

ECONOMIC OUTLOOK

Summary

Whether we like it or not, escalating a tariff/trade war with China seems to be part of the administration's playbook and the policy is creating high levels of uncertainty. Companies must consider how to adjust supply chains, how much consumer and industrial prices will be impacted by the tariffs, how much of the price increase to absorb versus passing on to the buyer, etc. You get the idea. Real-time pricing mechanisms like stock and bond prices adjust to headline stories on a daily basis. This results in higher levels of implied and realized volatility.

The threat, and now reality, of a tariff/trade war has been with us for about the last 18 months but has recently escalated dramatically. Heavy export-reliant economies like Taiwan, South Korea, Japan, Germany and China have experienced a significant slowdown in the new orders and shipments of manufactured goods as supply chain relationships come under scrutiny. Although U.S. manufacturing has yet to move into contraction mode, measures of global manufacturing have been shrinking for two months. In fact, of the global purchasing manager indices (PMIs), 68% are below 50, which indicates a contraction. Their underlying components are weak as well. Thankfully, the measure of the U.S. service sector, which represents 85% to 90% of our economy, has remained above 50 even though it hit a three-year low this month.

An additional economic indicator worth following has been the aggregate hours worked for production and nonsupervisory employees. These hours have dipped at a 0.7% annual rate over the last six months, which indicates a weaker hiring trend in the coming months. To us, these are some of the factors that suggest that the second half of 2019 will be weaker than the first half, both domestically and globally. The longer the tariff/trade conflict extends, the slower GDP growth will be and the lower our interest rates will fall, with or without the Fed. No one knows exactly how this will end but returning to 3%+ rate of GDP growth seems unlikely anytime soon.

Positives

Private payrolls advance 156,000 last month, better than expected

Personal income and spending numbers have been consistent and positive the last few months

The Fed's favored inflation measure, the PCE Core Deflator, has been steady at 1.6% year-over-year

Negatives

ISM Manufacturing Index and new order components were weak and below the 6-month average

Decline in average weekly hours is equivalent to 375,000 lost jobs

Most recent Leading Economic Index reading was negative

Unknowns

The extent to which trade impasse alters long-term global trade

The impact of tariffs in wholesale and retail prices

EQUITY OUTLOOK

Summary

Domestic equity markets continued to grind higher in July and the S&P 500 index finished the month up 1.4% closing at an all-time monthly high. Anticipation of a rate cut by the Fed, continued trade discussions between the Trump administration and China and corporate earnings were the major drivers throughout the month. With the vast majority of companies already having reported, earnings results have generally been mixed with a number of multinational companies pointing to the trade environment as a significant headwind.

Equity momentum started to wane in the closing days of July. A solid jobs report gave markets pause that the Fed was unlikely to cut more than 25 basis points and steadfast U.S. economic fundamentals may not warrant significant or continued accommodative action. Fundamentals abroad, however, paint a much bleaker picture. The developed international MSCI EAFE Index lost 1.3% and the MSCI Emerging Market Index shed 1.2% for the month, as international markets extended their relative underperformance in 2019.

The Russell 1000 Growth Index climbed 2.3% in July and once again outpaced the 0.8% rise in the Russell 1000 Value. Given the choppy earnings results and forecasts, there were no clear trends from an economic sector standpoint. Consumer services (+3.4%) and information technology (+3.3%) were the top two performing sectors while energy (-1.8%) and health care (-1.6%) were the laggards.

Current market crosscurrents give investors reason to be optimistic but also cause to be cautious. Given equity valuations are slightly stretched historically, any misstep in trade discussions or by the Federal Reserve could result in a meaningful market pullback. Persistently low interest rates can support extended stock valuations for equity markets but the corporate earnings outlook suggests strength will have to come from other sources. As we head into the closing months of 2019, it may be up to the consumer, supported by recent wage gains, to drive the economy and propel equity markets higher.

Positives

Accommodative Federal Reserve

Resilient U.S. consumer

Negatives

Global economic slowdown

Investor sentiment overly optimistic

Unknowns

Stalled trade negotiations

Brexit path and impact

FIXED INCOME OUTLOOK

Summary

Interest rates traded in a relatively narrow range for the entire month of July as investors awaited the Fed's first rate cut in nearly 4,000 days. On the last day of the month, at the conclusion of their 2-day Federal Open Market Committee meeting, they delivered the well-telegraphed 25 basis point (bps) cut. While it was just as expected, during the following press conference Chairman Powell referred to the cut as a "mid-cycle adjustment to policy", as opposed to the "beginning of a lengthy cutting cycle." Although he tried to walk back the statement in subsequent answers, the markets began loudly voicing their displeasure. Equities and 10-year Treasury note yields declined while short rates increased. The curve flattening sent recessionary alarm bells ringing. The month ended before President Trump tweeted that he was preparing to apply a 10% tariff on all remaining Chinese imports, sending stocks and bond yields plummeting.

We have long espoused that the neutral Fed Funds rate is probably about the rate of inflation, implying two rate cuts, just to get to neutral, which seems appropriate given that inflation has been below target for the better part of the past decade. We would then throw in another cut as "insurance" against the softening economic data, disruptions and uncertainty caused by trade negotiations and risk of a Brexit-induced crisis in Europe. This would bring the overnight rate to a range of 1.50% to 1.75%. At that point, we believe the Fed can become data dependent. If a broad, all-encompassing trade deal is reached (unlikely anytime soon in our opinion) maybe no further cuts will be necessary. If the aforementioned risks develop, more cuts will be on the horizon. We acknowledge that rate cuts will not eliminate the uncertainties in the economy, but they can, at the margin, reduce concerns that the costs of funding will become incrementally onerous.

The yield of the 10-year Treasury note dropped 30 bps since the end of July as Trump tweeted about the new tariffs and China retaliated. Even in a lowest range, on these longer tenor bonds, since the Fall of 2016, we still believe U.S. fixed income assets represent an attractive relative value. Along with our rates, European rates moved lower as well. There are now over \$15 trillion in bonds with negative yields in Europe. Even the 30-year German rates were negative for a while. Not only does the U.S. have positive yields, it remains one of the few developed countries with a positive "real" interest rate (above the rate of inflation). While rates will ebb and flow, we believe that the likelihood of higher and lower rates are roughly symmetric at this point.

Positives

Economic momentum around the world is slowing

Trade tensions create uncertainties

Inflation unlikely to accelerate

Negatives

Real, inflation-adjusted yield is now sharply lower

Fed policy eases may be fully reflected in longer-term yields

China may be forced to sell bonds for U.S. dollars

Unknowns

Outcome of trade negotiations with China

Re-emerging tensions with North Korea and Iran