September 2019

U.S. Stocks Slide and Bonds Gain in August as Trade War Flares

Overview

In August U.S. bonds climbed while domestic and foreign stocks declined, primarily in response to an escalation in the trade war between the U.S. and China and the potential implications it has for slowing global economic growth. The monthly return for the S&P 500 was down 1.58%, and non-U.S. stocks in the MSCI ACWI ex-USA fell 3.09%, while the U.S. Aggregate Bond Index gained 2.59%. Despite the short-term losses by equities, most indices are still positive YTD through August.

In this issue of *Insights*, we share our updated view on the shifting sands of Brexit and the newest escalation in the rift between the U.S. and China on trade. The potential outcomes for Brexit are so fluid that it makes forecasting, which is often a challenge, particularly difficult. A week ago it seemed likely that guided by new Prime Minister Boris Johnson, the U.K. would crash out of the European Union (EU) without a deal. Now Parliament has passed and the Queen has ratified emergency legislation blocking a no-deal Brexit and seeking a 3-month Brexit extension if it cannot agree to terms with the EU by October 19. Although an extension may diminish the adverse economic consequences of a no-deal Brexit, it prolongs uncertainty, which continues to take a toll on economic and investment activity. Globally, heightened uncertainty regarding Brexit adds to the worries caused by the more aggressive protectionist trade measures recently imposed by the U.S. and China. A smooth resolution to the trade dispute does not seem imminent, but this situation also is sometimes fast changing. Positive surprises on either front would likely be welcomed by equity markets.

Performance

Domestic and foreign stocks retreated in August, but core U.S. bonds and U.S. dollar-denominated emerging market debt gained (see table below).

	August	2019 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	1.58	7.61	3.85	4.62	US Muni Bonds
BarCap US Agg Bond TR USD	2.59	9.10	3.35	3.91	US Taxable Bonds
BoAML US High Yield Master II TR USD	0.39	11.15	4.85	8.44	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	0.75	13.50	5.45	7.44	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-2.64	6.83	-0.69	2.71	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-0.17	6.92	0.83	1.22	Hybrid/Hedged Equity
DJ Industrial Average TR USD	-1.32	15.14	11.77	13.60	US Equity -- Large
S&P 500 TR	-1.58	18.34	10.11	13.45	US Equity -- Large
NASDAQ Composite TR USD	-2.46	20.89	12.97	16.07	US Equity -- Large
Russell 1000 TR USD	-1.83	18.48	9.85	13.49	US Equity -- Large
Russell Mid Cap TR USD	-2.85	19.57	7.94	13.48	US Equity -- Mid-sized
Russell 2000 TR USD	-4.94	11.85	6.41	11.59	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	-3.09	8.76	1.37	4.71	Int'l Equity -- Comprehensive
MSCI EM NR USD	-4.88	3.90	0.38	4.07	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-2.32	1.93	-8.58	-4.28	Commodities
HFRX Global Hedge Fund USD	0.38	5.43	0.08	1.25	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 8/31/2019

The S&P 500 lost 1.58% on the month, a bit better than the Russell 1000 Index of large companies (down 1.83%). The Russell 2000 Index of small companies also declined last month (down 4.94%). Despite these losses, large-cap and small-cap Russell indices have still advanced 18.48% and 11.85%, respectively, for the year through August. The MSCI ACWI Index Ex-USA Index, a measure of all stocks outside the U.S., fell 3.09% in August, but it remains up 8.76% YTD through August. The MSCI Emerging Market Index fell in line with U.S. small caps, down 4.88% for the month, but it also remains up 3.90% YTD through August.

