September 2018

U.S. Stocks and Bonds Rise in August Amid Continued Uncertainties Abroad

Overview

In August, U.S. stocks and bonds rose, and foreign stocks and bonds fell. Economic data in the U.S. continued to be strong. August began on an upbeat note after the Trump administration reached a conciliatory trade agreement with the European Union in late July, and steps toward dialogue with China surfaced later in August. The administration's approach to Turkey over the detention of a U.S. citizen compounded economic instability that had been brewing already for some time. In this installment of *Insights*, we focus on three main areas: the Federal Reserve and its likely path forward, foreign geopolitical affairs in China and Great Britain, and the upcoming U.S. midterm elections. The Federal Reserve will meet later in September, and it is widely expected to raise its key benchmark rate 0.25% and lift its target range to between 2.00% and 2.25%. This would be a fitting response to solid U.S. economic indicators and firming inflation. As the August asset class performance details reflect, many investors in foreign assets have become uneasy about the effects of the U.K.'s formal departure from the European Union (Brexit), idiosyncratic EM hot spots in Turkey and Argentina, and the still unresolved trade and tariff policy between the U.S. and both Canada and China. These matters are largely isolated from one another, but together they have prompted market jitters that could continue. Finally, the upcoming November elections in the U.S. present the possibility of a change of control in the House and Senate, the implications of which for financial markets are uncertain.

Performance

U.S. equities rose sharply in August July, led by small companies. The S&P 500 advanced 3.26% on the month.

	August	2018 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.26	0.25	4.12	4.32	US Muni Bonds
BarCap US Agg Bond TR USD	0.64	-0.96	2.49	3.70	US Taxable Bonds
BoAML US High Yield Master II TR USD	0.72	1.93	5.63	8.37	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	-1.73	-4.49	5.61	6.64	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-6.09	-10.47	-1.33	1.88	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-0.23	0.74	3.01	0.06	Hybrid/Hedged Equity
DJ Industrial Average TR USD	2.56	6.73	14.64	11.34	US Equity -- Large
S&P 500 TR	3.26	9.94	14.52	10.86	US Equity -- Large
NASDAQ Composite TR USD	5.85	18.31	19.07	14.38	US Equity -- Large
Russell 1000 TR USD	3.45	10.07	14.36	10.93	US Equity -- Large
Russell Mid Cap TR USD	3.11	8.15	12.80	10.92	US Equity -- Mid-sized
Russell 2000 TR USD	4.31	14.26	13.00	10.46	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	-2.09	-3.53	5.43	3.44	Int'l Equity -- Comprehensive
MSCI EM NR USD	-2.70	-7.18	5.04	3.45	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-1.77	-3.87	-8.01	-7.56	Commodities
HFRX Global Hedge Fund USD	0.45	-0.55	1.35	0.05	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 08/31/2018

Year-to-date through August, the S&P 500 Index is up approximately 9.9%. Small company domestic stocks in the Russell 2000 Index have fared even better, gaining nearly 14.3% in 2018 through August. Foreign equities declined in August after having rebounded in July. EM equities are now down 7.2% for the year, as measured by the MSCI Emerging Market Index. The broad foreign benchmark, the MSCI ACWI Index Ex-USA has so far this year retreated 3.5%.

