October 2019

# U.S. Stocks Rebound in September on Hopes of Boost from Monetary/Trade Policy

## Overview

In September, U.S. and foreign stocks climbed, domestic core bonds declined, and emerging market bond performance was mixed. These asset class returns reflect a prevailing hope that central bank policy would help to stabilize global growth and that there might be an improvement in global trade relations when the U.S. and China meet this week. The monthly return for the S&P 500 was up 1.87%, and non-U.S. stocks in the MSCI ACWI ex-USA gained 2.57%, while the U.S. Aggregate Bond Index declined 0.53%. Despite the short-term losses by core taxable bonds, most major indices including bonds remain positive YTD through September.

The dominant economic and investment themes this year have been trade policy (negotiation of terms between the U.S. and its major trading partners) and monetary policy (actions by global central banks). Those themes remain dominant and likely will continue to be the key drivers of economic and investment news for the foreseeable future. In this issue of *Insights*, we focus on the particular effect global trade policy and global monetary policy have, especially on the U.S. manufacturing and farm industries. There has been a global growth slowdown, which is reflected in various data releases, among them manufacturing/services orders and U.S. farm business. The U.S. economy, in particular, is solid, but GDP growth is slower than in recent years and decelerating, a trend that may well continue for the next few quarters.

## Performance

Domestic and foreign stocks, as well as high yield U.S. bonds, advanced in September (see table below).

| | Sept. | 2019 YTD | 5-Year Annlzd | 10-Year Annlzd | Category |
|---|---|---|---|---|---|
| BarCap Municipal TR USD | -0.80 | 6.75 | 3.66 | 4.16 | US Muni Bonds |
| BarCap US Agg Bond TR USD | -0.53 | 8.52 | 3.38 | 3.75 | US Taxable Bonds |
| BoAML US High Yield Master II TR USD | 0.32 | 11.50 | 5.36 | 7.85 | US Corporate HY Bonds |
| JPM EMBI Global Diversified TR USD | -0.46 | 12.99 | 5.74 | 6.88 | Int'l/Emerging Bonds (USD) |
| JPM GBI EM Global Diversified TR USD | 0.96 | 7.86 | 0.55 | 2.47 | Int'l/Emerging Bonds (Local) |
| | | | | | |
| HFRX Equity Hedge USD | 0.88 | 7.87 | 1.03 | 1.04 | Hybrid/Hedged Equity |
| | | | | | |
| DJ Industrial Average TR USD | 2.05 | 17.51 | 12.28 | 13.56 | US Equity -- Large |
| S&P 500 TR | 1.87 | 20.55 | 10.84 | 13.24 | US Equity -- Large |
| NASDAQ Composite TR USD | 0.54 | 21.54 | 13.51 | 15.49 | US Equity -- Large |
| | | | | | |
| Russell 1000 TR USD | 1.73 | 20.53 | 10.62 | 13.23 | US Equity -- Large |
| Russell Mid Cap TR USD | 1.97 | 21.93 | 9.10 | 13.07 | US Equity -- Mid-sized |
| Russell 2000 TR USD | 2.08 | 14.18 | 8.19 | 11.19 | US Equity -- Small |
| | | | | | |
| MSCI All Country World Index ex-USA NR USD | 2.57 | 11.56 | 2.90 | 4.45 | Int'l Equity -- Comprehensive |
| MSCI EM NR USD | 1.91 | 5.89 | 2.33 | 3.37 | Int'l Equity -- Emerging |
| | | | | | |
| Bloomberg Commodity TR USD | 1.17 | 3.13 | -7.18 | -4.32 | Commodities |
| HFRX Global Hedge Fund USD | 0.45 | 5.90 | 0.32 | 1.07 | Multi-Asset Alternative Invm't |

*Source: Morningstar Direct. Data through 9/30/2019*

The S&P 500 gained 1.87% on the month, a bit better than the Russell 1000 Index of large companies (+1.73%). The Russell 2000 Index of small companies also rose last month (+2.08%). Large-cap and small-cap Russell indices have advanced 20.53% and 14.18%, respectively, for the year through September. The MSCI ACWI Index Ex-USA Index, a measure of all stocks outside the U.S., rebounded 2.57% in September after having fallen in August, and it has posted an 11.56% gain YTD through September. The MSCI Emerging Market Index rose in line with U.S. small caps, up nearly 2% for the month. Despite bouts of volatility, the EM Index has managed a 5.89% gain YTD through September.

