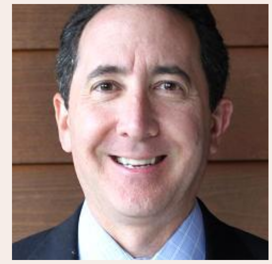
Monthly Commentary

June 2018

By Peter Boockvar
Chief Investment Officer – Bleakley Advisory Group



The investing environment in the month of June – and the first half of the year - can best be described in the opening line of Dickens "A Tale of Two Cities". "It was the Best of Times, it was the Worst of Times" - depending on where one was investing. Written in 1859, that dichotomy has truly stood the test of time and parallels can be drawn to current global market conditions.

To highlight the disparity, consider the S&P 500 is up about 1% for the year but the MSCI ex US stock market index was down 3.7% for the month and 6.4% year to date[1]. The DJIA was down .60% in June and lower by 2% year to date while the US domestically focused Russell 2000 was up .60% in June and 6% for the year[2].

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Within fixed income, the US Treasury yield spread between the 2yr and 10yr notes in June fell to 33 bps, an 11 year low, at the same time economic growth in Q2 should be between 3-4%[3]. Within US corporate bonds, high yield continued to outperform investment grade paper, while in Europe, German bunds continued to be a flight to safety while we saw major volatility in Italy.

In this commentary, we will get deeper into the bifurcation in markets seen in June and what this all means for the 2nd half.

Equities Tariffs and the Economy

Whereas rising interest rates were a key factor driving market behavior in Q1, trade worries over tariffs became the predominant influence in Q2. As tariffs are now being levied between the US and our trading partners, investors leaned into US domestic based small-cap stocks and the big cap tech stocks that we all know. Everything else was discarded, particularly markets overseas.

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China, the 2nd largest economy in the world and main target of US tariffs, had a particularly poor month in June as they are very vulnerable to a trade battle and are simultaneously trying to reduce the debt exposure across their highly leveraged economy.

The Shanghai composite was down by 8% in the month of June alone, taking its year to date performance to -16%[4]. Looking at Asian markets broadly, Taiwan, India and Australia are the only markets positive year to date. Japan, Hong Kong, South Korea, are all in the red. In Europe, every single major market is down on the year with the export heavy German DAX in lower by 5%[5].

1-5 Bloomberg

On July 1st, Canada responded to our steel and aluminum tariffs with a series of their own on a variety of US goods. The next round of US tariffs on China will be implemented on July 6th and will soon be followed by retaliatory Chinese tariffs on many US goods.

Expect Q2 earnings releases in the coming months to be littered with comments on what the impacts will be at company specific levels. Daimler in Germany has already warned what the impact could be on their manufacturing plant in Alabama and Harley Davidson quantified the negative impact on their business.

Notwithstanding these current concerns, we remain hopeful that there will be an ultimate resolution resulting in lower trade taxes for everyone and at the same time protects US intellectual property.

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Interest Rates and Monetary Policy

The Fed raised the fed funds rate by another 25 bps to a range of 1.75-2.0% in June and we expect another hike this September[5]. The Fed finally achieved its long sought after 2% core inflation target in June. The question now is does the upward inflation trajectory stop here or will it continue to rise, thus pressuring the Fed to keep on raising rates. We are of the belief that it will keep on rising.

Starting this quarter, the rate which the Fed shrinks its balance sheet moves up to $40b per month - up from $30b a month in Q2[6]. With the European Central Bank adding just $35b, it will be the first time in years that we will see a net reduction in liquidity when combining the actions of these two major central banks.

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June also saw a continued compression in the yield curve. The spread between the 2yr Treasury yield and the 10yr shrunk to just 33 basis points, down from 43bps at the beginning of the month[7]. This spread started the year at 52 basis points and was at 94 basis points one year ago[8]. We must take note because - as stated in the previous monthly report - before every recession since 1955, the yield curve has inverted. However, not every inversion has led to a recession.

We believe the flattening is due to a few factors, 1)the markets belief that US growth will eventually slow in response to a continued pace of monetary tightening, 2)growth worries from the tariffs, 3)a lid being kept on long term interest rates because of the very low level of European and Japanese bond yields.

5-6 www.federalreserve.gov; 7-8 Bloomberg

The US Dollar

While the dollar index (heavily weighted to the euro) was up only slightly in June, it does mark the 3rd straight month of gains[9]. This recent strength is one of the main reasons why emerging markets are feeling stress as they import inflation and make dollar denominated debt tougher to carry.

The dollar rally this year really started in earnest this April as the ECB remained very dovish, Italian bond yields skyrocketed and growth began to slow in Europe while Brexit worries continue to weigh on the pound. We remain of the belief that the dollar rise is not sustainable - as rising US debt and deficits will eventually become a headwind as they imply a greater supply of US dollars.

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Conclusion

We expect the two major macro factors influencing markets - global tightening of monetary liquidity and the uncertainty around long-term market implications for trade/tariff battles – will continue to drive volatility and potentially offset pockets of positive economic data for the duration of 2018.

In the meantime, US GDP growth finished the 1st half of the year on a solid note, with likely 3-4% growth[10]. The question now is whether those levels are sustainable in light of major supply constraints in both labor and transportation. We are also keeping an eye on growth overseas as the J.P. Morgan Global Manufacturing PMI at its lowest level since July 2017. We expect to see another strong earnings season to come for Q2 but anticipate more cautious guidance for those companies hit by tariffs.

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973.575.4180
Bleakley.com