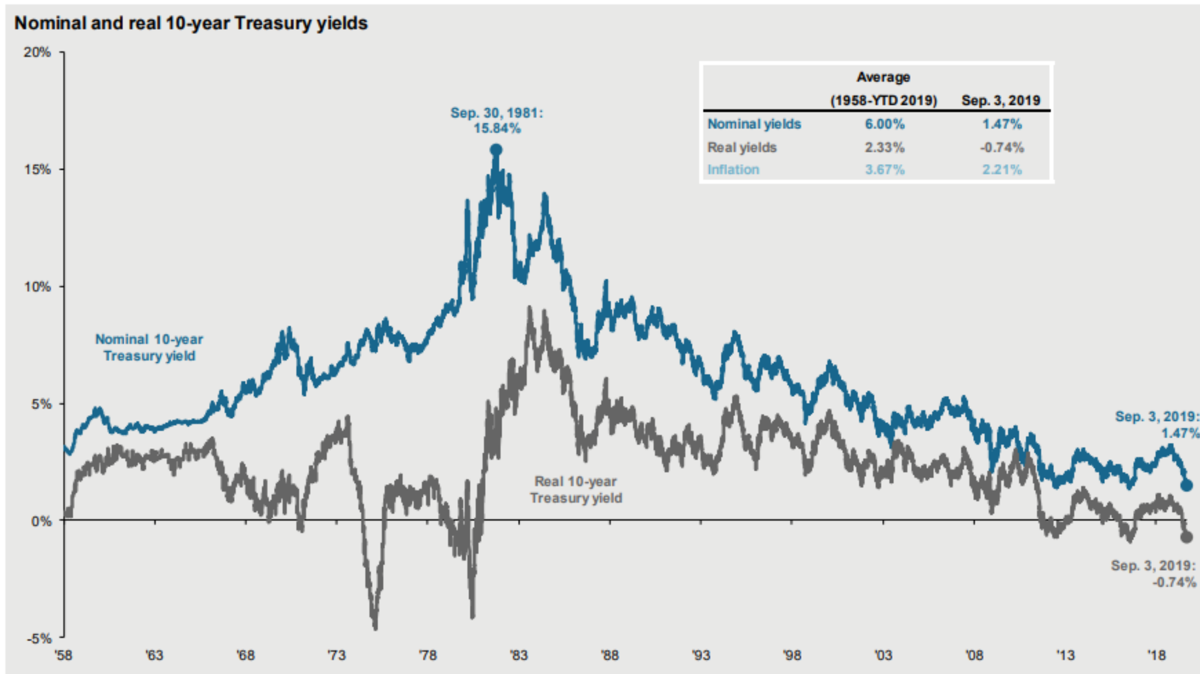
Once again, U.S. bonds gained as investors sought safe-haven assets in response to the heightened tensions between the U.S. and China on trade and indications of further deceleration of global economic growth. The Bloomberg Barclays U.S. Aggregate Bond Index gained 2.59% in August. Emerging market bonds were mixed. U.S. dollar-denominated emerging market bonds in the JPMorgan EMBI Global Diversified Index rose 0.75% in August and have risen 13.50% YTD through August. The local currency EM bond index, the JPMorgan GBI EM Global Diversified, was down sharply on U.S. dollar strength and idiosyncratic market disturbances in places like Argentina; it fell 2.64% in August. A 50/50 blend of the two EM bond indices has a YTD gain through August of approximately 10.17%.

Outlook

We continue to believe that the U.S. economy generally remains sound; in fact, Q2 GDP growth was 2.0%. Growth is slowing, however, for reasons that include the fading effects from earlier tax reform, declining business sentiment and spending, and especially ongoing uncertainty about global trade policy and geopolitics like Brexit and the Hong Kong protests. The uncertainty surrounding trade policy not only pertains to the tensions between the U.S. and its major trade partners, including China, but also between other players, such as Japan and South Korea. The election of Boris Johnson to succeed Theresa May as UK Prime Minister reignited worries about a hard, no-deal Brexit, but the House of Commons seems to be intervening to prevent that.

The concerns related to both Brexit and U.S./China trade inform much of the concurrent policy shifts by global central banks toward more accommodation to counter slower growth and subdued inflation. These attempts either to cushion global economies from additional deterioration or to stimulate them from weak positions are likely to continue. Bond yields have continued to decline in response to concerns about the slowdown of global growth.

