Insights: July 2018

Market Overview and Performance

And so it begins. The dangerous path toward a full blown trade war, which we have written about over the past few months, has been opened with the implementation of tariffs this month. The US began with the first round of tariffs in June which were unsurprisingly met by retaliatory actions by China, the European Union and others. The US quickly responded with fresh tariffs on an additional $200 billion worth of goods. It does not take long to realize how rapidly these actions can spiral well beyond the original design and truly hamper global trade. While most pundits have suggested that matters will remain contained, we are less sanguine. As Maury Obstfeld, the IMF's chief economist stated recently, "The risk that current trade tensions escalate further — with adverse effects on confidence, asset prices and investment — is the greatest near-term threat to global growth." He continued, "If current trade threats are realized and business confidence falls as a result, global output could be 0.5% below current projections by 2020…The U.S. is especially vulnerable because it may find a relatively high share of its exports taxed in global markets." Perhaps most worryingly, there appears to be little evidence suggesting that any side would be willing to back down. In fact, US Treasury Secretary Steve Mnuchin said trade talks with China "have broken down." This leaves us with concerns for the second half of 2018.

On another important note for us personally at Litvak & Co. - we have moved! After four years at our original location, we opened a new larger office space to better accommodate future growth. Please feel free to contact with any questions or requests for a visit.

	Month to Date	*Year to Date*
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	0.62	2.65
Russell 2000 Index	0.72	**7.66**
MSCI EAFE Index	-1.22	-2.75
MSCI Emerging Markets Index	**-4.15**	**-6.66**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.12	-1.62
Barclay's U.S. Aggregate Credit Index	-1.19	**-6.38**
Barclay's U.S. Aggregate Corporate High Yield Index	0.40	0.16
Barclay's Municipal Bond Index	**0.09**	-0.25
Macro Measures		
Gold	-4.00	-4.37
Crude Oil	**9.59**	**18.52**
CBOE Volatility Index	4.10	**31.39**
USD Dollar Index	0.69	2.66

Current Theme – US Equity Market Still Resilient While the Bond Market Signals Caution as the Trade Wars Become Reality

"Past the Point of No Return" - Tariffs from Various Regions Go Into Effect Resulting in the Announcement of Even Larger Tariff Programs

As we have said throughout much of 2018, it is remarkable that the US equity market has maintained a mildly positive trend thus far in 2018. After the whipsaw action of January and February, the market has settled into a trading range around the opening levels of the year.

S&P 500 Has Been Range Bound For the First Half of 2018

Source: Thomson One

Despite this fairly resilient reaction to various threats globally, the reality is that only a few stocks are actually holding up the entire market. Consider the table below. Amazon, Netflix and Microsoft alone account for *71 percent* of the S&P 500 return for the year. Throw in three more tech bellwethers, and you quickly get to the full index return for all of 2018 being generated by just six names.

Top Six Tech Names Account fort Entire Market Return

	% of S&P 500's YTD Returns	% of Nasdaq 100's YTD Returns	YTD Change
Amazon	35%	41%	49%
Netflix	21%	21%	117%
Microsoft	15%	15%	19%
Apple	12%	12%	13%
Alphabet	8%	8%	11%
Facebook	8%	8%	16%
Top 3	**71%**	**78%**	
Top 4	**83%**	**90%**	
Top 6	**98%**	**105%**	

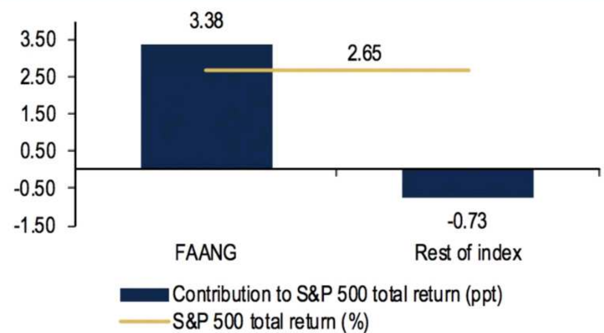
Source: @HumOnTheMarkets; Carl Quintanilla

One might be tempted to look and that table and think, "Well yes, a huge company like Amazon being up 49 percent in six months will influence the index return." But the market really is as narrow as the table would suggest. Looking below, BofA Merrill Lynch finds that if you exclude the "FAANG" stocks, the return for the index is actually *negative* in 2018.

