Q3 2018 | Capital Markets Outlook

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Politics and protectionism may restrain economic momentum

During the second quarter, relatively little has changed with regard to the path of the Trump administration's trade policy. A 25% tariff on $34 billion of imports from China is planned for July 6, and China is expected to counter with tariffs targeting goods from swing states that Trump carried in the 2016 election, where voters might vote for his opponents this coming November. Additional U.S. tariffs on autos and auto parts are rumored to be coming next.

Trade and investment barriers rise

Congress is still working on legislation that will update the process for approving foreign firms targeting domestic acquisition candidates under the CFIUS (Committee on Foreign Investment in the United States), making inbound investment more burdensome. This has consequences for NAFTA negotiations: Many members of Congress concede that it is now too late in the process to get the required approval for any new NAFTA 2.0 deal. Negotiations are likely to stall between Mexico's July 1 presidential election, in which leftist candidate Andres Manuel Lopez Obrador prevailed, and the U.S. midterm elections on November 6. Some geopolitical strategy research firms expect Trump to announce a formal withdrawal from NAFTA during the summer.

Asset allocations

Shading in the table indicates the change from the previous quarter

	Underweight	Neutral	Overweight
EQUITY		●	○
U.S. large cap		●	
U.S. small cap		●	
U.S. value		●	
U.S. growth		●	
Europe		●	
Japan			●
Emerging markets		●	
FIXED INCOME	●		
U.S. government	●		
U.S. investment-grade corporates	●		
U.S. mortgage-backed			●
U.S. floating-rate bank loans		●	
U.S. high yield	●		
Non-U.S. developed country		●	
Emerging markets		●	
COMMODITIES			●
CASH		●	

Currency strategy

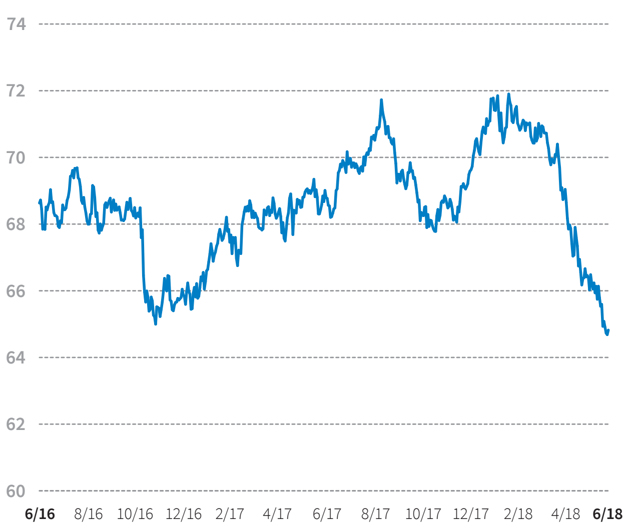
U.S. dollar versus	Favor other	Neutral	Favor dollar
€ Euro	○	●	
£ Pound	○	●	
¥ Yen	●		

The ECB signals caution

The Fed meanwhile, in its most recent meeting, pledged to continue its policy of quantitative tightening (QT) at an accelerating rate. The pace of balance sheet runoff increases from $30 billion per month to $40 billion per month starting in July, and then tops out at $50 billion per month in October under the plan released by the FOMC last year. While the Fed follows this timetable, there was an important new development in the European Central Bank's (ECB) June meeting: ECB President Mario Draghi finally announced an end to their bond-buying program. The program will scale down from the current 30 billion euros per month to 15 billion euros per month in October and end completely at year-end. While this announcement had been expected for several months, the ECB surprised markets by pledging to keep its policy rate slightly negative "at least through the summer of 2019." The announcement sent the euro down 2% against the U.S. dollar, adding fuel to the fire of dollar strength seen since mid-April. In that period, the dollar index (versus six major currencies) is up almost 6%, while an index of emerging-market currencies (JPMorgan Emerging Market Currency Index) has declined almost 10% since mid-February.

Emerging-market currencies are down almost 10% since February

JPMorgan Emerging Market Currency Index, 6/30/16–6/21/18



Source: Bloomberg.

The storm beneath the calm

Given the cross-currents of liquidity being removed from the system via QT and a sudden burst of U.S. dollar strength, we can start to connect the dots back to signs of stress lurking under the surface of otherwise calm markets. While the S&P 500 and the Nasdaq 100 are up for the year through June by approximately 3% and 11%, respectively. Outside of the well-known issues with Deutsche Bank, a broad swath of banks across the continent are down 10%–20%. Meanwhile, in emerging markets (EM), the equity markets in Turkey, Argentina Indonesia, Philippines, and China are all down 15%–17% in local currency terms. EM bond spreads have widened almost 100 basis points this year — almost as much as they did following China's surprise revaluation of the yuan in August 2015. And according to the Institute of International Finance (IIF), over $1.9 trillion in emerging-market debt and loans mature by the end of this year, with 15% of that denominated in dollars. Russia and Turkey will see some of the larger rollovers, and their currencies are down 10% and 20%, respectively, versus the dollar, making the cost to roll that debt even more burdensome.

