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Capital Market Perspectives – July 2018

Don’t Ignore the Chatter – a Trade War represents a Major Risk

There’s been a lot of sideways action in this year’s capital markets. We have had a couple of mini-corrections already but equity markets have done a remarkable job of ignoring some clouds on the horizon.

The big elephant in the room that investors have chosen for the most part to ignore is the possibility of an all-out global trade war.

What started back in February as aluminum and steel tariffs has delved into a war of words and escalation of tariffs between the world’s three largest economies of the US, China and Europe.

There is almost a sense of disbelief that this could be happening after decades of globalization. We are so used to the free flow of goods and services across borders that we hardly ever stop and think about where things are made. Is a Toyota Camry Japanese or a “Made in the USA” car from a company that so happens to be domiciled in Japan? Is your iPhone an American product or a product made in Asia for a US-based company?

Global companies such as Apple or Toyota operate in highly inter-linked global supply chain and sales channels. A trade war will be highly disruptive to global trade and manufacturing. Ultimately, an all-out trade war creates massive uncertainty and significantly lowers global economic growth going forward. According to Oxford Economics a trade war could cost the global economy $800 Billion.

Thus far we are operating in a kind of détente state. US Treasury Secretary Steven Mnuchin told Congress last week that talks with Beijing had "broken down" and the US was essentially waiting for China to offer concessions. Such a response by the Chinese government is highly unlikely to materialize.

A Trade War between the US, China and Europe has major implications for investors in both equity and fixed income markets. Capital markets tend to react negatively to uncertainty especially when the event (in this case a trade war) has not been observed in recent times.

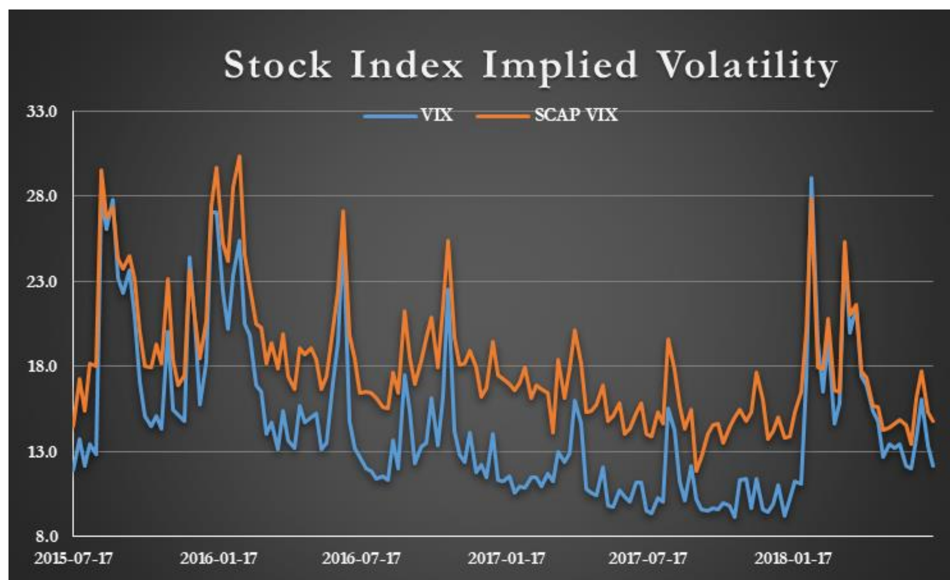
The first set of tariffs went into effect this month – **we are no longer hoping to avert a trade war, we are in one.** The only question is how long and deep this war will be.

Will cooler heads prevail before the damage to global economic growth is irreversible? Much of our economic system depends on trust and abiding by previously signed agreements – a Trade War will have longer term ramifications beyond simple dollars and cents.

What has happened so far this year in capital markets?

In general, investors have put blinders on and ignored the trade war chatter. Volatility in the markets while higher than last year has remained significantly below historical norms.