Once again, U.S. bonds gave up some of the strong gains that occurred in August, as investors moved from safe-haven assets to riskier assets like equities. These reversals reflected a viewpoint that the worries that overshadowed August, although not unfounded, may have been overdone in the near-term. The Bloomberg Barclays U.S. Aggregate Bond Index gained 2.59% in August but gave back 0.53% in September. The corresponding Municipal Bond Index lost 0.80%. Emerging market bonds were mixed. U.S. dollar-denominated emerging market bonds in the JPMorgan EMBI Global Diversified Index fell 0.46% in September after gaining in August, and they have still risen 12.99% YTD through September. The local currency EM bond index, the JPMorgan GBI EM Global Diversified, also reversed course from August. It had fallen 2.64% in August, but it rose 0.96% in September. A 50/50 blend of the two EM bond indices has a YTD gain through September of approximately 10.42%.

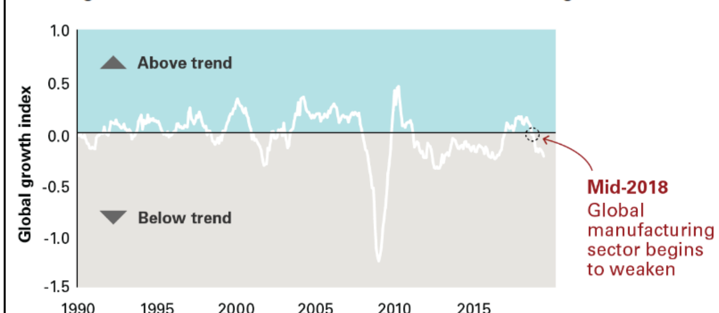
## Outlook

We continue to believe that the U.S. economy generally remains sound; in fact, Q2 GDP growth was 2.0%. There also remains some disparity in outlooks reflected in the rates and core bond markets (which have priced in recession-like conditions) and the credit and equities markets (which have priced in healthier outcomes). The challenge for investment positioning is still that uncertainty is high, especially around trade policy. Deterioration in the strength of the U.S. consumer or in trade negotiations between the U.S. and other nations could skew economic and investment outcomes negatively; however, a breakthrough in trade policy and marked success by central banks (monetary policy) or legislatures (fiscal policy) to support global growth could result in higher prices in riskier assets such as stocks and high yield bonds.

Compared to the growth trend over the last year, growth is slower and going lower (i.e., decelerating). Prominent reasons for this include the fading effects from earlier tax reform, declining business sentiment and spending, and ongoing uncertainty especially about global trade policy and the effects of monetary/fiscal policies, as well as geopolitics like the Hong Kong protests, Brexit, and Mideast conflicts. The uncertainty surrounding trade policy pertains to the tensions between the U.S. and its major trade partners, not only China but also between others such as Europe, Japan, and South Korea.

The consequence has been a downturn in business capital expenditures and global manufacturing activity since, as you can see in the nearby chart, mid-2018. It was last year that global growth began to dip below-trend. Other, more widely-used metrics than