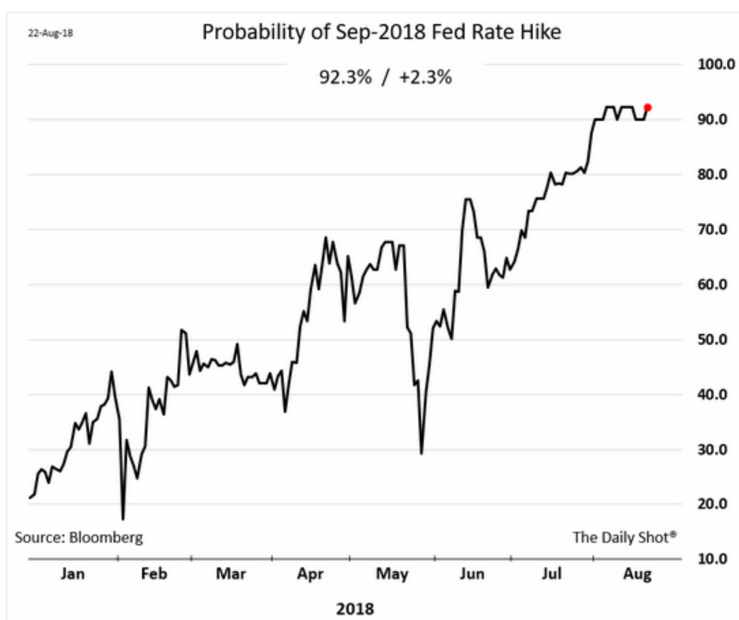
The Bloomberg Barclays U.S. Aggregate Bond Index rose last month, climbing 0.64% as yields fell due largely to risk aversion toward foreign assets. U.S. high yield bonds also gained, but emerging market bonds (both dollar-denominated and local currency) stumbled. Investor worries about global trade, short-term currency fluctuations, and the rising U.S. interest rate trajectory resurfaced, and uncertainty about the debt and currency situation in primarily Turkey roiled markets.

Outlook

Economic data in the U.S. has continued, broadly, to improve. For instance, the ISM Manufacturing Index in August rose to a 14-year high, beating expectations. Residential real estate construction has risen. Employment has strengthened further from already low levels. Pockets of turbulence abroad have checkered the global picture. Turkey's currency nosedived in August, and the U.S. dollar and the Japanese yen (both seen as safe haven currencies) strengthened. Overall, however, the global economy is still strong, and we think that problems will remain largely isolated. In our view, the broad investment outlook remains on balance largely positive, and, despite trade concerns and some structural challenges in Europe, the global expansion is likely to continue with the United States as its growth engine.

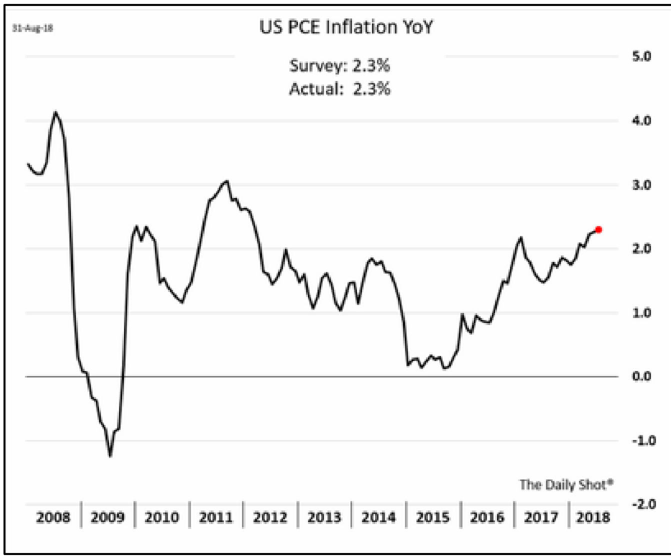
Federal Reserve Policy

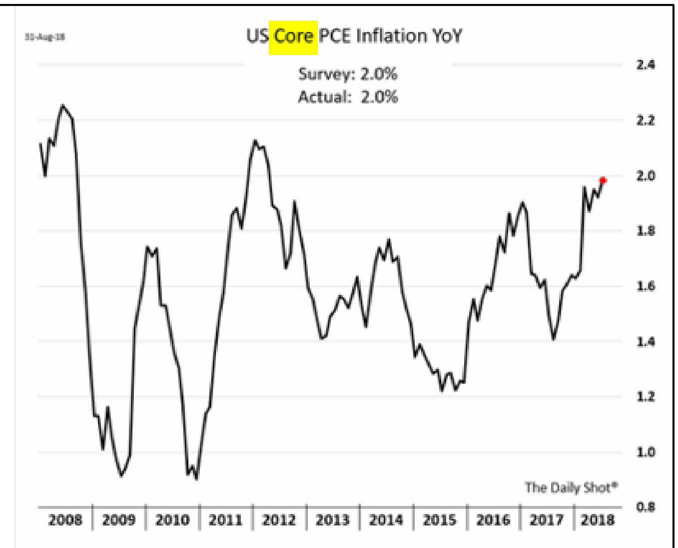
When the Federal Reserve Open Market Committee meets on September 25-26, it is nearly certain that it will raise its benchmark Fed Funds rate one-quarter percentage point. Such a move is already priced in, as you can infer from the nearby chart of market expectations for the probability of an increase.