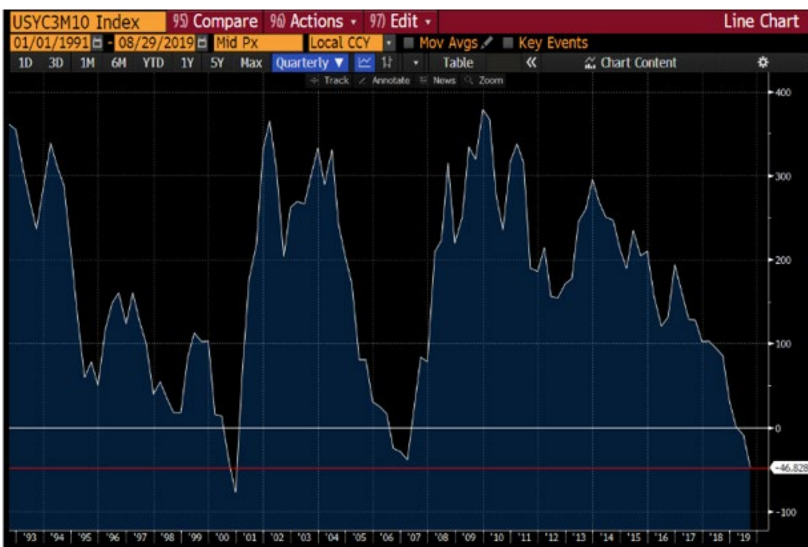
At the beginning of the year, the US 10-year Treasury Note had a yield of 2.40% and the S&P 500 Index was at 2,500. At that time, based on oversold equity conditions and the prospect of a US/China trade deal, it seemed to many that rates may have come down too far and that both rates and stocks could climb somewhat higher throughout the year. It further seemed that the Fed may have to cut interest rates later in 2019. Fast forward eight months, and while large-cap stocks have rebounded 15% (equities were oversold), rates are stuck moving lower (and the Fed has cut already once in 2019). As shown below, U.S. Government bond yields now stand at their lowest levels in the last 60 years.



Source: BLS, FactSet, Federal Reserve, J.P. Morgan Asset Management.
Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core CPI inflation for that month except for August 2019, where real yields are calculated by subtracting out July 2019 year-over-year core inflation.

The Federal Reserve has cut once, but instead of being seen as an "insurance cut," the move by the Federal Open Market Committee looks to be part of a more sustained cycle of rate cuts. The reason for this dramatic decline in bond yields is that the trade war with China has continued to escalate. As a result, economic growth and inflation expectations globally have been downgraded. What were trade "skirmishes" last year between the Trump administration and Xi's government have devolved into a proper trade war. Manufacturing activity has slowed around the globe, and countries that are more dependent on manufacturing and trade have underperformed, which has led to an inverted yield curve.

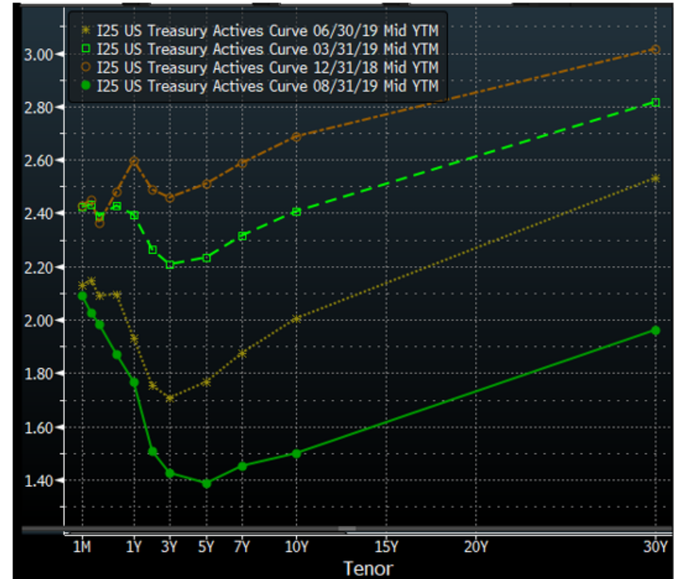
As shown in the nearby chart, the 10-year minus 3-month Treasury spread inverted in March, and it is now approximately as inverted as it was in 2000 and 2007. The bottom line is that bonds are signaling a persistent slowdown, while equity markets are signaling a soft-landing (i.e., growth decelerates but does not contract).



