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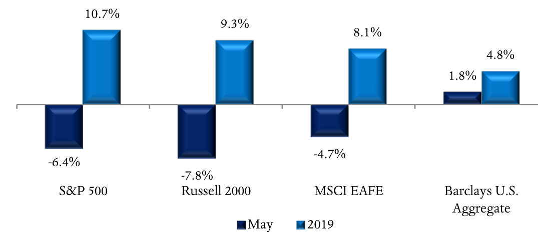
Markets

Gravity took hold of equity markets in May, as optimism over the dovish tilt from global central banks waned, economic growth deteriorated, and trade negotiations between the US and China broke down, leading to higher tariffs and a "tech war." The S&P 500 index, which started the month at an all-time high, retreated -6.4% during the month (+10.7% ytd), while the smaller capitalization Russell 2000 declined -7.8% (+9.3% ytd). Overseas equity markets were also buffeted as seen by the MSCI EAFE index's -4.7% retracement (+8.1% ytd). In Europe, the Stoxx 600 returned -4.8% (+12.1% ytd). Similarly, in Asia, Shanghai stocks dropped -5.6% (+16.6% ytd), while Tokyo equities fell -7.4% (+3.9% ytd). Emerging market equities were also routed during the month, declining -7.2% (+4.2% ytd).

Fixed income markets increasingly anticipate that the US Federal Reserve will reduce interest rates, starting later this year. Expectations presently call for more than three rate cuts by the end of 2020. As such, and in a risk-off environment, US 10-year Treasury yields declined significantly in May (-37bps, from 2.50% to 2.13%) as investors bid the risk-free bonds up by +2.4%. The bellwether Barclay's US Aggregate index also rose +1.8% (+4.8% ytd). Conversely, high yield bonds recorded their worst monthly performance of 2019 as spreads widened markedly (+81 basis points) and defaults ticked -up, leading the index to pull back -1.3% (+7.5% ytd).

The price of crude oil slid in May, with the WTI benchmark ending the month at $53.50 per barrel, down from $63.91 (-16.3% mtd; +17.8% ytd). Concerns focused on rising inventories and potentially lower demand for energy products stemming from escalating trade disputes between the US and China (as well as Mexico). In sympathy, commodity equities declined -7.7% in May (+3.9% ytd).



Geopolitics

US-China trade negotiations seemingly reached an impasse in early May as US President Trump complained that the pace of progress was not fast enough for his liking. In response, the US increased the tariff rate on $200 billion worth of Chinese imports from 10% to 25%, and announced that it would proceed to impose a 25% levy on the remaining $300 billion worth of Chinese goods. This led to China retaliating by increasing their tariff range from 5-10% to 5-25% on $60 billion worth of US imports. Further, the Trump administration ratcheted its pressure on Huawei, the Chinese technology company, and world's No. 1 telecom supplier and No. 2 smartphone maker, by banning American companies from doing business with it. This led to Chinese retaliation against a list of thirty US companies. The Chinese have publicized three preconditions for a trade deal: that the US must remove "all additional tariffs" levied on Chinese exports, that Chinese purchases of US goods to help reduce the trade deficit "should be realistic," and that the text of a final agreement should be "balanced." Apparently, the conditions are not acceptable to the Trump administration, so investors are bracing for a protracted trade war, with Chinese President Xi Jinping calling it a "new Long March."

Then, at month-end, President Trump signaled the intention to levy a 5% tariff on all Mexican imports, effective June 10, to pressure the country to do more to crack down on the surge of Central American migrants trying to cross the US border. Soon after, a deal with Mexico was reached, averting the levies. It is interesting

to note that the world has been in a low tariff (circa 5%) environment since 1980, and sub-15% since 1950. From an economic perspective, the initial impact of higher taxes is usually inflationary (due to the higher cost of goods), but as demand slackens, in reaction to the reduced affordability, deflation in affected markets typically ensues.

Europeans headed to the voting booths for Parliamentary elections. More than 50% of voters turned out, the highest level in two decades and a sharp increase from the 42.6% seen in 2014. In a signal of increasing fragmentation and polarization, Europe's traditional centrist coalition lost its majority (declining from 54% to 43%), with far-right populist parties and liberal, pro-European Union, parties both gaining ground, securing 25% of the seats, up from 20%, but perhaps not as much as had been expected. The Greens, a party coalition focusing on environmental issues, went from 52 seats in the European Parliament in 2014 to 69 in 2019, making them the fourth largest voting bloc in the EU. In France, Marine Le Pen's National Rally party won the highest share of the vote at 23%, while Matteo Salvini's anti-immigrant, populist party the League made big gains in Italy. In Greece, a sweeping victory by New Democracy, led by Kyriakos Mitsotakis, forced PM Alexis Tsipras and SYRIZA to call snap elections to be held on July 7. The local stock market cheered the outcome, rising 13% following the results. Voters in the United Kingdom weren't initially even supposed to participate in this election; they were meant to have left the EU by the end of March. But with several delays, and plans for separation now set for October, UK voters had to take part, and gave the new Brexit Party, formed just six weeks ago, led by populist Nigel Farage, more than 30% of the vote. In contrast, Prime Minister Theresa May's Conservative Party ended up in fifth place, with 8.7% of the vote, while the Labour Party also fared poorly, down 10% from 2014. For now, the results are more likely to have bigger implications at the national level, particularly in Italy, Greece and the UK.