Excluding FAANG; Market Return is Actually Negative

Chart 5: Excluding FAANG stocks, index returns would have been negative

FAANG stocks' contribution to the S&P 500 1H18 total return



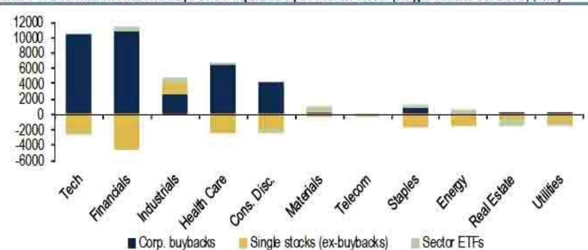
Note: FAANG = FB, AAPL, AMZN, NFLX, GOOG/GOOGL
Source: S&P, BofA Merrill Lynch US Equity & US Quant Strategy
Source: BofA Merrill Lynch US Equity Strategy; Trevor Noren

We see other confirmations of this trend as well. For example, numerous equal weighted measures of various equity indices are much weaker than the cap indices which suggest that the average stock is trailing the performance leaders by a significant amount. Further, as BofA Merrill Lynch points out below, the only buyers during the first half were corporations buying back their own stock (dark blue bars). Single stocks and ETFs actually saw outflows (yellow and gray bars). That is not what happens when the market is healthy and there is appetite for broad participation.

Corporate Buybacks Were Only Buyers of Stocks in 1H18

Chart of the week: 1H sector flows

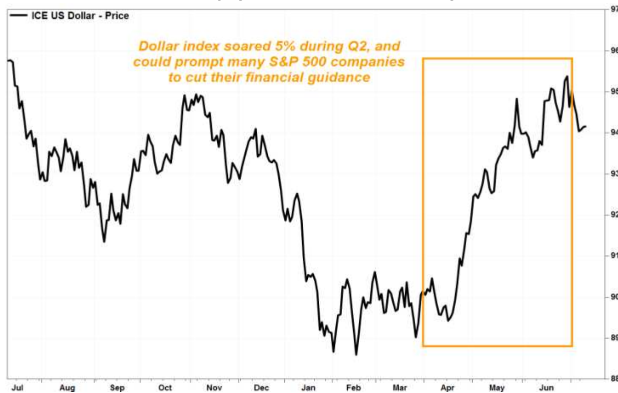
Chart 1: BofAML clients net buys of US equities by sector in 1H18 (single stocks vs. ETFs, $mn)



Source: Bank of America Merrill Lynch
Source: BofA Merrill Lynch US Equity Strategy; Zero Hedge

Again, we would stress that this a good first half of the year given all of the macro headwinds. Yet, as we look to the latter half of the year, we see that many of the feared concerns earlier in the year are starting to become reality. Look at the US Dollar - it was up five percent in the second quarter. This hurts companies with revenues being derived outside the US and may hinder earnings. Already, Coca Cola and Carnival Cruises have announced that the dollar will shift from a tailwind into a headwind for them in 2H 2018.

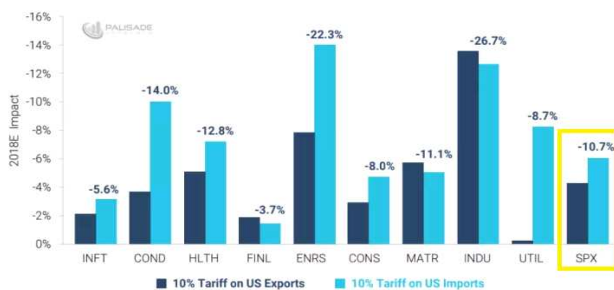
US Dollar Rose Sharply in Q2 = Headwind for 2H18



Source: Factset; Marketwatch

And of course, now we are faced with the reality of trade tariffs slowing down growth. In the chart below from Barclay's research, they estimate that announced tariffs will negatively impact S&P 500 earnings by almost 11 percent this year. Goldman Sachs reached a similar conclusion with their data. And while some sectors will clearly be impacted more that others, (Energy, Industrials, etc.) the influence on earnings growth will most certainly be negative in all areas.