Figure 1

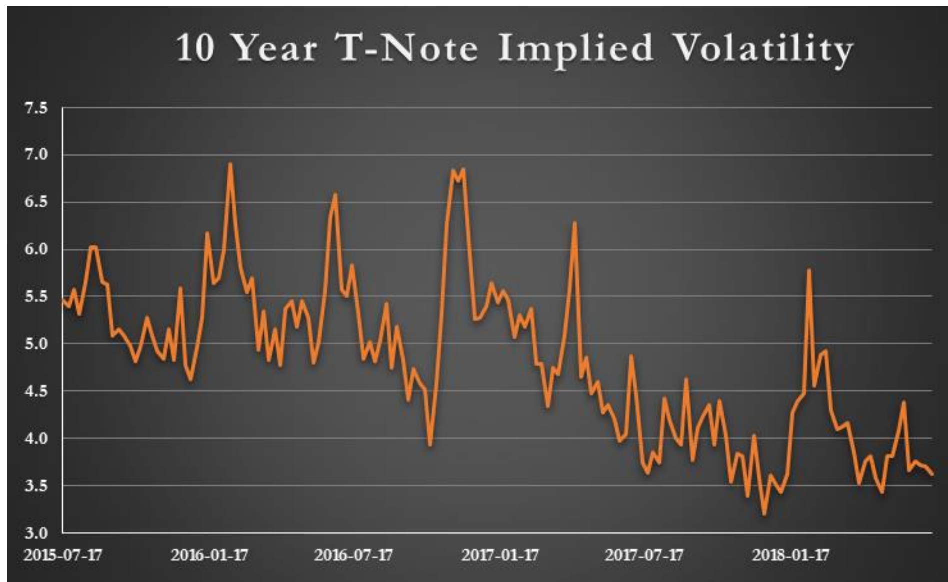


Source: Quandl, Fred Economic Data, Insight Financial Strategists, April 2018

We have had a couple of volatility spikes this year but as chatter of an eminent Trade War picked up capital markets have remained largely indifferent.

Asset class returns shown in Table 1 have likewise remained tightly range bound. This year we have, however, seen some significant reversals from last year. For example, emerging market equities, the best performing asset class of 2017, is currently the worst performer of the year.

Figure 2



Source: Quandl, Fred Economic Data, Insight Financial Strategists, April 2018

In general, this year all key asset classes have performed within tight historical norms with equities out-performing bonds once again. Much of the under-performance of international stocks and bonds has been due to the strength of the US dollar.

Table 1

ASSET CLASS	2018	2017	2016	2015	2014	2013	LAST 3 YEARS	LAST 5 YEARS
US LCAP	2.6	21.8	12.0	1.4	13.7	32.4	12.0	13.4
US SCAP	7.7	14.6	21.3	-4.4	4.9	38.8	11.2	12.5
INTL EQ	-2.8	25.0	1.0	-0.8	-4.9	22.8	4.7	6.4
EM EQ	-6.7	37.3	11.2	-14.9	-2.2	-2.6	6.1	5.0
COMMODITIES	10.4	5.8	11.4	-32.9	-33.1	-1.2	-3.7	-9.4
REAL ESTATE	0.5	5.3	4.9	6.4	34.6	-1.4	7.9	8.5
US BONDS	-1.6	3.5	2.6	0.6	6.0	-2.0	1.7	2.3
INTL BONDS	-1.2	11.3	1.6	-6.6	-2.1	-1.3	3.7	1.3
EM BONDS	-6.0	10.5	10.2	0.8	7.6	-6.4	0.0	4.9
CASH (1-3 YRS)	0.0	0.4	0.9	0.6	0.6	0.4	0.4	0.6
60/40	0.9	14.5	8.2	1.1	10.6	18.6	7.9	9.0

Source: iShares, Insight Financial Strategists, July 2018

US small cap equities and energy intensive commodity ETF's have outperformed this year. The outperformance of US small cap has surprised many market strategists but could be attributable to their lower international exposure.

