INVESTMENT STRATEGY
OUTLOOK

THE ECONOMY

Rate Cut Seems A Matter Of When, Not If

As of this month, the current U.S. economic expansion became the longest U.S. expansion on record. As the expansion began its 11th year, however, it wasn’t clear whether we should be celebrating its birthday or planning its funeral. That has nothing to do with the age of the expansion. Though it is common for people to assume that its advanced age means the expansion must be on the verge of ending, there is considerable evidence showing that the age of an expansion has little, if any, impact on the probability of entering a recession. For anyone not convinced, we’ll note that Australia’s current expansion began in 1991, rendering the current U.S. expansion a mere pup by comparison.

Though age is not one of them, there are reasons to wonder whether or not the current U.S. economic expansion will make it to its next birthday. The industrial sector of the economy has clearly softened, freight markets have shifted into a lower gear, the pace of job growth has slowed, and the yield curve, as measured by the spread between yields on 10-year and 3-month U.S. Treasury securities, has become inverted, which in the past has been a reliable predictor of recession, albeit with a lengthy lag. At the same time, global economic growth has slowed sharply and global business sentiment has clearly deteriorated. Lingering uncertainty over the course of trade policy is weighing on firms, here and abroad, which is likely acting as a drag on business investment spending.

When we published our 2019 outlook for the economy back in January, we noted that we expected to see slower real GDP growth and slower job growth than was the case in 2018. Those were fairly easy calls to make, however, given that the 2.9 percent growth in real GDP in 2018 was the strongest annual growth of the current expansion and that job growth actually accelerated in 2018. In that sense, that the pace of real GDP growth and the pace of nonfarm employment growth have slowed in 2019 is no surprise, but the more relevant question is whether these slowdowns are going beyond what we anticipated at the start of this year. Making it more difficult to answer this question is that businesses, both in the U.S. and globally, are struggling to adapt to a trade regime that can seemingly change quickly and without notice. So, while we expect that the current economic expansion will live to see another birthday, we’ll admit to being less confident in that call than we were a few months ago.

We clearly are not the only ones feeling less confident in our outlook for the economy. Having effectively adopted an easing bias at their June meeting and stating their intention to “act as appropriate to sustain the expansion,” for the FOMC the question seems to be when, not whether, they will cut the Fed funds rate. The financial markets have already answered the “when” question, with a cut in the Fed funds rate at the July FOMC meeting seen as a done deal. While we do expect the FOMC’s next move to be a rate cut, we’re not convinced this will come in July.

In late-June, we laid out a series of markers that we thought would go a long way towards determining the timing of the initial funds rate cut. Those markers were signs of progress on a trade agreement between the U.S. and China at the G-20 summit, signs that the U.S. manufacturing sector was beginning to stabilize, continued expansion in the services sector, and a solid June employment report. Our thought was that if each of these boxes was checked, it would be hard, or at least harder, to justify a rate cut at the July FOMC meeting. One could argue that each of those boxes has been checked, although admittedly at least some of the evidence is less than rock solid.

For instance, the U.S. and China agreed to at least keep talking, thus foregoing the “nuclear” option of higher tariffs applied to a much broader range of goods. At least for now, as there is no guarantee we won’t end up there at some future point. The ISM Manufacturing Index slipped a bit in June, but at 51.7 percent was better than expected and indicates continued, albeit slower, expansion in the manufacturing sector. The ISM Non-Manufacturing Index remains firmly in expansionary territory, thus helping allay concerns that the softening in the industrial sector has spilled over into the broader economy. Finally, the June employment report was much stronger than expected, with private sector payrolls rising by 191,000 jobs and job growth being more broad based across private sector industry groups than in any month this year. The June ISM Non-Manufacturing Index and the June Employment Report together tell us that the broader economy is still on solid ground despite uncertainty over trade policy and a slower pace of growth in the manufacturing sector. While not ruling out a rate cut at this month’s FOMC meeting, this does make a rate cut harder to justify on the grounds of the economic data.

