SAGE FINANCIAL GROUP
Investment and Wealth Management

# SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

June 2019

## Escalating Trade Tensions Prompt Equity Declines in May

### Overview

In May, domestic and foreign stocks and bonds declined primarily in response to a reversal in progress between China and the U.S. on trade policy. The monthly return for the S&P 500, for instance, was sharply lower, -6.35%, and non-U.S. stocks in the MSCI ACWI ex-USA declined 5.37%. U.S. bond prices rose and yields fell as investors sought safe-haven assets. For instance, the Bloomberg Barclays U.S. Aggregate Bond Index rose 1.78%. Trade tensions between the U.S. and China escalated starting the first week of May, and the markets rapidly began again to price in risks to global growth, risks they largely had pushed to the margins. As we have noted over the last several months, we continue to think that trade-related risks likely will be a source of volatility for markets throughout the year. In this issue of *Insights*, we share our view on the slowing of global economic growth that is likely to result from rising tariffs and increasing trade tensions. We have organized our outlook into three topics: (1) developments around the risk of recession, (2) the U.S./China disagreement on trade, and (3) a potentially more dovish Federal Reserve.

U.S. trade policy affects U.S. commerce in North America and Europe, as well as China. In our view, the deterioration in trade negotiations between the U.S. and China is the most significant of the three and has the potential to have the greatest effect on near-term economic and market health. Increased tariffs with trading partners come at a time when U.S. fiscal stimulus is fading, unemployment is at the lowest point in decades, inflation remains muted, and regulation of the tech industry (which has been the biggest contributor to recent U.S. earnings growth) seems to be rising. Overall, the U.S. economy remains sound in large part due to a strong consumer, but, in our view, is increasingly susceptible to outside shocks.

### Performance

Stocks, commodities, and high yield bonds fell in May, but core U.S. and EM bonds gained (see table below).

| | May | 2019 YTD | 5-Year Annlzd | 10-Year Annlzd | Category |
|---|---|---|---|---|---|
| BarCap Municipal TR USD | 1.38 | 4.71 | 3.58 | 4.58 | US Muni Bonds |
| BarCap US Agg Bond TR USD | 1.78 | 4.80 | 2.70 | 3.83 | US Taxable Bonds |
| BoAML US High Yield Master II TR USD | -1.27 | 7.52 | 4.37 | 9.30 | US Corporate HY Bonds |
| JPM EMBI Global Diversified TR USD | 0.41 | 7.65 | 4.67 | 7.58 | Int'l/Emerging Bonds (USD) |
| JPM GBI EM Global Diversified TR USD | 0.30 | 3.04 | -1.32 | 2.98 | Int'l/Emerging Bonds (Local) |
| | | | | | |
| HFRX Equity Hedge USD | -2.01 | 4.52 | 0.69 | 1.14 | Hybrid/Hedged Equity |
| | | | | | |
| DJ Industrial Average TR USD | -6.32 | 7.54 | 10.88 | 14.17 | US Equity -- Large |
| S&P 500 TR | -6.35 | 10.74 | 9.66 | 13.95 | US Equity -- Large |
| NASDAQ Composite TR USD | -7.79 | 12.85 | 13.22 | 16.74 | US Equity -- Large |
| | | | | | |
| Russell 1000 TR USD | -6.37 | 11.05 | 9.45 | 14.02 | US Equity -- Large |
| Russell Mid Cap TR USD | -6.14 | 13.55 | 7.89 | 14.43 | US Equity -- Mid-sized |
| Russell 2000 TR USD | -7.78 | 9.26 | 6.71 | 12.84 | US Equity -- Small |
| | | | | | |
| MSCI All Country World Index ex-USA NR USD | -5.37 | 7.15 | 1.31 | 5.80 | Int'l Equity -- Comprehensive |
| MSCI EM NR USD | -7.26 | 4.09 | 1.79 | 5.03 | Int'l Equity -- Emerging |
| | | | | | |
| Bloomberg Commodity TR USD | -3.36 | 2.31 | -9.52 | -4.18 | Commodities |
| HFRX Global Hedge Fund USD | -1.02 | 2.22 | -0.32 | 1.22 | Multi-Asset Alternative Invm't |

