Q4 2018 | Capital Markets Outlook

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Equities face skepticism over rates and trade

Even before equities sold off in early October following the spike in the 10-year Treasury yield, clouds were on the horizon.

Market action on September 17 and 18 was a microcosm of an investment landscape that is becoming more opaque. On September 17, U.S. equities sold off sharply on the rumor that the Trump Administration was about to impose new tariffs on an additional $200 billion of Chinese imports. The NASDAQ 100 finished the day down almost 1.5%, with mega-cap tech standouts such as Netflix, Amazon, and Apple down anywhere from 3% to 5%. Overnight, the Chinese Ministry of Finance quickly announced retaliation on $60 billion of U.S. goods imported to China (despite U.S. warnings that retaliation would be met with yet another round of tariffs). Yet stocks bounced up on September 18 even with a disappointing earnings report from FedEx and what the CEO of the global shipping company called trade issues that “are very worrisome.”

Tax cuts have fueled optimism

We had written earlier in the year that we were respecting the possibility of continued upside in risk asset prices, despite their rather rich valuations, because of the potential that corporate tax cuts and full expensing of business investment would unleash CEO animal spirits and fuel an uptick in capital expenditures.

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	○	●	

It is fair to say that these factors may also be reasons why markets have thus far continued to ignore the dangers of an escalating trade war between the United States and China, and have been more focused on the strength of corporate earnings and economic growth.

Markets downplay trade's economic impact

We believe there are two schools of thought regarding the Trump administration's tactics with respect to China trade. One school believes that the tit-for-tat escalations have simply been negotiating tactics to pressure the Chinese to make a deal leading into the U.S. midterm elections so that Trump can declare "victory." The second school believes that the Administration's China hawks — the Lighthizer/Navarro faction — are consolidating power and will settle for nothing less than a full disintegration of global supply chains, a halt to transfer of intellectual property and sensitive technology, and a dismantling of the World Trade Organization. Based purely on market action during late September, it would appear that probabilities have shifted toward the former school.

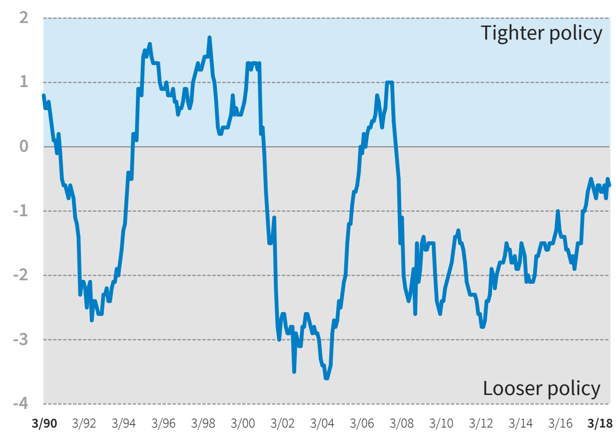
A yield curve inversion is within sight

While we cannot rule out a resolution to the trade dispute with China that would be favorable for the economy and markets, we are also increasingly mindful of a handful of caution signals appearing on the horizon. We would argue that these pose a bit more of a threat than the typical "climbing a wall of worry" attitude. The first signal is the yield curve, which the Fed is on pace to invert — potentially within the next six to nine months. Historically, the curve inverts before recessions. The financial media seems to be littered with excuses as to why this time would be different. Examples include that the Fed's balance sheet and ECB policy are keeping U.S. long rates artificially low, that the term premium for holding long-dated bonds is lower now than it has been historically, and that the Treasury borrowing at the front end of the curve is pushing short rates artificially higher, among other examples. We, however, take a dim view of any line of reasoning that starts with "this time is different." We think you ignore the message from the yield curve at your peril.

We concede that a flat curve is not the same as an inverted one, but flat may be fleeting, as the Fed seems on track to deliver at least four more hikes to its policy rate over the next year. The Fed is also quite eager to change the description of its policy setting from accommodative to neutral. And as long as its estimate of the neutral rate (or r*) keeps rising, the Fed will feel at least some pressure to "catch up" with increases. If the long end remains close to 3%, we could see an inverted curve in 2019.