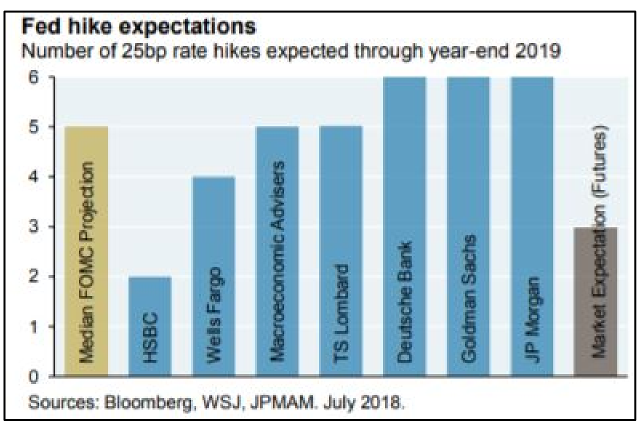
One of the key reasons for the likely move is that the Fed's preferred measure of inflation, the Personal Consumption Expenditures (PCE) deflator, has risen to the Fed's target range. It can be helpful to keep in mind that the Fed uses a different metric for its policy decisions than the widely cited Consumer Price Index (CPI). It also helpful to remember that the Fed chooses to look at the *core* inflation reading of the PCE, which excludes more volatile components like food and energy. The reason is that it wishes to base policy moves on more stable underlying inflationary pressures, not those that are ephemeral.

As you can see from the two inflation graphs below, U.S. PCE inflation has been edging up recently. The headline (all-items) inflation rate in August was 2.3%, year-over-year. The *core* measure (i.e., excluding food and energy items) rose to 2.0%, year-over-year, which is the Fed's long-term target rate. For more than the last five years, the core measure has been below the long-term target rate. Now that economic growth, low unemployment, and other factors have boosted core inflation to the Fed's target rate, the Fed would be hard-pressed to justify not raising rates at its next meeting.





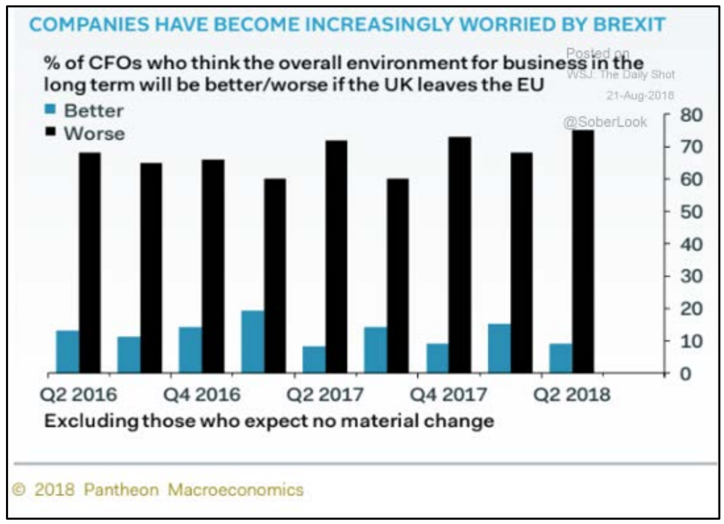
This is another way of saying that inflation pressure in the U.S. is currently neither overly hot nor overly cold. The economy is expanding well, but it is not overheating. This is one reason that we believe that the near-term risk of recession is currently very low. In fact, as you can see from the bar chart below, major financial institutions currently most commonly anticipate that the U.S. central bank will make 5 or 6 rate increases of 0.25% between now and the end of 2019. The current target Fed Funds rate range is between 1.75% and 2.0%. If there are just 5 such rate increases, that would lift by the end of next year the policy rate to a range of between 3.0% and 3.25%. Such a range may be as high as the Fed goes during the current economic cycle. Barring any unforeseen shock, by the end of 2019 economic growth in the U.S. will likely have moderated from its current growth rate as positive effects from the tax reform passed last year fades. The ever data-dependent Fed will want to guard against policy measures that choke economic growth, and we think that at some point the Fed will pause to assess how the economy is absorbing its policies. It may also continue to consider to some extent the foreign financial situation in both developed Europe and the emerging world.