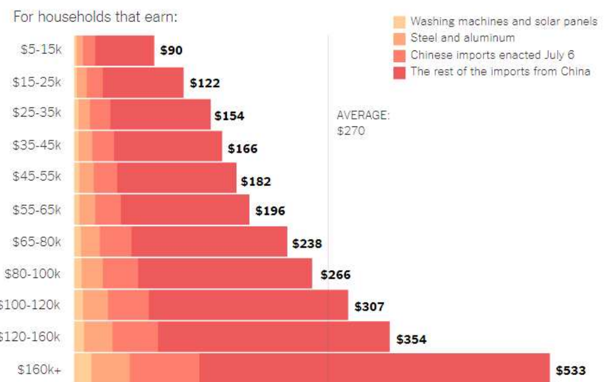
Estimate For Tariff Impact on Earnings is Almost -11%



Source: Barclay's Research; Palisade Research

While we often speak about economic conditions for companies, tariffs are immediately felt by end consumers. Data from researchers at Princeton and London School of Economics suggest that price increases could hit $270 for the average US family this year. And supporting anecdotes are now becoming more frequent. Toyota for example, has said that the cost of the average Camry will increase by $1800.

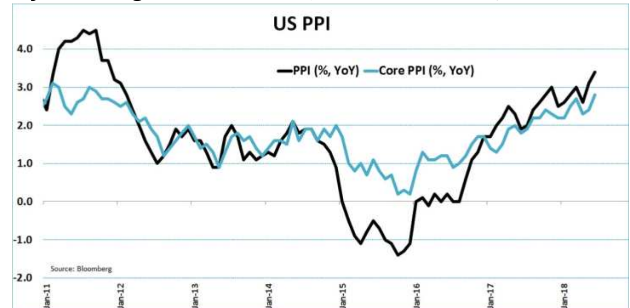
Average Cost of Tariffs to US Households May be $270



Source: New York Times

Paying more for a car or a washing machine due to tariffs is not a pleasant experience for consumers, but the effect is compounded by the fact that we now have inflation increasing across the board. As the chart below demonstrates, producer prices are now increasing at a rate of 3.4 percent and the prices paid by consumers is now growing at 2.9 percent.

Inflation Highest Since 2011; PPI Now + 3.4%, CPI +2.9%



Source: Bloomberg; Jeroen Blokland

As the following chart shows us, this is becoming a problem. As prices for goods and services are rising, combined with the additional "tax" on goods brought about by tariffs, wages are not increasing at all.

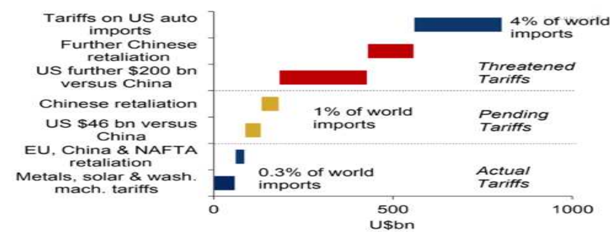
Real wage growth has been in decline for three years and is now *negative* when inflation is taken into account. Consumers feel this acutely and as you can see consumer confidence, on the rise since late 2016 is now moving sharply lower.

Real Wage Growth (Inflation Adjusted) Now Negative

Source: Zero Hedge

Those confidence measures are not likely to improve anytime soon unfortunately with the ratcheting up of trade war tensions. As the chart below highlights, while the actual amount of tariffs levied have been small on a global scale, the escalation of retaliatory actions mounts quickly.

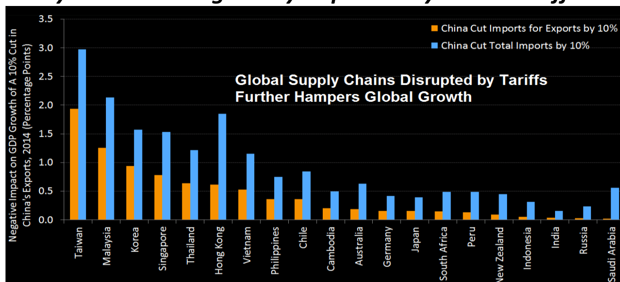
Tensions and Reactions Escalate Quickly in Trade Wars



Source: Oxford Economics; Wall Street Journal

And while not specifically targeted, other nations within the global supply chain suffer as well, making overall global growth more challenging to achieve.

