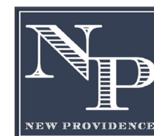
Our View

July 2019



Preface

The second quarter offered something for everyone, with global stock and bond markets producing strong returns (see Table 1). The most interesting aspect of returns year to date has been the markets' interpretation of the environment. Bond markets have been strong on the presumption that the Federal Reserve, and other global central banks, will cut rates due to data suggesting weaker economic growth. Lower bond yields and inverted yield curves have traditionally been indicators of something ominous coming, but equity markets have taken that same economic data and concluded that bad news is good news. The S&P 500, for example, closed the second quarter at an all-time high.

Does something have to give? Or, can both the stock market and the bond market be correct so that everyone's a winner? We are reminded that markets do focus on fundamentals from time to time, although you do not always know when.

Chart 1: S&P 500 Earnings[1]

Chart 1, updated from last quarter, exhibits two interesting data points. First quarter earnings are now finalized and worse than consensus expectations, ending the quarter +0.6% year over year, versus expectations of +5.0%, and Q2 earnings are now expected to show a negative growth rate (-6.7% y/y). Only three months ago second quarter earnings for the S&P 500 were expected to grow roughly +7%; yet, the equity market has not reacted. Why? One might argue that the market is now using a lower discount rate as bond yields decline which affords a higher valuation multiple for stocks. Another reason could be that consensus projections for Q3 (+7.0%) and Q4 (+14.2%)[2] call for a reversion to year over year growth.

Table 1: 2019 Performance YTD[1]

Index	Q2	YTD
S&P 500	4.3%	18.5%
MSCI All Country World Index ex -U.S.	3.2%	14.0%
Barclay's Aggregate Index	3.1%	6.1%
Barclay's Global Aggregate Index	3.3%	5.6%

However, underlying that assumption is an anticipated expansion in margins that is far in excess of anything we have seen post the financial crisis. This is an aggressive assumption since labor costs are not likely to go down in a tight labor market, and the U.S. dollar has not shown weakness that would help the relative competitiveness of American goods and services. This makes us cautious about the exuberance that we are observing.

The Short View

Markets apparently believed a trade deal between the U.S. and China was a done deal until early May. The casual market observer could see ex-poste that the actual level of risk was higher. Trading a portfolio around news headlines, tweets, and Fed press briefings isn't investing and it isn't risk management. It is noise, that re-prices very quickly, and distracts from a more appropriate timeframe for investing.

[1] Source: Bloomberg.

[2] Source: Bloomberg for all consensus growth estimate data.

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The Long View

More interesting is the potential long-term impact of the tactical and strategic shifts that U.S. policy may have on the global competitive landscape. A few examples illustrate just how interesting and complicated policy shifts can be to long-term dynamics:

- **Technology:** The U.S. is undoubtedly the leader in technological innovation. It is using its considerable influence to disrupt some of China's homegrown technology blue-chips, either through persuasion applied to the ultimate consumer, as is the case with Huawei, or via limiting access to critical technology components such as semiconductor chips. This may be effective in the short-term but, considering the strategic necessity of technology to modern economies, China will build its own capabilities to serve first its domestic market and then to compete globally, as we are now seeing with 5G network technology. If technology becomes a balkanized sector there are a myriad of possible ramifications, including: an increase in innovation; a narrowing of the competitive gap between the U.S. and others; and deflation in unit price economics.

- **Supply Chains:** U.S. imposed trade tariffs make Chinese goods more expensive to American consumers, which may cause some consumers to switch to domestic brands that are less expensive. It could also lead to some Chinese supply chains being repatriated to U.S. soil. If so, given the increased efficiencies of automation, it is not obvious that the re-shoring of manufacturing will lead to increased jobs. It is more likely that supply chains will move to areas where labor and input costs are more moderate than both China and the U.S. Southeast Asia is a likely beneficiary, where supply chains have already been migrating for years, as Chinese manufacturing costs have risen.

- **Reserve Currency Status:** The U.S. accounts for roughly 20% of global economic output, but over 50% of global currency reserves and trade is in U.S. dollars. Thus, the U.S. has a significant advantage being able to print the primary currency of global trade. An ancillary result of this privilege is that the U.S. is able to impose unilateral sanctions on foreign entities and countries, and even to restrict others from doing business with sanctioned entities. For example, any U.S. dollar payment that flows through a U.S. bank or that uses a U.S. payment system (e.g. Swift) allows the U.S. to prosecute the offender and/or seize the offenders U.S. based assets. This tactic is incredibly powerful, isolating sanctioned entities financially.

The more this tactic is used the more likely it is that trading partners will seek ways to increase their independence and reduce future risk. China, while not subject to these sanctions, now buys oil from exporters like Russia with its currency (Renminbi) rather than U.S. dollars. As part of the Belt and Road initiative, China is making sizable loans in Renminbi to sovereign nations for the dual purpose of creating a commercial infrastructure web that benefits China's exporters and to increase the ubiquity and availability of Renminbi as a common trade currency. Strategically, it makes sense for China to continue this effort for two reasons: it reduces the global reliance on the U.S. dollar for trade; and, it elevates the Renminbi, which advances the hope that someday it will achieve global reserve currency status. This may be a long way off, but an unintended long-term consequence of U.S. policy may be ultimately a decline in the value of the U.S. dollar, and higher U.S. interest rates.

Current Positioning

We have not made meaningful changes to our asset allocation in the second quarter and thus remain modestly underweight risk assets, primarily exhibited by an underweight to U.S. equities, partially offset by an overweight to Asian equities, which we favor over the long-term because of the combination of lower valuations and faster growth rates.

The increase in short-term volatility that the trade conflict has generated has provided a benefit to our managers in Asia who are able to buy great businesses at even more attractive valuations. Many of these Asian businesses are not impacted at all by trade with the U.S., making macro headline generated sell offs an opportunity to upgrade portfolios.