Sterling Advisors

THE MARKET MATTERS

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March 2019

When Threats Become Opportunities

U.S. equity markets have surged back to life following 2018's challenging fourth quarter. Since the December 24th low, the S&P 500 Index has advanced almost 20%. That leaves the index just 4% below its all-time high set in September (Bloomberg). After heading for the exits late last year, traders' appetites for risk have returned authoritatively in 2019. As a result, investments in cyclicals such as the financials, energy, and industrial sectors have outperformed over the past two months. Emerging market equities and high-yield debt discovered reinvigorated demand as well. Why the broad-based change in sentiment? Below we discuss the two main drivers behind the stock rally and their sustainability moving forward.

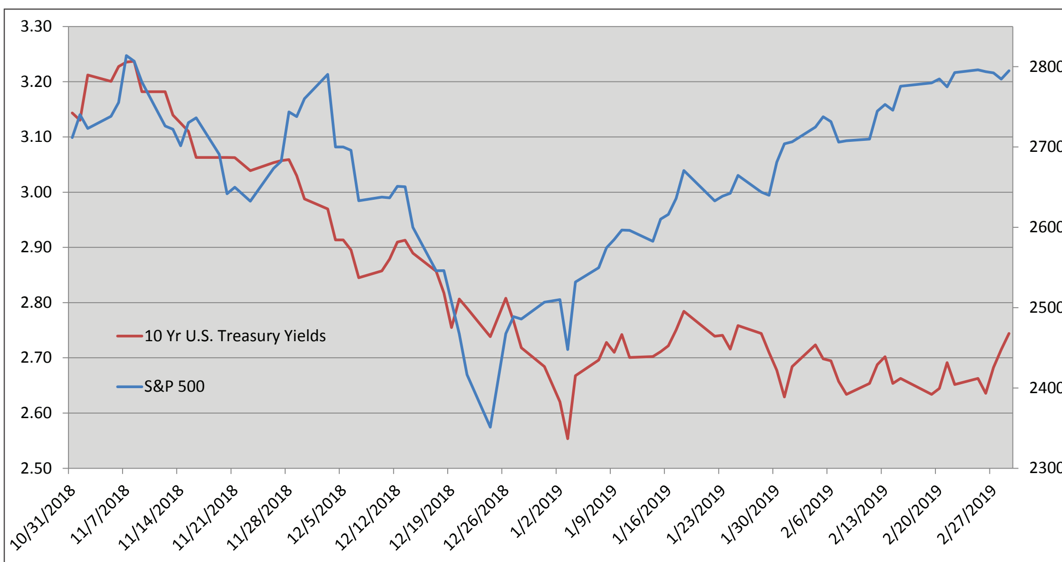

Figure 1: 10 U.S. Treasury Yields (left axis) vs. S&P 500 Index (right axis) since October 31, 2018

Source: Bloomberg

U.S.-China Trade Relations – Throughout the latter portion of 2018, the U.S.-China trade conflict routinely escalated. It fostered a dramatic increase in geopolitical tensions and global growth uncertainty. Beginning on September 24th, U.S. tariffs on $200 billion of Chinese imports went into effect. China retaliated with $60 billion of its own. So began a two-month period of back-and-forth between the two nations that pulled S&P 500 volatility to its third-highest point in more than seven years (Bloomberg). U.S. and Chinese industrial production slowed significantly. Leading world economic bodies such as the International Monetary Fund downgraded 2019 growth expectations sharply to account for the damage that would be done by a long-term trade battle between the world's two largest economies. Global equity markets swooned. The S&P 500 fell away from its all-time high by 20%. A flight-to-quality ensued that pulled 10-Year U.S. Treasury yields down from 3.24% to 2.55%, their lowest yields (i.e., highest prices) in 10 months. And just when tensions seemed to ease, developments such as the arrest of Huawei Technologies Co. CFO Meng Wanzhou's emerged. However, on the same day as her arrest, the U.S. and China announced a 90-day truce that halted a massive amount of new tariffs from going in place until March 1. That decision laid the foundation for a productive first quarter 2019 on the trade front.