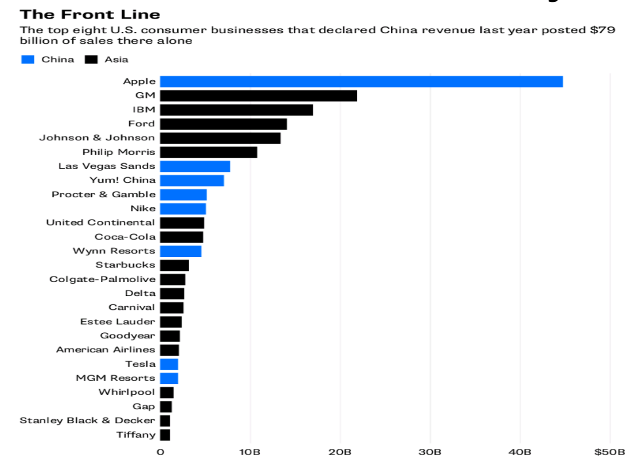
Many Countries Negatively Impacted by Trade Tariffs



Source: Bloomberg; OECD Economics

That being said, as of now, the main event seems to be between the US and China. Much has been written about the fact that China will not be able to match the US tariffs simply because they don't import nearly as much stuff as Americans do from them. However, China holds a quite a bit leverage on several fronts. From a purely consumer standpoint, China is now the largest retail market in the world at over $6 trillion dollars. It is therefore a very important market for many major US consumer brands as one can see from the chart below.

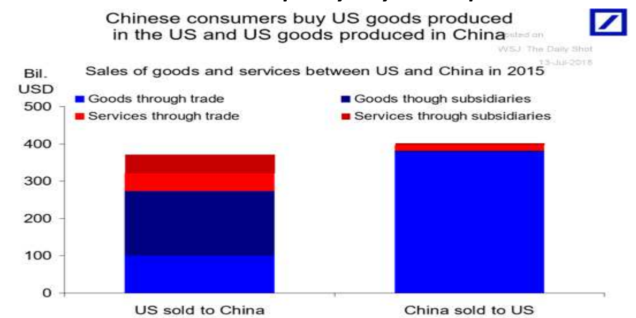
US Cos. are Vulnerable to Chinese Consumer Changes



Source: Bloomberg

If Chinese consumers shy away from US brands in an organized way, as they have done in past, the reverberations can be swift. For example, when consumers were encouraged to stay away from South Korean goods as they were for a time in 2017, Hyundai's market share was cut in half in less than a month. This could occur completely outside of the tariff policy. But its not just trade – look at the services goods that move through subsidiaries in China.

China Has Retaliation Capacity Beyond Imported Goods



Source: Deutsche Bank Research

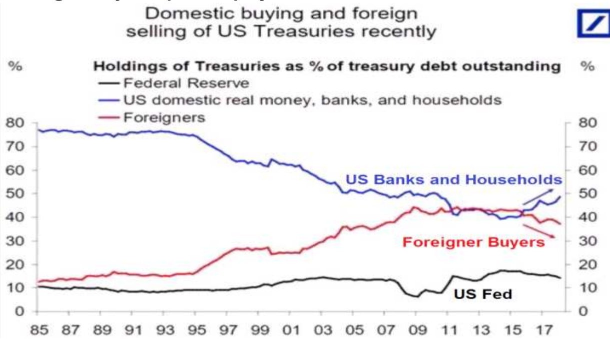
Other measures are at their disposal as well. A weaker currency makes their goods more competitive globally and fluctuations are easier to digest when the currency is managed by the government as is the case in China.

Chinese Yuan Has Weakened in 2018 – Helps Their Trade

Source: Deutsche Bank

The most strategic weapon available to China is the US Treasury market. The US is absolutely dependent on foreign buyers to fund its exploding debt levels. As David Rosenberg, Chief Economist and Strategist at Gluskin Sheff, stated recently about the tariffs, "The end-game retaliation comes via a global boycott of the Treasury auctions. Foreign entities fund half the US fiscal deficit, which is set to double. Imagine the locals funding their own budget gap! This forces the savings rate up at the expense of spending. Recession follows."