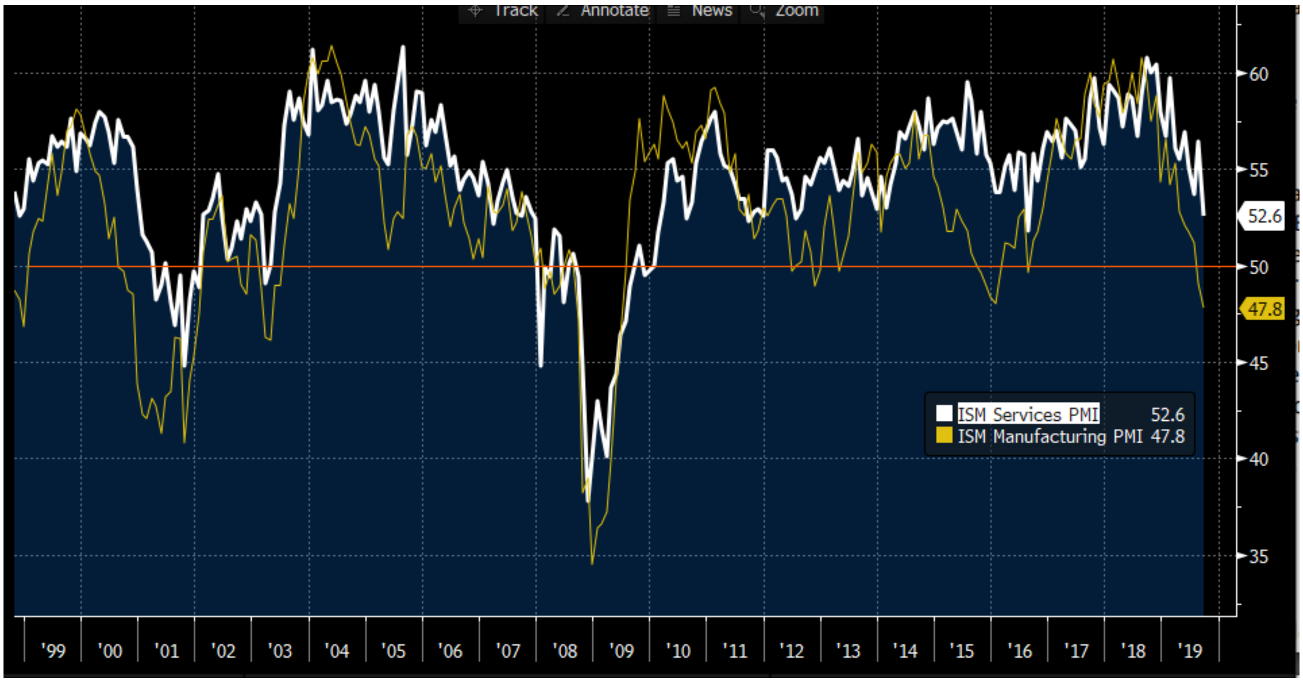
Global growth has fallen below trend amid manufacturing downturn



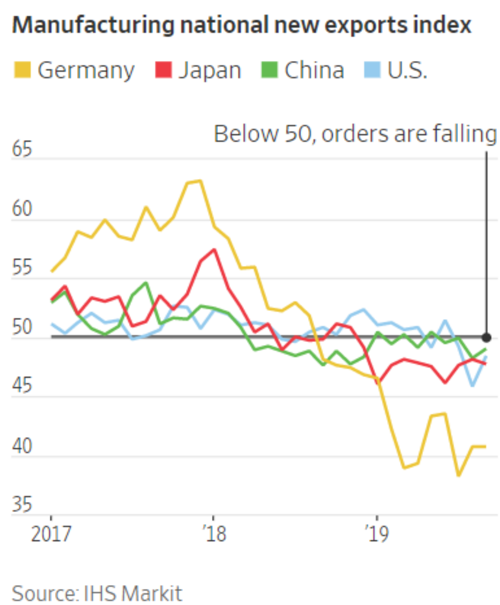

**Notes:** The figure shows global growth as derived by the Vanguard Leading Economic Indicators Index series. This proprietary model comprises more than 70 economic indicators covering all sectors of the global economy. It is designed to anticipate turning points in the business cycle and slowdowns in payroll growth. Data cover January 1990 through August 2019.

**Sources:** Vanguard calculations, based on data from Thomson Reuters Datastream.

Vanguard's Leading Economic Indicators have reflected a similar pattern in their recent updates. For instance, the ISM's Purchasing Managers Index (PMI) measures both manufacturing and service activity in the economy. The chart below indicates that manufacturing in the U.S. is contracting (a reading below 50), and the service sector has been trending downward since late last year. Typically the service data follows the trajectory of the manufacturing data. If that pattern holds this time, then services activity should decline further, perhaps not contracting but weakening still.