*Source: Morningstar Direct. Data through 5/31/2019*

The S&P 500 fell 6.35% on the month, nearly identical with the Russell 1000 Index of large companies (down 6.37%). The Russell 2000 Index of small companies also fell sharply in May (down 7.78%). Despite these losses, both large-cap and small-cap Russell indices have advanced 11.05% and 9.26%, respectively, for the year through May. The MSCI ACWI Index Ex-USA Index, a measure of all stocks outside the U.S., dropped more than 5% in May and is up 7.15% YTD through May. The MSCI Emerging Market Index tumbled more than 7% for the month and is up just about 4% YTD through May.

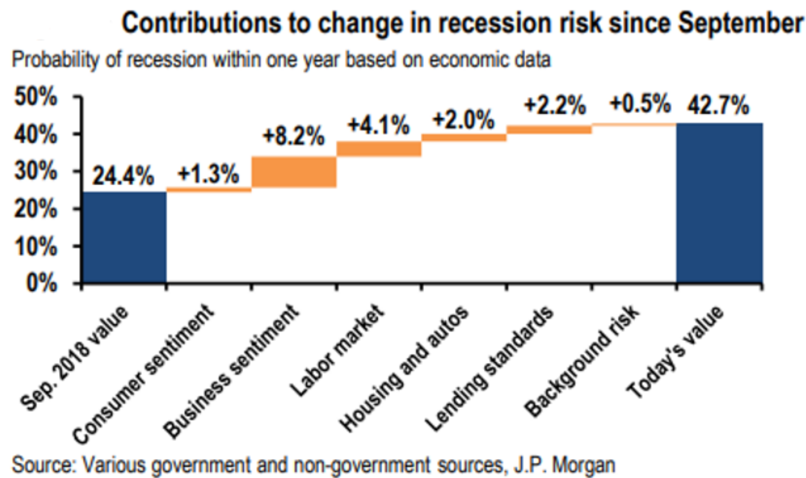
In contrast, the Bloomberg Barclays U.S. Aggregate Bond Index rose 1.78% in May. Yields on the 10-year Treasury Note fell 0.38% on worries of economic decline and interest in safe-haven assets. Factors that drove investors to core U.S. bonds also drove them out of U.S. high-yield bonds, which fell 1.27% in May (according to the Bank of America/Merrill Lynch U.S. High Yield Master Index). Emerging market bonds gained, however. U.S. dollar-denominated emerging market bonds in the JPMorgan EMBI Global Diversified Index gained 0.41% in May and have risen 7.65% YTD through May. The local currency EM bond index, the JPMorgan GBI EM Global Diversified, also rose 0.30% in May. A 50/50 blend of the two EM bond indices has a YTD gain through May of approximately 5.35%.

## Outlook

At present, we believe that the U.S. economy remains sound (Q1 GDP growth was 3.1%), but growth is slowing as the effects of the tax cut fade. Further, increased tensions between the U.S. and its major trade partners pose a decided risk of slowing global growth, including in the U.S. Such a risk heightens economic and business uncertainty, as well as potential worries about eventual increases in consumer prices. Financial markets tend to react to anticipated decelerations in economic growth, as seen with the sharp declines in global equity prices in May. Bond yields in multiple countries have fallen in response to concerns about future growth, including in the United States, where the yield curve has again become inverted. A bond yield curve is said to be inverted when the yield on short-term bonds is higher than the yield on long-term bonds. As of June 4, the difference (i.e., spread) between the 10-year Treasury Note and the 3-month Treasury Bill was -0.19%. This inversion, which has lasted at present for approximately 3 weeks, is much wider than the 0.03% spread inversion that lasted for only a few days at the end of March. In other words, the U.S. bond market is signaling that the future economic and investment outlook is increasingly cloudy. In our view, the escalation in U.S. trade hawkishness, whatever its reasons (and, to be sure, some topics are quite legitimate), has made both the U.S. and global economy and markets more vulnerable to any adverse policy decision or external shock.