Source: Bloomberg, as of 8/29/2019

The nearby graph shows the U.S. Treasury Yield Curve at four different points in time. The top line (orange) is the beginning of the year, and moving down the graph are lines for the end of Q1, Q2, and 8/29/2019. Every point on the curve has moved down, and the yield for the 10-

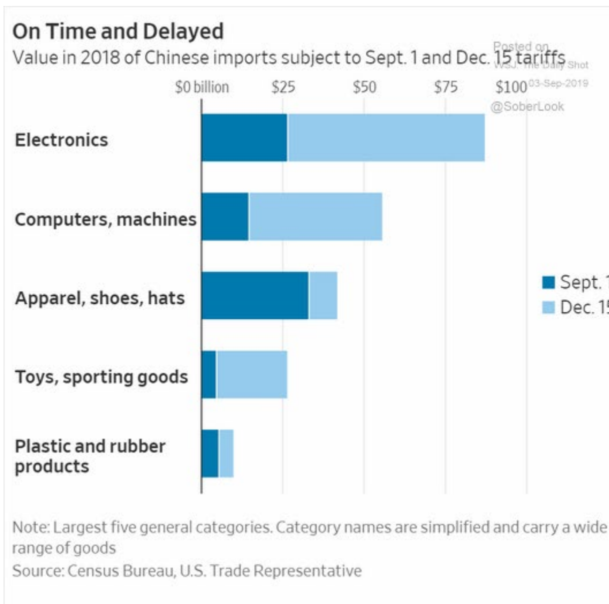
year Treasury Note has declined the most. The escalation in the trade dispute between the U.S. and China has begun to raise worries about the price and consumption of consumer goods. Tariffs are set to become a bigger problem for merchants and consumers. This is illustrated by the two charts below.

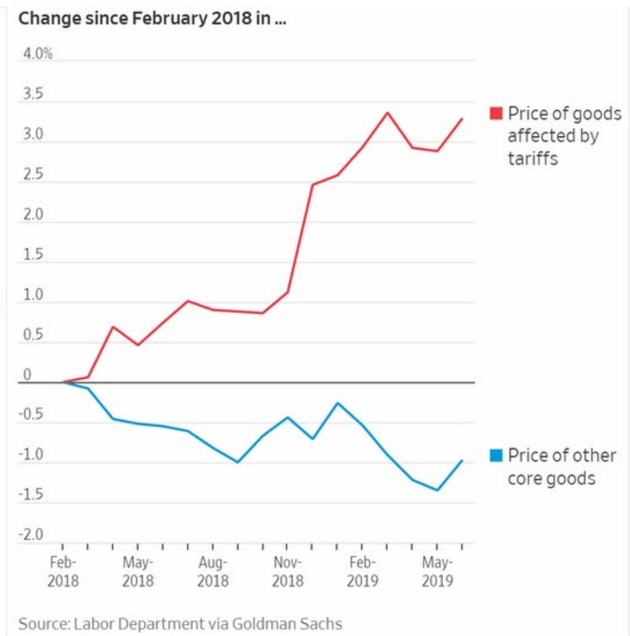


Source: Bloomberg, as of 8/31/2019

The chart on the left below shows the amount of goods affected by the 9/1 and 12/15 tranches of tariffs on consumer goods. The 12/15 tranche was specifically delayed to lessen the pain for holiday shoppers. (Read: The Trump administration didn't want shoppers on Black Friday after Thanksgiving to be walloped with higher costs for goods on sale.)

As shown below in the graph on the right, companies have increased the price of goods affected by the tariffs much more than the price of other goods. The upshot is that tariffs matter, and they eventually will weigh on consumption, which accounts for about two-thirds of the U.S. GDP.

