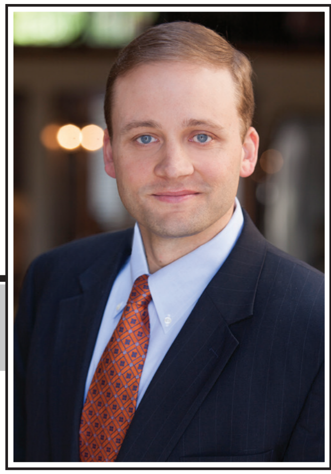
Sterling Advisors

THE MARKET MATTERS



Chip Hughey, CFA®
Head of Fixed Income Strategy and Services

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Fourth Quarter Playbook

As we enter the final quarter of 2019, we face a reinvigorated level of uncertainty. There is no shortage of potential threats to the U.S. economic expansion – the same expansion the Federal Reserve reasserts its pledge to protect in every public appearance. But can the Fed truly address a slate of threats that lies so far outside its traditional purview of domestic price stability and full employment? The Fed is correct that heightened global instability directly challenges its primary objectives. But the tools at its disposal – limited by the central bank's already-accommodative stance – are not designed to combat many of the economic challenges the U.S. and the world at-large currently face. The variables that effect the health of the U.S. economy are more global in nature today than at any other point in the history. To the contrary, the U.S. Federal Reserve is a domestic support system which, at best, can only hope to create ripple effects that result in positive international impact. That makes the final quarter of 2019 feel vulnerable. We have spent so much time and ink this year dedicated to the Fed, the Fed, the Fed, and what it may or should do next. The tougher question: how much does it matter? Below we discuss the key developments to monitor in the final months of 2019 that, try as they may, Fed officials are ill-equipped to address.

U.S.-China Trade War – U.S. monetary policy and the ongoing trade dispute have become deeply intertwined. The Fed can foresee the long-lasting damage a protracted trade war and decoupling of the U.S. and Chinese economies could create. Therefore, Powell & Co. feel compelled to lean more dovishly in the event President Trump and Chinese President Xi cannot ultimately ink a trade deal. Simultaneously, President Trump routinely hammers the central bank for not throttling up accommodation to support the U.S. economy through this trade-plagued purgatory in which we find ourselves. The trade standoff has become the biggest hamper on global growth by a wide margin – with its negative effects still growing. Nothing would ease economic anxieties more than for the U.S. and China to start cooperating. However, it could be argued that additional Fed stimulus (by lower interest rates and/or asset purchases) serves to embolden U.S. negotiators and their more draconian impulses on the trade front. Therefore, the supportive impact of dovish Fed policy is being diluted by the safe space it is creating for increasingly aggressive trade negotiation tactics. The Fed has now lowered benchmark rates twice since the onset of the trade war in response to deteriorating growth expectations. Meanwhile, the U.S. and China keep adding bricks to the wall that obstructs open trade between the two powerhouses. If the U.S. and China continue to ratchet tensions and postpone a deal, it could easily drag the developed world into a synchronized global recession. The Fed may be able to soften such a blow, but it cannot prevent it singlehandedly.

The Impeachment Inquiry – On Tuesday, September 24th, House Speaker Nancy Pelosi officially initiated an impeachment inquiry against President Trump in response to a whistleblower complaint that he pressured the Ukrainian president to launch an investigation against Democratic opponent Joe Biden and his son, Hunter. The inquiry is being launched on the basis that President Trump may have violated his oath of office and meddled with U.S. elections. Investigators will try to demonstrate President Trump took steps to cover up the conversation, thereby suggesting he knew his conversations with the Ukrainian government crossed diplomatic and constitutional lines. President Trump will use the inquiry as the latest example of his political opponents seizing any opportunity to complicate his leadership efforts, which could serve to mobilize his supporters as the 2020 election cycle heats up. Partisan politics aside, the decision to initiate an impeachment inquiry is a historic one – and one that will create yet another distraction for the current administration. President Trump is only the fourth sitting president to face these types of proceedings. It almost certainly eliminates the chance of impactful bipartisan legislation for the foreseeable future such as an infrastructure spending plan with the power to create a new growth engine. It also throws more sand into Congressional gears that already have substantial operational issues. We believe the likelihood of President Trump's removal from office – which would be the most disruptive outcome for U.S. markets – is very low given the GOP control in the Senate.Still, it introduces heightened legislative complications in a period of souring growth and inflation expectations in the U.S. and abroad. The inquiry makes the Fed's job more difficult even though it falls well outside of the Fed's control.