**1) Recession Risk**

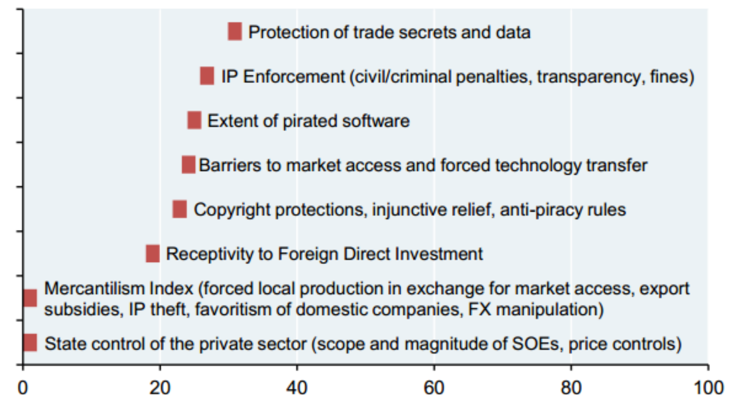
We are still of the view that, despite weaker recent economic conditions, an economic recession is unlikely this calendar year; however, the increasing magnitude and lengthening duration of the U.S. yield curve inversion have increased the probability of a recession sometime within the next 12-18 months. J.P. Morgan, for instance, currently estimates a 43% chance of a recession within 12 months looking at the indicators below, a forecast that generally aligns with ours.



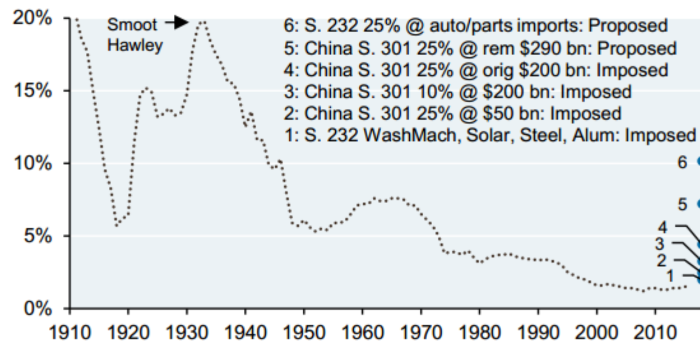

Since September of 2018, consumer and business sentiment have begun to sour, cyclical industries such as housing and automobiles have continued to weaken, and bank lending standards have gotten tighter. Some of this deterioration, especially in the auto industry, stems from the trade disputes.

**2) U.S./China Disagreement on Trade**

In mid-April, a definitive agreement between the U.S. and China on trade policy was widely seen as all but certain; by the end of the first week in May, however, all of that near certainty had unraveled. Ostensibly the reason was China's backtracking on previously agreed-to terms involving intellectual property (IP) rights, forced technology transfers, and future enforcement of the agreement. Whatever the merits or demerits of the Trump administration's approach, the United States has long had a legitimate objection to China's theft of intellectual property and lack of adherence to international agreements. China has, as the graphic on the left below illustrates, benefited greatly since its entrance into the World Trade Organization (WTO) in 2001. At the same time, it has remained as ruthless as ever in things like software piracy, as disinclined as ever to foreign direct investment, as indifferent as ever to copyright protections, and as prejudiced as ever toward domestic companies. As the graphic on the right below shows, China has some of the worst ratings among both developed and emerging economies.



The effect of the Trump administration's approach (the imposition of tariffs on commercial partners in Japan, Europe, North America, and China), has been a return, or projected return, to tariff rates not seen since the 1940s, as you can see in the graphic below.



Source: Esteban Ortiz-Ospina and Max Roser "International Trade", US International Trade Commission, USITC, US Census, JPMAM. May 2019.

The natural questions are what is the endgame for the relevant players, particularly the U.S. and China, and what are the likely effects of the resolution?

Both China and the U.S. are engaged as doggedly as they are in this dispute and their own trade practices for the simple reason that each wishes to extend its sphere of economic and political influence as widely and as deeply as possible across the globe. What has been cast as an economic dispute in terms of trade is ultimately a geopolitical dispute in terms of hegemony. This is the reason, for instance, that China has launched its Belt and Road initiative across Asia, Africa, and recently Europe via Italy. We see analogies to the conflict that Thucydides records in the 4th-century between Athens and Sparta over control of Mediterranean trade. This observation about global dominance is instructive, because it suggests that the tensions between the economic giants are likely to persist even after the eventual agreement on trade policy is reached. Another reason for this is that ongoing enforcement of trade policy remains a point of dispute between the powers, and it will likely be contested even after any deal is reached. China does not, as noted above, have a stellar track record as a scrupulous adherent to its international agreements.