Since the beginning of the truce, many (though not all) of the threats and inflammatory rhetoric have subsided in favor of diplomacy and substantive negotiations. The finger-wagging and threats of retaliation have slowed dramatically. The U.S. and China are now speaking largely from the same script. Each regularly touts the progress and good vibe between negotiators behind closed doors. So much so, the U.S. and China agreed to extend the talks beyond the March 1 deadline and hold off yet again on implementing more bilateral tariffs. U.S. equity bulls breathed a sigh of relief; equities extended their rally. Although the extension of the negotiation period – with no agreement in place – leaves uncertainty in the air, the fact it was announced in the context of progress helped avoid panic. Markets are acutely aware of the erratic negotiation tactics the White House is capable of choosing. Seeing a more collaborative strategy being implemented has helped resurrect the risk-on mindset.

The likelihood of the U.S. and China reaching a trade agreement has increased over the past few months. Optimism is growing. One of the largest threats to global growth may find a benevolent resolution yet. There are still hurdles to be cleared, particularly in the realm of protection of intellectual property rights and the U.S.'s ability to penalize China for any future theft. Any risk of a stalemate would cause a stir and likely disrupt riskier assets. We do continue to expect President Trump and President Xi to ink a deal in the first half of 2019, but also expect some halts in progress in the meantime. Therefore, we remain constructive on risk assets in the near-term but also expect volatility to rise from current levels – though not at the total expense of the recent rally in U.S. stock indices.

The U.S. Federal Reserve – Amidst all the trade turmoil at the end of 2018, participants were begging for a more patient tone from the Fed. Global growth faced consistent downward revisions. U.S., Chinese, and European data slowed. Brexit angst grew dramatically. President Trump upped political pressure on the Fed to ease its stance, an atypical move from a sitting president. Oil prices fell 35% and pushed the market's inflation expectations off a cliff. That's significant because the Fed is charged with maintaining price stability through monetary policy. Oil's price rout complicated those efforts. Many assumed too many concerns had arisen for the Fed to dismiss. No way it could continue upon its rate-hike path and balance sheet reduction program, right? Wrong. On December 19th, the central bank made two choices that fueled 2018's last leg down in U.S. equities. First, the Fed increased the Fed funds rate by 0.25% for the ninth time since December 2015 and made no changes to its 2019 projected rate path, despite the growing headwinds. Second, Fed Chair Powell described the Fed's balance sheet reductions as a program on 'autopilot.' It signaled a discomforting amount of rigidity in Fed policy as opposed to the pliability participants desperately sought. The market had already begun to suspect the Fed had become a viable threat to the U.S. expansion given its restrictive policy outlook. On December 19th, Powell seemed to confirm it.

Then came January 4th. That date kicked off the Fed's most abrupt 180-degree turn in recent memory. On that day, Fed Chair Powell went in front of the American Economic Association in Atlanta and pledged to be patient with monetary policy. He relabeled the balance sheet runoff as a flexible tool in the Fed's kit, the antonym of 'autopilot.' Since then, appearances among Fed officials have pushed the accommodative narrative. The Fed moved from a threat to a position of support. At the end of 2018 we wrote, "The Fed needs to renew its vow to stay data-dependent. The urgency it felt in 2018 to tighten – via rate increases and its balance sheet unwind – was overdone. It wants to restock its quiver with more arrows to fight the next recession – an understandable goal. But doing so too quickly will bring about the downturn it dreads before it can properly arm itself." In early January – and since – the Fed bought into this view. We believe the Fed is on hold for the first half of 2019 and will use the time to evaluate how its previous tightening is now impacting economic activity before making its next move. This is a welcome decision. The shift helped improve growth expectations which, in turn, have supported the 2019 equity rally. Meanwhile, the Fed's dovish pivot helped keep U.S. Treasury yields low and stable. That is restoring a sustainable risk-reward relationship between stock and bonds.

In both instances – in trade negotiations and Fed policy – threats were reshaped into opportunities through better policymaking. A continuation of recent trends would likely extend gains in risk assets and leave U.S. yields in a palatable range over the near-term. But risks remain. The U.S. yield curve is already inverted between 1-5 year maturities and remains very flat elsewhere. If the U.S. or China unexpectedly pushes away from the table, markets would likely react very negatively. Global data continues to demonstrate a broad, slowing trend. All of this will need to be monitored closely. But the best way to combat these serious challenges requires a supportive Fed and harmonious global trade.

Thus far, 2019 has moved us a few steps closer to both.