Commodity indices have been propped up by the increase in oil prices this year but most commodities especially in the agriculture complex remain under duress in no small part due to the trade tensions.

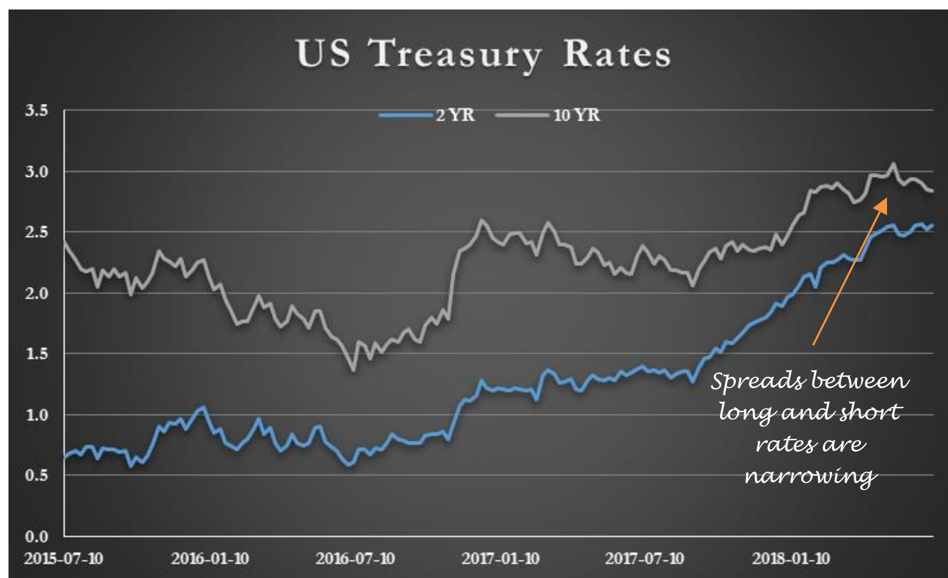
No doubt 2018 has been a disappointing year for investors especially after the wonderful performance of last year but it could have been worse. Investors have remained calm about a pending trade war but now that it is game on we see trade tensions between the US, China and Europe as a significant risk in the second half of 2018.

What about rising interest rates? Is that a major risk factor as well?

The Federal Reserve is on a path to raise short-term interest at least a couple more times this year. The short end of the yield curve depicted in Figure 3 by the 2 Year US Treasury Note has been on a clear upwards path since the beginning of 2017.

The Ten Year Note has similarly been rising steadily in the last year but its rate of increase has not kept up with the rise in short-term interest rates. In a sense this is what economists would expect – the short-end of the yield curve is mainly controlled by monetary policy while the long-end is much more driven by market dynamics.

Figure 3



Source: Quandl, Fred Economic Data, Insight Financial Strategists, July 2018

The gap or spread between the Ten and Two Year Notes is usually thought of as an indicator of future economic growth. Research has shown that a negative spread has most often led to an economic recession 12 to 18 months later.

A narrower spread such as what we are currently observing today indicates slowing economic growth over the next 12 to 18 months but the indicator is not yet flashing the “R” word.

Should we worry? Our view is a qualified yes. The current economic recovery in the US is over 9 years old. According to Goldman Sachs the current recovery is the third longest in the history of the US.

From a purely statistical perspective the odds of a slowdown are higher than normal. What makes this time around unique is the aggressive monetary expansion undertaken after the Financial Crisis.

The Fed has only recently started taking some of the punch bowl away. The narrow gap between the Ten and Two year Treasury Notes at the very least should be viewed as a risk factor and a portend for slower economic growth ahead.

What about inflation as yet another risk to consider? Did markets not go through an inflation “scare” earlier this year?

No doubt inflation risk remain top of mind with ourselves as well as investors in general. Without a Trade War in sight we would be a lot less concerned. Our long-held view has been that we are living in a world of plenty of slack capacity and technological developments such as robotics have dampened inflationary pressures.