What then are the likely effects of any resolution? There remains a possibility (certainly not a guarantee and maybe not even a probability) that the Trump administration will forge either an agreement with China at or shortly after the upcoming G20 economic forum later in June, or that it will broker another cease-fire, such as the short-term truce that was reached at the end of November. If so, equity markets might recover somewhat from May's losses, but longer-term investors would do well to look out farther than that. As we have just explained, the tensions are likely to continue well after the ink dries on any U.S./China trade accord. Moreover, it is unclear whether currently-imposed tariffs will be relaxed. The Trump administration sees the continuation of tariffs as a key mechanism to ensure compliance. Regardless of whether tariffs remain or are relaxed or removed in the future, they are in place now. And that, in our view, is adverse for both financial markets and the global economy.

A working paper published earlier this year by the International Monetary Fund of the "Macroeconomic Consequences of Tariffs" is not encouraging. Based on data from 1963 to 2014, the outcomes tended to include lower economic output, slower productivity, higher unemployment, and little change to trade balances. The fact is this: tariffs raise prices. And in fact, as you can see from the table on the right, forecasts from several sources envision some effect on overall U.S. inflation from the imposition of tariffs on Chinese goods. Depending on the extent and magnitude of the tariffs, the effect on overall inflation could push the annualized rate above the Fed's 2% target, which in turn would put the Fed in a policy bind: how to deal with rising inflation at a time of slowing growth.

*Estimated one-time impact of tariffs on China on US inflation*

| Forecast by | Impact on 2019 US inflation | Resulting from |
|---|---|---|
| ***J.P. Morgan*** | 0.1% - 0.2% | • Latest hike to 25% on $200bn in Chinese exports |
| ***Federal Reserve*** | 0.1%<br>0.4% | • Tariffs imposed in 2018<br>• Across the board 25% tariff on all Chinese goods |
| ***Bridgewater*** | 0.2%<br>0.4% | • Partial escalation<br>• Full escalation |
| ***Goldman Sachs*** | 0.2%<br>0.6%<br>0.9% | • Tariffs imposed in 2018<br>• Across the board 25% tariff on all Chinese goods<br>• 25% on China plus autos |

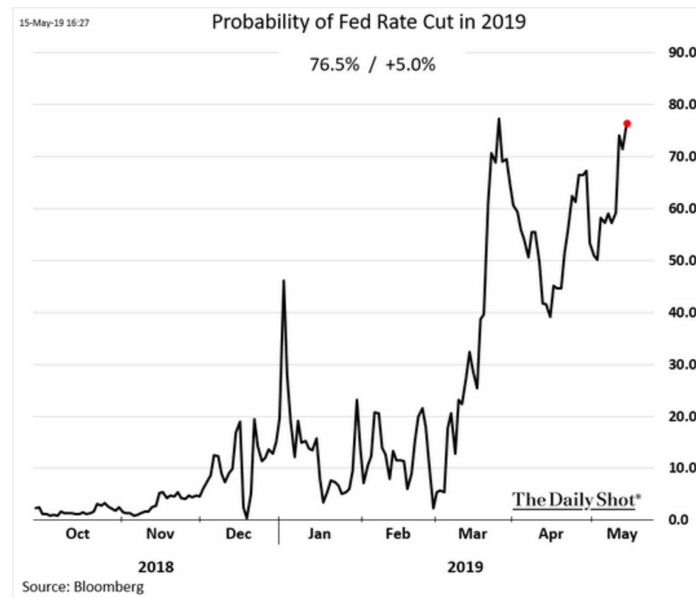
The pattern of the economic and investment consequences of trade wars is one that aligns rather well with the sequence that commonly accompanies economic slowdowns: financial markets adjust (or decline) before the economic slowdown (or decline) is seen. In a trade war, initially, tariffs function as a tax on the firms that try to absorb the increased cost of trade, which then tends to decrease the corporate earnings and profit margins of those firms. Both consequences weigh on those companies' stock prices, which often either decline or do not rise as quickly as before while they adjust to the lower expected future earnings. To recoup earnings and profit margins, firms often eventually pass along certain increased costs to consumers who may already be somewhat jittery about their buying power if financial markets have been volatile, stock markets have declined, and economic activity has slowed. As a result, consumption may slow, along with economic growth, and the resulting lower or declining GDP growth can reinforce the lower or declining stock market prices that so often anticipate economic disruptions.

