Sterling Advisors

THE MARKET MATTERS

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July 2018

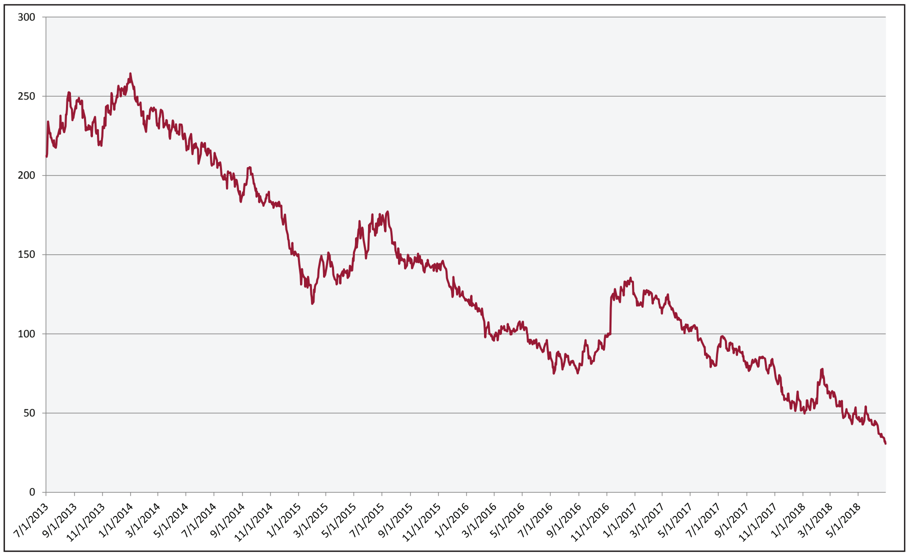
Halftime Adjustments

That was *fast*. Frenetic geopolitical and economic developments resulted in a blink-and-you-missed-it first half to 2018. Some events were anticipated, others much more difficult to foresee. Volatility jolted higher in stark contrast to its catatonic state in 2017. Political uncertainty fueled choppier trading and more dramatic daily moves in U.S. equity and fixed income markets. But the year-to-date results are fairly muted. Through June 30, the Dow Jones Industrial and Bloomberg Barclay's U.S. Aggregate Bond indices are roughly flat and -1.6% respectively, on a total return basis (Bloomberg). But it feels like we are just getting started. As the third quarter begins, we explore some of the year's key market drivers and disruptors thus far – and what we may face through year-end.

Global Trade: It is probably fair to label the ratcheting global trade tensions as the big disruptor so far this year. The escalation can be dated back to March 8, when President Trump announced new tariffs on all steel and aluminum imports minus those from Canada and Mexico. Three weeks later, China responded with a proposal for 25% tariffs on more than 100 U.S. products. The U.S. wasted no time in putting forth 25% tariffs on more than 1,000 Chinese products two days later. Since mid-April, the pleas, threats, and retaliations have grown in frequency and severity. The result: major concerns among equity investors and U.S. companies. Uncertainty alone is enough to weigh on stocks – we saw that with North Korea's nuclear war threats last year. But this is different. This uncertainty directly threatens global growth prospects – which are already fragile – and business sentiment. The prospect of an all-out trade war shakes U.S. companies' confidence and willingness to invest in new capital projects, employees, and research. A more defensive stance from businesses translates to similar behavior among investors and consumers. The Dow is down almost -2.0% since trade issues stole the spotlight in early March. In that same span, U.S. fixed income has benefited from investors seeking shelter from the storm. But this is a lingering storm, at least in the near-term. We expect the Trump administration to continue ramping up the rhetoric. Whether this is 'Art of the Deal' tactics in motion or simply bluster remains to be seen. But a clear path toward resolution is needed to return U.S. equities back to record highs. Until then, the demand for U.S. fixed income should expand, suppressing yields and keeping the U.S. yield curve flat. Perhaps the desire for a GOP 'win' closer to midterm elections will facilitate a U.S.-China deal, but that means trade concerns could fuel volatility for several more months.