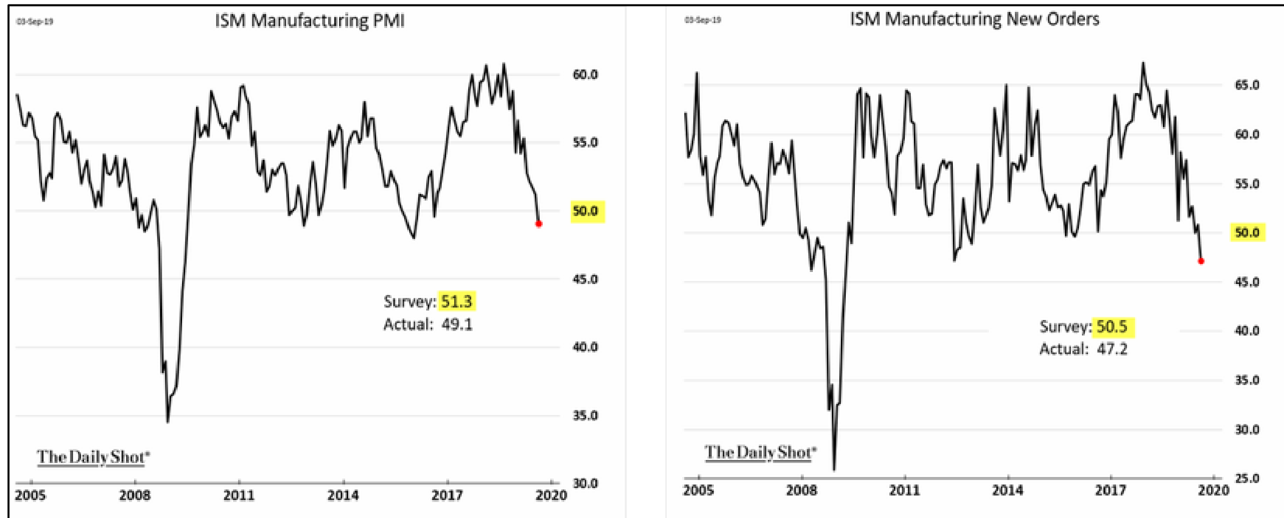




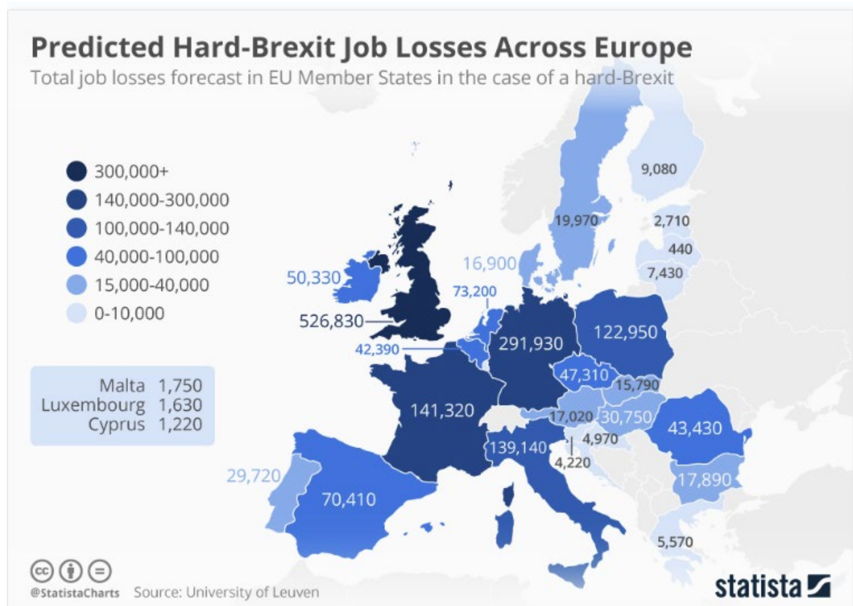
The U.S. consumer remains the major driver of growth, primarily due to a very strong employment situation. Although the pace of hiring has started to decrease, jobs are still plentiful and described as easy to get by job applicants. Moreover, Q2 earnings were better than feared. Of the 500 firms in the S&P 500 Index, 494 have reported, and they have registered year-over-year revenue and EPS growth of 3.58% and 1.60%, respectively.