How could these stresses emerge? Just months ago, the common narrative was one of globally synchronized, above-trend global growth. With S&P 500 companies posting earnings growth of 24% in the first quarter and estimates suggesting they will continue to do so for the remainder of 2018, how is it that U.S. large-cap stocks, excluding FAANG (Facebook, Apple, Amazon, Netflix, and Google), are essentially unchanged for the first half of the year?

Business conditions are more challenging

As is always the case when analyzing market movements, there is no single, clear-cut answer. Our operative view is that we are coming to a crossroad of sorts. The global financial system is more heavily indebted than it was prior to the financial crisis in 2008. Corporate leverage is higher, the debt burden of many emerging-market economies is higher, and the fiscal situation of many developed-market economies is worse. Those facts were easily overlooked when global interest rates and credit spreads were falling, as they were for just about every year since the Great Recession in 2008. The dangers of leverage were also kept in check by the asset purchase programs of the world's major central banks. The real fed funds rate has quickly returned to positive levels and is approaching the natural rate of interest.

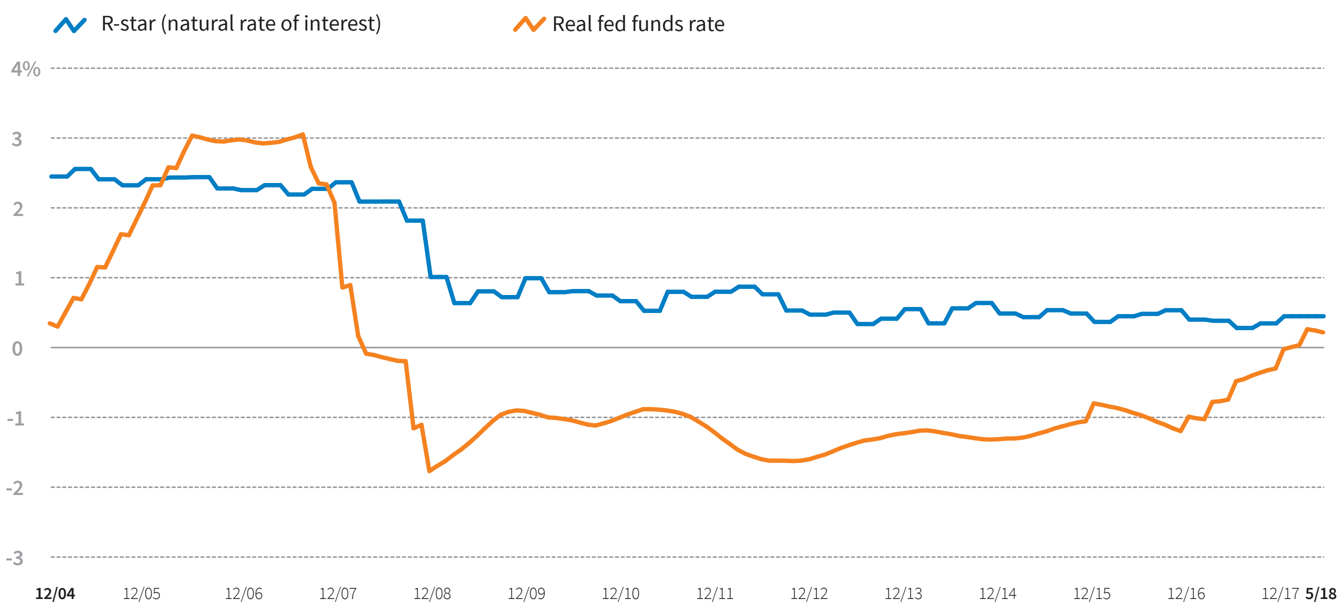
Just as these changes in the terrain have happened slowly and incrementally, it seems intuitive that the reversal of the conditions that had been in place should have the opposite effects — namely higher volatility and a higher burden of proof for risky assets. It's worth noting, as well, that the United States has already used a major tool in the fiscal policy arsenal, which was best saved for when the economy most needs it. Finally, with the Powell-led Fed signaling a shift to less forward guidance and to what looks like a preset trajectory to invert the yield curve, should the recent movements of the curve's long end continue, we will pass another key signpost in the traditional "late cycle" landscape.

It's time to reduce risk

Several of our quantitative tools are suggesting we are later in the cycle, and we have reduced some of our risk-taking in equity and commodities. Trade war remains a key risk to the global economy, not because of the first order effects of tariffs themselves, but due to second-order impacts to global supply chains and a potential reduction in corporate animal spirits, which have effects on capital expenditures and hiring. Politics in Italy and the possibility of a confrontation with the European Union in their budget process also pose a risk into early autumn. We will closely follow trade policy developments and eurozone risk over the next few months.

While not tight, Fed policy has become much more restrictive over the past year

Real fed funds rate and R-star rate, 12/31/04–5/31/18



Source: Bloomberg. R-star is the real natural rate of interest, or the inflation-adjusted short-term interest rate expected to prevail when the economy is operating at its full potential (Federal Reserve Bank of San Francisco).

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