Preface

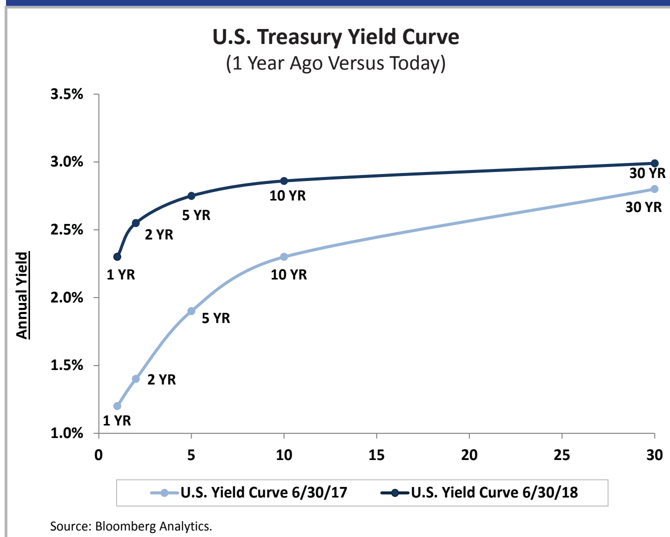
The second quarter was characterized by continued uncertainty and market turbulence as investors grappled with strong corporate earnings offset by increased macro and political risks. Consequently, global equity markets showed mixed performance with the S&P 500 generating a positive return (+3.4%), while non-US developed market equities declined (-1.2%) and emerging markets receded (-8.0%)[1]. From our perspective, the outlook for equities has deteriorated somewhat for several reasons, outlined below.

Concerns

- **Tariffs**: We continue to believe that embarking upon a trade war is illogical, as it is inflationary, detrimental to trade volumes, and disruptive to business activity, which is quite dependent on world-wide supply chain integration. Much of the public discussion so far may be just positioning and negotiating through public channels. However, it is clear the recent trade rhetoric indicates a growing risk of escalation on the small base of tariffs that have already been put in place or announced. Indicative of the inflationary risks posed by the imposition of tariffs is the fact that domestic prices of steel and aluminum have increased 39% and 13% respectively[2], over the last twelve months.

- **Federal Reserve Policy**: Interest rates in the U.S. have increased. The 10-year U.S. Treasury bond now yields 2.86% compared to 2.40% at the beginning of the year, and the yield curve has flattened considerably (see chart 1). The availability of U.S. Dollars throughout the world has decreased via quantitative tightening. This combination could, in time, lead to a financial accident, especially if combined with other possible drains of liquidity such as higher oil prices and an increasing U.S. federal deficit.

Chart 1



- **Corporate Earnings**: In the U.S., corporate earnings are expected to grow 29%[3] this year, a very meaningful increase significantly aided by the recent corporate tax cut. There are possible threats to this increase from higher input costs (e.g. oil), higher interest rates, rising labor costs and a stronger U.S. dollar. Whether these factors will impact earnings this year or next is not knowable, but the advent of cost pressures seems inevitable to us.

- **Valuations**: The reshaping of multi-decade defense, trade and economic structures and alliances has the potential to negatively impact financial markets. Challenging existing norms is likely to increase uncertainty and volatility and is unlikely to be beneficial to valuations in asset classes where valuations are already high.

Current Positioning

Reflecting what we have set forth, we are gradually reducing exposure to equity markets in portfolios by several percentage points[4]. Geographically, the reduction in exposure will come primarily from long-only investments in the U.S. and Europe. We are maintaining exposure in Asia at relatively high levels with an eye toward boosting this exposure consistent with client mandates should Asian stocks continue to slump. Proceeds from the sales of current equity positions will be allocated to Diversifying Strategies, across a variety of investments, where we are continuing to seek attractive opportunities that have low correlation to equity markets. The shape of the yield curve in the U.S. continues to reinforce our conclusion that it's prudent to remain short duration as there is very little yield pickup available as one extends out on the yield curve (see chart 1). We have recently moved some of our short duration investment grade corporate exposure to one-year U.S. Treasuries which have a similar net yield and no credit (default) risk. We continue to be comfortable with taking credit risk in specific strategies where the manager has an excellent track record of credit analysis.

Asia -- A Long-Term Opportunity

Some of the threats to equity markets may create additional investment opportunities in Asia, where we have a positive long-term view. As an example, the Shanghai Stock Market is down over 20% since its January peak largely due to negative trade sentiment, as China is clearly one epicenter of the U.S. Government's trade agenda. This reaction to flee Chinese equities is likely too focused on perception rather than actual economic impact. While China exports much more to the U.S. than it imports, giving the U.S. greater opportunity to escalate, investors appear not to recognize

[1] Source: Bloomberg, indices are S&P 500, MSCI EAFE and MSCI EM.
[2] Source: Bloomberg, generic first futures contract.
[3] Source: Bloomberg, CY 2018 for the S&P 500.
[4] Actual decreases in equity exposure are done on a portfolio by portfolio basis and will differ depending on client risk profiles and existing exposures.

