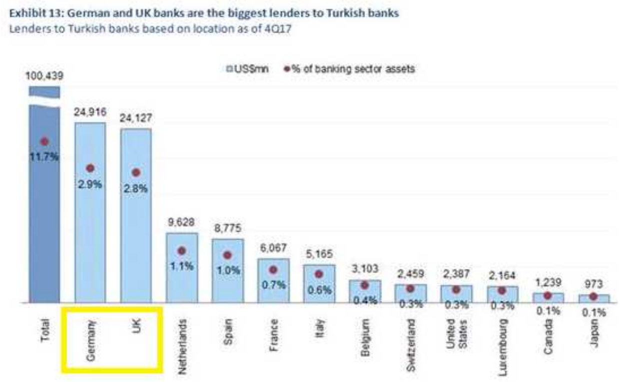
So there is clearly an issue of stability here and the current fear is that this problem will not remain contained within Turkey. As one can see below, Spain, France, Italy, the UK and Germany all hold significant amounts of Turkish debt. It is important to note that Turkey is not part of the EU so a Greece style rescue package from that body is not possible.

Many Large EU Economies Hold Substantial Turkish Debt

Source: Thomson Reuters; BIS; Capital Economics

There is also further concern among investors that the entire European banking system may be in a more precarious position than previously thought. As highlighted below, Germany and the UK are the primary lenders for Turkish banks. If loan defaults begin to develop in Turkey, the peripheral impacts could spiral out to other large economies quickly.

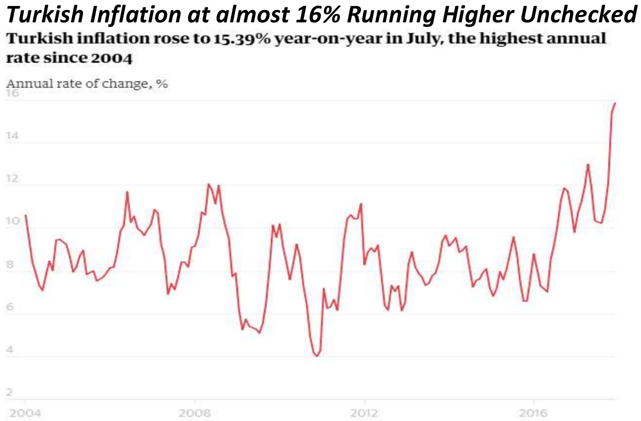
There is Concern Over Risk in the Global Banking System



Source: Driehaus Capital; BIS

What has changed recently is the shift by Erdogan to a more autocratic style of rule, his replacement of the Head of Economic Policy with his son-in-law, and his steadfast refusal to increase interest rates. Doing so would greatly help combat what is shown below – soaring inflation which is now close to 16%. Typically, in past similar situations, central banks raise rates aggressively to help shore up their currency and make their local debt more attractive to foreign buyers. Erdogan has in fact done the opposite, holding interest rates steady and in fact stating his belief that lower rates would be preferable method of action in his view.

Turkish Inflation at almost 16% Running Higher Unchecked



Source: Guardian; Turkish Statistical Institute

This response is very worrisome to investors and they have acted accordingly. As the chart below very clearly demonstrates, investors have aggressively shed their exposure to both the Turkish currency and Turkish bonds, driving 10-year government bond yields north of 21 percent. This generally only makes things worse.

Turkish Bond Yield Skyrockets While Currency Plummets

Source: Bloomberg; 361 Capital

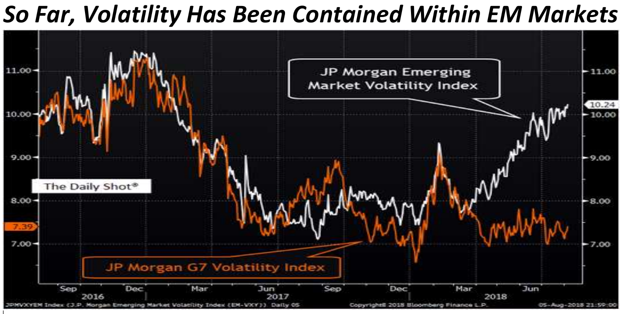
All of these developments are no secret to the market. As seen below, the credit default swaps for Turkish government debt, essentially a reflection of what you would have to pay to insure against a government default, has risen meaningfully this summer.

Turkish Credit Default Swaps Moving Significantly Higher

Source: The Daily Shot; Bloomberg

Other investor behavior is displaying a fear of contagion as well. Emerging markets volatility has increased substantially while developed market volatility has remained remarkably stable.