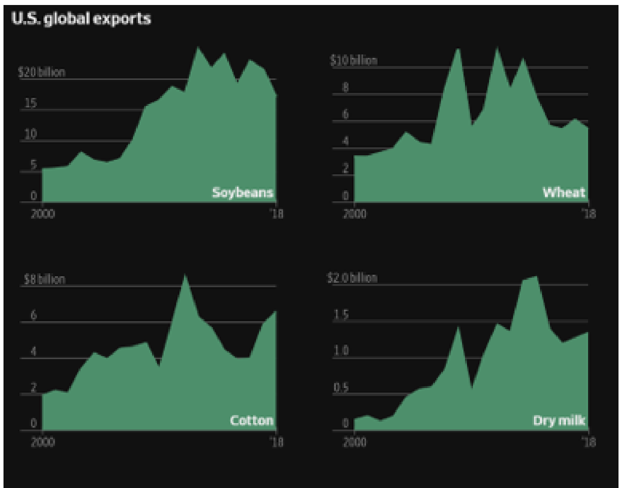



At the same time that manufacturing activity has been declining and contracting, U.S. exports have fallen even farther, as the graphic on the left below illustrates. This decline in exports results from not only the trade tensions, especially with China but also the stronger U.S. dollar, which makes goods more expensive for overseas purchasers. The U.S. is not the only country experiencing manufacturing weakness (chart on the right).

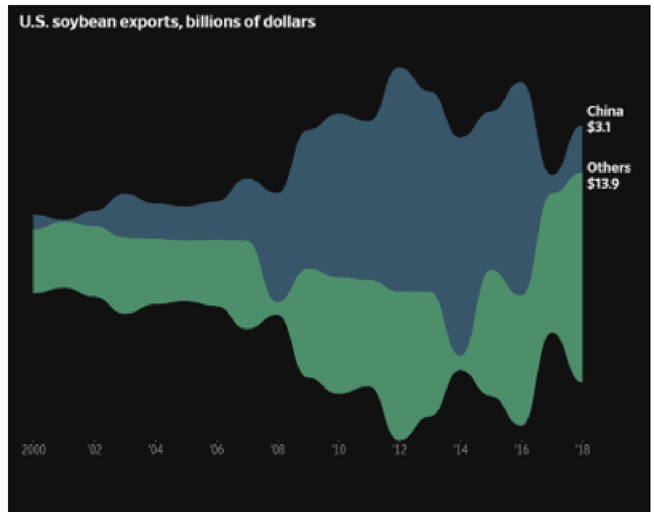



The important points to note regarding global manufacturing are (1) that weakness in this sector is a function of both a late-cycle environment and less trading of goods and services between countries because of policy disputes, and (2) that the subdued activity in both manufacturing and services in several major economies both hinders the future global growth outlook and increases adverse investment risks.

A second industry in which we can see the combined effects of the slowdown in global economic activity, the ongoing trade policy disputes, and domestic energy policy decisions is American farming. The recent toll taken on U.S. farmers has been extreme for three main reasons. One is that the trade war has removed for the time being a major purchaser of U.S. farm goods, especially soybeans. U.S. global exports have trailed off for goods like soybeans, wheat, and corn (graphs shown below).




China began cutting back on purchases as part of the tit-for-tat fight with Washington. Both sides agreed this month to hold off on new tariffs for some imports.

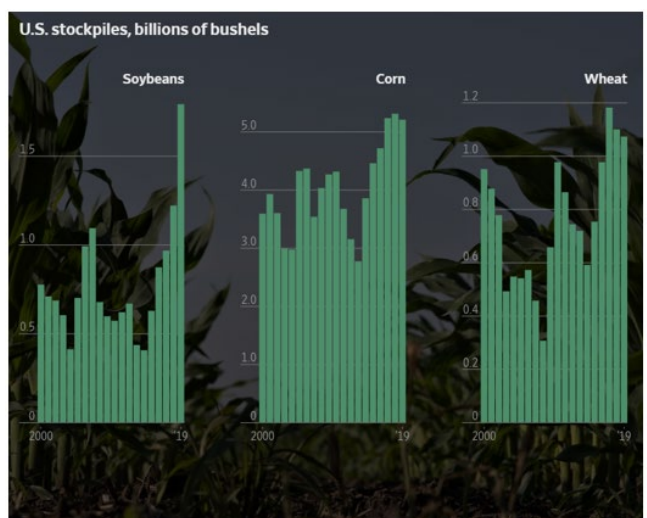



Soybeans are the biggest casualty. China has long been the main buyer, but it accounted for only 18% of U.S. soybean exports in 2018.

Source: *Wall Street Journal*, September 26, 2019.

As a result, stockpiles of many crops have risen, including corn and wheat), but soybeans have suffered the most (see the nearby chart).

