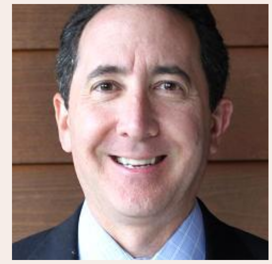
Monthly Commentary

July 2018



By Peter Boockvar
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As July closed out with the S&P 500 index up 5% year to date, it's important to identify where that growth was generated. If I were to define the market action in the month of July in one word it would be 'rotation.' The FANG+ stock index (which includes Facebook, Apple, Netflix, Google/Alphabet, Tesla, Twitter, Nvidia, Alibaba and Baidu) - the leading names that have dominated recent market performance - fell 4.4%, the 2nd worst month since the market correction in January 2016[1]. On the other hand, industrials rebounded by 7.4% after falling in four of the previous five months over tariff worries[2]. The Financial sector broke a five month losing streak, recovering approximately 5%, after solid bank earnings and as the yield curve stopped flattening[3]. The US Treasury market also provided plenty volatility in the month and much of it can be traced back to bond behavior in Japan. The US 2 year and 10 year yield spread, mid-month, fell to 24 basis points, the lowest level since August 2007, but finished the month around 30 basis points[4]. The yield on the 10 year Treasury is starting the month of August at 3.0%[5].

"Industrials rebounded by 7.4%...and financials broke a five month losing streak adding 5% after solid bank earnings..."

Equities and Tariffs

One can't talk about US stocks without talking about the FANG stocks because they so dominate the indices. This group of stocks makes up about 45% of the NASDAQ 100 index and about 15% of the S&P 500, with all of technology accounting for 25% of the S&P 500[6]. In July, there was some splintering of the technology market leaders after second quarter earnings were reported. Amazon, Apple and Google reported great numbers, but the stock responses were mixed. Facebook, Netflix and Twitter's earnings disappointed and the news was reflected in the declines of their respective share prices. In my opinion, these are all great companies with dominant positions.

"FANG stocks now make up about 45% of the NASDAQ 100 Index and 15% of the S&P 500…"

The month of July also brought some relatively positive signs on the tariff front. The President of the European Commission, Jean Claude Juncker, met with President Trump in DC and they agreed to discuss further opening up their markets. This will hopefully lead toward an end of the steel and aluminum tariffs on the EU and remove concerns about possible tariffs on autos. Also, it looks like we are about to see some high level discussions between the US and China, as Treasury Secretary Mnuchin is scheduled to meet with the Vice Premier Liu. We can only speculate where the talks go, but at least they are ready to discuss the issues. After falling 8% in June, the Shanghai composite gained back about 1%[7].

1-7 Bloomberg

Economic Trends

The US reported a 4.1% GDP growth rate for Q2, a solid performance driven by consumer spending, business investment and exports (big contribution from soybean exports ahead of the tariff implementation)[8]. This follows a 2% pace in Q1 and brings hope that we might finally see a full year of 3% growth[9]. We'll see in the Q3 data how much of the activity in Q2 was pulled forward ahead of tariffs.

Growth outside of the US was moderate. The Eurozone reported economic growth of 2.1% in Q2, down from 2.5% in Q1, and the slowest pace of growth since Q1 2017. Anything above 2% should be considered good, for Europe[10]. Germany, with 40% of its economy dependent on exports, is very sensitive to global trade and something we're watching closely in terms of gauging global trade. The economic statistics out of China, Japan and others have softened due to trepidation over the direction of tariffs. Hopefully, with some clarity on tariffs and an easing of the tensions, things will begin to improve again.

"We'll see in the Q3 economic data just how much of the 2nd quarter activity was pulled forward ahead of tariffs."

Interest Rates and Monetary Policy

As the world is very integrated, getting a full lay of the land means staying on top of market action and economic activity, not just in the US, but globally. The biggest driver of interest rates in July was the Bank of Japan. To quickly preview, the Bank of Japan has been the 800 pound gorilla in the venue of central banking. They own 40% of the Japanese bond market, 75% of the stock ETF market, and their balance sheet is approaching 100% of GDP[11]. The end result has been a yield curve that has been as flat as a table between their overnight rate and the 10 year maturity. Making this happen, in addition to asset purchases, has been a policy called 'yield curve control,' which has the intention of keeping the 10 year yield within 10 basis points of zero. The side effects of this policy have been pronounced, as it has negatively impacted the profitability of Japanese banks, the lifeline of their economy.

The Bank of Japan finally provided some relief to banks and said they will allow the range around the 10 year yield to be 20 basis points instead of 10[12]. The effect of this change was rather dramatic in the JGB bond market, as the 10 year yield rose from .035% on July 20th to .13% on August 1st[13]. The reason why this matters for the rest of us is that European rates and US rates are highly correlated. During the same time period, the German 10 year yield rose from .33% to .49% and the US 10 year yield rose from 2.85% to 3.0%[4]. Thus, where Japanese bond yields go can influence what mortgage rate a US home buyer pays.

"The biggest driver of interest rates in July was the Bank of Japan…as they provide relief to domestic banks and allow the 10 year yields to rise, the impacts will ripple globally.

8-10,13,14 Bloomberg, 11,12 Bank of Japan

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Commodities & the Dollar

The US dollar was basically unchanged in July, closing up fractionally as emerging markets stabilized and rates rose overseas[15]. The dollar index remains well below its recent peak seen in late 2016, but off the early lows of 2018.

Commodity prices are really getting moved around by the daily leanings on tariffs. Oil prices, after closing June at a multi-year high, fell back about $4 per barrel. The price is still near $70[16]. The direction of sanctions on Iran, supply issues from Venezuela and the increase in supply from OPEC have been the competing factors. The US consumer is paying 24% more to fill up their gas tank this summer than they did last year[17].

Soybean prices, which fell by 16% last month in response to the Chinese tariffs, did rebound by 5% on hopeful signs the Europeans will buy more inventory and China tensions will ultimately calm down[18]. On the other hand, copper prices, a great reflection on Chinese economic growth, fell 4.5% after dropping by 4% in June[19].

Conclusion

The US stock market rallied for a 4th straight month as corporate earnings season got off to a good start, the economy put in a good performance in Q2, and trade tensions eased. These positives helped offset the continued issue of rising interest rates and tighter monetary policy. As the latter should further intensify in the months to come, the tug of war should continue. International markets finally rebounded after falling in four of the past five months.

We hope that we've reached the peak in tariff worries and it only gets better from here because American business is becoming more worried about the impact. As stated, there are open lines of negotiation with our key trading partners.

Rising interest rates and more central bank removal of accommodation will remain a key story of 2018 and something we are watching closely.

15-19 Bloomberg

"The U.S. consumer is paying 24% more to fill up their gas tank this summer than they did last year."

The US stock market begins June little changed for the year which should be considered a good performance in the face of the sharp rise in interest rates that we've seen year to date.

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