In other words, what is concerning, is that the risk of recession has recently risen because of intensifying tensions on the trade front, and typically financial market declines precede the manifestation of economic recession, which is similar to the effect that tariffs imposed in a trade war can have on both markets and economies. What normally occurs some 12-24 months after a bond yield curve first inverts (i.e., a market and economic decline) is also often a common response to elevated tariffs imposed for some time (i.e., a market and economic slowdown). In the present case the possibility exists that trade policy could hasten market and economic challenges.

It is important, though, to emphasize that, despite these observations, it is very difficult to say precisely where markets will head in the near-term, and we think that the massive imbalances in the economy that existed in the two most recent recessions (extended valuations in the early 2000s, overextended consumer/debt in 2007) currently do not exist. Further, banks are incredibly well-capitalized and better-regulated now than they were before the collapse in 2008. These two factors (lack of imbalances, well-capitalized banks) along with a third -- vigilant and nimble central banks and central governments eager to stimulate -- would likely lead to a much more mild/shallow recession than the two most recent recessions.

**3) Federal Reserve Policy**

Previously, the Federal Reserve had projected that it would neither raise nor cut short-term interest rates in 2019. However, due to recent developments on trade policy and slower economic data in the U.S. and around the world, it is now perhaps more likely than it was two months ago that the Fed might lower interest rates sometime this year. Currently, interest rate futures markets reflect a broad anticipation that the Fed will cut rates one or two times before the end of 2019. This viewpoint can change rapidly, but it is worth noting how much already has changed in such a short period of time.




What might be the effect of a Federal Reserve cut? We cannot know exactly how financial markets would react to a Fed rate cut, which could be seen either positively or negatively. In a positive scenario, an interest rate cut could be perceived as ammunition to address slowing growth in a conventional way. In this scenario, markets could be reassured that the world's most influential central bank is eyeing the total effect of global economic conditions and commercial relations between nations. The U.S. Treasury yield curve could normalize from its current inverted state to something that looks more healthy. As opposed to the last two economic cycles in which the Fed's hand was (or was felt to be) forced into continuing to hike rakes to control financial imbalances, a dovish Fed may lead to a soft-landing (i.e., no, or a very shallow, economic recession).

However, an interest rate cut may be negative if it proves to be a self-fulfilling prophecy of economic weakness and impending recession. That is, a rate cut designed to forestall economic downturn might, by heightening broader market, consumer, and business anxiety, indirectly "cause" that downturn to materialize. An inverted yield curve can be taken to be a self-fulfilling prophecy in its own right for at least two reasons. First, companies can see the inverted curve as a sign that the economy is going to grow more slowly in the years to come and delay hiring, research and development, etc. Second, banks may tighten lending standards in part due to pressured profitability from shrinking net interest margins. (Banks make consumer loans at long-term rates and pay deposits at short-term rates.) In this less positive scenario, the U.S. and global economy would likely slip into a mild recession, and the Fed may need to cut further to stem the tide.

Overall, it now appears more likely than it did previously that the Federal Reserve may cut interest rates in 2019. We do not think that a Fed cut means a recession is imminent. As opposed to previous cycles, the Federal Reserve is much more cognizant of how equity prices and global economic conditions affect the U.S. economy. A cut in interest rates because of geopolitical instability (e.g., trade) could be viewed as positive by market participants and stimulate the economy, although that response is not guaranteed.