Tax Reform: This one resides on the positive side of the ledger, especially for U.S. businesses. December's tax overhaul, the largest since the 1980s, cut the corporate tax rate from 35% to 21%. Corporate earnings are reaping the benefits with profitability soaring relative to recent years. Lower corporate tax bills have encouraged new capital spending, hiring and sporadic wage increases. That's all good – but nothing is perfect. Tax reform will likely force the U.S. budget deficit above $1 trillion by 2021. U.S. government debt issuance will balloon to help backfill the shortfalls created by lower taxes receipts. That's probably a sustainable trend for a few years, but tax reform sets up the U.S. for a significant increase in its indebtedness – typically not a long-term positive. Also, the benefits of individual tax cuts are uneven. Many Americans are reporting they haven't noticed a change in their take-home pay. That means a lot of consumers' purse strings are not being loosened by tax reform. Lastly, several studies have demonstrated how a U.S. vs. the World trade war could quickly wipe the gains generated by tax reform off the table. Therefore, trade uncertainty is tarnishing some of tax reform's luster. That being said, the market appears capable of digesting our elevated debt supply for now. That makes tax reform a net-positive for U.S. growth prospects over the next year or so and probably extended our economic expansion further into the future than it otherwise would have reached. But there's no free lunch. Its consequences will have to be addressed eventually.

U.S. Federal Reserve: The central bank raised its benchmark rates twice in 1H 2018. That brings the grand total to seven since levitating from zero in December 2015. Under the guidance of new Fed Chair Jerome Powell, the Fed sounds a bit different. 'Fedspeak' has become more straightforward and succinct. This is a good thing for comprehension and clarity, but the hawkish message is that much more jarring. The Fed is determined to raise short rates despite the yield curve teetering on inversion. A yield curve inversion, where short yields eclipse those of longer maturities, is an established harbinger of economic malaise. The most common measure is the spread between 2- and 10-Year U.S. Treasury yields. As of this writing, that yield differential stands at just 31 basis points (0.31%), an eyelash more than a 25 basis point rate hike. Consensus is growing that the U.S. yield curve will invert, maybe in the back half of this year. Without a meaningful pick-up in U.S. inflation and/or international yields (which are suppressing U.S. yields due to strong overseas demand for our higher rates), the Fed's current tightening plans will almost inevitably invert the curve. That distinct possibility is starting to weigh on growth outlooks and equity valuations. At this point, the Fed's aggressive pace of rate normalization is becoming a reason why longer yields refuse to move higher. Monetary policy has become overly restrictive on an already-delicate economic expansion. But the Fed's fear of an inflation overshoot – which in our assessment are overdone – is compelling policymakers to keep turning the crank. Given our subdued core inflation outlook, we believe the U.S. will continue to slide closer to an inverted curve as the year progresses. That would likely weigh on risk assets and keep investors on edge. The subsequent expectations of a slowdown would reduce companies' willingness to invest and consumers' willingness to spend. Just a few years ago, the Fed was the U.S. economy's most powerful ally. They are now positioned as one of its largest threats.



Graph 1. The yield differential between 2- and 10-Year U.S. Treasury yields since mid-2013 Source: Bloomberg

U.S. Economic Data: U.S. economic data still looks solid by a wide range of measures. Unemployment is at its lowest point in 18 years (3.8%, Bloomberg) and should continue to improve from here. There are underlying concerns about the falling Participation Rate, which considers the number of people actively looking for work. And tight labor conditions such as these should be driving wages (and inflation, by extension) higher. But the fact remains that hiring trends are robust and wages may be starting to creep higher. Inflation appears to be slowly (finally) wakening up from a long slumber. We wish the Fed would give it a hot cup of coffee as opposed to this warm glass of milk. U.S. consumer and real estate activity held fairly strong in the first half of 2018, but rising mortgage rates and trade uncertainty are just starting to weigh on these sectors. Domestic manufacturing conditions are near 12-month highs and tax reform continues to spur optimism and profitability.

The economy remains on stable footing, but markets tend to grow leery well before data delivers concrete evidence. Therefore, we must stay vigilant. The two-year rally in U.S. equities may have skewed some investors' portfolio weightings. Now may be an opportune time to re-evaluate asset allocations to ensure they still align with long-term objectives. A few simple halftime adjustments can set us up for the strong finish.