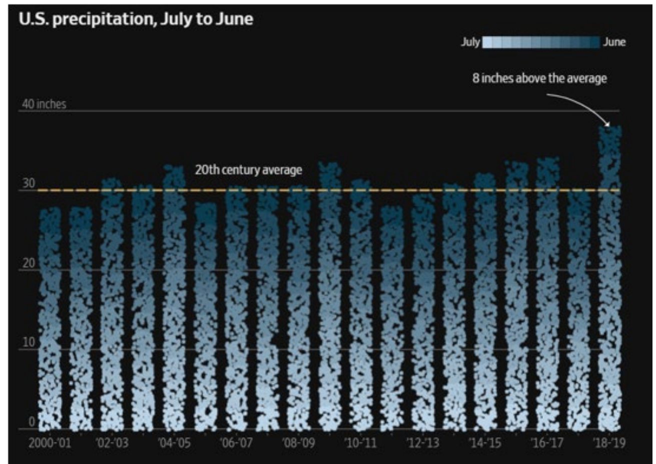
Corn farmers in Iowa have suffered, and corn stockpiles have built up, for a second reason: domestic energy policy. In addition to decreased purchases from foreign buyers, especially China, due to trade tariffs and the stronger U.S. dollar, corn farmers have seen decreased demand for their crop because of waivers extended by the Environmental Protection Agency to 31 small oil refineries, which would otherwise have had to blend ethanol (based on corn) with gasoline. China is a huge buyer of American ethanol, but in 2016 it imposed tariffs to protects its own producers. When the U.S. government imposed tariffs on Chinese goods in 2018, China retaliated with higher tariffs on ethanol. Both policies -- energy and trade -- have hurt farmers.




As U.S. farm exports have fallen, crops have piled up in storage.

Source: *Wall Street Journal*, September 26, 2019.

Third, record rainfall over the last 12 months has affected planting and crop yields, which in turn decreases the amount of various crops sold on domestic and foreign markets. As shown to the right, U.S. precipitation naturally but especially in the midwest has been above the average over the twentieth century.



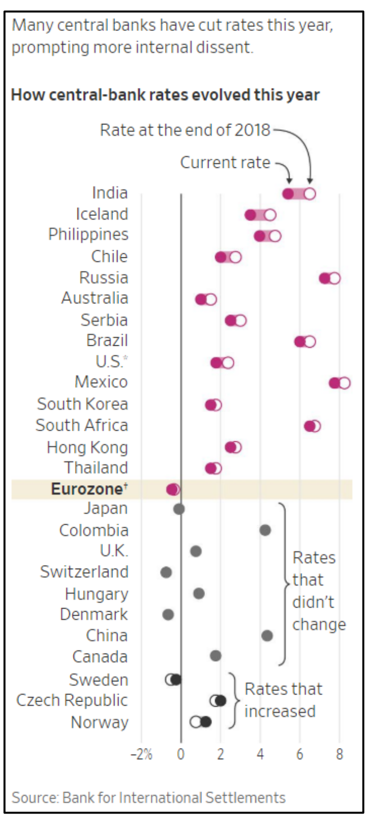

Adding to the problem for U.S. farmers is severe weather. The 12 months from July 2018 to June 2019 were the wettest since record-keeping began in 1895.

Source: *Wall Street Journal*, September 26, 2019.

The upshot is that various natural occurrences and policy decisions have put the U.S. farm industry in a bind, and there is no clear or definitive end in sight to the uncertainty.

Partly to combat these impairments to global economic growth, many central banks have lowered policy interest rates. Whether, when, and to what extent to continue stimulative monetary policy is becoming more contested within the respective central banks. Also, monetary policy typically operates on a 6-12 month lag, which is to say the stimulative effects on an economy take some time to filter through the economy. The nearby graphic shows how a number of countries or economic blocs, like the Eurozone, have altered their policy rates since the end of last year.