Global Policy Matters

Although the media focused last month on the economic and political challenges that Turkey faced, especially in view of its square-off with the Trump administration, we believe that the more important topics in foreign affairs are the countdown to Great Britain's formal exit from the European Union (Brexit) and the still-unresolved trade policy differences between the U.S. and China. This is not to suggest that Turkey (or Argentina for that matter) will quickly get its economy, monetary policy, and currency houses in order. Such things will take time. But we do believe that their problems are largely isolated from one another and will not be the causes of contagion to the emerging market world broadly considered. We will continue to watch those developments, but our attention at present is also on other foreign affairs.

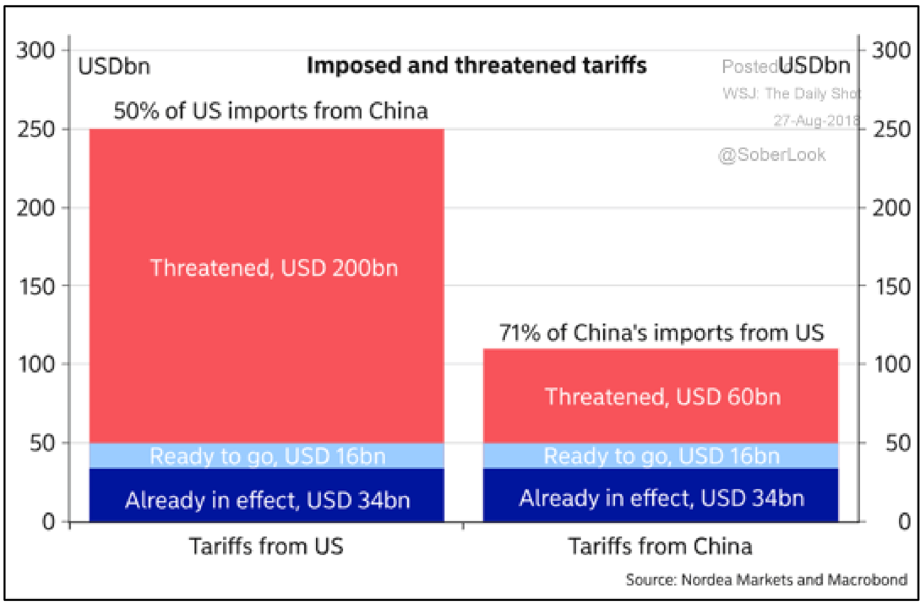
First, Brexit has resurfaced as a geopolitical potential risk. The graphic nearby depicts the progression of chief financial office (CFO) opinion about the consequences of Britain's leaving the EU. The percentage of CFOs in the U.K. who believe the business environment will be worse after Brexit is complete has risen to its highest quarterly level since the survey began. Approximately 75% of respondents believe it will be worse.



Currently, there remains no transition deal on the books between the U.K. and the E.U. This lack of an agreement raises the level of uncertainty about what effect the exit will have on British and European companies, trade, immigration, worker status, and cooperation. If there is no deal by the end of March 2019, the U.K. will revert to operating under World Trade Organization rules. This is widely seen as an arrangement that would hurt British companies because of automatic tariffs that would be imposed on goods and services. The graph below maps the timeline until the official Brexit and notable events on the calendar.