So Far, Volatility Has Been Contained Within EM Markets



Source: Bloomberg; JP Morgan

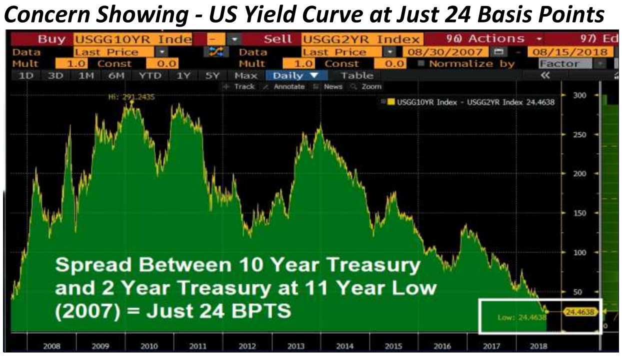
Importantly, investors are also acting on their perceptions of risk by re-allocating capital. As one can see below, institutional investors have aggressively moved away from exposure from emerging markets and European equities and shifted dramatically into the "safe-haven" of U.S. equities.

Investors Are Sharply Shifting Allocations Toward US

Source: IIF; CPM

While a resolution to the situation remains unclear, the most likely scenario, given that it is in all parties' best interest would be some combination of a rise in Turkish interest rates, capital controls (which the market does not like), and/or an IMF bailout. There are issues with all of these measures and the current relations between the United States and Turkey does not help matters. Additionally, there are talks of either Qatar or Russia stepping in to assist Turkey. In the meantime however, the bond market continues to tell us that overall risk level of the global economy is moving higher and not lower. The U.S. yield curve has continued its flattening trajectory and the spread between the 10-year and 2–year treasury bonds now stands at just 24 basis points, a level not seen since 2007.

Concern Showing - US Yield Curve at Just 24 Basis Points



Source: Lisa Abramowicz' Bloomberg

Going Forward

The resilience of the U.S. equity market that has persisted throughout much of 2018 looks like it may be at the beginning stages of showing fatigue. However, ironically, the difficulties created by the disruptive nature of the trade tariffs and the potential of contagion spilling over from Turkey have only made U.S. equities more attractive in the eyes of many. With the U.S. dollar spiking to multi-year highs and interest rates climbing higher, traditional safe havens like gold and bonds are not appealing to investors. However, as we have written about for much of the year, evidence of slowing global growth, a relentlessly flattening yield curve and the reverberating impact of trade tariffs, now combined with a potential emerging markets crisis, lead to a very challenging path moving forward. We continue to believe that the downside risk is being underestimated by most investors.

Within US equities, we continue to favor the information technology, financial and energy sectors, particularly in light of the rising inflation we are seeing. The technology sector continues to display very strong sales growth and profitability. Financial names are still reasonably priced and will benefit from a raising rate environment and a reduction in their tax rates and regulations. The energy sector continues to benefit from a move off of its lows last summer which should help the bottom line of energy companies for the remainder of the year. A new area of interest for us is healthcare. In general, these names are less impacted by trade issues, and after lagging for much of this year, health care names are now outperforming the S&P 500 in 2018. With valuations still reasonable in many areas of the sector, we will be adding where appropriate.

With the potential damage to global trade that tariffs represent, domestically focused small and mid-cap stocks are attractive in our view. Small cap stocks in the Russell 2000 Index experienced considerable multiple compression during the February sell-off making their valuation levels compelling versus their large-cap counterparts. Importantly, smaller non-global companies are generally less impacted by trade tariffs, making them a good counterbalance to internationally exposed companies. As evidence of their beneficial characteristics, the Russell 2000 Index is up 3.2 percent since June 30th, while the S&P 500 is flat.

As the protectionist stance of the U.S. becomes more entrenched, equity markets outside of the US are compelling in our view. Even with the political and Turkey oriented issues, Europe and Japan are seeing their past simulative policies now bearing fruit in terms of economic growth and inflation. This has directly translated into better earnings for companies located in these regions. They remain particularly attractive since valuations are lower than the U.S. and expectations are much more reasonable. Japan especially is seeing inflation and wage growth improvements that have been absent for decades. We have favored emerging markets equites for much of this year however, they are the most impacted by interruptions in global trade and U.S. dollar strength so we remain vigilant. Even more so now that Turkey has highlighted the difficulties faced by countries with large debt balances and a weakening currency.

Our biggest concern in the fixed income market is the flattening yield curve. With the yield curve at its flattest level since 2007, the bond market is suggesting that apprehensions about future growth are justified and that the Fed will continue on its path of raising short term rates. Additionally, the new supply of treasury bonds in the second half of this year will be an astounding $739 billion, a figure only matched in the dark days of 2008. This should push yields even higher with an increasing dependence on foreign buyers. As a result, we continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We continue to focus our exposure on municipal bonds and short-term corporate bonds and believe that the opportunity in these segments provides a better relative value.

Gold has been hampered this year by the strong move up in the US dollar. While we continue to hold some exposure as a diversifier, other areas of the commodity complex are more appealing given rising inflation.

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.