In the event of an all-out Trade War we are less sure about our thesis calling for mild inflation. Given that the US imports a lot more than it exports in terms of goods we are highly exposed to tariffs. A tariff is nothing more or less than an additional tax.

Tariffs increase costs to business and consumers. While most tariffs announced so far apply to industrial goods and machinery the additional cost will be passed on eventually to consumers. Toyota has, for example, estimated that a 25% tariff on imported vehicles will raise the cost of a Camry by $1,800.

Tariffs are additional costs that companies will likely pass on to consumers. Sure, some domestically sourced products will become more price competitive. But, unambiguously, prices will rise to meet the additional cost burden.

Figure 4

Source: Quandl, Fred Economic Data, Insight Financial Strategists, July 2018

In our view, the risk of an inflation spike has increased dramatically from end of year levels. So far investors have not yet priced this in. Inflationary expectations remain low with the June 2018 CPI showing a 2.8% increase. The latest reading on 10 year out breakeven inflation (as anticipated in market prices) is 2.1%.

Bond markets are clearly not anticipating a surge in inflation over the next decade. However, caution is in order as an inflation spike would undoubtedly generate concern among both equity and fixed income investors. Let's keep our fingers crossed that no such inflation scare occurs this year.

What do we expect in the intermediate-term from capital markets? While all this talk about trade wars and inflation scares may fill our daily news capture, it is worthwhile to remember that fundamentals drive long-term asset class performance. We remain cautious but optimistic.

In the short-term, capital markets can be heavily influenced by changing investor sentiment, but over the horizons that truly matter to most investors most periods of capital market stress tend to wash out.

While a Trade War is unpleasant we expect rational heads to prevail in the long run. The President's war on trade is not universally accepted even within his own party so we would expect some political pushback once the economic cost of tariffs is recognized by voters. It is our hope that a full-blown Trade War can be averted even though damage has already been done.

Our views are informed by a number of proprietary asset class models updated as of the end of June, 2018.

Our current intermediate term views reflect:

- **A preference for stocks over bonds despite their higher levels of risk**

- **A preference for international over US equity** based on valuation differentials – we still like emerging market stocks

- Within US stocks we **favor small cap over large cap exposure** due primarily to lower levels of export business and superior fundamentals

- Within the fixed income market, **we favor credit exposure** as we believe that economic conditions will remain robust and default risk will be contained

- **Higher allocations to commodities** as this asset class gradually recovers from the bear market it's been in since the 2008 Financial Crisis while also serving as an effective inflation hedge

- **A return of risk on/off type of equity market volatility**– this will surely stress investors without a solid plan for navigating market turbulence

What should individual investors do while the Trade War games play out? For starters evaluate your goals, risk attitude, spending patterns and investment strategy. Make sure that the shoe still fits. Capital markets are not static and neither are personal situations.

A long-term orientation and tactical flexibility will be a necessity of investors as they navigate what we think will be difficult market conditions over the next decade.

Such an approach will be especially important for individuals near or already in retirement. The sequence-of-returns-risk is especially important to manage in the years surrounding retirement when the individual will start drawing down savings.

Our approach at Insight Financial Strategists explicitly deals with this type of sequence-of-returns-risk by building the individual's portfolio around the concept of goal-oriented buckets. Each bucket has a distinct goal and risk profile.

The short-term bucket, for example, while customized for each individual, has the overriding goal of providing a steady stream of cash flow to the individual.

The goal of the intermediate-term bucket is different – this part of the portfolio is designed to grow the purchasing power of the individual in a risk-controlled manner. A sometimes bumpier ride is the price of growth for this bucket but the rewards should be more than commensurate with the additional risk taken.

Finally, the long-term bucket is designed to maximize the long-term appreciation of this portion of the portfolio. This bucket will be the most volatile over the short term and is suitable for individuals with time horizons exceeding ten years and able and willing to withstand the inevitable periods of capital market stress.

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