May 2019 Economic Statistics

	May-19	Dec-17	Dec-16
Federal Funds Target Rate	*2.25 - 2.50%*	*1.25-1.50%*	0.50 - 0.75%
Consumer Confidence Index	*134.1*	*122.1*	113.7
Manufacturing PMI Index	*52.1%*	*59.7%*	54.7%
Unemployment Rate	*3.6%*	*4.1%*	4.7%
JPY/USD	*108.26*	*112.67*	116.87
USD/EUR	*1.1167*	*1.1996*	1.0513
Gold/oz.	*$1,305.25*	*$1,302.45*	$1,151.46
Oil (WTI)/bbl	*$53.50*	*$60.42*	$53.72

United States

US economic data has begun to stumble. Both the New York and Atlanta Federal Reserve banks estimate Q2 GDP growth will decelerate to just over 1.0%. Housing sales, building permits and starts are all in mid-single digit decline year-over-year. The data is similar for automotive sales, and inventories are at the highest level since the recessionary levels of 2009, leading to production and job cuts. On the labor front, the US economy produced a subdued 75,000 jobs in May, far short of expectations. Employment gains for April and March were also reduced by a combined 75,000. In all, the economy has created an average of 151,000 new jobs in the past three months, down from as high as 238,000 at the start of the year. May's underlying data showed that hiring slackened off in almost every key segment of the economy and employment fell in retail and government. The pace of wage growth over the past year also slowed to 3.1% (down from 3.4% earlier in 2019). The unemployment rate clung to a 49-year low of 3.6% and a broader measure of joblessness that includes part-time workers, known as U6, dipped to 7.1%, the lowest level in 19 years. On the positive side, the manufacturing PMI survey remains in expansionary mode, and consumer confidence is holding up, with May's reading rising to a very healthy 134.1, up from 129.2 last month.

April's headline personal consumption expenditure index (PCE), the Fed's preferred measure of inflation, was just 1.5% year-over-year. While the Fed had previously telegraphed its belief that the current inflation

shortfall is transitory and thus was inclined to simply hold rates steady, recent comments from vice chair Richard Clarida suggest the central bank would be willing to cut rates if the data indicated a material deterioration in the economic outlook.

Europe

Eurozone data in May was somewhat mixed. The flash manufacturing PMI fell to 47.7, indicating contraction, while the employment component also dipped below 50. There were some positive signs in the data, though. The new export orders component, while still below 50, did tick higher, and eurozone consumer confidence picked up in May to its highest level this year. The initial estimate for Q1 GDP also beat expectations, with annualized growth of 1.6% over the last quarter.

The latest employment growth numbers (+1.4% annualized) have been solid, indicating that trade uncertainty is not yet hurting the service sector, which has so far proved resilient. Another positive factor for the region's manufacturing is that the US has put the discussion over global auto tariffs on hold for up to six months.

Asia

The re-emergence of trade tensions between China and the US is of acute concern for Asian growth. China's renminbi was rattled, falling against the US Dollar by 2.5% in May, offsetting some of the impact of the tariffs on exports to the US, which economists claim could reduce China's GDP growth by up to 0.8%. These adverse effects, however, could be mitigated by further policy responses by the Chinese authorities. Specifically, May saw an incremental banking reserve requirement ratio cut of 20 basis points. In addition, the government announced tax cuts on personal and corporate incomes, aimed at stabilizing growth. Nevertheless, the latest Chinese economic data was much weaker than expected. Retail sales and industrial production (IP) data was particularly soft, with IP decelerating to 5.4% year-over-year in April, from 8.5% the month before. Automobile sales declined -14.6% in April from the year-ago period, with overall inventories at a very high 4.6 months.

India saw the conclusion of its six-week long general election, with Narendra Modi's Bharatiya Janata Party surprisingly winning an absolute majority in the lower house. This outcome provides much needed stability on local policy, and may lead to actions which will unleash the potential for long-term growth in India.

Outlook

Rising import tariffs are beginning to affect the increasingly interconnected globally economy, as seen by cargo demand which has declined 4.7% compared with the year-ago period. Industrial metrics have also begun to contract in China, Japan, and Germany. The resilient US manufacturing base is still in expansion mode and the overall economy appears well supported, however durable goods and factory orders, industrial production, and capacity utilization have all softened in recent months. Looking ahead, we expect a period of subdued economic expansion, led by uncertainty in business decision making, during an already mature phase of the cycle. In all, the US should maintain positive economic momentum, and China, intent on stabilization of its economy via stimulus, is likely to provide a tailwind to global growth.

With regard to equities, the prospect of peak margins (on account of rising input costs, including wages), combined with limited revenue growth due to the slowdown in global growth, lead us to forecast range-bound US corporate earnings for the next several quarters. Stock indexes have already begun to discount such a scenario, trading at a modest 16x forward earnings. In turn, statistics show that value stocks are trading at historically large discounts compared to the multiples currently being paid for growth equities. As such, we envision a constructive period ahead for high quality and value oriented stocks.

We believe that financial markets will continue to exhibit heightened volatility in the coming period, on account of unpredictable global growth, coupled with trade uncertainty. Thus, short duration US bonds, as well as select non-market correlated investments, should be considered by risk averse investors seeking to protect portfolios.

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Sources: Barclays, Bloomberg, Bureau of Labor Statistics, Conference Board, Department of Agriculture, Federal Reserve, Financial Times, IMF, Institute for Supply Management, MSCI, Reuters, Russell, Standard & Poor's, and the Wall Street Journal