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Brexit – We are just one month away from the U.K.'s planned exit from the European Union. The three potential outcomes in the near-term, listed in order of greatest to least negative impact: 1) hard Brexit with no U.K.-E.U. deal in place; 2) delay the October 31st Brexit deadline to some future date; 3) the U.K. and E.U. formalize a structured divorce compromise and the U.K. leaves in orderly fashion. Despite U.K. Prime Minister Boris Johnson's posturing, recent maneuvers suggest he wants to strike a deal with E.U. officials. By stating he wouldn't step down if the deadline was postponed, Johnson signaled a reluctance to use the nuclear option (i.e., no-deal Brexit). We believe a Brexit delay is the most likely outcome for 2019. Negotiations are currently sporadic and fruitless. Kicking the can down the road appears likely. It leaves a major source of uncertainty in place for global markets to navigate. It may continue to damage Eurozone data and sentiment. The slowdown in Europe is far more pronounced than the U.S.'s weakness thus far. Though a hard Brexit would wreak far more chaos, postponement is still not a great outcome for international risk markets in the near-term. It would suppress European yields which, in turn, would keep anchoring U.S. yields as well.

Middle East Tensions – In mid-September, Saudi Arabia suffered an unexpected drone and missile attack on its Aramco oil fields which the Saudi government and the White House blamed on Iran. The attack escalates tension in the Middle East and pushes the region closer to military conflict. Saudi Arabia's oil output was crippled by the strike, reducing its oil output by roughly 50% and the world's total supply by approximately 5%. U.S. energy prices have crept higher since the disruption, which illustrates our sensitivity to any conflict in the Persian Gulf and our likely involvement should conflict break out. The inflamed unease in the Middle East is a relatively new challenge, but an important one. A major disruption to the world's oil supply – a meaningful chunk on global GDP – would have major implications on growth and inflation, which can be greatly affected by rising oil prices. It's an exogenous threat capable of creating a huge impact on the world economy. Policymakers would be able to do little more than watch.

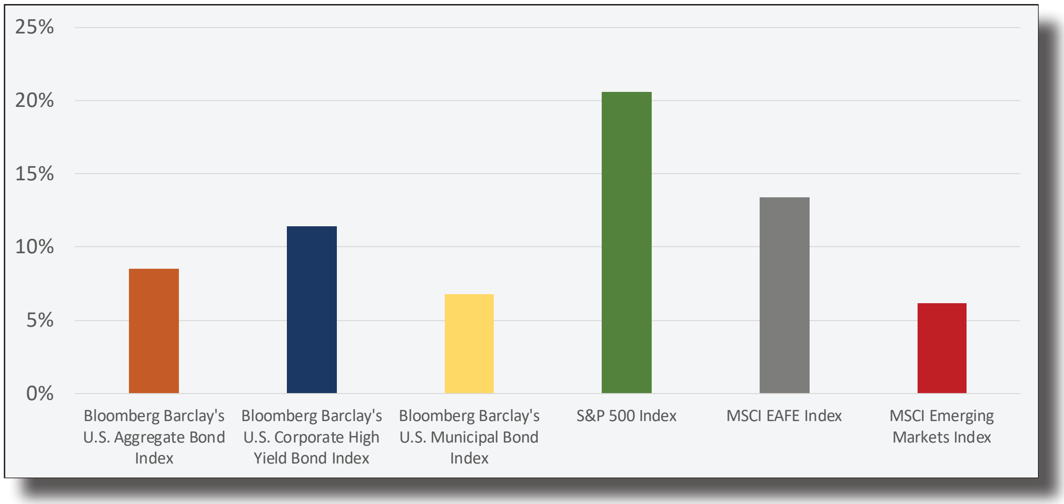

Chart 1. Major indicies total returns (YTD) through 3Q 2019 Source: Bloomberg

Through 3Q 2019, the Bloomberg Barclay's U.S. Aggregate Bond Index and the S&P 500 Index are up roughly 8% and 20%, respectively (Bloomberg). A diversified domestic portfolio has fared very well this year. The S&P 500 Index remains less than 2% away from its all-time high levels. However, the 3-Month-to-10-Year U.S. yield curve remains inverted and U.S. leading indicators suggest economic conditions are softening. Clear threats to the expansion exist. It's a prudent time to run portfolio diagnostics to ensure a given portfolio's risk characteristics align with the client's objectives and risk appetite. Now is an opportune time to implement such allocation adjustments given the favorable performance across U.S. equities and fixed income.

The Fed cannot protect us from every threat. But if we are prepared, we don't need them to.