## Conclusion

Despite sharply negative performance in May by U.S. and foreign stocks, for the year through last month, the S&P 500 Index had posted a 10.74% return, and foreign stocks in the MSCI ACWI ex-US index had still gained 7.15%. Investors ought not to lose sight of these gains. We have noted for months that we did not think that the rate of gains realized in early 2019 was likely to continue at the same pace or with the same magnitude throughout the remainder of the year and that there was the distinct possibility of a pullback. Whether the sort of retrenching that occurred in May will continue remains to be seen against the shifting economic and geopolitical landscape.

We have also previously written that major risks to economic and market stability may have their source in geopolitical surprises more than any fundamental financial imbalance or investor exuberance. That remains, in our view, the case. China's withdrawal of concessions in the ongoing trade spat with the U.S. and the U.S.'s tariff-raising response has altered the outlook for the global markets and economy. We continue to think that, in time, China and the U.S. will strike a trade deal, but the precise path to the goal line may still be filled with ups and downs.

At home, domestic economic growth currently seems durable, inflation remains low, and employment remains high. The U.S. economy is likely to continue to grow this year but at a slower pace than it did in the first quarter. Corporate earnings growth is lower than a year ago, and investors may take note. Abroad, economic growth in key economies such as Europe and China also seems to be decelerating.

In our last two monthly *Insights*, we explained that the initial temporary and shallow inversion of the Treasury yield curve should not be seen as overly alarming but also should not be ignored. Now that the curve has inverted again -- and done so more steeply and for a period of weeks -- we believe that risk of a recession within the next 12 months has risen, especially since the steeper and protracted inversion comes against the backdrop of slowing global growth and heightened global trade tensions. Still, the historical record provides ample precedent for equity price appreciation, sometimes for extended periods, after a yield curve inversion and before the next bear market and/or recession. The challenge for investors is that it is very difficult to reap all the market gains and none of the losses associated with a recession because it is next to impossible to predict precisely when it will come.

Investors who may have been tempted by the strong equity market returns through April to add risk assets to portfolios may take the pullback in May as a reminder that unforeseen shocks like a reversal in a geopolitical trade deal can change the market and economic landscape at a stroke. Investors who rightly note the inverted yield curve and escalating trade tensions may do well not to assume that any future recession will be like the Great Depression or Global Financial Crisis since neither the tariff levels nor financial imbalances are anywhere near what they were in 1930 or 2008. We believe investors of both temperaments should take this opportunity to discuss with their wealth manager whether their portfolio remains appropriately positioned, consistent with their long-term risk tolerance and goals, both to capture gains and withstand declines. The present environment

is one in which investors may be particularly inclined to act overly aggressively or overly defensively. Given the wide range of potential economic and market outcomes, we believe that both responses represent investing pitfalls to avoid.

*The information and statistics contained in this report have been obtained from sources we believe to be reliable but cannot be guaranteed. Any projections, market outlooks or estimates in this letter are forward-looking statements and are based upon certain assumptions. Other events which were not taken into account may occur and may significantly affect the returns or performance of these investments. Any projections, outlooks or assumptions should not be construed to be indicative of the actual events which will occur. These projections, market outlooks or estimates are subject to change without notice. Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. All indexes are unmanaged and you cannot invest directly in an index. Index returns do not include fees or expenses. Actual client portfolio returns may vary due to the timing of portfolio inception and/or client-imposed restrictions or guidelines. Actual client portfolio returns would be reduced by any applicable investment advisory fees and other expenses incurred in the management of an advisory account. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Sage Financial Group. To the extent that a reader has any questions regarding the applicability above to his/her individual situation of any specific issue discussed, he/she is encouraged to consult with the professional advisor of his/her choosing. Sage Financial Group is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. A copy of the Sage Financial Group's current written disclosure statement discussing our advisory services and fees is available for review upon request.*

*Sage Financial Group has a long track record of citations and accolades. Rankings and/or recognition by unaffiliated rating services and/or publications should not be construed by a client or prospective client as a guarantee that s/he will experience a certain level of results if Sage is engaged, or continues to be engaged, to provide investment advisory services. Nor should it be construed as a current or past endorsement of Sage by any of its clients. Rankings published by magazines and others generally base their selections exclusively on information prepared and/or submitted by the recognized advisor. For more specific information about any of these rankings, please click here or contact us directly.*

*© 2019 Sage Financial Group. Reproduction without permission is not permitted.*