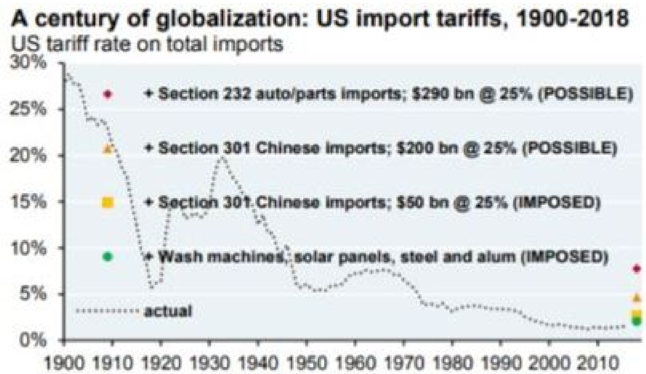
Currently, it is a toss-up as to whether the Brexit negotiators between the U.K. and E.U. forge a viable deal in time. In this respect, it mirrors the current negotiating tensions between the Trump administration and major trading partners like China and Canada. While there is no fixed deadline by which negotiations between the U.S. and China must wrap up, the longer an agreement eludes the two countries, the higher the potential for market volatility, because trade skirmishes prompt market skittishness.

The graphic below compares tariffs imposed and threatened by the U.S. and China. China has retaliated in exact quantity to the tariffs that the U.S. has already put into effect or has ready to take effect. The U.S. has threatened an additional $200 billion worth of imports, which China has not yet fully matched—and cannot match fully because that amount exceeds the worth of all goods from the U.S. that China imports.



The two charts below present two different windows onto the trade dispute. First, the chart on the right ("A century of globalization") shows how relatively little in tariffs on various items the U.S. has imposed recently relative to the start of 1900, when the tariff rate on actual Chinese imports was close to 30%. Until this year's trade skirmish, it was around 2%. The newly imposed tariffs designated by the green circle and gold square have raised the tariff rate to around 3%. Proposed additional tariffs would take the rate to around 8%.

Source: Bloomberg, Goldman Sachs. August 31, 2018.



Source: Esteban Ortiz-Ospina and Max Roser "International Trade", US International Trade Commission, JPMAM. 2018.

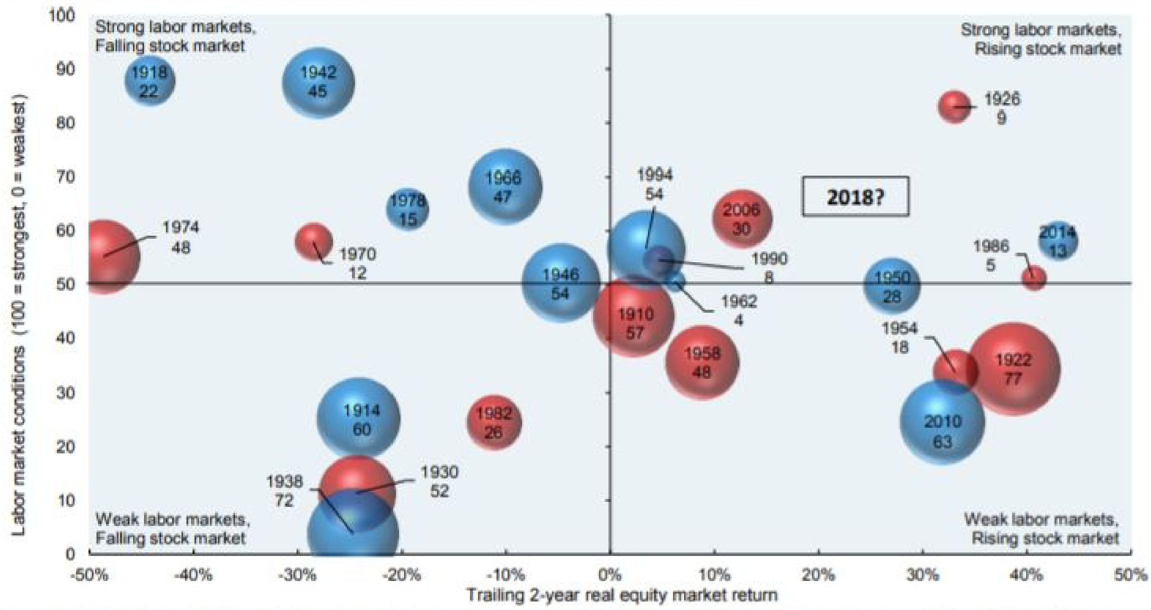
The graph on the left above shows that China's equities have suffered far more than U.S. stocks. If U.S. stocks with Chinese exposure had suffered as much as Chinese stocks have so far, there would likely be far more pressure than there has been to-date on the Trump administration to forge a lasting deal with China on trade and end the cycle of protectionist policy proposal and retaliation. Without knowing what would be an acceptable outcome from the U.S. administration's perspective, it is difficult to hypothesize about when such resolution might occur. We do, however, see as a positive sign recent engagement between the two countries and the planned high-level talks, such as that in which Vice President Pence will participate in November at the East Asia summit in Singapore and the Asia Pacific Economic Cooperation forum in Papua New Guinea. President Trump will have an opportunity to meet with Chinese President Xi several weeks later at the G20 forum. At this point, resolution before late fall seems unlikely, and financial markets may remain vulnerable to trade-related volatility events through then.