Still, one can make a compelling case for a July rate cut on the grounds that the Fed funds rate is out of alignment with market interest rates. Market interest rates have been pushed lower, on the short end of the yield curve by expectations of Fed funds rate cuts, and on the long end by diminished expectations for U.S. economic growth and inflation, but also by steady inflows of foreign capital attracted by higher yields on U.S. dollar denominated assets. That many foreign central banks are set to add still more monetary accommodation will only reinforce these inflows, keeping upward pressure on the U.S. dollar and downward pressure on U.S. interest rates and inflation. Said another way, the FOMC is in the position of having to move to effectively stand still. On this basis, it makes sense for the FOMC to begin cutting the Fed funds rate sooner rather than later.

Source: BEA; BLS; ISM

STOCKS

Many Happy Returns, Now What?

June proved to be an excellent month to be an investor in global equity markets, with the most notable performance coming out of the S&P 500, which rallied 7 percent on a total return basis, recouping all of its losses from May and hitting an all-time high to close out the month. The Russell 2000 closed higher by a nearly identical figure as its large-cap counterpart, but on a price basis the small-cap index remained 10 percent behind its all-time high reached at the end of August, 2018. International markets closed higher month-over-month as well, with both the MSCI EAFE (international developed markets) and MSCI Emerging Markets indices rising 5.7 percent in price. Both indices have lagged the S&P 500 and Russell 2000 meaningfully year-to-date through June. This follows the 4th quarter of ’18 in which each of the four indices declined in price by between 7.4 percent and 20.2 percent. After experiencing strong absolute performance year-to-date, what’s next for stocks? Simplistically, how global equities close out 2019 will be largely influenced by just two variables: 1) a U.S./China trade resolution, or lack thereof, and 2) Federal Open Market Committee (FOMC) monetary policy expectations.

On trade, a meeting between President Trump and Xi Jinping, President of the People’s Republic of China, at the G-20 on June 29 led to a trade truce, with an agreement to halt new tariffs while negotiations are ongoing. Both sides appear to want a deal, but each leader is emboldened to stand their ground by hard-liners at home, making the path to
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a pact all the more difficult. Some speculate that China is “running out the clock” on the Trump presidency, banking on a losing bid for reelection and his replacement taking a softer stance. President Trump appears to have support from both sides of the aisle on this issue, while recent economic data out of China has softened, highlighting a potential miscalculation China may be making should they string the U.S. along. Consumer spending in China has softened despite stimulus efforts, and savers have plowed yuan into bitcoin as economic weakness is expected to be met with more stimulus and a weaker currency. President Trump’s focus on limiting the reach of Chinese telecommunications equipment giant Huawei, a company believed to have deep ties to the Communist party, could loom large in negotiations, and may provide the U.S. with leverage in talks.

On monetary policy, the FOMC’s dovish about-face in January was the initial catalyst for the rebound in stocks, and the Committee has provided the market with a calming message since. As investors, one potential problem remains that market participants continue to expect the FOMC to be extremely accommodative, even after a strong June nonfarm payrolls report, with between two and three quarter-point rate cuts in play by year-end. Admittedly, this is now more closely aligned with our expectation for two rate cuts through year-end, but we doubt that economic data down the road will term will weaken drastically enough to justify more than two cuts. Relative to where we were prior to the June nonfarm payrolls report, the market is now only slightly mispricing FOMC accommodation, and while monetary policy should be a major determinant of the U.S. economy, it will likely fall short of what’s presently shown in the Fed funds futures market. This may yet prove to be a case of “be careful what you wish for” - if FOMC policy does manage to meet or surpass current market expectations, the economy may already be in a place where rate cuts fail to quickly turn the tide.