Already there are signs that the U.S. is not immune to the impediments to economic activity that the trade dispute and geopolitical uncertainties present. U.S. manufacturing output, as measured by the ISM manufacturing purchasing managers index (PMI), recently dipped into contraction territory (below 50) for the

first time in three years, as shown in the graphs below. The same occurred for the new orders data. Both were surprises below surveyed expectations. Small business optimism has dipped to a near7-year low, according to the WSJ-Vistage Small Business Survey. The slowdown is due in part to trade uncertainty and difficulty finding qualified workers.



Similar data (contracting manufacturing activity) has appeared in the U.K., which is one reason that the specter of a no-deal Brexit in recent weeks has roiled some business confidence. It has been estimated, for instance, that job losses across Europe could be significant if the U.K. leaves the European Union (EU) without a deal. Estimates vary, but we have seen figures of between 250,000 to 750,000 lost jobs in the U.K. alone if a no-deal Brexit occurs.



As noted above, however, more than 20 members of Prime Minister Johnson's party joined opposition parties in an attempt to pass legislation that would prevent the U.K. from tumbling out of the E.U. on October 31 without a deal. It is possible that there will be a general election that could change the face and direction of the U.K. with regard to Brexit ahead of an important summit between the U.K. and E.U. in October. The situation remains protean.

What are the possible ramifications of the current situation with Brexit and U.S./China trade? Although much of the current economic and geopolitical data is gloomy, we believe that there are real possibilities for positive changes on key fronts.

Upside scenarios: Positively, economic growth would likely stabilize or increase, and equity market prices would likely move higher, if:

- *Brexit*: Brexit is delayed with a clear path to more positive terms for an eventual exit, or an exit is avoided altogether.
- *Hong Kong Unrest*: protestors and the government find additional common ground related to the protestors' list of grievances and the government's relationship with the mainland.
- *U.S./China Trade*: both parties strike a more official truce and agree not to escalate further while trade negotiations are resumed in earnest, and if the Trump administration in a show of good faith cancels the tranche of tariffs scheduled to be imposed on December 15.

Downside scenarios: Economic growth and equity market prices will likely remain volatile, and prices could go sideways or decline if:

- *Brexit*: the outcome of Brexit is not resolved with the deadline pressing, and a no-deal Brexit again becomes the most probable outcome.
- *Hong Kong Unrest*: protestors and the government remain deadlocked beyond the recent withdrawal of the extradition legislation that sparked the unrest; that withdrawal may not be enough to quell citizen discontent, and business activity could suffer.
- *U.S./China Trade*: the current cooling of rhetoric is not followed by commensurate actions, and future proposals lack substance or credibility.

Conclusion

The uncertainties related especially to Brexit and U.S./China trade relations make it a difficult time for investors because, depending on one's time frame, there is a wide range of potential outcomes.

But the U.S. economy remains on generally solid footing, even if growth is slowing, especially when compared with Europe and Japan. We think that a combination of factors -- especially low inflation, declining GDP growth, and persistent uncertainty about the direction of global trade -- is likely to (a) keep bond yields low in coming months and (b) prompt increased central bank activity to bolster or stimulate their economies. In our view, then, policy shifts by the Federal Reserve and other global central banks toward more accommodation will continue to be a key investment theme for the remainder of 2019. Temporarily this could be positive for both stock and bond investors if they can look past the headlines: for bond investors, it may mean increased demand for high-quality bonds and lower yields; for stock investors, it may mean support for economic growth and the corporate earnings that stem from it. As is often the case with investing, however, much remains outside investors' direct control, and that is a reason to maintain all-weather portfolios throughout the year, and not just as summer fades to autumn.

Throughout the year we have made portfolio changes that have had the overall effect of adding duration (which has benefited from falling yields) and reducing some equity allocations (which has allowed for both upside capital appreciation and decreased some volatility associated with downward price moves at times.) We believe that well-diversified portfolios like those we have constructed can withstand environments like this one, and also durably help to advance clients toward their longer-term goals. We are privileged to navigate the current path with you.

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.