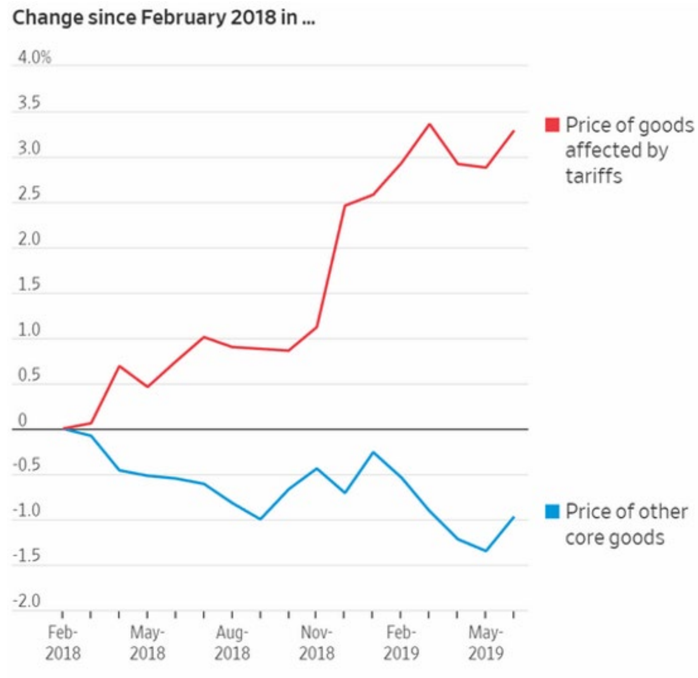
Weakness in Europe, for instance, prompted outgoing European Central Bank (ECB) President Mario Draghi in his last policy-setting meeting to reignite quantitative easing measures to stimulate growth. These various bond purchases and interest rate cuts may have their intended result, but they were fiercely opposed by powerhouse countries including Germany, France, and the Netherlands, who are concerned about already deleterious negatively-trading government bond yields in Europe and about what levers, if any, the ECB will have to counter additional weakness or broader recession in the eurozone.




In the U.S., the Federal Reserve's Open Market Committee has lowered its overnight policy rate twice already this year in response to weaker data. There was internal Fed dissent about the last rate cut (from Rosengren and George). Policy easing was not unanimous, and future decisions are likely to be as or more hotly contested.

We expect one more cut this year. If you had asked us at the end of September, we would have said the third cut this year would be most likely in December; however, the weaker manufacturing and service data just discussed has increased the likelihood, according to futures markets, that the Fed will cut again at its meeting in October. To be precise, according to Bloomberg data, the probability of a Fed cut at the end of October rose on October 3 to 87.3%, from 70% on October 2, and both up from 40% the last week in September.

What seems to be happening in the U.S. at least is that the hope for a Fed-orchestrated soft-landing has been at times boosting stock markets. This could continue if Fed policy and its effects meet market expectations. On the flip side, there is also downside risk to these Fed actions. The risk is that the Fed under-delivers stimulative policy and positive effects relative to market expectations. This is possible given the internal divisions within the central bank board of governors, as noted above, and also potential modest inflation movements due to pass-through effects from trade tariffs.



Source: Labor Department via Goldman Sachs

The consumer price index (CPI) is currently 1.7% through August for all items, and 2.4% for core (less food and energy, which has risen with Mideast tensions). The Fed's preferred metric, the personal consumption expenditures (PCE) price index shows 1.4% for all items and 1.8% for core, both below the Fed's 2.0% target. But as you can see in the graphic nearby, the price of goods affected by tariffs has grown much more than the prices of other goods have fallen. Newer tariffs have targeted certain retail items like mobile phones that may be gift items near the holidays as well as items that consumers regularly purchase throughout the year. Companies may be reaching the point at which they cannot, with a slowing economy and a stronger dollar, absorb the costs of tariff increases themselves without passing them on to the consumer. Currently, the U.S. consumer remains healthy, but if that changes it would have negative consequences for U.S. GDP growth and, likely, for equity markets.

## Conclusion

The uncertainties related to U.S./China trade relations and global monetary policy make it a difficult time for investors. There is a wide range of potential outcomes. Which way results tilt often depends on non-fundamental reasons such as geopolitics, which are difficult to predict but which can be consequential. We believe that these difficulties and uncertainties are likely to continue, at least for the next few quarters. For this reason, we have generally become more cautious on the margins, made asset class positioning closer to neutral in areas like equities, and readied ourselves to take advantage of opportunities that may arise.

Manufacturing and farming industries have shown notable weakness in light of the global growth slowdown and trade-related effects. This weakness may continue for a time before it improves. But the U.S. economy remains on generally solid footing, even if growth is slowing, especially when compared with Europe and Japan. 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, but their effect on investments will have more to do with market expectations than mere central bank activity. Both positive and adverse outcomes are at present possible but highly unpredictable. We continue to believe that well-diversified portfolios like those we have constructed can withstand environments like this one.

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