Q2 2018 | Capital Markets Outlook

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For the markets, trade trumps inflation

At last, the first quarter delivered a 10% equity market correction — which commentators had feverishly awaited during 2017, as the market settled into a historic level of calm.

The popular narrative of the recent correction focuses on an inflation scare touched off by a large spike in U.S. wage growth seen in the January payrolls data. Our examination leads to a more nuanced explanation with portfolio strategy implications.

Analyzing the correction

At the end of January, Amazon announced a plan to enter the healthcare business, and stocks in the healthcare sector, such as Anthem, Cigna, and United Health, sold off hard on the news. At the end of the same week came the payrolls data showing the feared wage inflation. Then, to start the following week, the S&P 500 Index closed below its 50-day moving average and the VIX volatility index climbed to its highest levels since China's surprise renminbi revaluation in the fall of 2015. This turmoil triggered a wave of selling by leveraged short-volatility products, momentum-driven managed futures strategies, and CTAs (commodity trading advisor strategies).

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	●		○

When we analyze the impact of these three contributors to the volatility, we estimate that inflation fears and their potential impact on Fed policy account for only about 3%–4% of the 10% move.

Inflation skepticism

We have generally been skeptical that inflation is set to overshoot the Fed's target meaningfully in the near term. Some investors simplistically draw a straight line between the two most recent data points that support their view and extrapolate that into a linear trend to "prove" their thesis (an example of "confirmation bias"). But inflation dynamics are extremely slow moving and take years to develop.

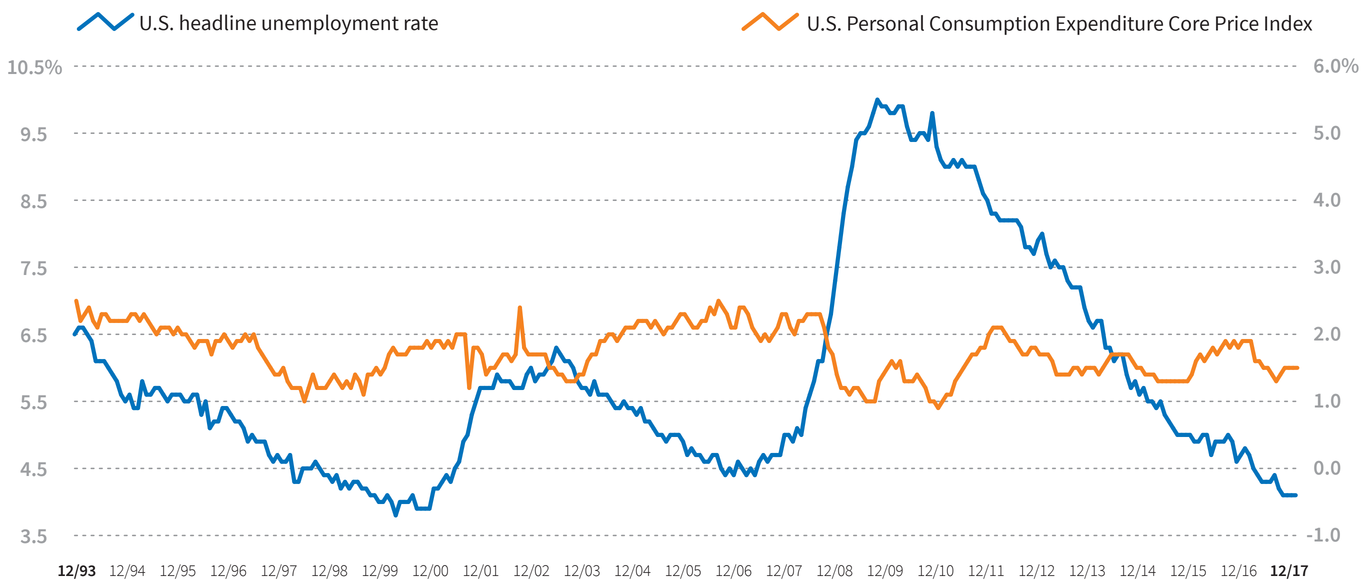
Long-term inflation dynamics show that the real story is the *disinflation* in place for the 18 months leading up to the January payrolls data. For example, the Federal Reserve Bank of Atlanta's Index of Core Sticky CPI Excluding Shelter actually fell from just over 2% (annualized) in mid-2016 to around 1% earlier this year. This index is designed to measure inflation in consumer prices that tend to be relatively stable through time. The 0.89% annualized reading in August 2017 was the slowest increase since the index was created in 1967. That disinflation came in spite of strong global growth, a steadily improving labor market, and a weakening U.S. dollar.