With the global backdrop signaling “economic slowdown” at present, the longer U.S./China trade negotiations drag on, the more likely it is that a garden variety slowdown could turn into something worse. While economic data may not foreshadow a looming recession at present, should business confidence and/or consumer sentiment wane further we may ultimately worry ourselves into one. Monetary policy should remain supportive of equities, but stocks are already pricing in optimistic expectations for rate cuts in our view, making the bar to chin to exceed those expectations quite high. We are more likely to see how effective central bank policy support can be given already low rates, and without business and consumer spending holding up, rate cuts may largely be for naught. Rate cuts and a weaker U.S. dollar would benefit emerging markets on a relative basis, while U.S. multinationals would see a boost as well. International equities, particularly those in Europe, while appealing on a valuation basis, are under a constant cloud of uncertainty with regard to a number of high-level policy-making posts turning over there within the coming year, with the head of the European Central Bank (ECB) being the most notable. We remain overweight large-cap U.S. equities and emerging markets relative to our long-term targets, and we continue to carry an increased position in international developed market equities going into the back-half of 2019.

BONDS
Ashaw In A Sea Of Liquidity

The same risk-on renaissance that pushed the S&P 500 to all-time highs during the month of June also produced strong rallies in some riskier pockets of the fixed income universe as well. Corporate credit was a big winner during the month, with the Bloomberg Barclays U.S. Corporate and U.S. Corporate High Yield indices surging 2.45 percent and 2.28 percent, respectively. U.S. dollar denominated emerging market debt rallied 2.71 percent as the greenback weakened a bit amid hopes for a 50 basis point rate cut out of the FOMC at its July 31 meeting, an expectation that has waned as we enter mid-month.

While taking credit risk was a profitable position during June, risk-averse areas also fared reasonably well with the Bloomberg Barclays Aggregate Bond Index up 1.26 percent, and the Bloomberg Barclays U.S. Treasury Index rising 0.92 percent. In short, we failed to find a major gilts/bonds/bills/bond benchmark that provided a total return during the month. This is largely, if not solely, a function of ample global liquidity at present, and with the market expecting further accommodative central bank actions over the coming months, investors can either lock-in rates now or potentially be forced to do so at a lower yield down the road.

Depending upon the day and/or the data source, somewhere between $13 and $14 trillion in global sovereign debt now carries a negative yield, meaning that investors are paying governments to hold their money. The yield on the 10-year German bond hit an all-time low of -0.40 percent on July 4 after hovering around -0.30 percent for much of the back-half of June. The yield on 10-year French government bonds also broke decisively lower, hitting an all-time closing low of -0.13 percent on the 4th of July after teetering around 0.00 percent for much of the month. Our 2 percent or thereabouts 10-year Treasury bond doesn’t look half bad by comparison! Given persistently low yields abroad, it’s difficult to envision U.S. rates moving markedly higher near-term as overseas capital seeking out any positive return can find few if any places to put it. The “buy the dip” crowd that emerges quickly and in union every time corporate credit spreads have widened out of late.

From a portfolio perspective, we remain anchored to our strategic, long-term targets with regard to our fixed income allocations. We continue to like the opportunity set, both from a total return and diversification perspective, provided by emerging market debt, while favoring corporate issuers over sovereign entities at present. Treasury bonds in the belly and long end of the yield curve offer a lower expected total return for buffeting of rate cut expectations. As such, we think these securities should continue to act as a buffer for multi-asset portfolios when, not if, an equity sell-off spurs a bout of risk-off, making them difficult to avoid. Admittedly, corporate credit isn’t cheap, but the same could have been said for the prior three and a half years. It’s not lost on us that the carry (yield) on high yield bonds relative to Treasury securities is going to be increasingly difficult to ignore given already low interest rates across the yield curve. There are two variables worth monitoring that could be supportive of high yield bond prices through year-end: 1) the potential for multiple, precautionary FOMC rate cuts this year; and 2) stable energy prices even if the current economic slowdown persists due to rising geopolitical risks.

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