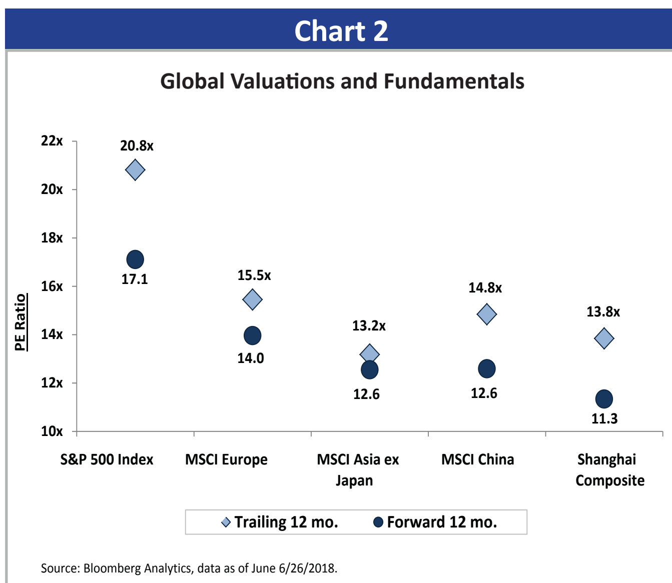
the vast number of domestic businesses in China, and in other Asian economies, that are not directly impacted by U.S. tariffs. Therefore, opportunities for portfolio managers to make long-term investments with attractive return characteristics should exist. Additional reasons why we view Asia constructively longer term are as follows:

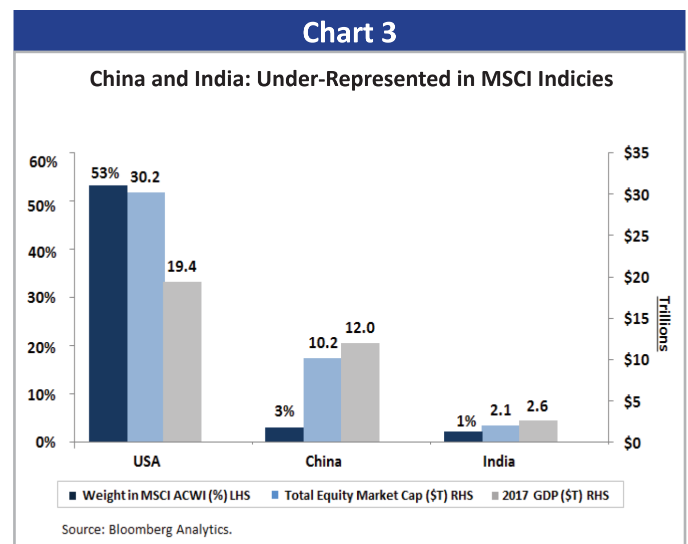
- **Demographics:** Asia has 4.5x the population of the U.S. and Europe and is home to many of the fastest growing economies in the world, including India and China. Asian countries like India, the Philippines, Vietnam and others have very attractive demographic profiles with young populations that will be prime earners and consumers for decades, which is a substantial advantage over many western developed markets.

- **Valuations:** Equity valuations in China and Asia are substantially lower than in Western markets (see chart 2) indicating modest expectations. Large economies and stock markets like China and India are also significantly under-represented in global indices (see chart 3). This is just beginning to change and will be a tail wind for a long period of time as index providers, such as MSCI, adjust their constituent weights to more fairly reflect global market capitalizations and/or nominal GDP.

- **Domestically Focused:** Many of Asia's dominant blue-chip companies are domestically focused and face little or no direct business interruption from the tariff/trade discussions that are on-going. For example, Tencent and Baidu, two of China's leading technology companies, have very little to no foreign revenue. Housing Development Finance Corp. (HDFC), India's premier housing finance company caters solely to India's domestic consumer.

- **Fiscal Condition:** Government debt levels and future entitlement obligations in most Asian countries are lower than their western peers, providing governments more fiscal freedom to focus on policy initiatives that accentuate long-term growth opportunities. China's "One Belt, One Road" initiative is a superb modern-day example of the Eisenhower Highway Act, but on a larger scale, the end goal being a massive infrastructure network for trade and transport that facilitates pan-Asian trade and inroads to Europe.





- **Sell-side Coverage:** The lack of equity research coverage in Asia is pronounced in comparison to western developed markets. In the U.S. 94% of publicly traded companies have research analyst coverage. In Asia ex-Japan this figure drops to 69%. Less coverage means more inefficiency, which accentuates the return opportunity for active investors in Asia.

If global trade concerns do lead to an equity market sell off, it is likely that there will be some indiscriminate selling which could produce very interesting long-term investment opportunities in Asian and other markets for investors willing to step in. With that in mind, we recently announced that Frank Brochin joined New Providence, bringing more than two decades of additional investment experience in non-U.S. markets with a concentration on Asia to our research team.