Analyzing inflation

Inflation is made up of many different moving parts, including actual prices, price volatility, expected future inflation, and the velocity of money, just to name a few of the larger drivers. Inflation expectations are unobservable, making this important component even more difficult to understand. One common way to interpret it is to look at the breakeven inflation rate implied by the yield on Treasury inflation-protected securities (TIPS) relative to other Treasuries, but TIPS are technically linked to headline CPI, which generally moves with oil prices. The Fed, on the other hand, mostly cares about core inflation, which strips out the volatile energy component.

Inflation has been low and steady compared with the economy and unemployment rate

Comparison of the unemployment rate and inflation (or price index, year-on-year)

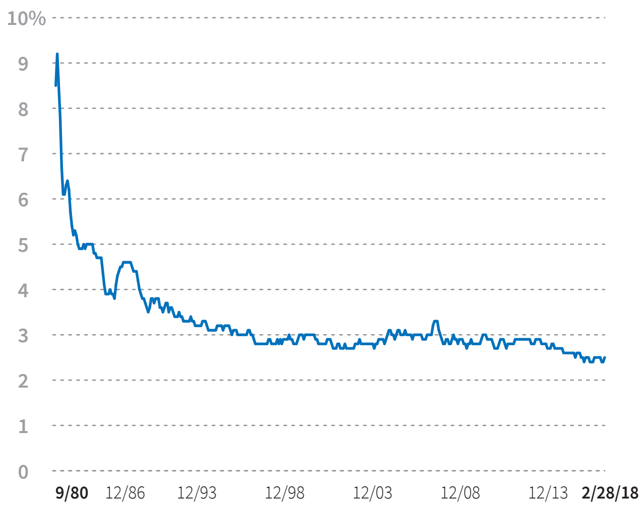


Source: Putnam, based on U.S. government data.

We believe a better read on expected future inflation might come from the University of Michigan Surveys of Consumers. One of the survey questions asks individuals about their expectations for price changes over the next 5–10 years. This measure has been hovering around 2.5% for the past 18 months — again the lowest readings in the survey's history, which stretches back to 1979.

Inflation expectations of consumers have remained near historic lows

Expected change in inflation rates, 3-month moving average



Source: University of Michigan Surveys of Consumers.

Importantly, core inflation in the United States is heavily weighted in the cost of housing and medical care, which makes up about half of the Fed's preferred inflation metric. Shelter-related inflation has bounced back from the depths of the 2008 global financial crisis, but has been well behaved. The same is true of healthcare-related prices, which are heavily influenced by government policy. Both of these could certainly turn up in the future, but again, that is likely to be a slow-moving development and would buck existing trends. The vast majority of the evidence points to more of the same — simply an end to recent and somewhat puzzling disinflation. We would downplay any inflation scare at this point.

Trade risk looms

A much larger challenge for markets in coming months will be the Trump administration's return to their campaign promises of "America First" trade policies. The administration in February announced tariffs on steel and aluminum, which were subsequently watered down to provide waivers for many companies and countries. Of even greater concern is the more China-targeted Section 301 findings on the cumulative costs of intellectual property theft and forced technology transfer; the preliminary estimates dwarf the expected impact of the initial metals tariffs.

With a stalled legislative agenda, upcoming midterm elections, and the Mueller investigation in the background, President Trump will be eager to keep attention focused on fulfilling his critical campaign message of "fair and reciprocal trade." The Ross/Navarro/Lighthizer faction of Trump's inner circle is hyper-focused on reducing the goods trade deficit with China. The opening shots in this new front were fired on March 22, as Trump declared ominously "That's really just a fraction of what we're talking about."

In addition to the possibility of trade war, the Trump administration's decision to block Broadcom's acquisition of Qualcomm based on national security concerns highlights an aggressive stance on cross-border M&A deals. The attempted takeover of Qualcomm, while by far the largest, is the latest of a series of cases in which the administration has killed deals initiated by non-U.S. acquirers.

Caution signs

These signs of protectionism come at a time when economic momentum is slowing from the breathless pace of global PMI (purchasing managers index) advances seen over the past year, and as global macroeconomic data has been surprising to the downside. These are the global macro developments we are most closely watching. In the meantime, positioning in our multi-asset portfolios continues to look decidedly late-cycle, as we prefer equity over both rates and credit, and have a positive view on commodities.

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