The federal funds rate is approaching the natural rate

Real federal funds rate minus the natural rate

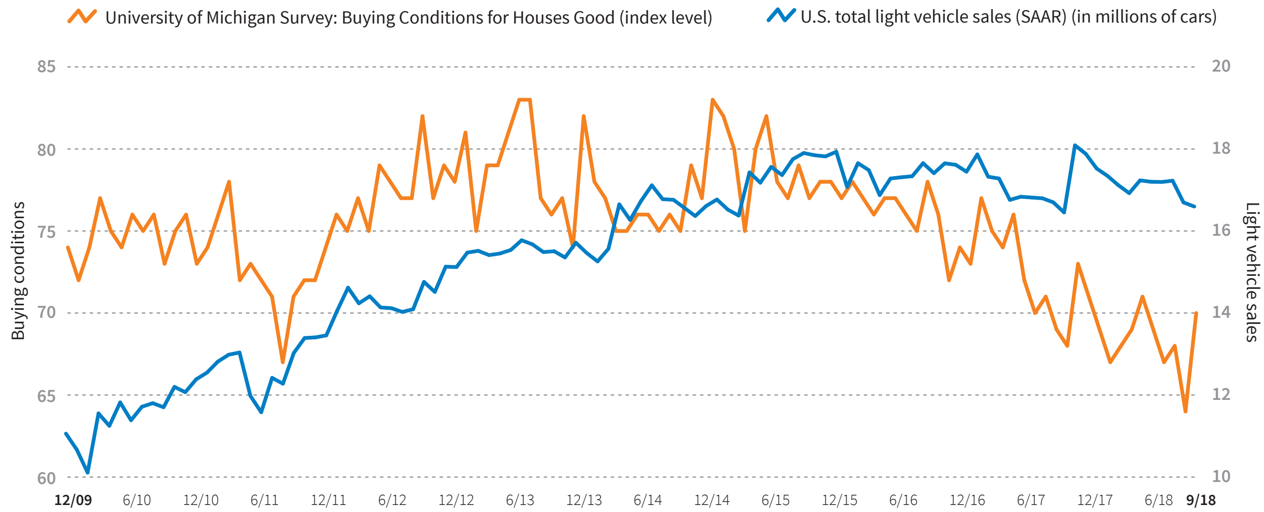


Source: Putnam. The natural interest rate is the rate at which real GDP can grow at trend while inflation is stable. The natural/neutral rate is unobservable; the estimate used here is from the Federal Reserve Bank of San Francisco. When the difference between the fed funds rate and the natural rate is negative, it may indicate that policy is loose, and when positive, policy is tight.

Rates are hitting consumer spending

It is also worth pointing out that large portions of the economy are just as sensitive to short rates as they are to long rates. Floating-rate debt and revolving debt are typically priced relative to the front end of the yield curve, so even if the yield on the 10-year Treasury is relatively stable, the Fed's tightening cycle can bite into consumer spending. It is notable that Cleveland Fed President and FOMC voting member Loretta Mester — historically a reliable dove favoring a go-slow approach to policy normalization — has changed tack. In an interview at the Kansas City Fed's annual Jackson Hole Symposium, she said "…we're at our targets, and yet we have accommodative monetary policy. Right now, this gradual upward path of policy rates seems appropriate to me." We are starting to see early evidence of some of that consumer pain in the most interest-rate-sensitive areas of auto sales and housing.

Housing and auto sales have weakened



Sources: U.S. Bureau of Economic Analysis (light vehicle sales) and University of Michigan Survey (buying conditions).

Regarding both the auto and housing sectors, it seems disingenuous to continue to describe the economy as "booming," as the President did in his address to the U.N. General Assembly at the end of September. Autos and housing together represent a large portion of both employment and GDP, so we are not just cherry picking a couple of random areas of weakness to make a point.

And, based on our proprietary U.S. Housing Surprise Index, which measures the strength of a broad swath of housing market indicators relative to what economists expect, it is fair to say that the weakness experienced in the second half of the year has caught most forecasters off guard.

Trade, the Fed, and consumers are reasons for caution

So, as we inch closer to the end of 2018, with the FOMC officially removing the word "accommodative" from its statement at the September meeting, we again face a large gap between the Fed's dot plot of economic projections and where market prices indicate that the policy rate will be next year. While it is still too early to sound the alarm on risk assets, with volatility as low as it is, it is fair to say that erring on the side of caution seems wise.

Housing disappointment

Putnam GAA U.S. Housing Surprise Index

Source: Putnam GAA. The Putnam GAA U.S. Housing Surprise Index measures actual housing data versus forecasts by professional economists. Negative index levels indicate the degree to which actual data is below economists' expectations.

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