U.S. Midterm Elections

One question increasingly on many people's minds is the outcome of the U.S. midterm elections. Will Democrats regain control of the House, the Senate, both, or neither? And what will be the investment implications if they do regain control of at least one chamber of Congress?

It is true that the incumbent President's party typically loses seats in midterms elections; however, the major routs (which you can see in the large bubbles in the graphic below) occurred when either equity markets or job markets were doing poorly. (The major exception to that occurred in 2006, when voters who were disaffected by the Iraq War caused the Republican Party to lose 30 seats.) Recently, though, U.S. equity returns have been strong, and the labor market has been healthy, in fact reaching full employment. Given this backdrop, there seems to be some tension between historical tendency and recent polling data on the President's approval rating. This year's midterms could be an exceptional year like 2006 because of voter opinion about the President and his agenda. Or the GOP might only lose 10-15 seats and retain the House.

Is the GOP heading for a historic rejection at a time of rising stock markets and strong labor markets?
Bubble color/size indicates President's party and number of House seats lost in midterm election



Source: Robert Shiller (S&P history), C. Romer (pre-1952 unemployment data), JPMAM. 2018. Excludes midterm elections of 1934, 1998 and 2002 when President's party picked up House seats in midterm elections. Labor market conditions reflect the level of unemployment and the 2-year change.

Whatever the outcome of the midterms, we think that the effect on legislative policy will be minimal. Since tax reform was passed last year, it seems unlikely that the Republican-controlled Congress will tackle entitlement reform or immigration policy in any meaningful way anytime soon. A split in Congress or a Democrat-controlled Congress with a Republican president’s veto power is likely to change that lack of legislative progress. Political gridlock is often neutral to positive for financial markets, since policy uncertainty is reduced. Currently we do not expect much of a direct, lasting effect on investments from the midterms, however they turn out.

Summary and Conclusion

Overall, the U.S. economy remains on strong footing. The Federal Reserve is positioned to increase rates gradually, and against a backdrop of durable domestic economic growth, low inflation, and full employment, U.S. equities continue to be, in our view, more attractive than their developed foreign counterparts. We remain positive on the global economic outlook despite ongoing trade concerns and pockets of turmoil in places like Turkey and Argentina. The Federal Reserve has stated that it believes the U.S. economy is strong, and Sage thinks that monetary policy will continue to tighten in the U.S., with the next rate increase later this month. Political uncertainty in Europe has increased in recent months, and economic growth data has moderated. The risk of additional trade and protectionist rhetoric is real, but some progress has been made on the NAFTA and European fronts, and there seems to be an ongoing negotiating path forward with China. In our view, investors should remain balanced in their asset allocations and avoid overemphasis of one or two investments relative to others. All told, we foresee continued global expansion that is consistent with a relatively low near-term risk of recession in the U.S. in view of strong corporate earnings, solid manufacturing activity, and positive consumer sentiment.