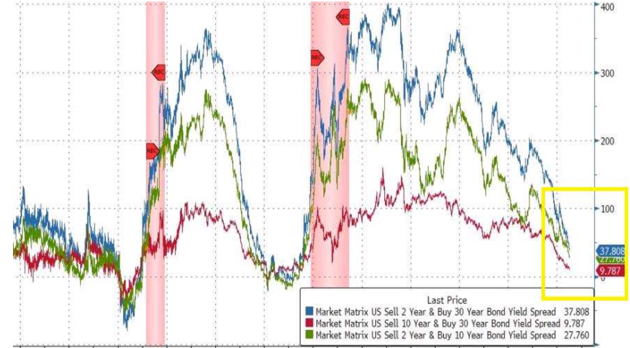
Foreign Buyers (China) of US Debt in Decline



Source: Deutsche Bank

Unfortunately, as the chart above demonstrates, foreign buyers of US treasuries, once the largest constituent of all holders, are in notable decline. In fact, the recent $33 billion of three year bonds auctioned on July 10th, showed the weakest demand since April of 2009. This has implications for future fundings and is one of the main contributors to the flattening of the yield curve which is now occurring at both the short and long end of the curve.

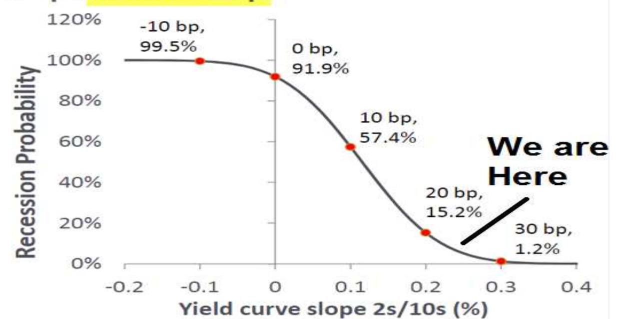
Both Long and Short Yield Curves Continue to Flatten



Source: Zero Hedge

We have discussed in the past how this indicator has correctly foreshadowed every previous recession. Although not likely in the near term, the chart below shows how the odds move substantially higher as the spread narrows. The current spread between the ten year and two treasuries is just 25 basis points.

Odds of Recession Becoming More Acute via Yield Curve



Source: Piper Jaffray

So despite what might seem like fairly rosy headlines in the news, there are clear concerns among investors. In fact, Federal Reserve Chairman Jerome Powell, very succinctly expressed this view in his testimony to the Senate Banking Committee this week stating, "We hear from our extensive network of business contacts a rising chorus of concerns. 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."

Going Forward

The market continues to look for direction as the US strategy regarding an endgame for trade tariffs remains completely unclear. The resilience of a sideways equity market with a slight positive tilt is therefore encouraging in our view. However, it is difficult to not be concerned about the continuing evidence of slowing global growth, a relentlessly flattening yield curve and the very real impact that just the first round of trade tariffs is already having on global trade. While second quarter earnings should support the notion that the first half of 2018 was strong, we are beginning to see evidence that the second half will be more challenging. That is not the scenario currently priced into the markets however. We continue to believe that the downside risk is being underestimated by most investors.

Assuming a benign environment for the time being, within US equities, we favor the information technology, financial and energy sector, 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. Given that tariffs will ultimately become the burden of consumers themselves, we are no longer positively inclined toward consumer discretionary names which have outperformed thus far in 2018 and are now expensive and vulnerable to worsening macro conditions.

With the potential damage to global trade that tariffs represent, domestically focused small and mid-cap stocks have become more 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. The Russell 2000 has outperformed the S&P 500 by 5.5 percent over the past three months.

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 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. This is particularly attractive since valuations are lower than the US and expectations are much more reasonable than the “priced for perfection” tone within the US market. Even in the face of recent US dollar strength, we also see long-term opportunity in emerging markets. As a group they are demonstrating strong profit growth, improved balance sheet stability, and very attractive valuation levels. Significantly however, emerging markets are the most impacted by interruptions in global trade and US dollar strength so we remain vigilant.

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 this year will be substantial, pushing 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.

Although gold has been hurt this quarter by a rising US dollar, we have maintained a position in gold in many of our portfolios as a non-correlated asset and continue to do so, adding when appropriate given the continued unsettled environment thus far in 2018.

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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